Deutsche Bank
Corporate Bank

Payables Finance

A guide to working capital optimisation

2nd Edition

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Following the publication of the first edition of this guide to payables finance in January 2018, the positive feedback it received from all around the industry – and the speed with which copies were flying off event stands – made it clear that this was a helpful service to the trade finance industry. With economic volatility and protectionist measures showing no signs of abating, it is no surprise that payables finance is more topical than ever and so, in response to market feedback, this updated second edition sets out to keep up the good work.

This edition includes a new case study, as well as a closer analysis of accounting treatment, the benefits to suppliers and how sustainability performance metrics have created lasting impact and outcomes.

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Foreword

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Persistent economic tension and uncertainty have put a strain on supply chains that increasingly stretch across the world. As a result, effective working capital management is more critical than ever to business success. In 2017, globalisation was fostering global supply chains and everyone was talking about "made in the world". This put pressure on working capital management and incentivised corporates to find new techniques to remain financially sustainable without compromising the health of their suppliers. In response to questions our own clients were asking us, we looked to produce the definitive guide to payables finance. Almost two years later, the global trade landscape is increasingly volatile. Protectionist tariffs and nationalist policies are being used to harness political and economic influence around the world. And as these take hold, with multilateralism looking more fragile than ever, corporates are tasked with maintaining integrated, uninterrupted global supply chains.

Against this backdrop of macroeconomic uncertainty, supply chain participants are seeking a way to shore up their operations – bringing supply chain finance instruments, such as payables finance, back into the spotlight – this time for different reasons. Traditionally, these programmes have been the preserve of large investment-grade buyers. But as uncertainty bites, we are increasingly seeing non-investment-grade companies looking to set up their own programmes as well in a bid to protect their suppliers and improve their own liquidity. This has always been done, but the prevailing environment is bringing the benefits into sharper focus.

While payables finance offers much-needed flexibility and stability to cope with these pressures, it also faces pressures of its own. Following the collapse of British construction company Carillion in January 2018, the accounting practices surrounding payables finance have come under increased scrutiny. Like a fire bell in the night, this awoke auditors and banks to the potential dangers of stretching the boundaries of trade payables accounting. Carillion's payables programme remained off its balance sheet, allowing debt to accumulate until it was too late – and businesses will need to take care that it doesn't look as though the same could be happening with them.

In spite of these challenges, payables financing is evolving in new ways. For instance, there is a growing appetite for sustainable business practices across the supply chain – with companies increasingly seeing the value of implementing sustainable practices from both a brand and a business perspective. However, barriers continue to stand in the way of global adoption. Tracking the sustainability practices of all participants in a supply chain is a colossal undertaking and will need buy-in from participants right down the supply chain.

With the market for payables finance – and our understanding of it – evolving all the time, this paper represents a revised and updated guide (replacing our January 2018 edition) that seeks not only to factor in the latest developments, but also to re-evaluate the key questions that define the industry. What is payables finance and where does it fit into the wider universe of supply chain finance techniques? What is driving demand for these solutions? How do the physical and financial supply chains interact? And how do you go about setting up a successful programme?

We hope you find it useful and welcome your input into the discussion.

1

What is supply chain finance, what is payables finance?

1.1 Definition of supply chain finance

Broadly speaking, and in line with the Standard Definitions for Techniques of Supply Chain Finance (see Appendix), supply chain finance (SCF) can be defined as the use of a range of financing and risk mitigation practices and techniques to optimise the management of the working capital and liquidity invested in supply chain processes and transactions.[1]

SCF is best understood by breaking down its constituent parts and examining the interplay between "supply chain" and "finance". The "supply chain", or the physical chain, is made up of a series of business processes that fall under three categories: procurement, manufacturing and distribution – the processes by which goods and services are purchased, transformed, and delivered. Each part forms its own complex process, typically requiring some form of funding and/or risk management.

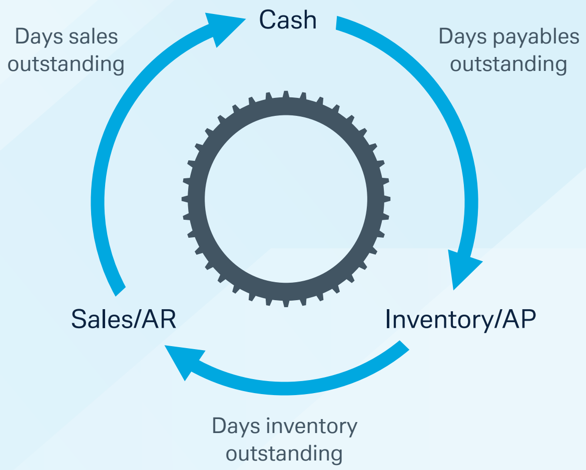
The "finance" aspect of SCF represents any instrument that provides financial support to participants in the supply chain. The term encompasses a range of financing and risk mitigation practices – from payables finance, to pre-shipment finance. The need for SCF is usually triggered by supply chain events, such as purchase orders, invoices, receivables and other related pre-shipment and post-shipment processes.

Figure 1: The cash conversion cycle

The cash conversion cycle (CCC) is the flow of cash as it is converted through inventory and accounts payable (AP), sales and accounts receivable (AR) and back into cash.

This is measured by days payables outstanding (the time it takes to pay suppliers), days sales outstanding (the time between selling and being paid by buyers) and days inventory outstanding (the time to turn inventory into sales), meaning CCC = DSO + DIO - DPO.

The shorter the cycle, the more efficient a corporate's operations, so treasurers must seek to increase DPO (extending time taken to pay outstanding invoices) and reduce DSO (ensuring incoming payments are received and processed as quickly as possible) if they are to unlock previously idle pools of liquidity.



Source: Deutsche Bank

1.2 The supply chain finance universe

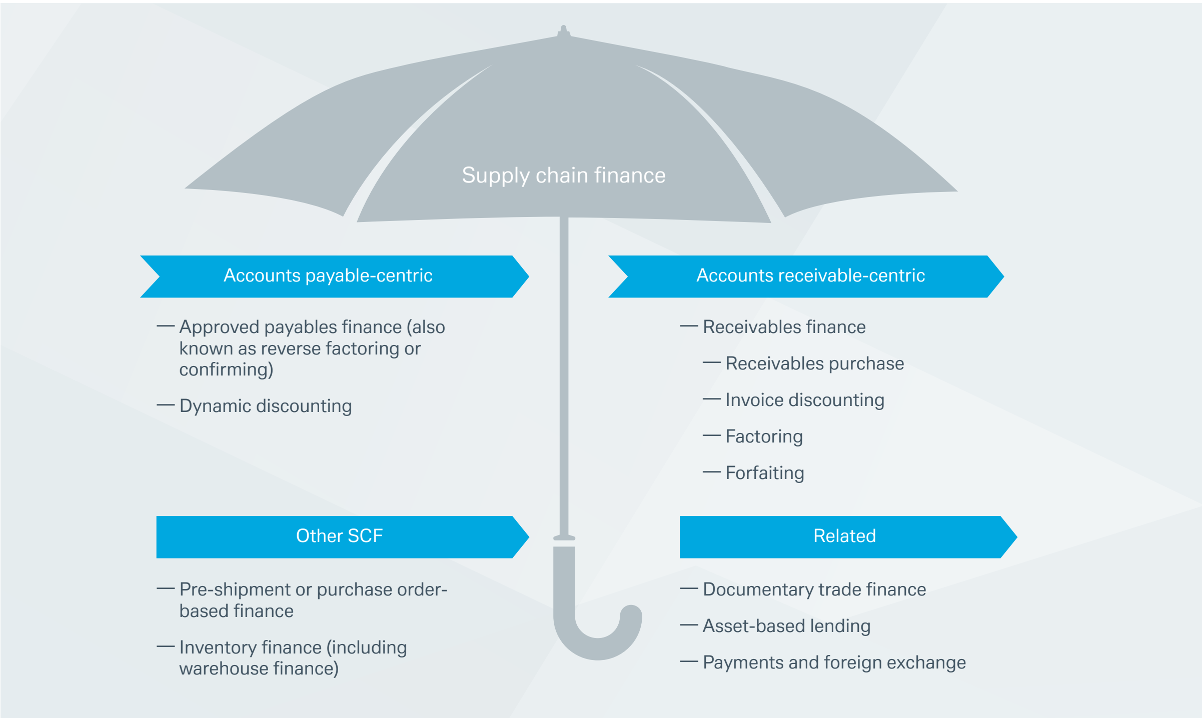
Over the last 30 years, the world of SCF has evolved into a complex and thriving universe. At Deutsche Bank (just one of a number of banks providing SCF), SCF now makes a significant contribution to our total trade finance business, and the bank processes €30bn worth of SCF transactions a year with more than 3.2 million invoices flowing through the platform.

But what different processes populate this universe? Generally speaking, SCF techniques are based on either accounts payable or accounts receivable. Accounts receivable techniques are the most common – with the global factoring market projected to exceed US$9trn by 2025.[2] Meanwhile, the most prominent techniques based on accounts payable are payables finance (see Section 1.3: Payables finance) and dynamic discounting. While payables finance provides balance-sheet-optimised financing for both buyer and supplier, dynamic discounting allows buyers enhanced flexibility as to when they can use excess cash to pay their supplier, securing scaled discounts for early payments.

On the other side, financing based on accounts receivable allows companies to sell on the debt held in outstanding invoices at a discount of the value of receivables pledged. This type of financing helps companies free up capital that is stuck in unpaid receivables, and also transfers the associated default risk to the financing company.

There are also a handful of non-debt-related techniques, including pre-shipment financing, post-shipment financing and inventory financing. Pre-shipment finance encompasses any financing that an exporter may need before sending its goods to a buyer (wages, production, raw materials etc.), while post-shipment finance helps ensure that exporters have sufficient liquidity while awaiting its payment. Inventory financing, on the other hand, is an asset-backed loan made to a company to purchase inventory, which then serves as collateral for the loan. A number of related techniques, such as documentary trade finance, payments and foreign exchange and asset-based lending, also support SCF processes.

Figure 2: The SCF “umbrella”



Source: The “Umbrella”, EBA Market Guide to Supply Chain Finance – 2014.

1.3 Payables finance

This guide focuses specifically on payables finance, a buyer-led SCF technique that enables a company to support its suppliers by granting them access to liquidity at favourable rates.

Helpfully summarised by the Global Supply Chain Finance Forum (see Section 6: Global Supply Chain Finance Forum) as "a buyer-led programme within which sellers in the buyer's supply chain are able to access finance by means of receivables purchase", this technique "provides a seller of goods or services with the option of receiving the discounted value of the receivables (represented by outstanding invoices) prior to their actual due date" and, typically, "at a financing cost aligned with the credit risk of the buyer". The buyer, meanwhile, is often able to negotiate longer payment terms in return – paying the total value of the receivable to the financier on the due date.

"This SCF technique is subject to a number of naming conventions, as is clear from the number of synonyms recorded in the Standard Definitions. The Forum decided that the term Payables Finance is a generic and neutral expression that captures the essence of the technique"

Christian Hausherr, Chair, Global Supply Chain Finance Forum and Head of Product Management, Trade Finance and Supply Chain Finance, Deutsche Bank

Under a payables finance programme, sellers in a buyer's supply chain are entitled to sell their trade receivables held against the buyer to the buyer's bank, receiving the discounted value of its receivables as represented by outstanding invoices. The buyer provides validation that an invoice submitted by the supplier is accurate, effectively confirming their obligation to pay the supplier for the underlying goods or services delivered. With this validation in hand, the financier can then accept the supplier's offer to sell the specific "confirmed" receivable, at a certain rate of discount and without recourse. Fundamental to the buyer-centric approach is that the financier relies on the buyer to validate and recognise the obligation owed to the supplier before the discounting takes place.

Within this structure, when the financing bank purchases a receivable from the supplier, they are in effect taking on the credit risk of the buyer. In a climate where credit capacity is scarce, the buyer may wish to ensure that the available capacity is targeted at those suppliers that are most strategic to their enterprise and in the greatest need of some financial support. Service providers should be able to share a best-practice approach with the buyer on supplier targeting and segmentation to help them optimise the allocation of credit capacity.

Today, payables finance, which was introduced into mainstream banking channels in the early 2000s, is one of the most commonly used SCF techniques.

Case study

1.4 Procter & Gamble

At 180 years old and headquartered in Cincinnati, Ohio, The Procter & Gamble Company (P&G) is one of the most well-known consumer goods companies – with operations in 73 countries and revenues of US$66.8bn in 2018. With a wide global reach and a diverse range of product offerings, P&G's complex supply chains need careful working capital management.

Following a lengthy review process and extensive discussion with banking partners, P&G announced its Cash Acceleration programme in 2013. With around 1,900 suppliers representing around US$18bn of annual spend, and 500 country/currency combinations, it was not possible for one bank to support the whole programme. Accordingly, Citi, J.P. Morgan and Deutsche Bank provide coverage in specific regions and countries throughout the world.

One of the key objectives of the programme was to ensure it was cash-sufficient, delivering between 90% and 100% cash productivity over multiple years. Any SCF programme had to be sustainable on a global basis and available globally at the same time, rather than region by region over time. Of equal importance, the programme had to be cost-effective for P&G's suppliers.[3] The breadth and scale of the programme required an internal multifunctional team spanning treasury, purchasing, legal, and shared services with business process and technical experts.

This initiative, leveraging P&G's sustained AA-investment grade credit rating, with SCF as a key enabler, was seen as a cornerstone for the company to achieve two key business commitments that were made to shareholders: a US$10bn productivity improvement and a US$2bn improvement in incremental free cash flow over three years.

The principle works on the basis that if the supplier has a lower credit rating than AA- P&G, it would cost that supplier more to fund an unpaid receivable for 75 days rather than receive cash from a bank after 15 days, discounted to pay the bank the interest cost of lending to investment-grade P&G for a further 60 days or more.

David S Taylor, P&G's President and CEO, reflects after five years of the SCF programme, "An important cash productivity project has been supply chain financing, which we continue to expand. This programme, which is a win for suppliers and for P&G, has yielded nearly US$5bn in cash in the five years we've been driving it. We improved payables by five full days last year on a constant currency basis."

"A clear and well thought-out structure, involving cooperation between procurement, finance and senior stakeholders is essential for a strong payables set-up. Procter & Gamble's programme is an excellent example of this – and the results are there to see in terms of its scale and reach"

Joao Galvao, Global Head of Supply Chain Finance – Payables, Deutsche Bank

2

Demand for payables finance

2.1 Early drivers of growth

Although payables finance has existed since the 1990s, the global financial crisis of 2008-2009 shone a new spotlight on the method of financing, and its value with respect to effective working capital management.

The global financial crisis put many manufacturers, retailers, and suppliers at risk of insolvency. As money from traditional bank-supplied credit lines dried up, companies increasingly looked to working capital management as an important tool to unlock previously idle pools of liquidity in their supply chains. Procurement teams began to scrutinise their supplier payment terms with more rigour and worked on lengthening them, putting pressure on smaller businesses.

In addition, supplier disruptions grew as a concern for many large corporates during the crisis. Recognising the negative impact that the bankruptcy of a strategic supplier could have on their own production lines, many companies began to think more seriously about the stability of the entire supply base – looking for new ways to aid selected suppliers as needed.

It was in this context that demand for bank-funded payables finance programmes surged. Using payables finance, large corporate buyers can extend or maintain existing supply payment terms, without threatening supply chain stability, and suppliers can access financing at a rate that reflects the risk of the better-rated entity in the supply chain.

2.2 Drivers of continued growth

2.2.1 The global cash opportunity

For banks, SCF represents a huge cash opportunity. In 2015, McKinsey estimated that there is around US$2trn in financeable secure payables globally – representing a potential revenue pool of around US$20bn. As of 2015, only US$2bn of that revenue was being captured. Nevertheless, the market is growing. Between 2010 and 2015, revenues from the existing programmes grew 20%, with McKinsey expecting this growth to continue at around 15% for the next three to five years.[4]

A more recent study by PwC highlights the attraction for corporate buyers. Its Working Capital Survey 2018/2019 estimates that global listed companies could release €1.3trn by addressing poor working capital performance – enough to increase capital investment budgets by 55%.[5] Yet, in the past five years, capital expenditure (as a percentage of revenues) has plummeted – with companies cutting investment to manage cash flows.[6] By improving working capital management solutions through the use of SCF, companies would be free to invest in growth without having to strain cash flows or seek additional funding.

Payables finance also has a wider role to play in helping bridge the much-discussed “trade finance gap” – the shortfall in trade finance provision as a measure against global demand. There have been several high-profile estimates aimed at quantifying the shortfall, with the most recent of these, released by the Asian Development Bank (ADB) in September 2017, putting the figure at US$1.5trn. That is down slightly from US$1.6trn the previous year, but it remains a substantial gap.[7]

Payables finance helps to bridge this gap – providing support to businesses that might otherwise be turned down for financing by tying their debt to the confirmed receivables of a trusted or highly rated company.

It should come as no surprise, then, that demand for payables finance is not limited to the traditional developed markets of Europe and the US. In fact, according to the ADB, 40% of this deficit originates in the Asia-Pacific region, with 74% accounted for by small and medium enterprises (SMEs) and mid-cap companies.[8] And according to an IFC/McKinsey study, emerging markets account for between 360 million and 440 million of the world's 420 million to 510 million micro, small and medium-sized enterprises – meaning the onboarding of the long tail would prove significant in any trade finance gap reduction.[9] That said, bridging the gap is, of course, a huge undertaking – one that payables finance cannot hope to fill entirely.

2.2.2 The need for supply chain stability

While the optimisation of working capital management continues to be the primary objective of many payables finance programmes, corporates are increasingly motivated by their ability to strengthen trading relationships and shore up points of vulnerability in the supply chain. For some corporate buyers, protecting the supply chain is becoming the number one priority, above even extending payment terms.

Macroeconomic volatility is amplifying these sentiments. The current uncertainty surrounding world trade negotiations is hurting trade volumes. Companies want to ensure that there will be no change in the cost of doing business across borders. This creates a lag, as trade decisions become attached to specific deadlines. At the beginning of 2019, a *Financial Times* poll of 81 economic experts highlighted the impact Brexit uncertainty was having on trade in and out of the UK.[10] Without knowing the cost of trade, businesses are understandably reluctant to commit to funding it. In the face of this uncertainty, payables programmes are beginning to gain traction – offering corporates the flexibility to push forward with trades that might otherwise be delayed.

"The current political landscape has raised questions as to whether the cost of doing business will remain constant. Amid the uncertainty – stemming in part from the unknown outcomes of Brexit and the US-China trade wars – we are seeing payables programmes continue to gain traction"

Dr. Rebecca Harding, CEO, Coriolis Technologies

2.2.3 Reaching out to the "long tail"

Suppliers of any size can form a critical element in a global supply chain. A small technology enterprise, which provides a very innovative solution, may need to be fed with money more quickly in order to fund development, while a producer of a small automotive part can bring the whole production line to a halt if they close down. Yet, SCF demand has historically been dominated by the huge anchor suppliers, which provide high-impact, low-risk opportunities for funders. As a result, the long tail, which is made up of numerous SMEs, has relied on less competitive credit card, overdraft and loan rates as sources of external finance.

A 2018 PwC survey highlighted the liquidity challenge faced by SMEs. The survey showed that, on average, it takes SMEs 36 days to convert invoices into cash – with 77% of participants expressing concern that their cash flow could be adversely affected by slow payments.[11] Fortunately, the articulation of the SCF message is evolving. Corporates are looking to extend their existing programmes to cover a larger proportion of the chain, which will include onboarding a higher volume of SMEs. In fact, since 2014, the adoption rate of payables finance has risen significantly – driven by uptake from companies with annual revenues below £5bn.[12]

The incoming challenge will be ensuring that the long tail is onboarded smoothly. A vast array of participants, such as those working in the production and distribution sectors, may not be familiar with payables finance, its processes, or its benefits. As such, educating the entire chain of the value of a payables programme – including improved working capital, financing at competitive rates and a more predictable cash flow – will prove a vital next step. (see Section 4.6: Understanding the benefits to suppliers).

2.2.4 Letters of credit vs. open account

The rise of payables finance is also, in part, reflective of the expansion of trade on open account terms – referring to trade transactions where the buyer is directly responsible for meeting the payment obligation in relation to the underlying transaction. Historically, trading partners have avoided these terms, except for trading relationships in, or with, low-risk markets where counterparties have a long history of dealing with each other. According to SWIFT, open account "represents the highest risk for the seller and the lowest risk to the buyer, and it is the most common way for buyers and sellers to do business in international trade today (approximately 80% of the market)".[13]

The transition to a situation where the vast majority of trade takes place on open account terms has challenged the utility of traditional trade finance instruments, such as letters of credit – which are relatively slow and incompatible – and fuelled the expansion of SCF.

Case study

2.3 Jumbo Supermarkten

Jumbo Supermarkten (Jumbo) had its beginnings in 1921 with the entrepreneurial Van Eerd family – a wholesaler in colonial goods. The first shops were set up in the 1970s, and the number of shops grew until father Karel and his children Colette, Frits and Monique opened a new, unique store in 1996 (in the belief that business could be done more efficiently).

Jumbo's unique store was a resounding success. It made possible what appeared impossible: a store that combines the largest selection, lowest prices and best service. Jumbo decided to expand what it saw as a winning formula.

Now, some 21 years after the first store opened, Jumbo has become the second largest supermarket chain in the Netherlands. It has acquired two major competitors: Super de Boer in 2009, and C1000 in 2012. Moreover, with the acquisition of the La Pace restaurant business (announced at the end of January 2016), Jumbo has expanded its reach beyond the Netherlands – into the markets of Belgium, Indonesia, Germany and the US.

Managing high volumes, maintaining a steady flow of goods

Retail business models are characterised by high-volume, low-ticket transactions in a business-to-consumer market – something very different from, say, the aviation industry. Everything happens fast, and so to ensure a steady flow of goods, customer satisfaction and, in turn, a healthy bottom line, Jumbo needs a healthy supply chain.

While inventory optimisation, cost and quality control, and end-to-end visibility are all invaluable management disciplines, Jumbo also wanted a solution that helped its suppliers reduce their dependence on traditional bank financing (since bank credit is often expensive or unavailable to these companies).

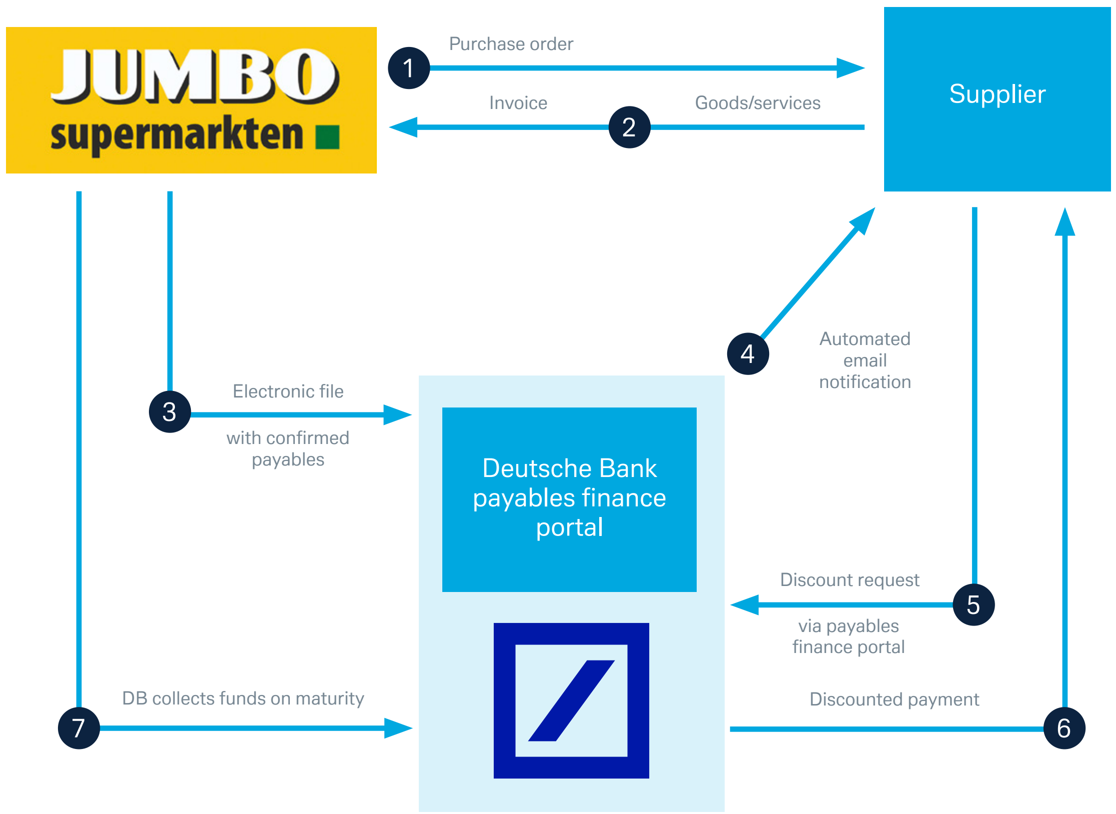
The Deutsche Bank/Jumbo partnership

Deutsche Bank won the mandate to provide the finance – working closely with Jumbo's own technical teams to design a tailored solution that allows the supermarket giant to process up to 40,000 invoices in a week (without sacrificing any richness of data or required information).

Once a suitable platform had been designed, clear targets, and a personal approach (with the help of Deutsche Bank's programme managers on the ground), resulted in the swift onboarding of all Jumbo's target suppliers within 12 months. For example, to ensure Jumbo's suppliers were fully engaged in the onboarding process, and understood the value of off-balance sheet liquidity, Deutsche Bank held a series of 'on the ground' meetings with Jumbo's suppliers in the run-up to programme launch. In addition, Deutsche Bank worked with Jumbo's procurement staff to ensure they too understood the programme's role in the management of the supply chain.

Today, 35,000 invoices approved by Jumbo are discounted every week on the Deutsche Bank platform. Jumbo has met its working capital objectives, and hundreds of its suppliers have access to quick, efficient liquidity.

In February 2017, the partnership between Deutsche Bank and Jumbo won a Global Finance Award for the 'Best Customer Implementation of a Supply Chain Financing Solution'.[14]



Step 1-2: Upon receipt of Jumbo purchase order, supplier delivers goods and invoice to Jumbo

Step 3-4: Jumbo uploads approved invoices on to Deutsche Bank's payables finance portal, which automatically notifies the supplier

Step 5: Supplier submits an online request to discount the invoice

Step 6: Deutsche Bank pays the supplier in an automated process

Step 7: Jumbo repays the invoice on maturity. If necessary, Deutsche Bank, acting as a fronting bank for the syndicated programme, forwards the payment to the relevant financier

Source: Deutsche Bank

3

Understanding the role of finance within the supply chain

Payables finance is a technique that provides support during a particular stage of the long and complex process that is the supply chain. In order to fully understand it – and the role it plays today – it is also important to understand how supply chains work, how they have evolved and are evolving, and how banks have adapted to lend support at key stages of the process.

This starts with understanding the physical supply chain.

3.1 The physical supply chain

As defined in Section 1.1 ('Definition of supply chain finance'), the physical supply chain is the mechanism through which goods and services are purchased, transformed, and delivered – and incorporates suppliers of all types and sizes, as well as their respective suppliers and so on. Payables finance owes much of its popularity to the fact that it gives greater financial flexibility to these suppliers – and therefore greater security to the anchor buyers that rely on them. The security provided, in guaranteeing the reliable provision of goods and services from suppliers, is an essential part of the production cycle – making it critical for a business's ongoing operation.

"Leading analysts are looking at important characteristics of supply chains, including the role of strategic suppliers whose contribution is so critical that any disruption in their ability to assure supply can cause the entire production process to grind to a halt. Similarly, service providers and others that support a supply chain and enable its activities can be critical to its ongoing operation, and as such, ought to be considered strategically important"[15]

Alexander Malaket, President, OPUS Advisory Services International; Deputy Head of the Executive Committee, International Chamber of Commerce (ICC) Banking Commission, quoted from Financing Trade and International Supply Chains

3.1.1 How have supply chains become integrated and global?

Supply chains are not static entities, however, and, over the past decade or so, they have undergone two main changes – becoming at once more integrated and more global.

In 2008, following the financial crisis, global economic growth slowed – reducing the volumes and values of trade. This started a race to begin streamlining supply chains – eliminating inefficiencies and costs wherever possible. Supply chain integration has played an important role in carving out these efficiencies. The process of integrating a supply chain involves bringing together numerous links in the chain, across each of the procurement, manufacturing, distribution and settlement phases, into a close, holistic relationship – enabling the supply chain to work seamlessly from end to end. The value-added services sector is becoming increasingly embedded in this broader supply chain, too – with closer connections reducing production periods, costs and waste across the entire chain.

This determined drive for optimisation has helped to create a more global supply chain as well. Large corporates need to ensure that their products meet high standards. And, as such, they will look to utilise the best possible expertise, at the best possible price, across a series of different fields – necessitating a global outlook. For instance, a single core part of a given machine will likely cross borders several times during the production phase. The raw materials may be procured in Germany, manufactured in China, and receive specialist refinement in the U.K – all before the product is distributed. An integrated supply chain ensures this global process is lean, for both the largest and smallest suppliers.

3.1.2 How are supply chains reacting to ongoing economic tensions?

But what do global supply chains look like today? A growing perception that the benefits of globalisation have not been equal across all geographies has given rise to populist policies, such as US trade tariffs. These policies are affecting the flow of trade – making it increasingly difficult for supply chains to operate as an integrated and global system. And as these operating conditions worsen, the supply chain must find a way to offset the business uncertainty. As a result, the financial supply chain is critical in ensuring the physical supply chain continues to operate smoothly.

3.2 The financial supply chain

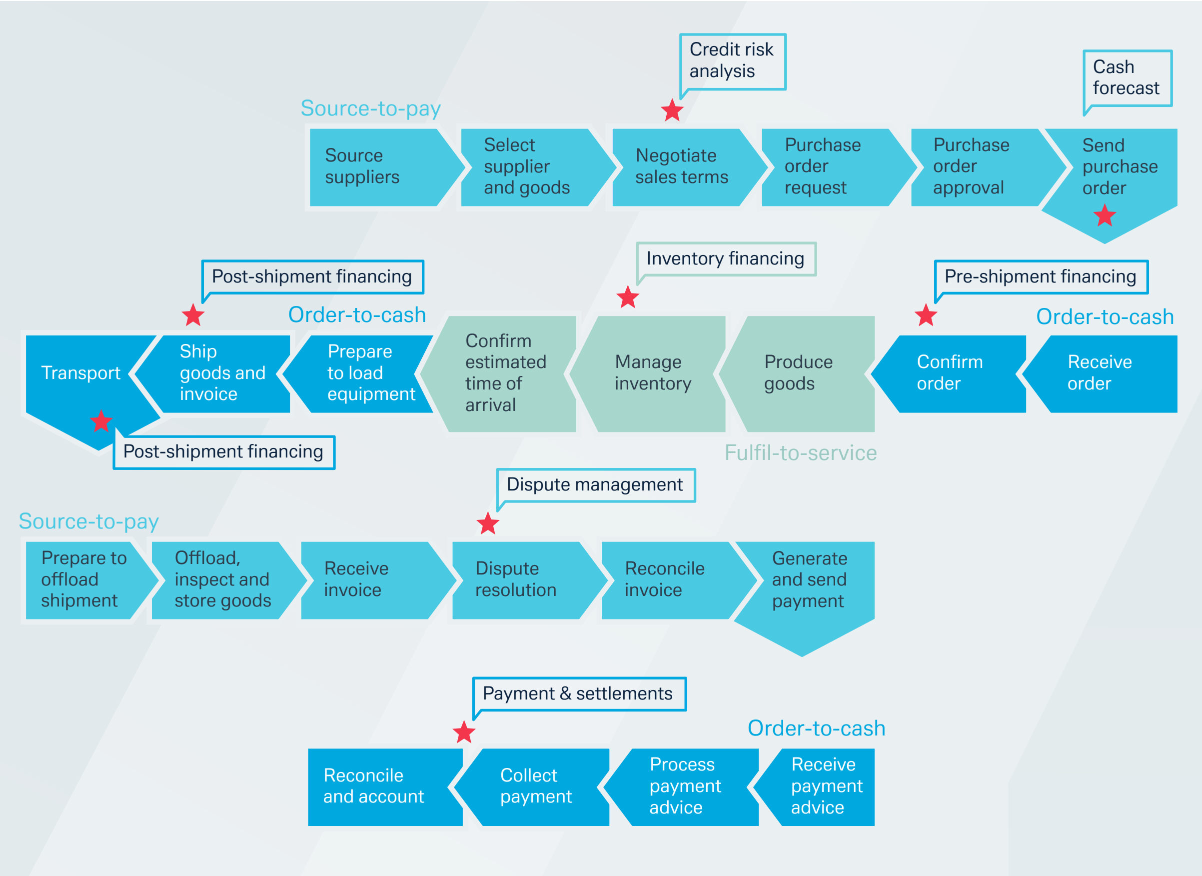
As defined in Section 1.1 ('Definition of supply chain finance'), the financial supply chain looks to facilitate the workings of the physical supply chain by providing financial support at key strategic points (see Figure 3) or flexible support that can be drawn upon at any point in the process.

"If businesses do not include financing in any trade facilitation programme, they are missing out on a key opportunity to bolster its global trade flows, trade relationships, and international supply chains"

Enrico Camerinelli, Senior Analyst, Aite Group

Over time, financial supply chain processes have become increasingly digitalised – leading to the creation of platforms for SCF.

Figure 3: Linking the physical and the financial supply chains



Source: Enrico Camerinelli

3.3 How do banks support the financial supply chain?

Banks take a comprehensive approach to providing support to the financial supply chain (see Section 1.2: The supply chain finance universe). But, when it comes to payables finance, one of the most talked about services is the payables finance platform.

3.3.1 What is a payables finance platform?

Many banks run payables finance platforms to centralise numerous supply chain offerings through a single digital portal integrated with the buyer's enterprise resource planning (ERP) system. This helps to facilitate the process of confirming and discounting payables contracts in a seamless, user-friendly manner.

In recent years, the number of supply chain offerings have grown (see Figure 4) – with many third-party providers (TPPs) offering their own platform-based solutions. Generally, TPP solutions separate the funding from the platform architecture and add specific fees related to the use of the platform.

However, a bank will have a wider dialogue with their clients beyond just payables finance, and successful programmes are often anchored in a comprehensive banking relationship – enabling the bank to stabilise pricing.

3.3.2 Beyond digital platforms

SCF platforms represent just one aspect of the broader payables finance proposition. The full proposition includes putting in careful thought to structure and set-up a tailored payables programme, as well as thorough Know Your Customer (KYC) and Anti Money Laundering (AML) checks on all participants in the chain.

Perhaps surprisingly, one of the most challenging aspects of setting up a payables finance programme is onboarding the suppliers. In this respect, one of the key roles of banks and other participants in the financial supply chain is communicating the benefits, simplicity and security of joining a payables programme. This is a marketing exercise, and the strategy varies not just according to the type, size and industry of the supplier in question, but also by geography – making local presence and an in-depth knowledge of a region's culture and languages a crucial part of a comprehensive service.

Figure 4: A short developmental history of the technology behind the payables finance platform

Buyer-led platforms

During the early 1990s, German retail giant Metro Group set up a supplier financing platform with its in-house financing entity MIAG in Switzerland. This platform is still operating today and is web-based.[16]

French retail group, Carrefour, soon followed – setting up a similar platform connected to its in-house financing entity, FINIFAC, in 2000.[17]

Bank-led proprietary platforms

By the early 2000s, a number of leading banks had established their own proprietary payables finance platforms, often sold to clients as part of a wider portfolio of banking solutions.

These platforms were integrated with the buyer's ERP system through host-to-host connectivity solutions. File Transfer Protocol (FTP) servers were commonly used as a means of secure data transmission. However, the process of implementing these secure data channels could take up to three months.

Increased competition, third-party platforms, and platform refinements

By 2010, the payables finance market was flooded with platform providers – including a number of TPPs (providers that separated the funding from the technological platform). With increased competition came a number of platform innovations and refinements. These include:

1. *Plug-and-play technology:* Today, a number of providers, including banks, offer a "plug and play" model, where the payables finance platform is connected to the buyer's ERP system and automatically extracts the required data. Such features have significantly reduced the time and effort required by a corporate buyer to initiate a programme.

2. *Digital documentation:* To simplify the onboarding process, many platforms now offer suppliers the option to upload or fill in the required documentation online. As legal frameworks on digital signatures are established – in Europe and beyond – this is fast becoming a new global standard.

3. *Global capabilities:* Until recently, large suppliers could be included on 20 different payables finance platforms, depending on their buyers and scope of geographical operations. The administrative burden could be enormous. This has changed: for example, today, suppliers signed up to several payables finance programmes run by Deutsche Bank clients are able to access all their global programmes through a single access point.

4. *Electronic invoicing (e-invoicing):* Historically, invoicing has largely been a paper-based process. E-invoicing (or the lack thereof) does not alter the effectiveness of a payables finance programme directly. However, it does have an impact on the client's broader working capital objectives (a 2017 report published by Billentis indicated that the incurred costs of receiving an invoice could be reduced by an average of €10 by moving to e-invoicing).[18] In response, some providers now offer e-invoicing solutions as an add-on to their SCF platforms. While take-up rate by corporate buyers has been relatively low (the treatment of e-invoices in legal and tax terms remains un-standardised across countries and security remains a key concern), the landscape is beginning to change. For example, in 2014, the EU issued a new European standard for e-invoicing.[19]

Source: Oliver Belin, Chief Marketing Officer at TradeIX and co-author of Supply Chain Finance Solutions, and Anil Walia, Head of Financial Supply Chain, EMEA, Deutsche Bank

3.4 Payables finance in practice

Case study

3.4.1 Electrolux

Electrolux – plugging in a global supply chain finance programme

AB Electrolux (commonly known as Electrolux) is a global household name. The Swedish-based corporate, established in 1919, today ranks as one of the world's leading appliance manufacturers. In 2016 alone, Electrolux sold more than 60 million household and professional products in more than 150 markets.[20]

Electrolux has invested heavily in making its global network of more than 1,000 strategic suppliers more transparent, flexible and responsive. The company employs a combination of techniques – from inventory optimisation to electronic invoicing solutions. However, payables finance, in particular, has become an increasingly prominent technique used by the company.

The SCF early years

Electrolux launched its first regional payables finance programme almost 30 years ago for its Italian suppliers. Its popularity prompted the company to repeat the structure in Brazil and then North America.

The attraction? As Johan Werme, Manager, Supply Chain Financing at Electrolux, says, "We started our payables finance programme to support our suppliers when we extended payment terms; we wanted to improve their cash-flow, and ensure they could grow in line with our ambitious business objectives."

Until 2011, Electrolux ran a series of localised and regionalised payables finance programmes in Europe, North America, Chile and Brazil.

Pricing is important, according to Werme, "Our choice of providers in those early days often came down to pricing – we wanted to be able to deliver the most competitively priced working capital to our suppliers."

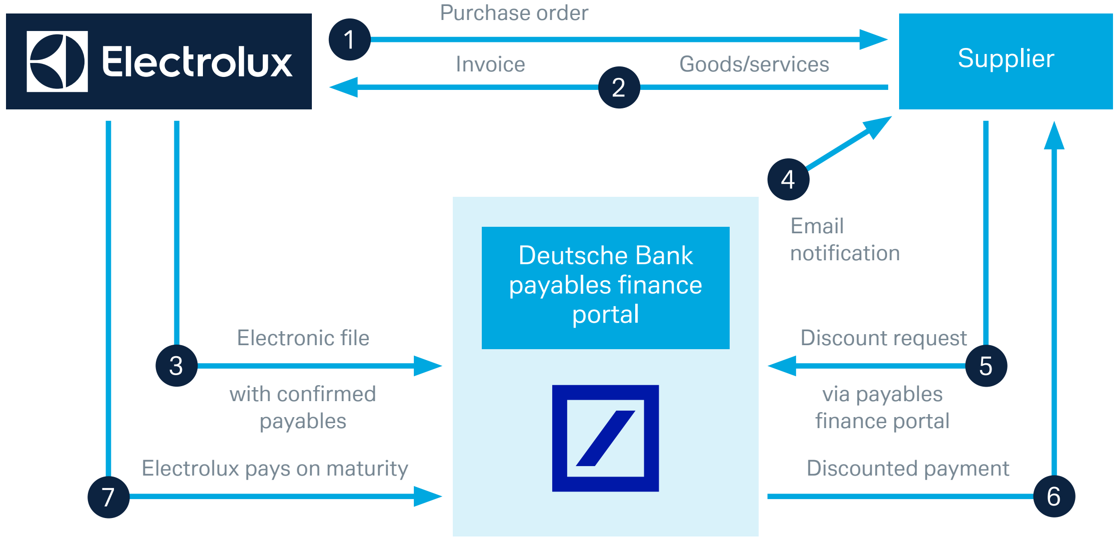
Building on the success of its regional programmes Electrolux sought a global payables programme. Initially focused on cross-border flows for its Asian suppliers, the programme quickly expanded to cover all regions and flows. The company wanted its buying entities and its suppliers to be supported (both in an operational and legal sense) locally, even when, for example, the buying entity was located in North

America, and the supplier in Asia. “We wanted to build a global programme, with global capabilities,” reflects Werme.[21]

Deutsche Bank won the mandate to provide this service on the grounds of effective programme reach in North America and evidence of global coverage. Electrolux receives monthly reports on global onboarding progress across the regions and Deutsche Bank has established a central coordinated global team to integrate the many and varied Electrolux accounting systems.

The global platform architecture

The Electrolux platform operates in much the same way as the Jumbo platform.



Supplier finance – workflow and platform

1-2 Supplier delivers goods and invoice to Electrolux
3-4 Electrolux uploads approved invoices onto Deutsche Bank’s payables finance portal, which automatically notifies the supplier
5 Supplier submits an online request to discount the invoice
6 Deutsche Bank pays the supplier in an automated process
7 Electrolux repays the invoice on maturity

Source: Deutsche Bank

Supplier network penetration

Deutsche Bank’s programme with Electrolux covers almost all of Electrolux’s cross-regional flows – with an 80% success rate of target suppliers joining the programme. In addition, while Electrolux’s target suppliers initially opted for selective discounting on their invoices, five years on, the majority of suppliers have selected automatic discounting for their invoices. “Moving forward,” concludes Werme, “what I would really like to see, is access to a more interactive platform – a platform that would provide real-time data on how many invoices have been discounted, or how many suppliers have been on-boarded in APAC, compared to the US this year.”

Case study

3.4.2 Auchan Retail

Auchan Retail – supporting suppliers, delivering quality

Auchan Retail (Auchan) is a France-based, international food retail giant. With an established presence in 17 countries across Europe, Asia and Africa, 3,715 stores to its name, and consolidated 2016 revenues of €52.8bn, Auchan has grown over its 55 years of trading to become the world's 11th largest food retailer.[22]

SCF has become one of the critical means through which Auchan is able to support its supplier bases, secure long-term supply chain sustainability, and in turn, ensure the continued provision of quality goods, and long-term revenue growth.

Supporting suppliers post-crisis

Auchan started its SCF programme in 2009, in response to growing liquidity difficulties faced by smaller suppliers in the wake of the global financial crisis.

As François Verrodde, General Manager of Auchan Suppliers Advanced Platform (ASAP) explains, "In 2009, several of our suppliers were struggling to finance their production (and the sourcing of their raw materials) and, in view of their difficult positions, were demanding early payments. SCF allowed us to offer our suppliers a low-cost source of funding (the risk for this funding was on us), while avoiding any adverse impact on our working capital."

"You need to imagine the scope and requirements of the programme three or four years down the line," explains Verrodde. Auchan needed smooth implementation, rapid supplier onboarding, and fair pricing across the numerous markets in which it operated.

Auchan first set up an SCF programme for its French suppliers. However, since then its scope has widened to other European suppliers – including those from Poland and Portugal – and, most recently, to Chinese suppliers.

Importantly, the corporate confirmed that the SCF programme has had "a positive impact on supplier relationships" and, in addition, has assisted the implementation of parallel projects with suppliers – such as electronic invoicing and automatic invoice approval.

4

Setting up a successful payables finance programme

As the payables market has matured and grown, new complexities, challenges, and opportunities have emerged. To ensure the implementation of a successful payables programme, corporates and banks must manage the regulations, terminology and legal structures pertaining to their payables programme.

4.1 Contractual and drafting issues

Contractually, before an early payment can be made under a payables finance programme, the supplier and financier must sign a Receivables Purchase Agreement (RPA) under which the supplier agrees to transfer all its rights (or title) to the trade receivable to the financier.

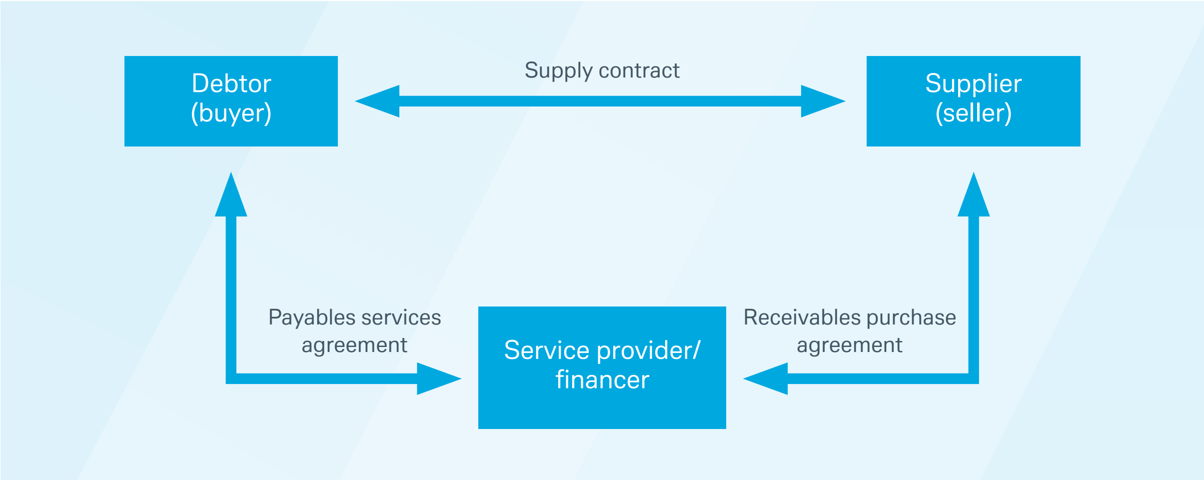
When drafting this document, providers (and their lawyers) must take care to ensure the assignment of receivables is "perfected" according to jurisdictional requirements. This means ensuring it will be recognised by the relevant local transaction courts as a "true sale" – crucial in the case of a default. Failure to achieve this can result in an analysis that it is a loan secured by the receivable instead. In the event of a supplier's insolvency, if the liquidators do not accept that a true sale has been achieved, the buyer could find itself in a situation where it has to pay the same invoice twice or the financier could have no valid claim on the receivable. The supplier would still have a claim against the buyer under the original invoice, and the financier (often protected by some form of irrevocable payment undertaking) could theoretically still claim the value underlying the discounted receivable from a buyer.

Reaching perfection is not always easy. And even within the EU, the rules relating to perfection of the assignment are different in almost every country and far from simple.

"Perfecting the title to the receivable is important. We have to ensure we take over the receivable exactly as it was originally committed. Shortcuts create risk"

Anil Walia, Head of Financial Supply Chain, EMEA, Deutsche Bank

Figure 5: The legal structure of a payables finance programme



Source: Sullivan

"If a German supplier is selling to a French buyer – and I am a UK SCF provider – theoretically every time I buy a trade receivable, I must make sure it was validly sold to me under German law, French law and English law"

Geoffrey Wynne, Partner, Head of Trade and Export Finance, Sullivan (London)

4.2 Global coverage

As supply chains become increasingly global, payables finance providers must offer capabilities that reflect the global nature of their client's business and supplier relationships. To do so, there are additional layers of complexity involved – in terms of regulatory, legal and operational challenges – if a buyer and its suppliers are located across national and regional borders.

As such, a successful global provider will need to have people on the ground who understand the local environment – in particular the regulatory environment – and who can respond to the supplier in the same time zone and the same language. In addition, a successful provider will need a global-friendly platform, and a cross-border funding model that can deal with the inherent FX risk.

"Foreign currency exposure, or FX risk, is inherent for at least one or both trading partners in the majority of international transactions, and may extend to impact a whole group of trading partners in the context of an international supply chain," notes Alexander Malaket, President, OPUS Advisory Services International; Deputy Head of the Executive Committee, International Chamber of Commerce (ICC) Banking Commission. He adds, "Buyers have noted the significant impact on cost, and have opted, as part of the SCF programmes offered through their trade bankers, to provide suppliers with the option to settle invoices in local currency. The banks, in effect, 'bundle' a trade or SCF solution with some form of currency hedge, be it spot conversion to the currency of the supplier at the time of settlement, or conversion on the basis of an FX contract, assuring settlement in local currency on the due date."[23]

4.3 Diversified funding sources

As the market has grown, so has the size of payables finance deals demanded by corporates. Some programmes (particularly those of the largest MNCs) have become so enormous that they now outstrip the funding capacity of a single bank.

Leading banks have created capacity for these enormous programmes by forming syndicates with other banks; usually the clients' other relationship banks (see section 1.4: Case study: Procter & Gamble).

However, managing a multi-bank payables finance solution introduces a number of new challenges – including technical and data compatibility issues, reporting requirements, and risk and compliance needs across all participants. As a result, only a handful of players currently have the capabilities and expertise to lead such syndicates.

"It is important to understand both the accounting and legal aspects of any sale. Getting it wrong may leave you exposed or, if you are a buyer, leave you with different rights from those you were expecting"

Sean Edwards, Chairman, International Trade & Forfaiting Association (IFTA)

One such consideration, as outlined by the ITFA Guide to IFRS 9 (see Figure 6), is the issue of achieving de-recognition on sale through transferring rights and rewards to the underlying assets (see also Section 4.1 Contractual and drafting issues). This is often referred to as a "true sale" and, as the Guide points out, can be achieved through a legal transfer or by other means. A full legal true sale is, in general terms, more desirable than a synthetic transfer of rights and rewards but this is not always possible. This is particularly important for syndicated payables programmes, where the fronting bank will want to sell on or hedge the risk of certain contracts under the programme – an undertaking that may be compromised if a true sale has not been achieved.

Moving forward, it is hoped that further financing capacity can be created through new linkages with the capital markets and the development of a deep secondary market for trade finance assets. However, in practice, this will take some years to crystallise and trade finance assets, for now, remain outside the comfort zone of potential institutional investors, despite some of the laudable work being done to raise awareness and successful funds.

4.4 Financial crime prevention

4.4.1 Customer experience

Minimising the risk of financial crime is an important consideration for banks. KYC and AML processes, for example, are part of providing a sustainable, long-term payables finance solution – and, as such, an essential part in any comprehensive and responsible offering. Non-performance or underperformance of KYC and AML obligations when onboarding suppliers would not only put banks at financial and reputational risk, but also compromise the whole supply chain. In turn it would raise the same reputational concerns for those companies involved in the payables finance programme. With trade-based money laundering on the rise – particularly in Asia – these regulatory obligations cannot be compromised.[24]

Reconciling these complex and thorough operational requirements with client demand for a smooth experience is not always easy. "Onboarding represents the first customer interaction for the financial institution and will set the tone for the entire relationship," noted Deloitte in 2017.[25] Profits are driven by good client experiences, and no financial institution can afford to impose a bad experience on a customer – either the buyer or any of its suppliers.

The problem is that the supplier isn't going to care that, relative to third-party competitors, banks are subject to a large number of regulatory requirements they have to manage when onboarding suppliers to their programmes. Pain points, say Deloitte, have included being "rerouted to different channels" and being asked the same question "multiple times".

The emphasis moving forward should be on enhancing the efficiency of compliance processes through the use of new technology, such as artificial intelligence, and utilities such as the Global Legal Entity Identifier Foundation (GLEIF) project, SWIFT's KYC Registry and IBM's blockchain-based shared KYC solution.[26] Advocating solutions that are light on compliance, or providers that are willing to take shortcuts in the process, will simply add to the problem.

The KYC-related aspects of onboarding suppliers are outlined in the current edition of the Wolfsberg Trade Finance Principles, which elaborate on customer and counterparty due diligence in a newly added Appendix on Open Account.[27]

In short, the technology is getting there, but where there are inevitable manual paper checks, financial institutions should take the opportunity of that client interaction to ensure the experience remains positive and consistent. More information on customer journeys can be found in the *flow* article 'Frontline economics' by Stefan Hoops, Head of Corporate Bank, Deutsche Bank.[28]

4.4.2 Artificial intelligence

Artificial intelligence (AI) can be used to enhance KYC/AML processes by:
— Providing a dynamic questionnaire that could adapt to customer responses
— Allow for real-time KYC anomaly detection; and
— Improve overall process speed and cost-efficiency.

In addition, an AI-enabled system that had learned money-laundering typologies could, in theory, proactively ascertain when and where risks are likely to emerge based on past trends. It could also analyse high numbers of contextual data points (such as account profile data from CRM, non-transactional behaviour from web login activity, and other unstructured data sources) to create a highly refined risk score and help ensure strong risk controls.

But AI is not just used to fight financial crime. It can also be used to assess the probability of a supplier joining a programme during the supplier analysis stage and determine optimum payment terms by analysing historical data on invoice payments. However, as Oliver Belin, Chief Marketing Officer at TradeIX, points out, “to be accurate using AI, you need vast amounts of historical data on every single commodity and every single product. You need a trading history and a procurement history on every specific product – a machine does not have that data yet.”

4.5 Accounting

From the perspective of buyers, suppliers and banks, the benefits of payables finance are clear. But, from an accounting perspective, there are several wrinkles to be ironed out. Currently, the industry uses accounting standards that are adaptable to a multitude of different business models. As a result, the standards are necessarily left open to interpretation – making it uncertain how auditors will classify trade payables.

Ideally, participants in the supply chain would prefer their trade payables to be accounted for within their working capital – not elsewhere on the balance sheet. Auditors, depending on their interpretation of the industry standards, can reclassify trade payables as bank debt. It is important for corporates and their banks to avoid this reclassification. Although in pure cash terms there is no difference between having a trade payable due in 90 days and having a bank debt due in 90 days, the perceived differences between the two are critical. Currently, a buyer’s aim is to maintain its status as a trade debtor, despite the fact that the supplier is paid early by the bank – keeping the liability off its balance sheet. Reclassification of trade payables to bank loans from the bank to the buyer, on the other hand, gives the impression that the buyer had to borrow money in order to pay the supplier – especially if the majority of suppliers are covered by payables programmes. As such, the amount of financial debt held by a buyer on its balance sheet increases – leading to negative implications for a corporate buyer’s loan covenants, its leverage, and its access to additional credit.

Sullivan’s Geoffrey Wynne explains, “The reclassification of trade payables as debt on the balance sheet matters. It can have serious implications for corporate buyers’ loan covenants”. This reclassification is based on a legitimate concern. In recent years, rating agencies have begun to place heightened levels of scrutiny on the trade payables sector. In 2015, Moody’s reported that “Reverse-Factoring has debt-like features”,[29] while in 2018 they stated that there were “flaws in accounting for supply chain finance arrangements”.[30] In January 2018, these concerns were confirmed by the collapse of Carillion, the warning signs of which were partly obscured by its use of payables finance in the form of its “Early payments facility”. As reported in the *Financial Times*, from 2011 to 2016, Carillion’s published net debt increased by only £11m, while its trade payable liability increased by almost £500m.[31]

Carillion, then, is an example of trade payables that should have been reclassified as debt. Banks and corporates can avoid this kind of situation by working together with regulators and auditors to structure programmes to minimise the perception and risks of debt-like features.

Measures include ensuring that the financier obtains the exact same rights to receive payment that the supplier had. This means that the bank does not, for example, have any greater certainty of being paid, and paid on time, than the vendor had. Likewise, corporate guarantees or additional security from the buyer – elements a buyer would not agree to in an ordinary vendor relationship – can risk contributing to a case for reclassification.

The proportion of suppliers that are onboarded to their payables programme also plays a role. If your entire chain buys into a programme, it gives the impression you cannot pay suppliers without heavy financing – risking reclassification. The challenge, therefore, is to strike a balance between providing comprehensive coverage for the greatest risks and maintaining an uncompromised balance sheet.

Putting in place these kinds of measures will be critical for corporates looking to avoid reclassification. But while different views have been exchanged over the past years, there is no consistent interpretation available that is shared among the relevant stakeholders.

Anil Walia, EMEA Head of Supply Chain Finance at Deutsche Bank says industry should sit down with ratings agencies, regulators and accounting bodies and agree on how SCF should be treated in company accounts. Trade payables still have to be paid – even if it is not bank debt. "Further clarity of the product offering and structure is needed, to avert the danger of "a negative watershed event for the SCF business."

Figure 6: IFRS 9 accounting information for banks

Accounting is not just an issue for corporates – there are a number of considerations for banks, too. Most notably, banks must follow the International Financial Reporting Standard 9 (IFRS 9) – which specifies how an entity should classify and measure financial assets and differentiates between assets to be held on one's own books and those to be sold.

Most payables will be categorised as "Solely Payments of Principal and Interest" (SPPI) based on the contractual cash flows of the instrument itself. This categorisation is a necessary step in determining the appropriate classification of financial assets under IFRS 9.

IFRS 9 then requires financial assets to be further classified according to the business model of the bank in question. According to ITFA's industry guide to IFRS 9,[32] this step, known as the business model assessment, "looks at an entity's expectation as to how a financial instrument will be managed by the business". Within this, IFRS 9 defines three distinct business models (though companies can fall into more than one), as summarised by the ITFA guide:

1. Hold to collect – Under this business model an entity anticipates that the financial asset will be recovered by collecting contractual cash flows. Financial assets held in this model are measured at amortised cost on which an effective interest rate is calculated.

2. Held for trading – Under this business model an entity expects to profit from the sale of financial assets. Financial assets held in this model are measured at fair value through profit or loss (FVTPL).

3. Hold to collect and sale – Under this business model an entity anticipates that it will recover financial assets through both the collection of contractual cash flows and sales. Financial assets held in this model are measured at fair value through other comprehensive income (FVOCI).

IFRS 9 allows some flexibility and any change in the applicable business model will not affect the way assets were previously categorised.

"The new IFRS 9 financial accounting rules have resulted in additional transparency to the balance sheet treatment of funded trade finance assets. As a consequence, these new financial accounting rules brought a new dimension and level of complexity to trade finance deal structuring"

Suzan van Toorn, Director, Trade Finance Structuring, Deutsche Bank

4.6 Understanding the benefits to suppliers

Perception of payables finance among suppliers is not always positive. Those who don't fully understand the benefits or have been subjected to poorly structured programmes can even conclude that large companies are forcing their suppliers into programmes in order to extend their payment terms.[33]

The key to avoiding this is to ensure that participation is always optional and that the programme is structured in a way that maximises the benefits for suppliers. In the same vein, it is vital that buyers ensure their suppliers understand the benefits afforded by a payables programme.

If the benefits of the programme are poorly articulated to the supplier, the attention of the supplier may be limited to the extended payment terms that may come with a payables finance programme. However, payments terms are just one component of a successful payables finance programme – the other component is enhanced financing conditions. What ultimately matters is the final outcome and financial benefits that are created for the supplier, which can be substantial depending on the supplier's individual financial situation.

When holding these discussions, it is often useful to think in terms of the cost of capital.[34] Often, and almost certainly with SMEs, the supplier will have a lower credit rating than the buyer – meaning the cost of funding under a payables programme is less than the supplier could obtain on its own. On this basis, it would often cost the supplier more to wait 100 days to be paid in full, than to get paid 99% of the total by the bank in just 10 days.

Payables finance can also be useful in facilitating transactions that might otherwise be tricky to execute due to conflicting production cycles. An SME may sell simple parts that are used in complex machinery. The buyer combines these materials and components to build complex machinery, which is a high-margin, low-volume business. In such a scenario, the supplier might need payment long before the buyer is able to convert its investment into liquidity. For many SMEs, the delay in payment can be detrimental to its cash flow. A payables finance programme can offset such a situation – allowing buyers to improve their payment terms and the liquidity of their suppliers at the same time.

It is also worth noting that the costs to the supplier of implementing a payables programme are negligible. Some small one-off costs may arise from the technical implementation effort and the analysis of the benefits of participation, but otherwise the primary cost is the discount agreed in exchange for an early payment.

Buyers have begun to take these messages on board. The ongoing shift away from DPO-driven payables finance (see Section 2.2.2: The need for supply chain stability) demonstrates how corporates are increasingly structuring their programmes to maximise supply-chain benefits and promote health and stability across their supplier bases. Leading the way in this respect, some buyers even look to pay the interest for their suppliers, though accounting implications mean that this approach is not yet widespread.

5

Sustainability

The goal posts for success are evolving. Increasingly, companies are looking into how sustainability standards can be baked into payables programmes in order to encourage ethical practices throughout the supply chain. The eye is shifting from outright profitability, towards brand, business and environmental benefits.

5.1 Sustainable supply chains

The concept of “sustainability” is beginning to gain traction in the payables finance world – with the idea of banks directing their capital at environmentally and socially responsible economic development having taken form in the launch of the Banking Environment Initiative in 2010, which was convened by the University of Cambridge Institute for Sustainability Leadership (CISL).[35]

It comprises 11 leading banks – including Deutsche Bank – with combined assets of more than US$10trn. The group is best known for its work on driving change in how banks support a sustainable economy through global agricultural supply chains. This is embodied in the Soft Commodities Compact initiative, which works with the banking industry to help transform soft commodity supply chains and help the banks’ corporate clients achieve zero net deforestation by 2020.

The goal is to encourage practices and techniques that support trade transactions in a manner that minimises negative impacts and creates environmental, social, and economic benefits for all stakeholders. And for each player along the chain, opportunities abound. Buyers gain an opportunity to incentivise sustainable practices in their supply chain, suppliers gain an opportunity to monetise their sustainable performances, and banks gain access to a largely untapped growth market.

5.2 Drivers and opportunities

The recent focus on sustainable measures has been driven by several factors. For corporates, the reputational risk management potential of SCF is very attractive – especially with corporate and social responsibility (CSR) performance evidence moving beyond aspirational statements in company reporting. In effect, sustainability risks have become business risks, too. For instance, during an environmental crisis, firms with a weak environmental social and governance (ESG) performance saw a 3% decline in their market capitalisation – or an average of US$378m per firm.[36] These business risks have led to new opportunities: globally, there is a huge US$660bn market for sustainable SCF, which represents a revenue opportunity of US$6bn for financial service providers.

Consumers are also driving this sustainable shift. In 2015, for example, global measurement and data analytics company Nielsen found that consumer brands committed to sustainability grew four times faster, with 66% of consumers willing to spend more on products from sustainable brands.[37]

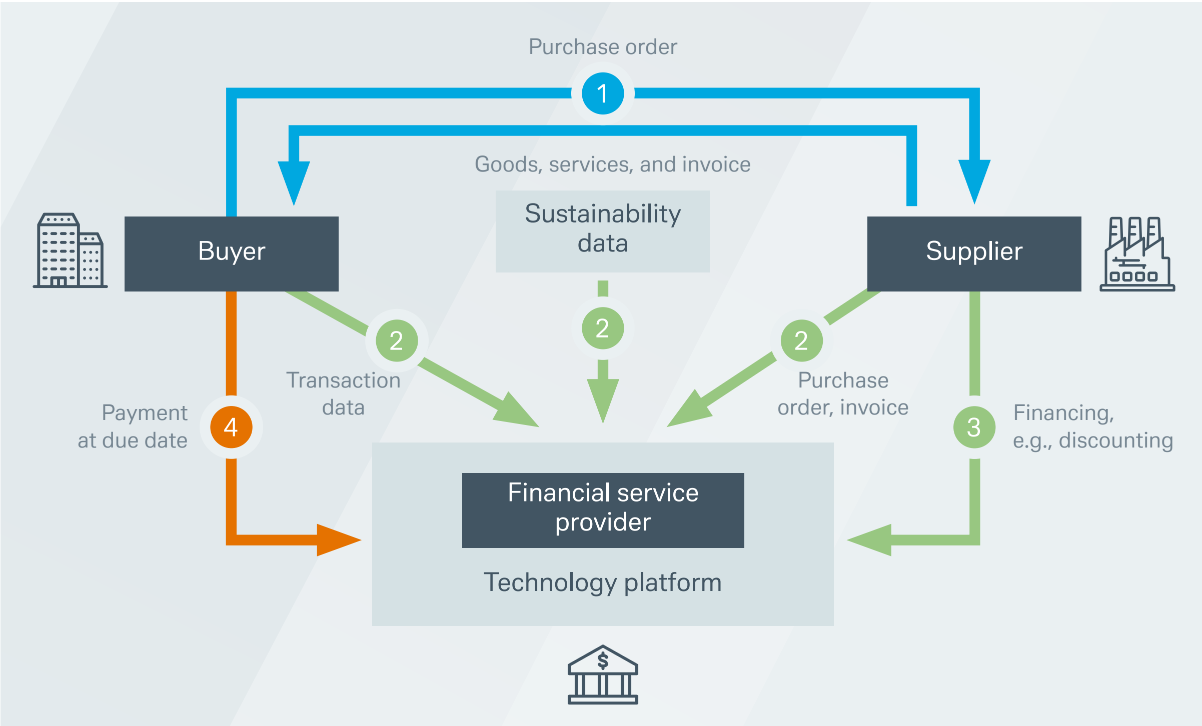
But how can corporates assert their sustainability credentials? They won't get far without a sustainable supply chain, argues Michael Kobori, Chief Sustainability Officer at Levi Strauss. "Supply chain finance is the only way to positively incentivise your suppliers to improve their sustainability performance," said Kobori at a 2018 conference organised by global non-profit sustainability consultancy BSR. Tara Norton, Managing Director of BSR, believes more can be done to transform supply chains so that Kobori's scheme to link financial terms to environmental, health and safety metrics becomes business as usual rather the exception (see Section 5.4: Case study: Levi Strauss & Co).

Norton also thinks that the growth of SCF, its rapid transformation away from paper-based processes into digital delivery, and the corresponding technology to capture and integrate sustainability data from the supply chains means that embedding environmental, social and governance risk management in supply chains is entirely doable. In the BSR report, entitled "Win-Win-Win: The Sustainable Supply Chain Finance Opportunity",[38] Norton provides more background on why and how SCF mechanisms can be leveraged to incentivise sustainable behaviours.

> "Incentives are crucial to making sustainability performance a business priority. Supply chain finance holds huge, previously untapped potential to tangibly reward suppliers throughout the entire value chain for sustainability performance as well as to support them in securing the necessary capital to make sustainability investments"
>
> *Tara Norton, Managing Director, BSR*

Key steps, says the report, for setting up a sustainable payables finance programme include:
— Developing shared goals between the sustainability procurement/finance departments and defining the spirit of the programme;
— Identifying a financing source (such as a bank, a syndicate of banks, an investment fund, or even the buyer's own capital) willing to provide services in the targeted geographies and sectors;
— Deciding which sustainability aspects to include for supplier rating – for example, health and safety, social, human rights, environmental. Ideally, these will be aligned with the company's sustainability goals and targets;
— Selecting a source for supplier sustainability performance data that provides comparable data across the targeted supplier base for the SCF programme;
— Finding a suitable technology platform that allows for the integration of sustainability data (if this is not brought forward by the potential financial service providers). It is important to make sure it is a one-click solution – or as close as possible – to make it efficient and convenient for all parties; and
— Clearly communicating to suppliers the advantages of the programme and how to access it.

Figure 7: Integrating sustainability into supply chain finance



Source: www.bsr.org

5.3 Practicalities of sustainable supply chain finance programmes

Though sustainable practices along the global supply chain have been on the rise, several barriers remain. A supply chain can be made up of hundreds of stakeholders, each with the ability to impact the chain's sustainable potential. Against this backdrop, providing proof of a supply chain's sustainability credentials can be incredibly difficult.

For instance, while a palm oil supplier may be able to prove that its crop was sustainably grown, it may not know how it was harvested. Then, if the supplier could prove the crop was harvested via sustainable means, it may not be able to prove that the workers who harvested the crop received a sustainable living wage. Given the number of participants in a single chain, tracing the sustainability of each link would require a near-impossible level of oversight. The next pivotal step, therefore, will be to determine what metrics should be used as sustainability benchmarks.

However, it is not simply a question of what to measure, but also how to measure it. Getting buy-in from the chain's numerous participants to provide detailed sustainability metrics can be a significant challenge. For example, implementing temperature controls along the global supply chain is an often discussed, and perceivably beneficial, next step. But, when a container with this capability is shipped, all maintenance while at sea must be carried out by the shipping company – and this company would likely expect financial incentives to play this additional role. It will, therefore, be important to define what a "fair deal" for participants looks like. Incentives will need to be large enough for participants to join the programme – especially if they have been part of a conventional SCF scheme already. Equally though, any financial incentives must strike the difficult balance between the reputational value of pursuing sustainable goals, and the impact on outright profits.

Case study

5.4 Case study: Levi Strauss & Co

Levi Strauss & Co. (Levi Strauss) is a landmark example of how SCF environmental and social compliance can be improved.

In November 2014, the San Francisco-based manufacturer of jeans announced it would provide lower-cost working capital to those of its 550 suppliers that performed best on its environmental, labour and safety standards.[39]

Its products are sold in more than more than 110 countries worldwide through a combination of chain retailers, department stores, online sites, and the company has a global footprint of approximately 3,000 retail stores and shop-in-shops.

Sustainability pays

The finance was arranged with the International Finance Corporation's (IFC) US$500m Global Trade Supplier Finance Programme. As suppliers improve conditions for employees and their environmental performance, they will be rewarded with lower interest rates on working capital provided through a special IFC facility.[40] As a result, Levi Strauss was able to rely on "fewer, more capable suppliers", as Michael Kobori, Chief Sustainability Officer at Levi Strauss, noted in the *Financial Times*.[41]

Given the intensely competitive nature of the garment industry, access to lower-cost financing is an advantage to suppliers. Beyond the cash benefit, the scheme also allows suppliers to differentiate themselves from competitors through the validation of its environmental and social ratings. And given that the industry employs 60 million people worldwide, often in low-income regions, the move has hugely positive ethical repercussions, too.

The SCF scheme uses the third-party platform from GT Nexus, a cloud-based SCF management system (acquired by cloud business software provider Infor in September 2015). It is part of a wider strategy of sustainability that also addresses chemicals used to produce the jeans as well as reduction of water and pesticides in cotton growing. Levi Strauss is a member of the Better Cotton Initiative, which aims to train 5 million farmers worldwide on more sustainable agricultural practices, and account for 30% of global cotton production by 2020.[42] The company is also involved in a recycling and upcycling initiative.

New cooperation agreement

Building on this scheme, the IFC announced in June 2019 that it is working with 42 Levi Strauss suppliers and mills in 10 countries to "identify and implement appropriate renewable energy and water-saving interventions that will reduce greenhouse gas emissions."[43]

6

Global Supply Chain Finance Forum

Established in January 2014 as an initiative from five industry associations that worked together on the development of The Standard Definitions for Supply Chain Finance (see Appendix), their work continues on providing guidance documents for the industry and its partners in full consultation with its stakeholders. These associations are:
— ICC Banking Commission;
— The Bankers Association for Finance and Trade (BAFT);
— Factors Chain International;
— The International Trade and Forfaiting Association; and
— The Euro Banking Association.

6.1 Work of the Global Supply Chain Finance Forum

The Global Supply Chain Finance Forum (GSCFF) engages with other industry initiatives such as the ICC Global Survey, the ICC Trade Register and the Wolfsberg Group to provide guidance on SCF in their particular fields of interest. This includes guidance on KYC standards for SCF as well as plans to study the evolution of the market and develop reliable statistics on SCF.

The Forum, says Chair Christian Hausherr, "will continue to issue additional guidance on individual techniques within SCF, including payables finance, which is currently a work in progress".

6.1.1 Trade Register Report

In the ICC Banking Commission's 2017 ICC Trade Register Report, Deputy Executive Committee Head Alexander Malaket stated that the Register needed to expand its product coverage and data collection to include SCF. The GSCFF saw that this went on to be included in the scope of the 2018 Trade Register Report as part of its continued role of providing crucial credit risk and default data in trade and export finance. Results indicated that over the period 2008 to 2017, "supply chain finance represents a similar or lower risk than other trade products".[44]

6.1.2 Trade Finance Principles

Another important piece of work was the updating of Trade Finance Principles, published by the ICC, BAFT and the Wolfsberg Group – an association of 13 global banks that aims to develop frameworks and guidance for the management of financial crime risks, such as KYC and AML. A further release was announced on 27 March 2019 covering two new appendices on FI Trade Loans and Open Account Trade.[45]

The Open Account Appendix elaborates on the question of KYC in the context of SCF and looks at the most prominent SCF techniques: receivables discounting and payables finance. The appendix provides industry guidance on how clients and counterparties in the context of SCF should be treated in terms of client due diligence and risk-based checks.

As explained in a press release from the ICC Banking Commission, "The document addresses the due diligence required by global and regional financial institutions of all sizes in the financing of international trade and will now feature information on open account trade and financial institutions' trade loans."

Importantly, the appendix on open account provides guidance on the specific application of controls by banks in the context of open account trade transactions and analyse receivables purchase techniques as defined by the GSCFF. The second newly added appendix also, explains the press release, "provides guidance on the application of controls by banks in the context of financial institutions trade loans (FITL), also called bank-to-bank trade loans".

Christian Hausherr's summary of this can be found in the *flow* articles, "Wider reach", published in August 2018,[46] and 'Closer inspection", published in April 2019.[47]

6.1.3 Industry guidance on supply chain finance technique

In June 2019, the GSCFF published the first in a series of industry guidance documents intended to provide clarity and consistency to the world of SCF.

Receivables Discounting Technique focuses on receivables discounting – a technique and form of receivables purchase, flexibly applied, in which sellers of goods and services sell individual or multiple receivables (represented by outstanding invoices) to a finance provider at a discount.[48] It was produced to help finance providers "clarify common market practices in risk management, documentation, and operational handling for receivables discounting transactions.

Commenting on the guidance, GSCFF Chair Christian Hausherr says, "Our hope is that this guidance will lead to an industry-wide, uniform adoption of the receivable discounting technique. When all parties use similar techniques and terminology, it makes for a more streamlined and efficient process." The guidance was developed to help finance providers clarify common market practices in risk management, documentation, and operational handling for receivables discounting transactions.

Also known as receivables purchase, receivables finance, invoice discounting and early payment of receivables, receivables discounting may be done on a 'limited recourse' or 'without recourse' basis. The practices described in the guidance cover 'with limited recourse' programmes as are most common for this structure. Such programmes:

- May also be applicable to similar receivables purchase techniques like forfaiting or factoring;
- Cover the sale of goods and / or services;
- Are typically uncommitted facilities extended to the seller of the receivables;
- Are typically transacted on an 'open account' basis, i.e., with or without explicit payment acceptance by the buyer and typically without underlying shipping documents; and
- May be applicable to programmes which are disclosed or undisclosed to the buyer.

A similar guidance on Payables Finance is a work in progress and is scheduled for publication in Q1 2020.

7

Outlook

Since the release of *Payables Finance: A guide to working capital optimisation* in January 2018, the industry has come a long way – continuing to adapt and evolve to meet the changing needs of global supply chains.

The demand remains strong as buyers look to stabilise and strengthen their supply chains in the face of an uncertain macroeconomic environment. And as smaller suppliers, with credit ratings that make it difficult for them to raise their own facilities become more prolific in international trade corridors, a means of supporting them via their better-rated buyers is more important than ever. Corporates report an expansion of the number and type of suppliers being onboarded to payables programmes – with many anchor buyers extending their services to cover smaller suppliers. As this process plays out, the need to understand payables finance, its benefits, how to operate it, and how to account for it looks set to become business as usual.

And providers are meeting the demand with increasingly sophisticated programmes. The desire for sustainable supply chains, for example, is being met by financial incentives within payables programmes – giving suppliers an opportunity to monetise their sustainable performance. In addition, great strides forward have been made towards improving the customer experience – with new technologies and utilities, including the GLEIF project, SWIFT's KYC registry, and IBM's shared KYC blockchain solution, all having helped make onboarding faster, safer and more robust.

As we move forward business will likely continue to grow in efficiency, becoming more digital and more standardised. We look forward to taking this journey with you.

8

Appendix

Standard Definitions for Techniques of Supply Chain Finance

Background to Standard Definitions

Launched in 2016, the Standard Definitions for Techniques of Supply Chain Finance (hereafter Standard Definitions) were developed to remove the uncertainty and ambiguity surrounding industry terminology.

Before its publication, inconsistent, and even contradictory, language was used to describe payables finance (and SCF more broadly) – a product of the market's rapid evolution. The inconsistencies have historically complicated advocacy efforts and hindered the effective communication of SCF programmes in a complex ecosystem of providers, clients, accountants, legal professionals, and regulatory authorities.

The Standard Definitions were compiled by a team of 20 senior practitioners, specialists, and line-of business heads, with additional senior experts and industry leaders comprising the steering committee and providing overall direction to the effort.

Summary of definitions

1. Receivables Discounting: sellers of goods and services sell individual or multiple receivables (represented by outstanding invoices) to a finance provider at a discount (synonyms include Receivables Finance, Receivables Purchase, Invoice Discounting)

2. Forfaiting: the without recourse purchase of future payment obligations represented by financial instruments or payment obligations (normally in negotiable or transferable form), at a discount or at face value in return for a financing charge (synonyms include Without Recourse Financing, Discounting of Promissory notes/bills of exchange)

3. Factoring: sellers of goods and services sell their receivables (represented by outstanding invoices) at a discount to a finance provider (commonly known as the 'factor'). A key differentiator of Factoring is that typically the finance provider becomes responsible for managing the debtor portfolio and collecting the payment of the underlying receivables (synonyms include Receivables Finance, Invoice Discounting, Debtor Finance)

4. Payables Finance: a buyer-led programme within which sellers in the buyer's supply chain are able to access finance by means of Receivables Purchase. The technique provides a seller with the option of receiving the discounted value of receivables prior to the actual due date and typically at a financing cost aligned with the credit risk of the buyer

5. Loan or Advance against Receivables: financing made available to a party involved in a supply chain on the expectation of repayment from funds generated from current or future trade receivables (synonyms include Receivables Lending, Receivables Finance, Trade Receivable Loans)

6. Distributor Finance: financing for a distributor of a large manufacturer to cover the holding of goods for re-sale and to bridge the liquidity gap until the receipt of funds from receivables following the sale of goods to a retailer or end-customer (synonyms include Buyer Finance, Dealer Finance, Channel Finance)

7. Loan or Advance against Inventory: financing provided to a buyer or seller involved in a supply chain for the holding or warehousing of goods (either pre-sold, un-sold, or hedged) and over which the finance provider usually takes a security interest or assignment of rights and exercises a measure of control (synonyms include Inventory Finance, Warehouse Finance, Financing against Warehouse Receipts)

8. Pre-shipment Finance: a loan provided by a finance provider to a seller of goods and/or services for the sourcing, manufacture or conversion of raw materials or semi-finished goods into finished goods and/or services, which are then delivered to a buyer (synonyms include Purchase Order Finance, Packing Credit Finance)

Source: Standard Definitions for Techniques on Supply Chain Finance

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