Reverse Factoring – Benefits for All

A growing number of transaction banks are implementing supplier finance programmes for their large credit-worthy customers who wish to support their supply chain partners. Reverse factoring is the most popular model, enabling banks to provide suppliers with finance at a lower cost than they would normally achieve through direct credit facilities. The credit arbitrage is achieved by the bank securing an undertaking from the buyer (who has a higher credit rating than the suppliers) to settle all invoices at maturity. By financing the buyer’s approved payables, the bank mitigates transaction and fraud risk.

In addition to the lower borrowing costs and the off balance sheet treatment of these receivables purchase programmes, a further attraction for suppliers invoicing in foreign currencies is that by taking early payment they protect themselves against foreign exchange fluctuations. In return, the buyer ensures a more stable and robust supply chain, can choose to negotiate lower costs of goods and extend Days Payable Outstanding, improving working capital. Given the compelling benefits of reverse factoring, the market challenge is to drive these new programmes into mainstream acceptance.

Single Bank Versus Multi-Bank Platforms

The recent financial crisis has proved a harsh reminder of the importance of ensuring multiple sources of liquidity and avoiding over-reliance on any single bank for funding. The initial approach of many large banks had been to develop proprietary platforms designed to give them a competitive edge and lock in customers. But the use of a proprietary platform makes it difficult for a corporate to coordinate a group of banks and to satisfy the anticipated demand for supplier finance.

Corporates wishing to create supply chain finance programmes are increasingly recognising the value of multi-bank platforms which offer a range of automation capabilities, including the centralised co-ordination of supply chain finance programmes by a panel of liquidity provider banks and institutional investors.

Maximising Investment Return and In-House Sources of Funding

In addition to managing banking partners to fund supply chain finance, corporate using a multi-bank platform can use their own surplus cash to capture early payment discounts.

The most common discount offered by suppliers is 2/10 net 30, meaning a discount of 2% flat if the customer pays within 10 days, instead of at the 30 day maturity. This discount equates to a massive 36% annual interest rate (43% effective interest rate). Additional benefits can be achieved through dynamic discount programmes, where “ad hoc” discounts are proposed to suppliers, enabling them to better manage inbound cash flow by accepting discounts on a
sliding scale. This flexibility is built into benchmark independent payment and invoicing networks and ensures maximum liquidity for the supplier base.

**NEXT GENERATION FINANCIAL SUPPLY CHAIN AUTOMATION**

Large electronic payment and invoice network providers have a valuable role in the emerging supply chain finance space, given the synergies between invoicing, payments and finance. These service providers bring a wealth of technology experience in payments and invoicing, and already enjoy trusted partnerships with banks. Smaller platform providers only have the capacity to focus on a narrow aspect of the overall order-to-pay cycle (such as enabling suppliers to accept finance offers or reformatting e-invoices). Larger, collaborative platforms span the entire financial supply chain, covering for example, purchase order distribution, invoice submission, status updates, document matching, approval workflow, dispute management, payments, remittance advices and supply chain finance.

The value of a holistic approach is derived from timely and efficient invoice approval—a basic pre-requisite for any successful invoice-based supply chain finance programme.

**AN ANSWER FOR BANKS**

A growing number of banks have come to terms with the high cost and risk associated with efforts to run their own supply chain finance platforms. Today’s economic realities mean that few banks can embark on costly new initiatives into territories outside core competences, such as lending and payments. They are adapting to the new business environment and outsourcing the management of their platforms to trusted partners—typically those who deliver Software as a Service (SaaS) solutions with proven track records in payments and invoice automation.

A number of existing supply chain finance platforms face a challenge with their bank partners. Both parties need to make their living from the interest margin charged on financing. The sum of the interest skim taken by the platform provider and the risk margin required by the bank is high enough that the total margin applied to the supplier finance leaves the bank with an inadequate return. It can prove more attractive for banks to partner with service providers who are not solely reliant on an interest skim on supply chain finance.

**SUPPLIER ON-BORDING – THE MULTIPLIER EFFECT**

One of the major roadblocks to scaling supply chain finance initiatives is the need for bank adoption. It is therefore essential to have a dedicated team and proven process for bringing suppliers into the network. The fastest-growing payment and invoicing network is currently on-boarding suppliers at a rate of 2,000–3,000 per month, with an existing community of more than 100,000 suppliers.

The multiplier effect of a large payment and invoicing network means that a new buyer will find that a significant percentage of its suppliers are already enrolled. Thus, the buyer can reap immediate cost-saving benefits like early payment discounts.

**STEP BY STEP JOURNEY TO FINANCIAL SUPPLY CHAIN AUTOMATION**

Experience demonstrates that there is no “big bang” in financial supply chain automation. Banks and corporates can only succeed in this journey if they embark on a step by step migration. Different geographies and business sectors are at varying stages of the journey and advancing at varying speeds.

A global platform needs to cater to different geographies. In USA for example, checks are still widely used in business-to-business payments and it remains a major challenge to migrate from check payments to electronic payments, which are less costly and faster. Many US businesses are reluctant to share bank account details with customers, based on a fear of fraud. A neat way of overcoming this problem is gaining acceptance. Trusted electronic order-to-pay network providers securely hold bank account details on behalf of suppliers and add these routing details to electronic payments to ensure straight-through processing (STP) and settlement.

In Europe most suppliers already provide full bank account details on sales invoices, realising this improves their chances of getting paid quickly. In the European market greater value is placed on electronic invoicing, supplier collaboration and reconciliation services.

**PRE-SHIPMENT FINANCE**

Although most of today’s supply chain finance solutions focus on financing after invoice approval, the need for finance actually occurs at the point of purchase order acceptance when raw materials need to be purchased. Traditionally, this finance is made available by suppliers’ local banks. But with the shift towards open account, local banks no longer have the security of a letter of credit to ensure reimbursement once the required goods have been shipped. This change in market practice highlights the need for new solutions to meet the funding gap that open account has created. SWIFT’s new Bank Payment Obligation, being piloted on their Trade Service Utility, looks likely to deliver a 21st century solution in the form of an automated LC Lite, whereby a buyer’s bank undertakes to pay the exporter’s bank subject to the matching of data relating to purchase orders, invoices and other trade documents, replacing the manual checking required in conventional LCs. This risk mitigation will fit neatly into large financial supply chain automation platforms with growing networks of buyers and suppliers.

**A MASSIVE MARKET OPPORTUNITY**

Supply chain finance is in its infancy. Many innovations and financing models are yet to come. A combination of the visibility and risk mitigation afforded by large payment and invoicing networks and multiple sources of liquidity from corporates, banks and institutional investors will play a key role in increasing the efficiency of the financial supply chain. Meanwhile, the multiplier effect of large networks means they are ideally positioned to accelerate growth and drive bottom line benefits for their participants, corporates and banks alike.