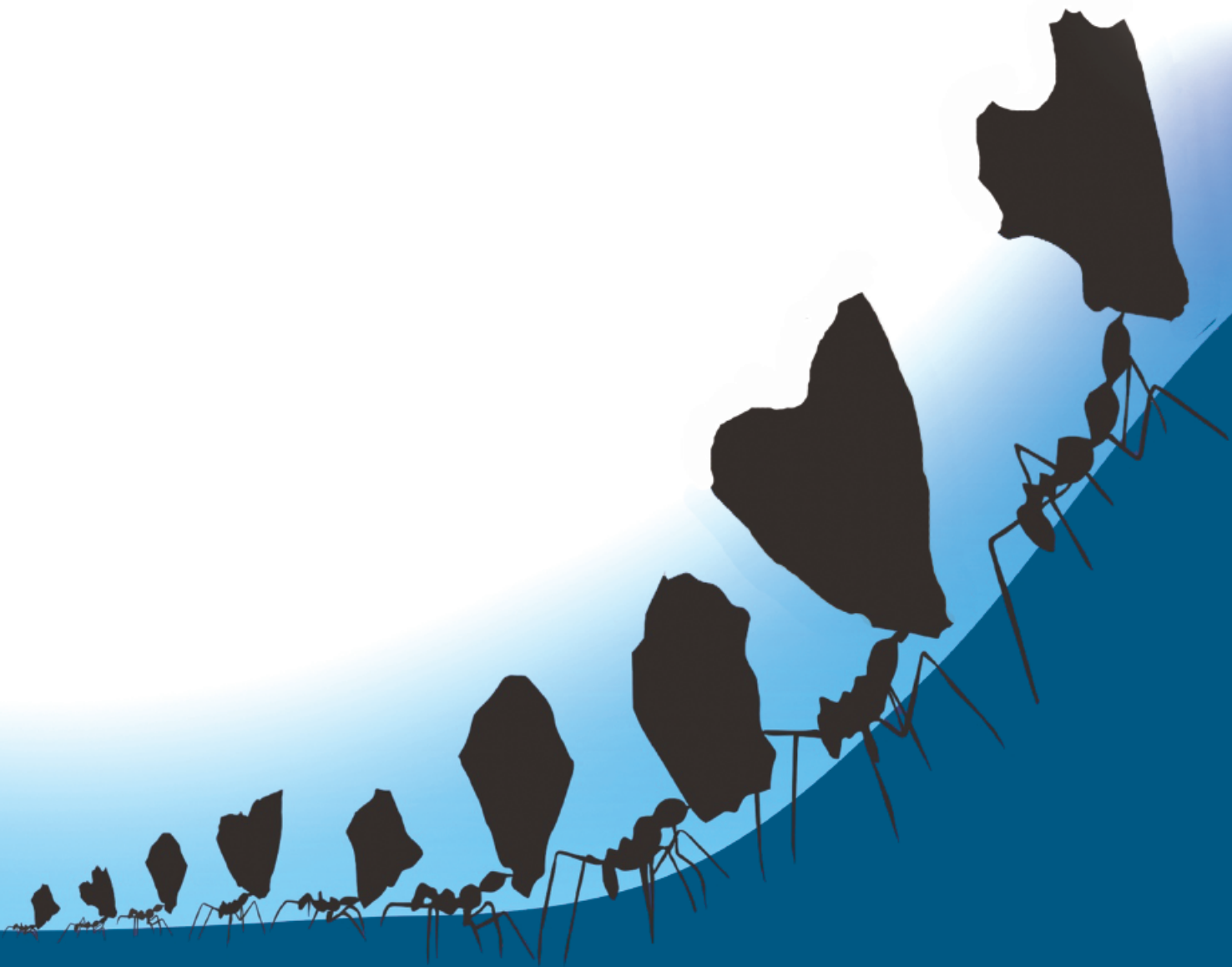


SUPPLY CHAIN FINANCE

REPORT OF THE SUPPLY CHAIN FINANCE WORKING GROUP • JULY 2010



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TREASURY, RISK
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PROFESSIONALS



Contents

	<i>page</i>
1.0 Executive summary	3
2.0 Introduction	5
3.0 The market	5
4.0 Observations	8
5.0 Investors	9
6.0 Credit ratings	11
7.0 The way forward	11
8.0 Conclusions	12
9.0 Next steps	12
Appendix 1 - Terms of reference	13
Appendix 2 - Key elements of Buyer Driven Receivables Programme	13

1.0 Executive summary

- 1.1 In September 2009 the Bank of England asked UK stakeholders to form a working group to review the supply chain finance market.
- 1.2 The supply chain finance working group (SCFWG) was chaired by The Association of Corporate Treasurers (ACT) and commenced its work at a time when bank lending to smaller companies was described by the Bank of England (BoE) as constrained. In the past six months there is no doubt that lending conditions have improved but there still remains a key role for supply chain finance. The lending market can benefit and is benefiting from supply chain finance structures.
- 1.3 The working group included a broad range of stakeholders but we should, in particular like to acknowledge the contribution from the following organisations;
- Asset Based Finance Association (ABFA)
 - KPMG
 - Legal & General Investment Management Limited
 - Orbian
 - Squire Sanders
- A number of other organisations that participated with enthusiasm have, in the end, decided to remain anonymous.
- 1.4 Terms of reference for the SCFWG and the group's key findings are as follows:
- 1.5 *To take a view on whether there is demand for an expansion of the SCF market and what the current impediments to expansion are.*
- The level of understanding of the differences between the various SCF mechanisms is generally poor
 - UK SCF market is funded by relatively few banks
 - The use of SCF mechanisms is often viewed negatively – incorrectly so in our view
 - Complexity and uncertainty of the accounting for SCF mechanisms is unhelpful
- But there is a growing demand for SCF mechanisms and volumes are increasing as are the number of providers.
- 1.6 *To evaluate the various structures of SCF programmes*
There are several supply chain finance structures:
- Supplier driven programmes – receivables factoring/discounting
 - Inventory finance

- Buyer driven programmes

The report gives an overview of the main characteristics of the main structures.

1.7 The SCFWG finds that these structures have developed to suit a variety of needs and that no one structure should be singled out as the preferred option. However, in market conditions where lenders are concerned with credit quality we do believe that buyer driven programmes can and will help ease funding conditions.

1.8 The two key benefits of buyer driven receivables programmes (BDRPs) that are attractive to lenders are that:

- The buyer (not the lender) takes the responsibility for the supplier for example dealing with adjustments for goods returned or faulty
- The funding is based on the credit standing of the buyer and not the supplier

As a result a BDRP is less complex than other structures and funding is likely to be less expensive for suppliers where the buyer's credit is stronger than those of its suppliers. The SCFWG is aware of new programmes being introduced recently and more importantly some of these new programmes involve banks that have not previously participated in the SCF market in the UK.

1.9 *To determine if it would be useful to establish a set of (voluntary) principles and/or standard documentation for SCF programmes and if so what they should be.*

- The short answer is yes it would be useful to do so
- As part of this report we have included a framework that outlines the key aspects of a BDRP (see Appendix 2)
- To prepare industry-wide principles and standard documentation is outside the brief and resources of the SCFWG but it should be possible to establish an industry body to take this forward. Such a body will need, at a minimum, to include lenders, buyers, suppliers and legal representation. We believe that the involvement of Her Majesty's Government and potential non bank investors will be positive and help in developing wider investor interest in SCF structures.

1.10 *Evaluate whether it would be possible for an SCF programme to issue a tradable asset that could be purchased by a range of investors and if there would be a market for such an instrument.*

- Since we began work on this report, there is no doubt that growth in the use of BDRPs has encouraged more banks, including overseas banks, to participate in this area

■ For the moment there is no evidence that a lack of funding is constraining the growth in the SCF market, but inevitably any extra liquidity would be beneficial

■ Non bank investment interest in SCF was mixed:

- Some investors such as money market funds are unlikely to be able to buy SCF assets at the moment
- Non bank investors are risk averse and lacked resources to evaluate numerous and varied structures that lacked scale. UK non bank investors favoured formally rated corporate bonds or commercial paper
- In our discussions with investors it was clear that they would consider investment in SCF structures (in particular BDRPs) but further market developments and standardisation were required. As a result we see development of a tradable instrument as a longer term goal

■ Asset backed commercial paper is an established funding mechanism that could produce a tradable instrument based on SCF assets in the future, but other options are also available.

1.11 In conclusion – SCF can help ease lending constraints for small to mid tier companies or those with a weaker credit standing.

At a time when bank lending is constrained some companies have turned to public debt markets for their funding needs. However, there remain a considerable number of small to mid tier companies that cannot access non bank funding. SCF, in particular BDRP, offers opportunities to expand lending to smaller and mid-tier companies and the larger companies – the “buyers” – can play a significant role by facilitating BDRPs that their supply chain can participate in. The benefits to suppliers can feed back as a benefit to buyers in terms of better relationships with suppliers and a reduction in possible financial weakness/instability of suppliers. Banks that have not participated in supplier driven SCF structures are starting to enter the UK SCF (BDRP) market.

We do believe that the SCF market would benefit from a coordinated industry focus on increased transparency and standardisation. In the longer term this would lead to non bank investors entering the market.

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Chairman, supply chain finance working group
July 2010
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2.0 Introduction

- 2.1** This report summarises the findings from the SCFWG set up at the request of the Bank of England (BoE) in accordance with the terms of reference included in Appendix 1.
- 2.2** This report focuses solely on supply chain finance within the UK.
- 2.3** The SCFWG included interested parties from the main stakeholders – UK banks, buyers and suppliers from the commercial sector, systems providers, UK investors, financial consulting and lawyers. In addition the SCFWG sought views from outside the core working group.
- 2.4** Supply chain finance covers a wide spectrum of funding activities including;
- Supplier driven programmes - receivables factoring/discounting both with and without recourse to the seller of the receivables;
 - Purchasing cards
 - Inventory – supplier owned and funded inventories
 - Buyer driven receivables programmes.

3.0 The supply chain finance market

- 3.1** Supply chain finance (SCF) is a term used to define the financial relationship linking the buyer and the supplier together in terms of payables and receivables. Several options and solutions are available in the market today, each with a variation on the offering.
- 3.2** Before deploying an SCF solution it is important to understand the drivers. Traditionally it has been used by buyers or suppliers to address adverse market conditions. These conditions have led many organisations' purchasing departments (buyers) to extend payment terms with their suppliers. Suppliers are being forced in turn to look for alternative solutions to receive their payment in a timely fashion. The most commonly recognised forms of supplier led SCF in the marketplace (e.g. factoring and invoice discounting) have often had a stigma attached (wrongly in our view) when buyers discover suppliers are using them.
- 3.3** Within a SCF solution there are typically four involved parties:
- The buying organisation "the buyer"

Table 1

DEPARTMENT	ROLE
Executive Board	Wherever possible a programme should be sponsored by a member of the executive board with the CEO or Managing Director supporting
Procurement	Vital that procurement understands the programme as they own the supplier relationship Procurement will lead the negotiation and placement of contracts with suppliers
Legal	The correct contract structure is critical to ensuring the right implementation for the buyer (financial treatment)
Financing / Treasury	Sourcing funding (internal/external) and liaison with banks and internal stakeholders, including setting expectation for returns from the programme
IT	ERP interfaces to platform provider and where appropriate funding banks
Accounting	Determine accounting treatment to ensure business needs are met with regard to consolidation as debt or trade creditor
Transaction processing	Management and ownership of the invoice approval and payment process (efficiency is a key success factor)

	TYPES	APPROACH	BENEFITS	POTENTIAL ISSUES
BUYER LED OPTIONS	PURCHASING CARD	<ul style="list-style-type: none"> Buyer agrees contract with PCard provider to provide solution for ad-hoc expenditure. Buyer/PCard provider set limits on spend per transaction and per card on a month by month basis. 	<ul style="list-style-type: none"> Excellent tool for consolidating low spend / high numbers of suppliers. Accounts Payable efficiency benefits and rebates available from suppliers. 	<ul style="list-style-type: none"> Only applicable for ad-hoc / low spend suppliers (the "tail"). Transaction fees charged by card provider make it expensive financing for the supplier.
	BUYER DRIVEN PAYABLES	<ul style="list-style-type: none"> Buyer organisation funds their own programme. Benefit driven from release of early payment discount from suppliers. Buyer organisation uses a financial institution with supporting technology to implement the programme. Early payment discounts are released from suppliers. 	<ul style="list-style-type: none"> If transaction fees are set at the appropriate level, it can create a return for Treasury functions on committed cash in excess of other traditional methods of cash investment. Early payment discounts released from suppliers at a more competitive rate than otherwise available. Benefits & facility requirements easy to plan – suppliers are either in / out of a programme. Reduced supply chain risk. Early payment discount offsets cost of external financing. Cash benefits can be released. Benefits & facility requirements easy to plan. Reduced supply chain risk. 	<ul style="list-style-type: none"> Need to ensure that transaction fees are set at an appropriate level to offset opportunity cost of capital. Negative cash impact for buyer. Accounting treatment needs careful consideration if it is important that the facility consolidates as a trade creditor (See Appendix II paragraph 7.0)
	BUYER DRIVEN RECEIVABLES	<ul style="list-style-type: none"> Similar to supplier led receivables, bank funded. This relies on the supplier selling their invoice. However under this model the discount rate is dependent on the buyer's credit standing. 	<ul style="list-style-type: none"> Cost of funding based on "buying" organisation which may be cheaper than that available to suppliers. Competitive market – many banks offer this service. Suppliers can release 100% of invoice value early. Reduced supply chain risk. 	<ul style="list-style-type: none"> Relies on supplier selling receivables.
SUPPLIER LED OPTIONS	SUPPLIER DRIVEN RECEIVABLES	<ul style="list-style-type: none"> Solutions such as factoring or invoices discounting, rely on suppliers selling their receivables to a bank, receiving a percentage of their receivables early for a discount. Discount is based on supplier credit standing. 	<ul style="list-style-type: none"> Reduced financial risk in supply chain. 	<ul style="list-style-type: none"> Funding availability is reducing for suppliers or costs are increasing. Only 65% - 90% can be released early by supplier.
	INVENTORY FINANCING	<ul style="list-style-type: none"> Solutions such as Vendors Managed Inventory; suppliers own the stock held on buyer organisation's site until the buyer organisation uses the product. 	<ul style="list-style-type: none"> Less cash tied up in stock for Purchasing organisation. 	<ul style="list-style-type: none"> No reduction in supply chain risk. Can result in increased cost of goods.

- The organisation supplying goods / services “the supplier”
 - A technology platform “the technology or system”
 - A funding institution “the funding provider or investor” (can be internal, external or institutional)
 - There is a further role for an integrator. The funding institution or the technical platform might take the role of integrator.
- 3.4** It is important, particularly within the buyer organisation that the correct parties are engaged to ensure that the benefits are realised. SCF is often an “afterthought”, a reaction to an instruction by treasury / finance departments to extend supplier payment terms. To deploy an SCF programme successfully, it is important that it is viewed as an initiative that requires the involvement of key departments within the buyer (see table 1).
- 3.5** SCF does not replace the service agreement between buyer and supplier. It does however impact on the commercial agreement where payment terms are affected or supplier discounts are being employed. Depending on the requirements of the buyer or the supplier, appropriate choices can be made on the selection of the best SCF programme to be deployed.
- 3.6** A technology platform is required to bring together the payment mechanism and triggers. This sits between the buyer, the supplier and the funding mechanism. Technology solutions differ across the marketplace and in many instances either are or resemble EIPP (Electronic Invoice and Payment Processing) systems. The principal five activities performed by the technology are:
- Purchase order generation, approval and receipt
 - Goods delivery/received data
 - Invoice receipt
 - Invoice matching, reconciliation and approval
 - Payment processing.
- 3.7** Depending on the SCF programme deployed, the technology may be provided by an independent solutions provider or by the funding institution. Many of the banks offer their own platforms for buyer-led receivables and supplier-led receivables financing. There is similar choice on the payables financing with specialist payment technology existing that facilitates the process. At the ad-hoc end of payables financing (e.g. Purchasing Card or PCard) the current systems can provide less information due to limitations at the acquirer end and it is rare that the system will receive a purchase order, invoice, perform the reconciliation and release payment. A PCard system is far closer in type to a traditional credit card released for ad-hoc corporate expenditure.
- 3.8** The role of the integrator is to provide advice and assistance to organisations who are embarking on the deployment of a SCF solution. The integrator should provide expert input in the selection of the appropriate solution, the accounting structures and tax implications, the selection of funding source (internal / external) and the ‘on boarding’ (recruiting) of suppliers.
- 3.9** As table 2 shows, the solutions split into two principal areas. In buyer led programmes, any funding is based on the buyer’s credit standing as the buyer accepts the risk of managing the suppliers and it is the obligor to the funder. Under supplier led programmes, the funder’s recourse is only to the supplier.
- 3.10** PCard programmes are typically associated with ad-hoc supplier expenditure and form a convenient way in which to consolidate many small suppliers into one single consolidated invoice. They are an established proposition and arguably have the highest level of expenditure transacting through programmes in today’s market. Suppliers are charged a transaction fee by the PCard provider for early payment. The buyer settles with the PCard provider on their pre-agreed terms (typically invoice cycle plus fourteen days). This approach is rarely applicable to suppliers where the buyer spends over circa £25,000 per annum due to the relatively high cost of the transaction fee compared to other sources of financing.
- 3.11** Buyer driven payables programmes are relatively new to the market. In a similar manner to PCards, transaction fees are set based on the buying organisation credit standing but are incurred by the supplier. Fees are typically lower than PCard programmes (research indicates it can be 50% lower). Under this programme there is the option for buying organisations either to seek third party funding or should their cash position support it, self fund the programme. In self funded programmes the early payment discount released from the suppliers replaces the income that treasury/finance departments would otherwise have made using more traditional methods of investing funds.

- 3.12** Buyer driven receivables programmes are growing strongly. In the market many of the major banks and specialist providers offer a solution. On occasion these programmes are referred to as 'reverse factoring'. In any given invoice cycle the supplier has the option to sell their receivables at a discount. Differing from invoice discounting/ factoring, under this model funding is provided to the supplier while the cost of funding is based on the credit standing of the buying organisation. The buying organisation can self fund their own programme.
- 3.13** Supplier driven receivables programmes are commonly referred to as factoring / invoice discounting. Under these programmes suppliers will, via a relationship with a financial institution have a facility available based on their receivables book. They can draw against this facility, selling the associated receivable to the financial institution for a discount. This is a convenient way for suppliers to control their own day's sales outstanding, however because the discounts are typically based on a combination of supplier credit standing and buyer risk, this can be an expensive form of financing for a supplier.
- 3.14** Inventory financing can take many forms and is again a well established offering in the market. This can range from inventory financing solutions provided by financial institutions through to supplier led programmes where suppliers will self fund the cost of inventory with buying organisations, typically for an increased cost on the goods. These programmes are typically referred to as consignment stock or vendor managed inventory (VMI) within manufacturing and production environments.
- 3.15** Globally there are a number of markets where SCF programmes are well developed. Developed markets typically have one to four providers, mature markets typically have over four providers able to supply the service.
- 3.16** The SCFWG only found reference to the UK market size of the buyer led receivables financing programmes. In 2008 the market was in its early stages with circa £100m outstanding. By 2009 this had grown to £700m and it is anticipated that by end of 2010 this will be circa £1bn. Market size is extremely difficult to estimate across each of the different SCF offerings.
- 3.17** The elements of a BDRP have been documented and are included within Appendix 2.

4.0 Observations associated with supply chain finance

- 4.1** From discussions within the SCFWG and with other interested parties the following observations emerged.
- 4.2** Accounting treatment seen as key by some buyers.
- 4.3** Formal credit ratings
 - Where an SCF programme is not rated money market funds are, in the majority of cases, excluded from investing in SCF instruments.
 - Without public ratings (for buyers) it may be difficult, but not impossible, to interest UK pensions funds to invest in such instruments.
 - Some buyers see SCF programme credit ratings as potentially negative for their overall company debt rating as there is a perception that rating agencies may treat rated SCF programmes as debt.
 - Rating agencies and particularly ratings for asset backed products have been tarred by the recent crisis.
 - The BoE has only acquired rated paper as part of the Asset Purchase Facility (APF). This implies that an unrated SCF programme cannot benefit from activities similar to APF in times of poor market liquidity.
- 4.4** General level of understanding of SCF products is poor. Often people hold a negative view of SCF (narrowly viewed as invoice discounting). In particular there is a need to educate analysts and commentators about the merits of SCF.
- 4.5** BDRP seen as simpler / more efficient than traditional invoice discounting. It focuses on the buyer rather than performance of the supplier and eliminates uncertainties that banks etc cannot manage. It should enable many suppliers to secure funding at better rates than they could on their own balance sheet.
- 4.6** No secondary market exists for SCF products. It is believed by some that a secondary market would develop naturally as the market size increased and complexity reduced.
- 4.7** It was initially discussed that the fact that a SCF programme may not be permanently drawn and hence fluctuating in size might be an issue for some non bank

investors but this became less significant as we investigated the market.

- 4.8** Hedge funds are unlikely to be investors in SCF programme as they probably would obtain inadequate margin pick up.
- 4.9** With the current steep upward sloping yield curve, investors may compare long term bond yields with very low yields on short term instruments. This implies that the yield on SCF short term instruments needs to be high relative to market interest rates to attract new investors.
- 4.10** As of autumn 2009 the number of investors in UK SCF programmes was relatively limited but is growing in 2010.
- 4.11** Those providers that focus on a particular section of SCF seem very, but probably needlessly, defensive of their own specialty.
- 4.12** Despite obstacles new investors have started to enter the market in search of relative yield and might be interested in SCF as increasing market size and standardisation of 'white labelled' platforms develop. Pension funds, sovereign wealth funds and banks not currently operating in the UK but familiar with SCF product are potential investors in SCF.
- 4.13** Platforms that are bank/investor independent are helpful to broader market availability but need to be more open to alternative funding sources.
- 4.14** Independent platforms need a strong market position to gain credibility in this market or a strong balance sheet to stand behind self certification of systems to give funding providers (and where relevant rating agencies) confidence.
- 4.15** A BDRP should respond to many of the issues set out in paragraphs 4.2 - 4.14 of this report.
- 4.16** The following are the principal issues that such a programme may not address:
- Non bank funding appetite within UK institutions – e.g. pensions funds
 - Secondary market trading
 - Risk based capital allocation of SCF assets
 - Ratings

Whilst the SCFWG believes that wider promotion of a BDRP will assist the development of funding for the supply chain it is concerned that attracting non bank funders into this market represents a significant challenge.

5.0 Investors in supply chain finance

- 5.1** Traditionally investors in SCF have been banks providing external financing either directly or via financial service platforms/providers. The credit crisis over the last two years has seen the rapid withdrawal of some banks from the SCF market and others who raised credit quality requirements and in some cases decreased funding.
- 5.2** A natural second investor would, in the past, have been money market funds, also known as AAA rated or liquidity funds. However the credit crisis has also severely affected the type of investments which these types of funds can invest in and retain their status.
- 5.3** Therefore in order to identify new investors in the SCF market we have held discussions with potential market participants. Three over-arching criteria were flagged in these discussions;
- A return relative to the risk of the facility and the time an investor would need to consider the asset – commercial paper and corporate bonds were seen as benchmarks
 - A secondary market
 - A clean asset/obligation – this favours the BDRP against traditional invoice discounting.
- 5.4** Essential to all investments is the requirement for some return relative to risk. The level of risk can be determined by many things. In the case of BDRP the credit risk and need for a clean asset is resolved by the strength of the buyer and the buyer managing the supplier issues.
- 5.5** The investor will consider the return to be relative to the amount of time and effort it will take them to review the programme given the amount of disclosure.
- 5.6** The majority of asset classes need a secondary market. This has been made very evident over the last two years

as investors struggled to sell assets out of funds or to price them correctly. A secondary market can become a self fulfilling prophecy so long as the SCF investment 'has an out'- this could be either as a guaranteed purchaser (inclusion in the Bank of England asset purchase facility) or an investment fund. Once the market is aware of the ability to trade the asset then it will be more seriously considered as an alternative to traditional money market instruments.

5.8 The SCFWG has considered the appetite of new investors for a BDRP and we set out some observations in table 3 below:

5.7 Are there any new investor classes that may consider SCF in the near future?

Our opinion is that the SCF market is specifically suited to the banking sector. There is a perception in the market that it is not possible for new banks to gain entrance as it is being restricted by the lack of open competition and the large market shares of existing participants. However the number of participants in the market is increasing.

Table 3: Review of potential investors

INVESTOR GROUPS	COMMENTS	SCFWG ASSESSMENT
Money Market Funds	<ul style="list-style-type: none"> ■ An obvious investor with significant funds to deploy BUT... □ Would require facility to be rated investment grade □ Would require liquidity guarantees □ Likely to be restricted by new regulations 	■ Unlikely to invest in SCF assets in their current form
Corporate Bond Funds	<ul style="list-style-type: none"> ■ Currently a steep yield curve and therefore would demand high returns relative to short term yields ■ Tend to look at fixed returns over several years 	■ Possibly an investor in the medium term
Hedge Funds	■ Inadequate return relative to bench mark assets	■ Unlikely to invest in SCF assets
UK State Owned/Controlled Financial Institutions	■ Currently purchase these assets	■ Ongoing investor
Financial Institutions	■ Some currently fund SCF outside the UK market	■ Ongoing investor outside UK
Local Authorities	<ul style="list-style-type: none"> ■ Highly restricted asset classes that can be considered ■ Direction could come from the government and/or existing suppliers but they would need skills to evaluate investments 	■ Ratings may enable LAs to invest
Pension Funds	<ul style="list-style-type: none"> ■ Risk averse ■ SCF could offer improved returns and adequate security for short term surpluses 	■ General acceptance of the instrument might attract pension funds over time

6.0 Credit ratings – from rating agency perspective

- 6.1** Although faith in credit rating agencies has, in the view of some commentators, greatly declined as a result of the crisis and their performance in respect of structured investment vehicles a rating for a BDRP is an important but not essential accreditation for investors. A rating is often seen as the 'door opener' to investors considering a new investment and also a way of reducing the yield cost to issuers.
- 6.2** The SCFWG spoke to two major rating agencies and the comments are summarised below:
- The best rating that BDRP could secure would be a pass through based on senior unsecured debt of the buyer. Depending on which industry and corporate analyst's review, it is possible that the rating for the SCF would be a notch or two lower than for the 'parent'
 - The rating agencies, in the working group's opinion, would not view a BDRP as detrimental to other ratings of the buyer so long as the programme did not increase their debt capacity or put another way 'so long as the SCF remained as a trade creditor for accounting purposes'
 - For large companies with good cash flow the rating agencies would view a BDRP as rating neutral. In some industries and for weaker companies however there may be concern that prime purpose is other than to strengthen the supplier chain
 - Rating agencies would need to do enough due diligence on legal structures and platforms to satisfy themselves that overall a BDRP was fit for purpose.

7.0 The way forward

- 7.1** Supplier driven programmes have an important place in this market but complexity and growing focus on risk averse lending may constrain development of the market as an efficient funding source.
- 7.2** Purchasing cards clearly have a place for low value high volume buyers and here both convenience and speed of payment are key factors.
- 7.3** After considering a range of issues, including perceptions associated with supply chain finance it is the view of the working party that BDRPs can help expand the SCF market. If other investor issues can be addressed it should be possible to attract non bank funders into this market.
- 7.4** The key reasons for focusing on a BDRP are as follows;
- The buyer is best placed to manage the risks that investors do not wish to be engaged with i.e. supplier performance, supplier credit risk
 - BDRP can help promote standardisation and increase transparency
 - BDRP should be less complex to implement and the level of Investor due diligence should be reduced.
- 7.5** Appendix 2 sets out the key elements of a BDRP.

8.0 Conclusions

- 8.1** The information the working group has obtained makes it clear that supply chain finance already exists in many different guises (both buyer led and supplier led). Within the constraints of the various products available it is working and fulfilling a valuable role in the provision of working capital to a diverse range of companies. The finance being provided has grown, particularly through buyer driven receivables programmes, and the marketing efforts of the providers implies that there is an expectation of some further growth. However, there is a belief that there exists the potential for supply chain finance to provide substantially more funding if certain barriers can be overcome.
- 8.2** In the current markets where the access to funding for smaller or less credit worthy suppliers is limited and under strain, buyer driven programmes display the best potential for expansion. There are efficiencies in terms of the mechanics and the financing rates achievable if larger and more credit worthy buyers take the lead in the process. Giving the suppliers the benefit of slightly easier access to funding performs a valuable function in today's markets for the good of the wider economy as a whole as well as the individual participants.
- 8.3** The provision of finance, which is largely from banks at present, has not been the only constraining factor so far. Rather the lack of knowledge amongst buyers and a lack of the appreciation of the mechanics and benefits might have held back growth.
- 8.4** The working group concludes that increased clarity and to an extent standardisation through programmes such as described in the Appendix 2, could contribute to improved efficiency, an expansion of the markets and making it more straightforward for new funders to enter the market.

9.0 Next steps

- 9.1** Provision of information, education and a practical guide to SCF is seen as the prime need to stimulate all sides of the market. In the first instance the businesses and the representative bodies involved in the working group are well placed to undertake this, both directly and by stimulating publicity around the subject generally.
- 9.2** The recommendations of this group remain merely recommendations for the moment. To become effective there is a need for some existing body or some new coalition of interested parties to take forward the concepts of SCF programmes.
- 9.3** Better transparency through the process will help new funding institutions enter the market, but further work is needed on developing a funding instrument that is capable of gaining a degree of liquidity. The working group did not find that securitising the receivables and financing through a special purpose vehicle was a prerequisite. Simplicity and legal certainty was required, so that some acknowledgement of the payables, or tradable instrument like a bill of exchange, could be devised.

Appendix 1

1.0 Supply chain finance working group: terms of reference

1.1 Background

Supply chain finance (SCF) is a mechanism that is widely used by large corporates and other institutions to support the access of their suppliers to working capital. It is currently a small, but developing, market in the UK. At present there are a number of different potential structures for SCF programmes, but no standard set of principles for SCF programmes. The Bank of England chaired a round-table meeting of SCF market participants in September 2009, the outcome of which was to establish this market-led working group to look into the issues facing the SCF market, and potential ways in which the market may develop.

1.2 Draft scope and purpose of the work

- To take a view on whether there is demand for an expansion of the SCF market and what the current impediments to expansion are.
- To evaluate the various potential structures of SCF programmes.
- To determine if it would be useful to establish a set of (voluntary) principles/ standard documentation for SCF programmes and if so what they should be.
- Evaluate whether it would be possible for SCF programmes to issue a tradable asset that could be purchased by a range of investors, and if there would be a market for such an instrument.

1.3 Deliverables and timetable

- The working group will report back to the wider group of market participants after each meeting to allow them the opportunity to feed in comments.
- It is the intention to publish a report on the above issues by which we hope would be endorsed by a wide range of market participants.

Appendix 2

1.0 Key elements of a Buyer Driven Receivables Programme

1.1 Overview

The overall objective of this appendix is to set out principles for a supply chain finance buyer driven receivables programme (BDRP) which:

- 1.2 Generally, make BDRP more straightforward to understand for all interested parties.
- 1.3 Specifically meet the criteria required to encourage a broader universe of investors and buyers to participate in BDRP.
- 1.4 Remove unnecessary complexity so discussions about, or analysis of, BDRPs are about what really matters, which include inter alia: (i) the underlying credit quality of the buyer; (ii) the costs of the programme; and (iii) the accounting implications for the buyer.
- 1.5 Are not overly restrictive. There is no point defining principles that render BDRP non commercial and/or do not work for significant portions of the market.
- 1.6 Relate specifically to BDRP.
- 1.7 Reduce barriers to entry by all participants. We have opted to set out principles for a BDRP because the buyer is best placed to address issues that may involve redress against a supplier. This issue relating to the supplier can complicate many trade related financing programmes. BDRP can offer a less complex structure which can be used by the supplier to generate working capital to the mutual benefit of the supplier relationship. It is hoped that the existence of a consistent approach to BDRP will ultimately lead to:
 - a) More buyers entering into BDRPs, both in terms of number and type (for example: more medium sized businesses)
 - b) More suppliers being able to fund growth of their businesses more easily
 - c) A wider investor base for BDRP incorporating investor classes outside of the commercial banks which have been the main investors

- d) A more robust market due to an increased ability to manage/syndicate and transfer risk
- e) More competitive pricing
- f) Facilitation of any oversight functions.

2.0 Definition of BDRP terms

2.1 Definitions

The BDRP is based upon a Buyer-led supply chain financing programme for Approved Payables between:

- a) a single Buyer
- b) one or more Suppliers

A "Supplier" is a company who supplies goods or services to another company, the "Buyer"

A "Payable" arises where the Buyer has been invoiced by a Supplier for goods and/or services provided

An "Approved Payable" (AP) arises where the Buyer has, in a legally binding format, acknowledged:

- i) the validity of the Payable
- ii) that the Payable will be paid without deduction or set-off at a date certain time.

3.0 Key elements of a BDRP

3.1 The following list represents the core elements which could comprise a BDRP:

- A Buyer
- One or more Suppliers
- A core financial obligation – the AP
- Information and IT systems – required for inter alia: monitoring / aggregating / payments
- Legal structures – which allow end investors to have claim, ownership or security over the AP
- A financial instrument(s) – which is owned by an Investor or Investors
- Investor(s)

4.0 Overview of buyer objectives

4.1 A Buyer entering into an BDRP wants:

- **Accounting:** the majority of buyers want acceptable accounting treatment (see para 7.0) to ensure that trade creditor obligations continue to be treated as Accounts Payable and not reclassified as debt. However in some cases buyers may be indifferent to this.

- **Platform stability:** a robust platform or structure which will allow Suppliers and Buyers to utilise, and have confidence in, BDRPs on a day-to-day basis
- **Pricing:** rational, competitive and a low varying margin over a trusted index
- **Continuity:** a financing source for their Suppliers which is reliable combining quality and possible diversification
- **Standardisation:** a general understanding that the BDRP programme is fit for purpose and meets a market standard
- **Non-Invasive:** Changes to payment terms and cost to the Buyer should be a matter for the Buyers and Suppliers and should not be directly affected by (but can be informed by) changes in the financing terms of the BDRP programme.

5.0 Overview of supplier objectives

5.1 In general, a Supplier using a BDRP wants:

- **Optional accelerated payment**
- **Minimal impact on existing debt facilities**
- **Platform stability:** a robust platform or structure which will allow Suppliers and Buyers to utilise, and have confidence in, BDRP programmes on a day-to-day basis
- **Pricing:** rational, competitive and a low varying margin over a trusted index
- **Continuity and scale:** a financing demand which is reliable and of adequate scale
- **Standardisation:** some understanding that the BDRP programme that has been entered into is generally fit for purpose and market standard
- **Non-Invasive:** Changes to payment terms and cost to the Buyer should be a matter for the Buyers and Suppliers and should not be directly affected by (but can be informed by) changes in the financing terms of the BDRP programme.

6.0 Overview of investor objectives

6.1 An Investor buying a BDRP investment wants:

- **Platform stability:** a robust platform or structure which will allow Suppliers and Buyers to utilise, and have confidence in, BDRPs on a day-to-day basis
- **Standardisation:** some understanding that the BDRP that has been entered into is generally fit for purpose and meets a market standard
- **Continuity:** an investment opportunity which is continually available
- **Yield:** Investment return reflective of complexity of BDRP and analysis of such

- **Tradability secondary market which allows:** the ability to transfer or trade the investment with another Investor in as simple a fashion as possible. Private placements could be accepted to a lesser degree
- **Buyer credit:** As far as is practicable, analysis of the BDRP investment simply requires examining the underlying credit of the Buyer and nothing else. No credit events from other parties (for example: originating banks, systems providers, suppliers) should impact the quality of the Investment

7.0 Accounting treatment

- 7.1** Many Buyers would see no benefit from an BDRP if the "trade payables" were re classified as "borrowings". The objective is for Buyers to maintain their payable as trade creditors despite the fact that the Supplier may have been paid (early) by a bank or other Investor. Some Buyers may be indifferent but the SCFWG assumes that reclassification of trade payable as borrowings would be unattractive for most Buyers considering a BDRP.
- 7.2** The working group believes that programmes that INCLUDE any of the following features run the risk of a re-categorisation into borrowings :
- Funding to the Buyer
 - Obligation from Investor to Buyer that funding (to pay other than on normal trade terms) will be available to Suppliers
 - Allow the Buyer to extend payment terms on outstanding invoices or future ones¹
 - Rebates to be shared between the Buyer and the Supplier
 - The Buyer to be a party to the arrangements between the Investor and the Supplier
 - The Buyer has any ongoing level of control over the Investor/funding vehicle
 - The Buyer's obligation to a Supplier is replaced with an obligation to an Investor
- 7.3** The accounting rationale underlying much of this is to determine whether a liability has been significantly modified and hence deemed to be extinguished or not. IAS 39 para 40 supplemented by AG 62 introduces the concept of quantitative 10% test when determining this, but there can be divergent views amongst the Big 4 accounting firms about how to apply the requirements of IAS 39 to the accounting analysis of supplier finance.
- 7.4** Some of the major accounting firms consider the need to perform a qualitative analysis to be a policy choice and others consider it to be essential and insist their clients consider both qualitative factors and quantitative factors when determining if a liability has been extinguished or not.
- 7.5** Whilst there are some clear don'ts, the Buyer will still want to ensure, if an Investor is making payments to the Suppliers, that the Investor will make payment on time and without set off – in themselves these are performance obligations that the Investor is taking on in return for mandate to manage the Buyer's payables (and should not jeopardise accounting treatment). We are aware of a number of BDRPs where the accounting treatment of "trade payables" has not been disturbed by the implementation of a BDRP. All of these programmes were reviewed by the respective auditors to ensure that the programmes did not convert "trade payables" into "borrowings".
- 7.6** We are also aware of several BDRPs where the Buyer has implemented a BDRP knowing that the "trade payables" will be reclassified as "borrowings".
- 7.7** Whilst the above sets out the generalities, and the list is non exhaustive, the issues are complex and can be quite subtle – so we must advise all Buyers to seek a specific review of their BDRPs before they are implemented.

¹ Agreement with supplier needed as in any normal trading relationship

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