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SMEs, Supply Chain Finance, And Regulations

Study on Regulatory Issues Affecting Trade and
Supply Chain Finance and SME Access

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Advancing Free Trade for Asia-Pacific Prosperity

Relevance of the study on supply chain finance



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- Finance is a **trade facilitation** component that is 'overlooked' in trade discussions
- Growth in efficiency of physical supply chain has outpaced growth in efficiency of financial supply chain
- Yet, supply chain finance holds **high potential, especially for SME financing**, especially in light of the increasing trend towards '**open account**' trade financing vs. traditional trade financing e.g. L/Cs
- What are impeding the growth and development of supply chain financing?

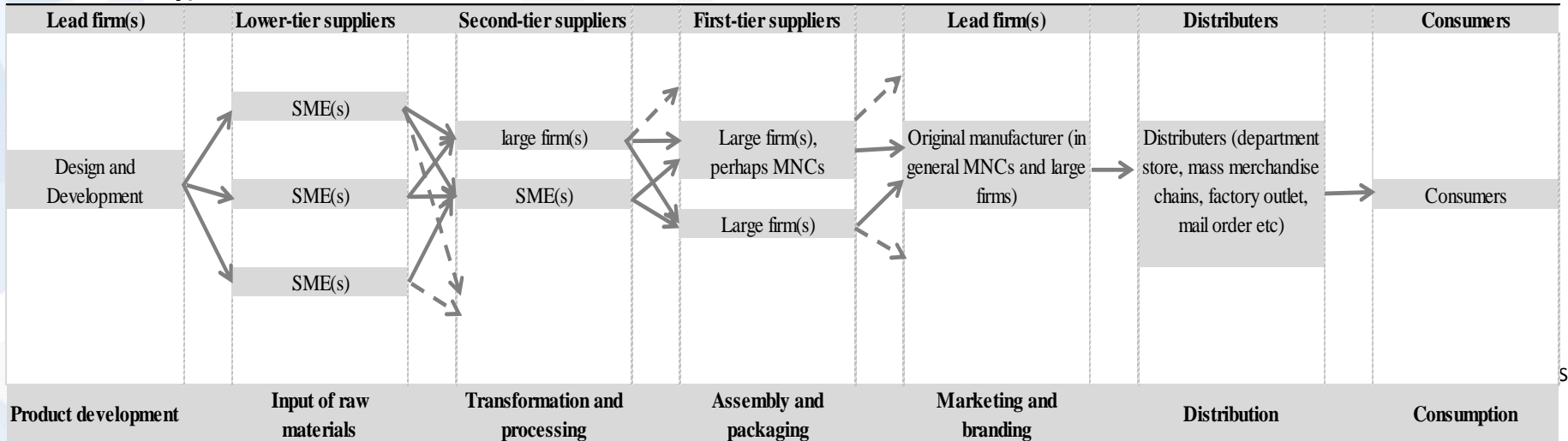
Supply chain and SMEs



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SMEs potential is stymied by lack of financing especially with increasing use of **open account trade financing.**

Example of a Global Value Chain (in one economy)



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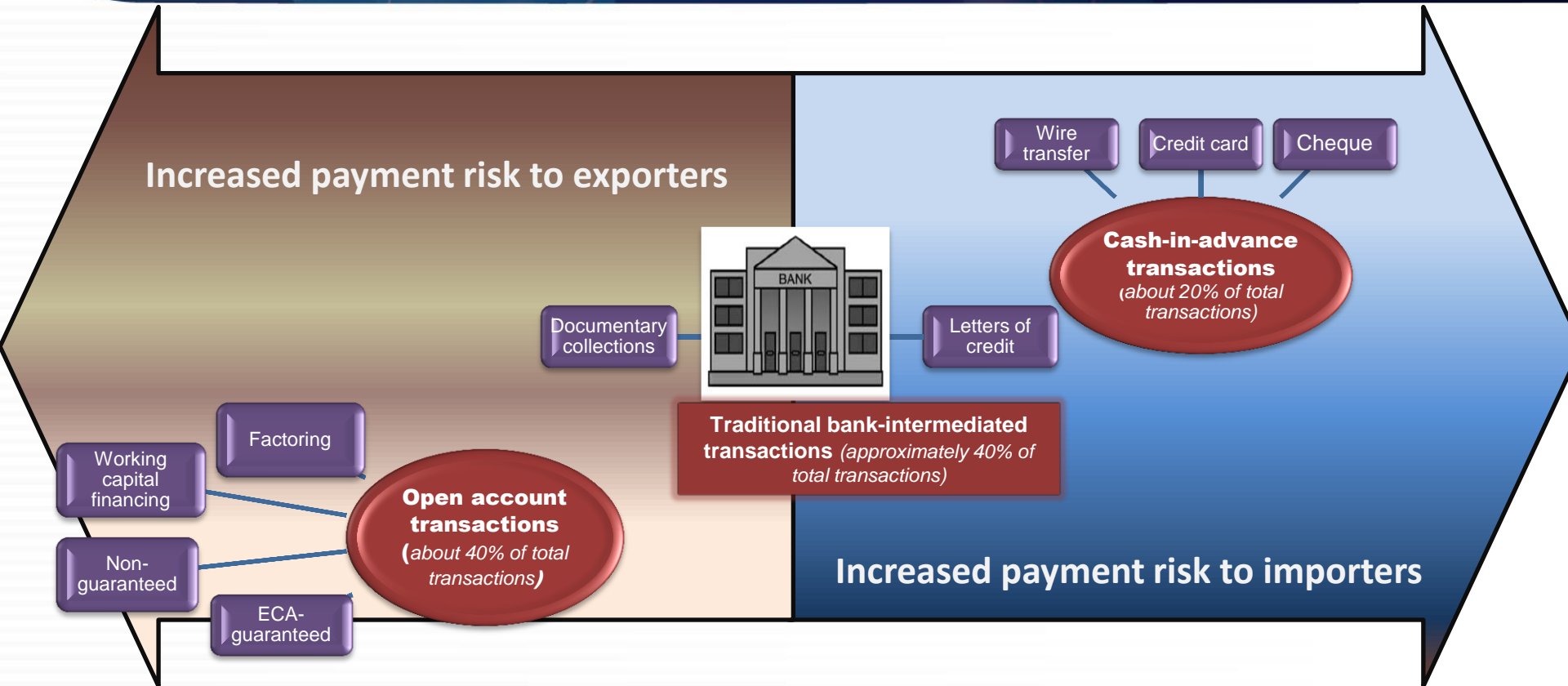
Large strategic suppliers may be MNC subsidiaries or arms-length large domestic corporates

SMEs are usually lower tier suppliers in GVCs; raw materials or intermediates suppliers to strategic suppliers

Methods of payment in international trade and the balance of risk



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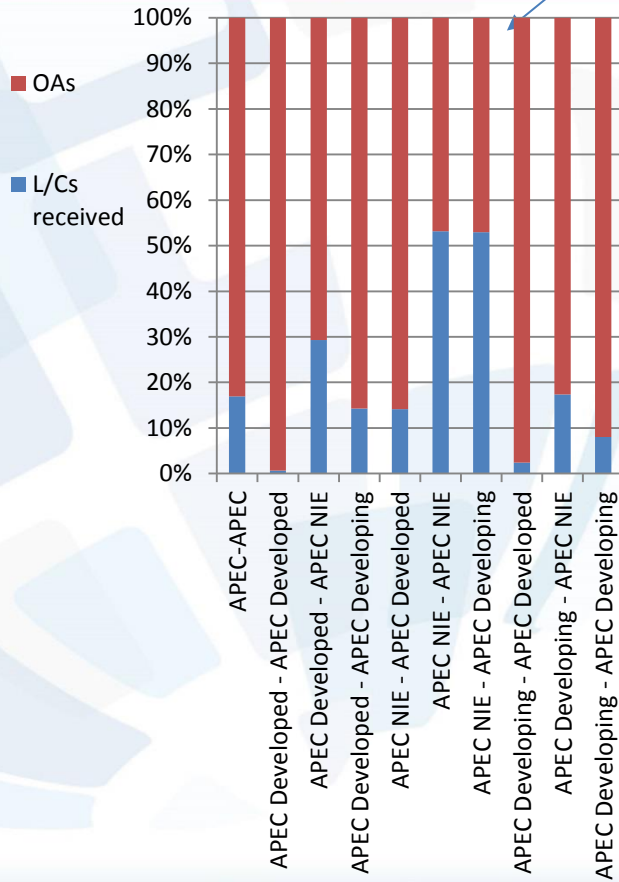


- Think of 'open account' transactions as akin to a 'buyers' credit'. Importers pay later after receipt of shipment.
- Increasing use of trade on open account terms squeezes exporters' working capital. Harder for SMEs

Trend towards more open account trade financing



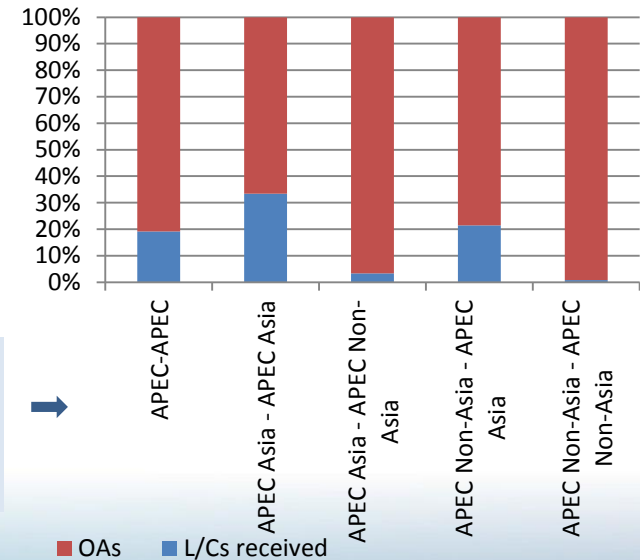
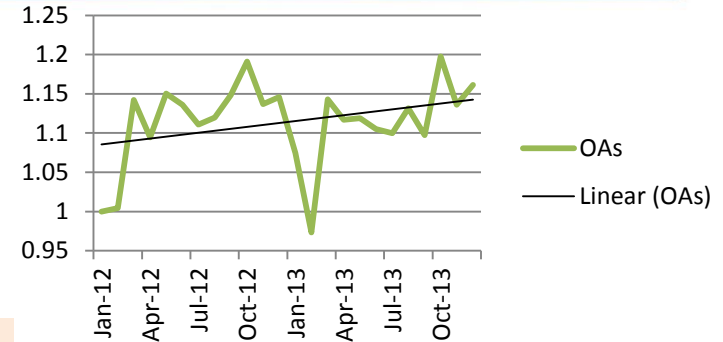
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Evidence shows increasing trend of open account trade financing

APEC developing economies' exporters are heavy users of open account trade financing

Large proportion of Asian exports are on open account basis



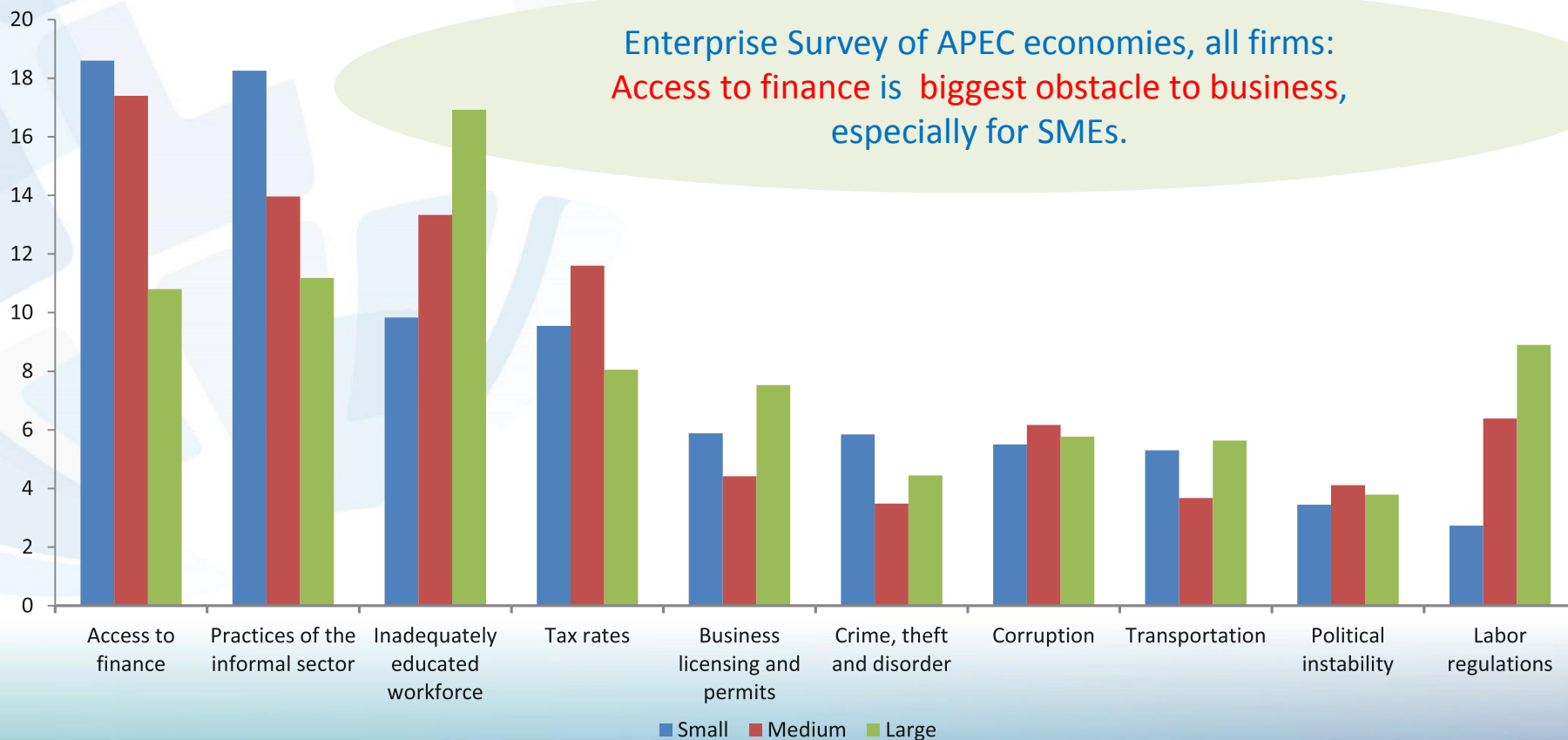
Increasing use of open account trade financing squeezes working capital of SMEs.

- Possibly part of the reason why firms, especially SMEs, consider access to finance as a major concern



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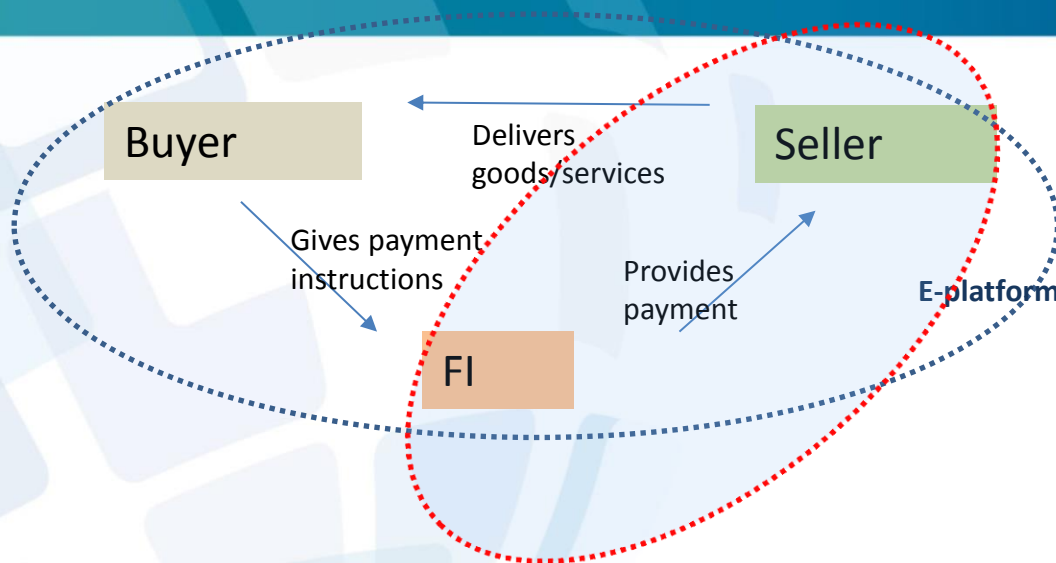
APEC, Small,
Medium, Large
Firms



Simple example: Buyer-led supply chain finance



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- Buyer usually asks its FI to **structure a supply chain financing** for its suppliers
- Provides FI with its **suppliers' list**
- FI **onboards suppliers** in the SCF platform after performing KYC

- With SCF, FI provides financing to seller (SMEs) **on the back of the buyer's creditworthiness**
- Cheaper rate
- Platform provides **visibility** that can trigger **financing at different stages** of the supply chain
- FIs use **different financing instruments** e.g. PO, AR, invoice financing, other pre-shipment or pre-export as well as post-export financing

Benefits of SCF



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- Under 'open account' trade financing' buyer's market position allows them to bargain for longer and **longer terms of payment**, which creates working capital problems for SMEs. Without sufficient funding, suppliers may be unable to deliver thereby **disrupting the buyer's supply chain**
- **SCF: helps supply chain stability** by allowing earlier payment to suppliers (reduce DSO- Days Sale Outstanding) , while allowing buyers to have longer payment terms (increase DPO- Days Payable Outstanding)
- Win for supplier, win for buyer, win for FIs.

Multiple variants of supply chain finance



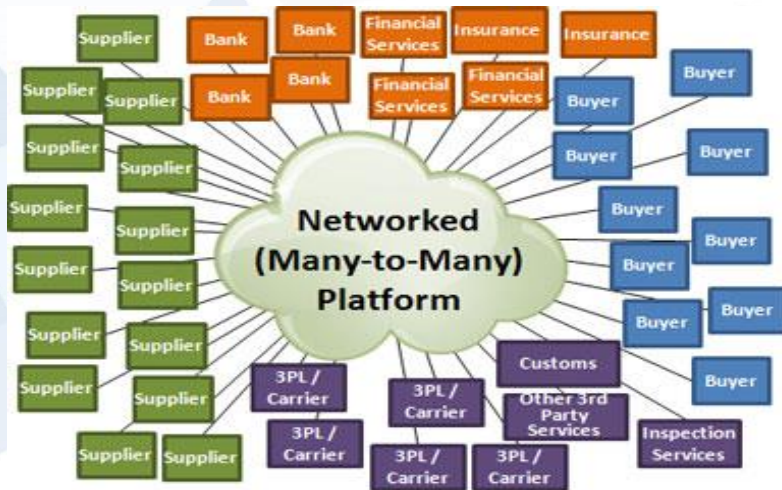
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- One bank, **buyer-led**, multiple suppliers + 3PL e.g. Walmart buying from suppliers
- One bank, **supplier-led**, multiple buyers +3PL e.g. General electric providing financing for buyers to purchase equipment
 - Credit quality check of buyers are more rigorous;
- Many FIs, one buyer, multiple suppliers + 3PL (**e-platform provided by third party provider**)
- Many FIs, multiple buyers, one seller +3PL (**e-platform provided by third party provider**)
- Many FIs, many buyers, many suppliers + 3PL e.g. Amazon
- Platforms can also be provided by FI or lead buyer or lead supplier or third party service providers or **government** (e.g. Mexico)

Examples of supply chain financing platforms



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Source: ChainLink Research

SCF makes financing possible at different points of the transaction lifecycle (even without recourse to a credit line and only a mouse click away)



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Issues affecting supply chain finance



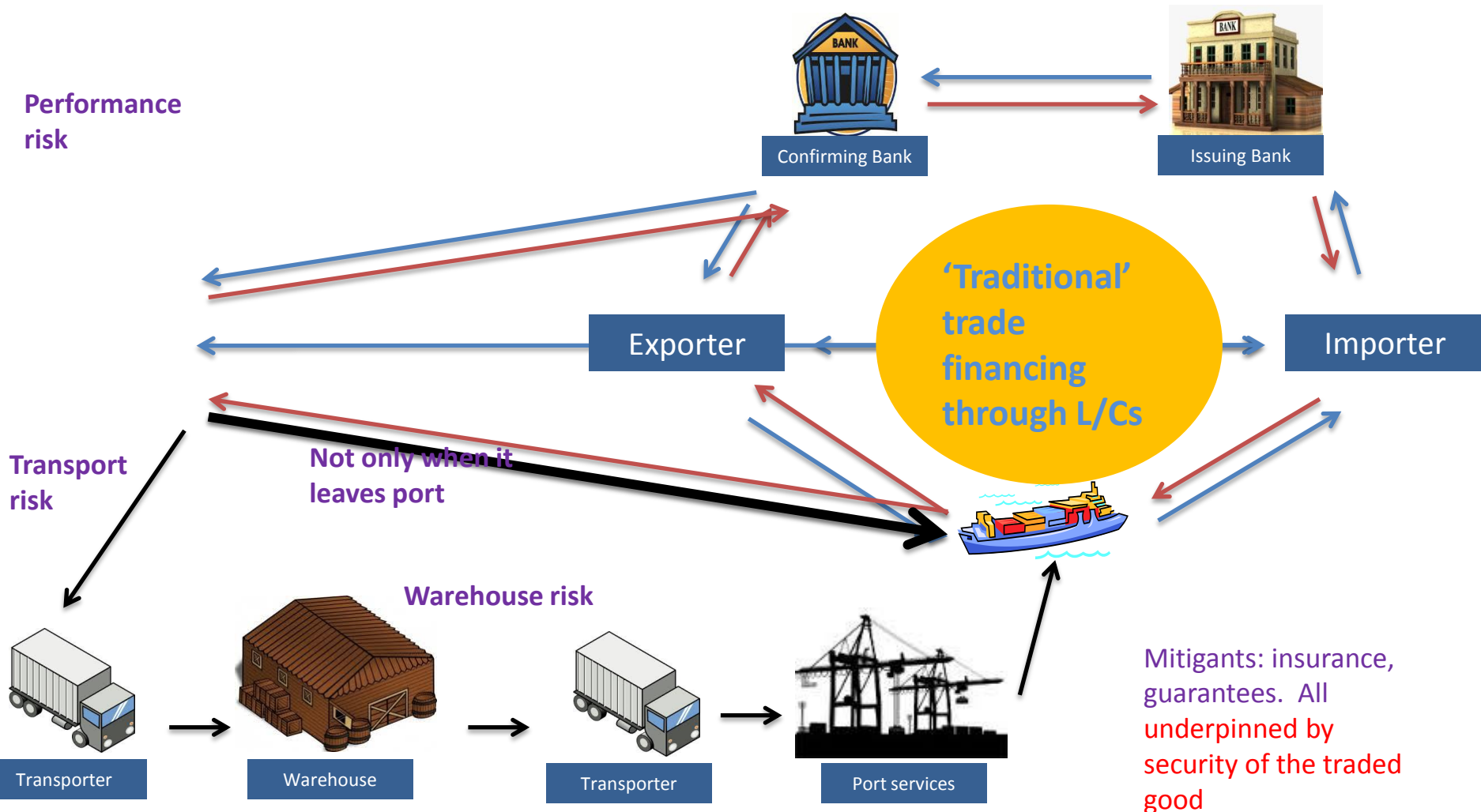
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- ‘Onboarding’ of each supplier in the platform requires multiple KYC/CDD/AML effort by banks;
- Having cross-border suppliers and different regulations in each jurisdiction compound the KYC difficulty.
 - ‘Policing’ expectations plus hefty penalties lead to increased compliance cost and exits from existing correspondent banking relationships
 - Eventually to expected higher cost of trade financing
 - Possibly, also to financial exclusion, especially of some developing economies and SMEs
 - Also to the rise of less regulated non-bank institutions that seek to fill the trade financing gap
- Higher capital requirements for trade finance due to Basel3 implementation is also expected to reduce the available trade financing lines by banks. Ongoing discussions
- Regulations on cross-border data flows (e.g. localization requirement) is another threat to the development of supply chain financing in developing economies because SCF e-platforms requires free flow of information.

Another way to look at supply chain finance is to consider the supply chain itself and understand factors that affect the granting of financing. A major issue is the quality of **secured transactions law** in various jurisdictions given risks at each stage of the supply chain.



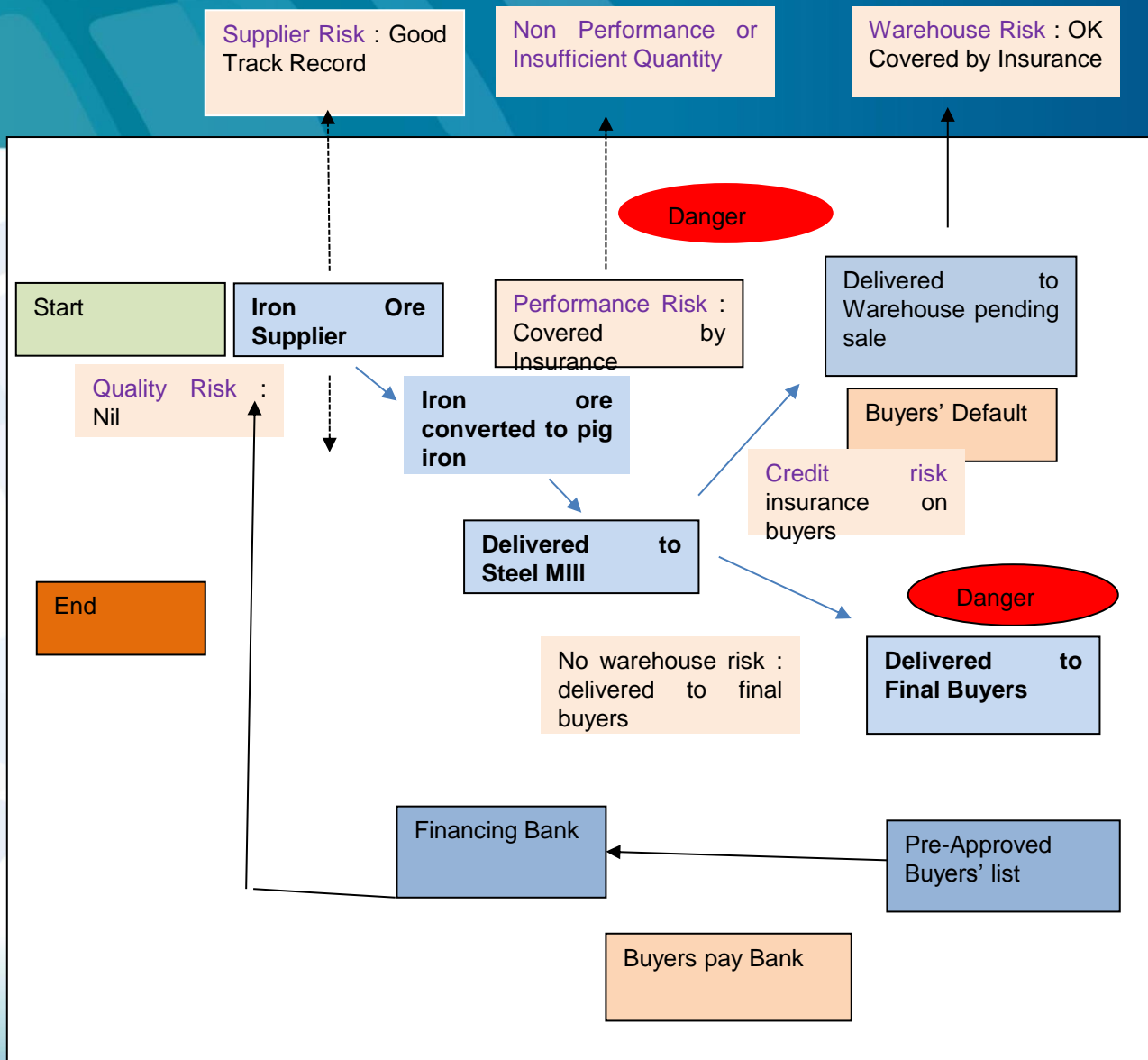
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Spectrum of risk



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Example: Qingdao metals; missing quantity in warehouse

One receipt used as collateral from multiple lenders => chase for collateral security

Key risks in the transaction

These have costs that add up



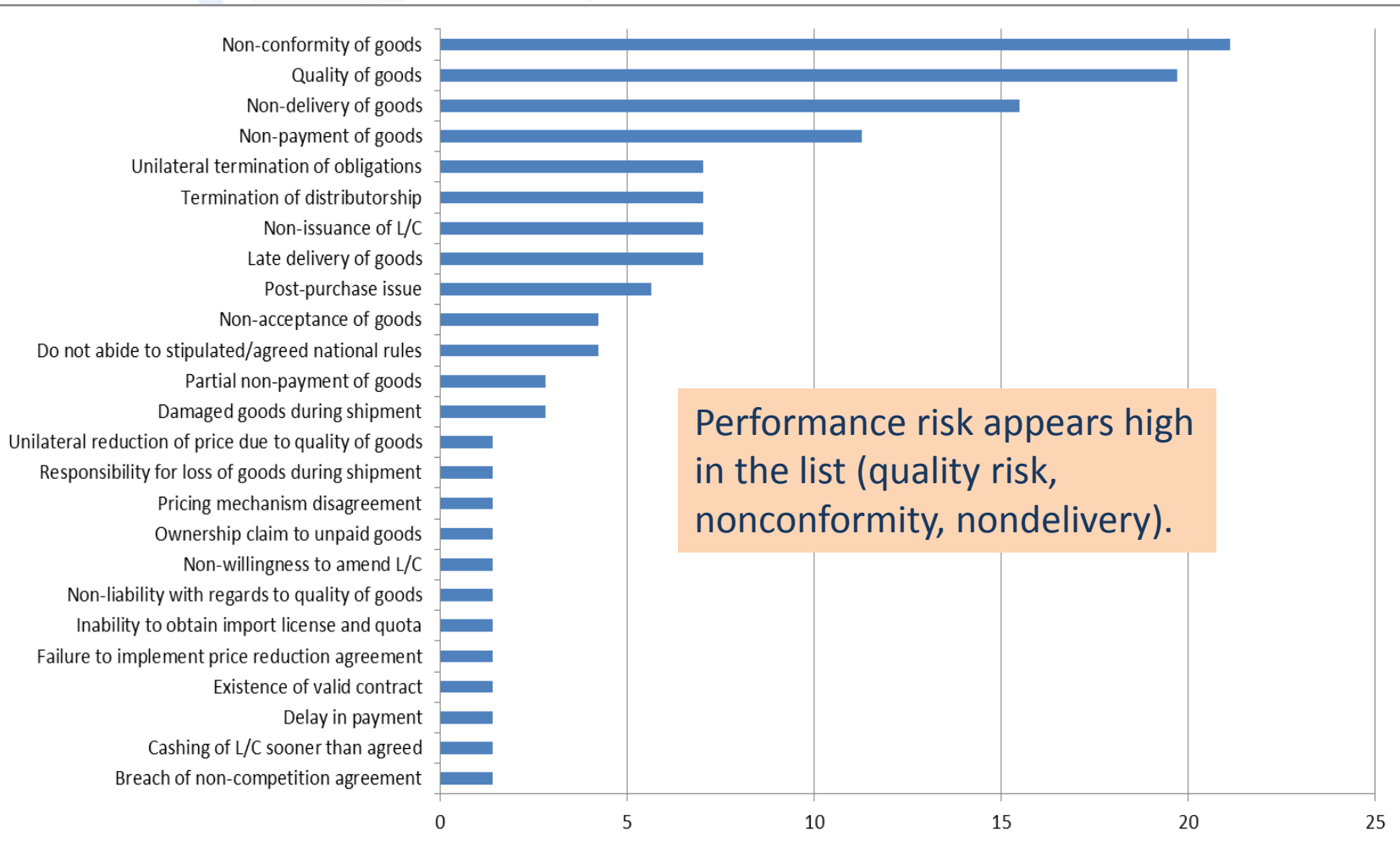
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Key risks	Probability	Impact	Risk Mitigant
1. Iron Ore delivery risk	Low	High	LC Payment
2. Quality, off specs risk	Low	High	Quality inspection certificate
3. Steel Mill production risk	Medium	Very High	Track Record
4. Steel Mill credit risk	Low	Very High	Good Balance Sheet
5. Sales Diversion Risk	Low	Very High	Contractual relationship with client
6. Warehouse reputation Risk	Low	Low	Fidelity Insurance
7. Buyer Credit Risk	Low	High	LC Terms ; Buyer Credit Risk Insurance: AA Rating
8. Political Risk affecting Payment	Low	High	Update situation of country; political risk insurance if necessary
9. Transportation Risk	Medium	High	Insurance
10. Country Risk	Low	Medium	Political Risk Insurance

Analysis of UNCITRAL cases gives an idea of what have gone wrong and can go wrong within the supply chain



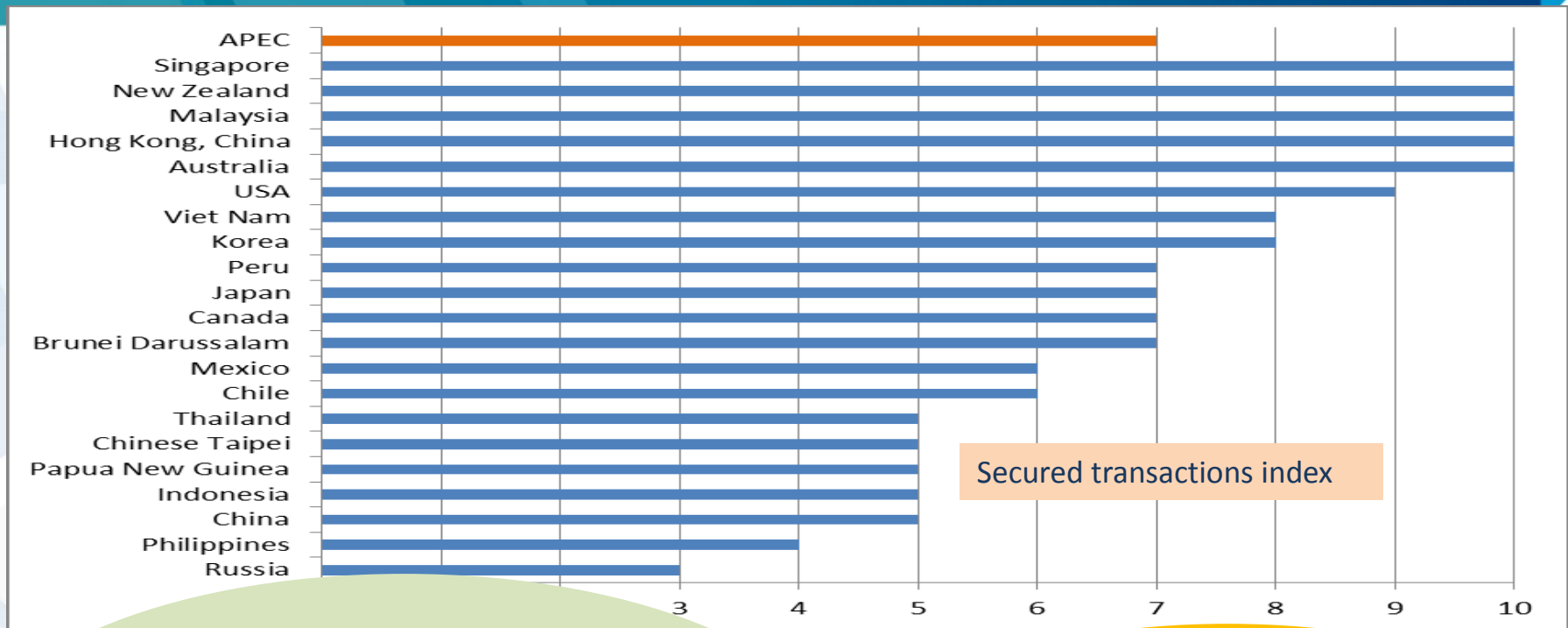
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What makes financing possible, despite risks, is if **security interests** can be cheaply and easily **created, perfected, and enforced**. In this regard, APEC Economies have varied secured transaction environment



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Financial institutions may still finance deals despite weak security interests **but for a higher price** (costs of mitigants at each point of the supply chain add up)

Else, they don't enter certain markets because of very high (hard to mitigate) risks => SMEs lose source of finance

Looked at from this perspective, the issues related to development of supply chain financing rest heavily on:



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- Quality of domestic commercial laws, regulations and enforcement.
Specifically, economies need:
 - A **clear legal framework** with broad permissible scope and sufficient creditor rights
 - A central and Internet-based **Collateral Registry**
 - Supportive banking regulations and supervisory practice
 - ✓ Including a friendly environment to create and operate non-deposit-taking lending institutions (NDTL)
 - Efficient and reliable support services (**collateral management companies**, credit enhancement companies, etc.)
 - Availability (or possibility to create) e-platforms linking up value chain actors

Recap of the Presentation:



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- ❑ Integrating SMEs into GVCs is an important topic because there are substantial benefits but huge barriers. **Finance** is an important concern especially for SMEs.
- ❑ Some thinking is needed to **balance** need to prevent 'unwanted' financial transactions and the **regulatory compliance burden** on FIs.
 - ❑ Current regulatory landscape is leading to **financial exclusion** (especially in emerging markets where cost of banking relationship has increased due to financial crime regulations compliance)
 - ❑ Economies can develop a central database or **KYC registry** to facilitate and complement FIs' own KYC effort.
- ❑ **Cross-border data flows** should remain free; **Balance** needed to protect privacy and need for data. Without information flow, not only supply chain financing but **trade is impossible**.
- ❑ Emerging markets need to improve the regulatory environment, enforcement and 'infrastructure' for credit e.g. through development of **collateral registry**, quality of **collateral management companies**, etc.

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