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Supply Chain Finance

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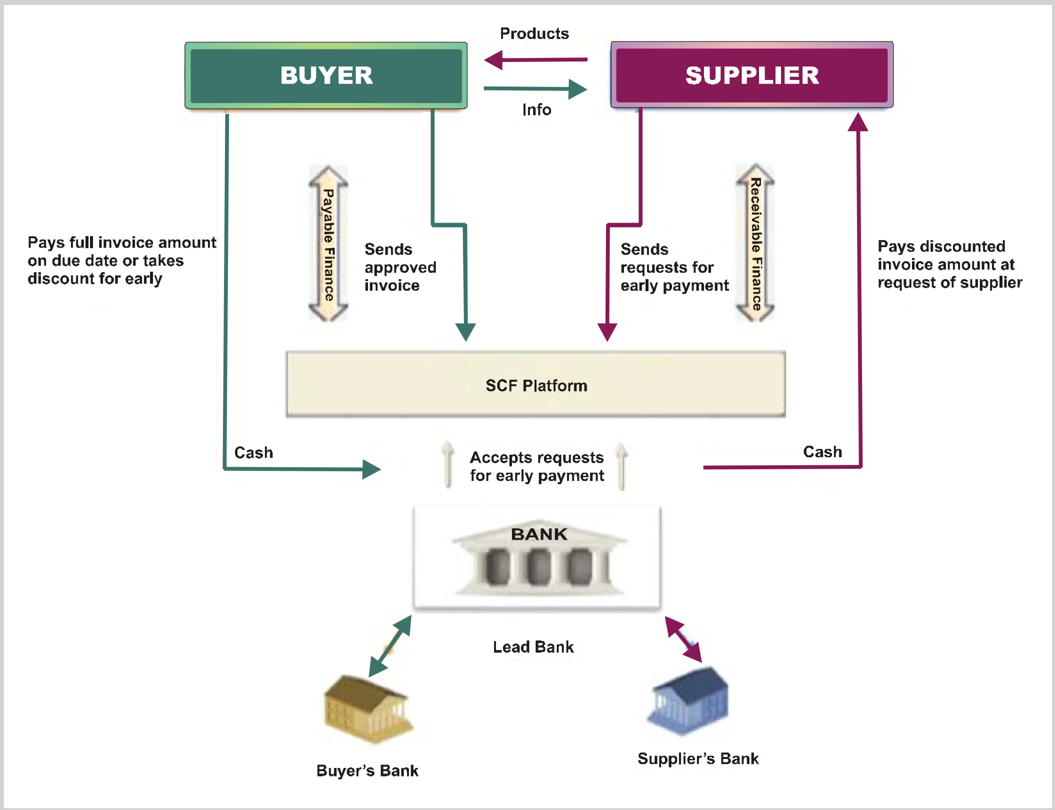
Accounts receivable financing is defined as "a continuing arrangement whereby funds are made available to a business concern by a financing agency that purchases the concern's invoices or accounts receivable over a period of time or makes that concern advances or loans, taking one or a series of assignments of the accounts as primary collateral security" (Raymond J. Saulnier, Neil H. Jacoby, 1943). According to Saulnier and Jacoby (1943), receivable financing has been in existence for centuries in the textile sector in the US. Later it got accepted as a financing mechanism in other sectors too. Originally, receivable financing was offered by Factors and finance companies. Only around 1933 commercial banks started offering receivable financing in order to increase their revenue. Since then receivables financing has evolved into many dimensions and it can also be referred to as Invoice Financing and Supply Chain Financing (SCF). European Banks Association has defined SCF as "the use of financial instruments, practices and technologies for optimizing the management of the working capital and liquidity tied up in supply chain processes for collaborating business partners - the buyer, the supplier and the financing institution" (European Bank Association, 2014).

The concept of SCF is one of the most promising tools for financing firms and has its roots back in the early '80s in the automobile industry. However, it did not really take off until after the burst of the recent economic crisis when it became widely used for businesses of all types and sizes. (Vousinas, Georgios, 2019).

Financial Instruments under SCF

Normally, the suppliers and buyers will have conflicting interests. That is, the suppliers would want early payment for the goods/services supplied and the buyers would like to delay the payments. In general, buyers are big companies and the suppliers are Micro, Small and Medium Enterprises (MSMEs) and hence the buyers have the bargaining power and be able to make the suppliers carry the inventory and to wait for longer period for receiving payments. MSME suppliers were perceived to be high risk customers and can avail finance from financiers at higher rate of interest. The higher rate of interest will be passed on to the buyers by way of charging higher price for the goods/services supplied. Realizing this the big buyers wanted to help the suppliers avail working capital at lower rate of interest. SCF instruments which enable building trust among the players (buyers, suppliers and financiers) offer the solution to this issue and provides a win-win situation to all the players. Figure 1 shows the relationship and flow of transactions among the SCF players.

Figure 1
SCF Circuit



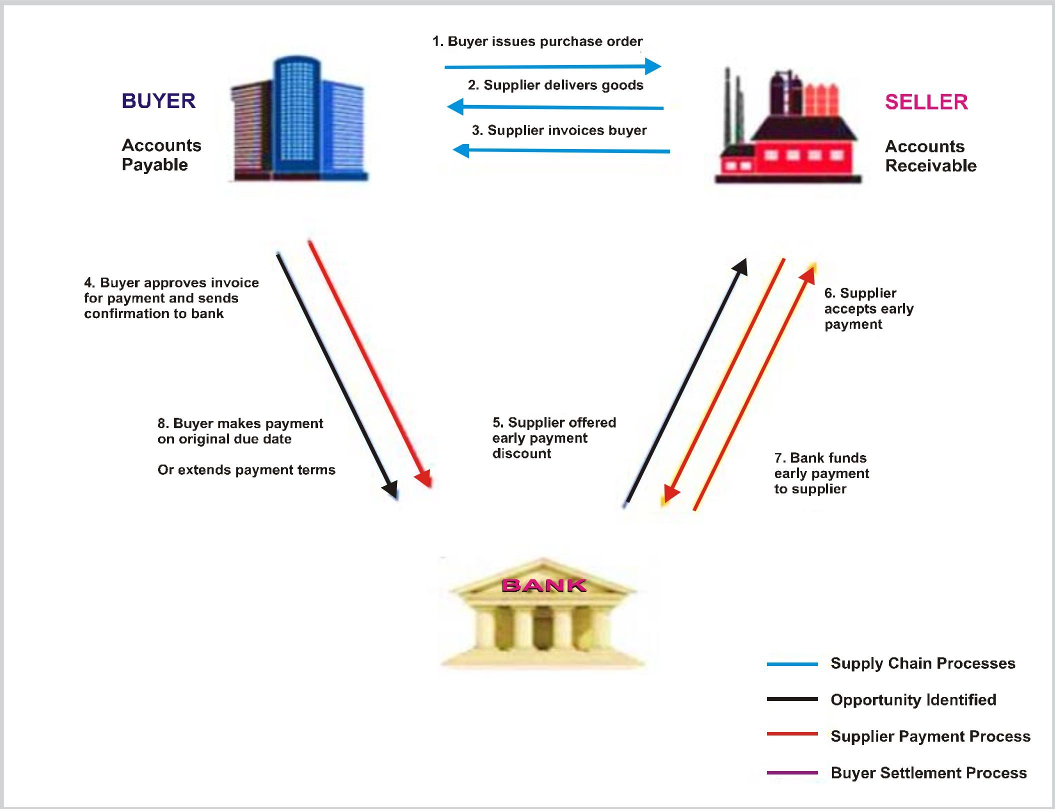
Source: Vousinas, Georgios, 2019.

Many financial instruments have been developed under SCF. More commonly used instruments are as below.

- **Receivable purchase:** Financiers purchase the accounts receivables of suppliers and provide cash to them. The financiers may either notify to the debtors or may not notify the debtors. If it is notified the financiers assume the risk of default by debtors (i.e., without recourse) and in case of non-notified finance the risk will remain with the suppliers (i.e., with recourse).
- **Invoice discounting:** Suppliers receive cash from financiers by discounting unpaid invoices with the financiers. The financiers offer cash equivalent to the invoice value minus discount. The discount may be, say, 20% for a 90 day invoice and hence the supplier may receive 80% of the invoice value. The discount will include interest for the advance and a fee for the services of the financier. The financier will get paid the full invoice value on the maturity date of the invoice. Under this arrangement the invoices are assigned to the financier as collateral and the supplier is responsible for collecting cash from its debtors and pay the financier.

- **Factoring:** Suppliers may sell their accounts receivable to a third party (Factor) who provides advance to the supplier and also undertakes collection of cash from the debtors. The debtors may either be notified about the sale of receivables or may not be notified. In case of notified factoring the factor assumes the risk of default by the debtor (i.e., without recourse) and in case of non-notified factoring the risk lies with the supplier (i.e., with recourse).
- **Reverse Factoring (The most popular SCF mechanism):** It is very similar to factoring. However, under reverse factoring the process is initiated by the buyer unlike factoring where the supplier initiates the process. Generally, the buyers will be big corporates enjoying high credit standing and can borrow money at very low rates of interest. Whereas, the suppliers who are small firms may be able to avail working capital at higher rate of interest or rather the banks may not like to lend money to them because of high risk. Whereas, when the buyer who is a big corporate initiates the process the supplier's risk will be equal to that of the buyer and hence the supplier can avail loan against its receivables at a rate of interest applicable to its buyers. The reverse factoring mechanism is depicted in Figure 2.
- **Forfaiting:** Forfaiting is nothing but assigning the export receivables to a Factor by the exporters. The factor, in this case, can also be referred to as forfaiter.
- **Dynamic discounting:** Traditionally, suppliers may offer cash discounts to buyers in order to get early payment for the goods/services sold. This mechanism does not provide flexibility to the buyer on when to make the payment. On the contrary, in dynamic discounting the buyer can decide when to make the payment and accordingly the cash discount. The discount will be higher if payment is made earlier and vice versa. Moreover, as dynamic discounting is done on a web based platform it also enables the buyer to select invoices for early payment. The suppliers too can initiate discounting under this mechanism. This benefits both the buyers as well as suppliers.
- **Purchase order financing:** Under this the suppliers get finance for confirmed purchase orders from financiers. This facilitates the suppliers to get short term finance, normally, for executing big orders at reasonable rate of interest. Purchase order financing enhances liquidity and thus the suppliers can accept more orders. This mechanism is facilitated by SCF platforms.
- **Asset based lending:** Banks offer loan against inventory and receivables and the inventory/ receivable financed is offered to the bank as collateral. In general, the banks take some other assets, preferably immovable properties, as additional collateral. This is one of the traditional method of working capital financing by commercial banks.
- **Inventory financing:** Some business firms may have to pay quickly to the suppliers than the time that they take to sell the products. For such firms loan is provided against the inventory.

Figure 2
Reverse Factoring Mechanism



Source: Vousinas, Georgios, 2019.

TReDS

Trade Receivables e-Discounting System (TReDS) is a mechanism offered on stock exchange platforms in India for facilitating discounting the receivables of MSMEs. The invoices can be uploaded on the platform either by the MSME suppliers or the corporate buyers. Three parties, namely, MSMEs (suppliers), corporates (buyers) and financiers are involved in the process of discounting. Financiers can quote their bids (discount) for the approved invoices. The supplier will accept the lowest discount rate and will receive cash from the financier who quoted the lowest discount. On the maturity of the invoice the corporate will pay the full value of the invoice to the financier. Currently, there are three RBI approved TReDS platforms in India. They are:

1. A TREDS Ltd. (Invoicemart)
2. Mynd Solutions Private Ltd. (M1xchange)
3. Receivables Exchange of India Limited (RXIL)

Merits of Supply Chain Finance

SCF offers number of benefits to all stakeholders including the suppliers, buyers and financiers.

Benefits for businesses (suppliers and buyers)

Major benefits of SCF to business firms are as below.

Access to liquidity: Suppliers' cash conversion cycle is reduced significantly and thereby improves liquidity. Particularly, MSMEs that are otherwise deprived of liquidity support from formal lending institutions are benefited tremendously by SCF.

Cleaner and stronger balance sheet: Sale of receivables will lead to enhancing liquidity and make the balance sheet cleaner and slimmer. Moreover, fund raised through SCF is not seen as debt and makes the balance sheet stronger.

Reduced financing costs: SCF is utilized by suppliers who sell their goods to highly rated corporates with strong market position and high credit risk rating and financiers consider the credit risk of the corporate and hence the rate of interest will be substantially lower.

Risk management: In SCF without recourse to the suppliers the risk of default by the buyers is passed on to the financiers. The suppliers thus are protected from the credit risk.

Eliminate early payment discounts: Supplier used to offer significant discounts to the buyers in order to motivate them to make the payment earlier than due date of the invoices. On the contrary, in SCF there is no need for early payment discount to be offered to buyers.

Benefits for financiers

The benefits of SCF to financiers are as follows:

Higher return: Risk in SCF is substantially lower compared to traditional working capital loans to MSMEs and hence the level of Non-Performing Assets (NPA) will be substantially lower. Therefore, banks need to maintain significantly smaller economic capital. The return on equity from SCF will therefore be high for the financiers.

SCF is self-liquidating in nature: Banks in India offer cash credit to business firms for financing working capital needs. Cash credit is a limit and every year the limit is reviewed and renewed. Whereas, finance offered under SCF will get recovered and closed on the maturity date of the invoices discounted. The financier's exposure therefore is for a short tenure and is self-liquidating in nature.

Cross selling opportunities: In SCF the financiers become a strategic partner in managing the operating cycle of suppliers as also the buyers. Financiers get to know the business firms and their financial service requirements better and hence can cross sell other services to them efficiently.

Conclusion

Receivable Financing which has transformed into SCF offers win-win situation to all the three parties including suppliers, buyers and financiers. Though it was present since many decades back the Global Financial Crisis 2008 triggered the need for increased adoption of SCF. Another major trend that is enabling the adoption of SCF by more players is the Fintech. There is tremendous potential for the SCF to grow in terms of number of financiers, suppliers and corporates and also the volume of funding. Given the benefits and technology facilitating adoption of SCF, in few years' time from now working capital requirements of business firms will largely be fulfilled by SCF.

Reference

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