Challenges Involved in Embracing Financial Supply Chain Management

PI ETA Consulting Company

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Financial Supply Chain Management

- **What is Financial Supply Chain (FSC) Management?**
- FSC Management can be thought of as
  - **The management of the close and successful collaboration between Cash and Trade in an effort to improve and enhance working capital efficiency through seamless integration of the various processes involving cash and trade using systems automation, and the optimization of the cash and treasury management process.**

Financial Supply Chain Management

- According to Killen Associates:
  - "… a typical billion-dollar company spends approximately USD 27 million annually for unnecessary working capital and inefficient processing functions because they lack visibility into the financial supply chain and receivables"

The Challenges in Embracing FSC Management

- **What are the challenges in embracing FSC Management?**
  - **Timely reconciliation between Invoices and Inventory**
  - **Combining Shipping and Payment Information**
  - **Cross-border trades leading to Foreign Exchange Market Risks**
  - **Cashflow Liquidity Risks**

The Challenges in Embracing FSC Management

- **What are the challenges in embracing FSC Management?**
  - **Inefficient Management of Borrowing Costs**
  - **Credit Risks**
  - **Operational Risks**

Challenges in Embracing FSC Management

- **Timely reconciliation between Invoices and Inventory**
  - **If Invoices cannot be reconciled with Inventory in a timely manner, goods cannot be moved in good time. This can result in losses due to delays in processing and an increase in related costs.**
  - **Volume reconciliation is usually a challenge for most organizations.**

Challenges in Embracing FSC Management

- **Combining Shipping and Payment Information**
  - **If Payment Information cannot be reconciled with Shipping Information in a timely manner, goods cannot be moved in good time. This can result in losses due to process delays and an increase in related costs.**
  - **Volume reconciliation is usually a challenge for most organizations.**

Challenges in Embracing FSC Management

- **Cross-border trades leading to Foreign Exchange Market Risks**
  - **Managing Foreign Exchange Market Risks can be a challenge.**
  - **Due to varying deal sizes, often many deals may not be sufficiently large to warrant a deal-by-deal hedge, hence in order to hedge, consolidation of risk exposures is necessary.**
  - **Also, timing of exposures provides a challenge.**

Challenges in Embracing FSC Management

- **Cashflow Liquidity Risks**
  - Cashflow Liquidity Risks have to be included in FSC Management considerations.
  - Managing such risks is often also a challenge, as one has to be able to consolidate and manage the timing and amounts of liquidity available to the timing and amounts of liquidity required.
  - Tough balancing act with costs incurred that have to be managed.

Challenges in Embracing FSC Management

- **Inefficient Management of Borrowing Costs**
  - Has a linkage to Liquidity Risks Management.
  - Often times, there may not be any consolidation between various subsidiaries, units etc, and hence organizations do not enjoy the effects of netting.
  - Also, organizations may also tend to inadvertently borrow short-term money to resolve long-term cashflow requirements, leading to unneccessary increased costs.

Challenges in Embracing FSC Management

- **Credit Risks**
  - Credit Risk is due to a Counterparty failing or unwilling to meet its financial contractual obligations.
  - Failure of counterparties within the Financial Supply Chain to deliver on promises can lead to failures in parts of the system, and hence result in losses. Some of these failures are fatal!
  - Not many organizations (non-bank) participating in the FSC have properly set-up systems and processes to evaluate and manage such credit risks, and hence are subject to unmanaged losses resulting from such risks.

Challenges in Embracing FSC Management

- **Operational Risk**
  - **Basel Working Group defines Operational Risk as:**

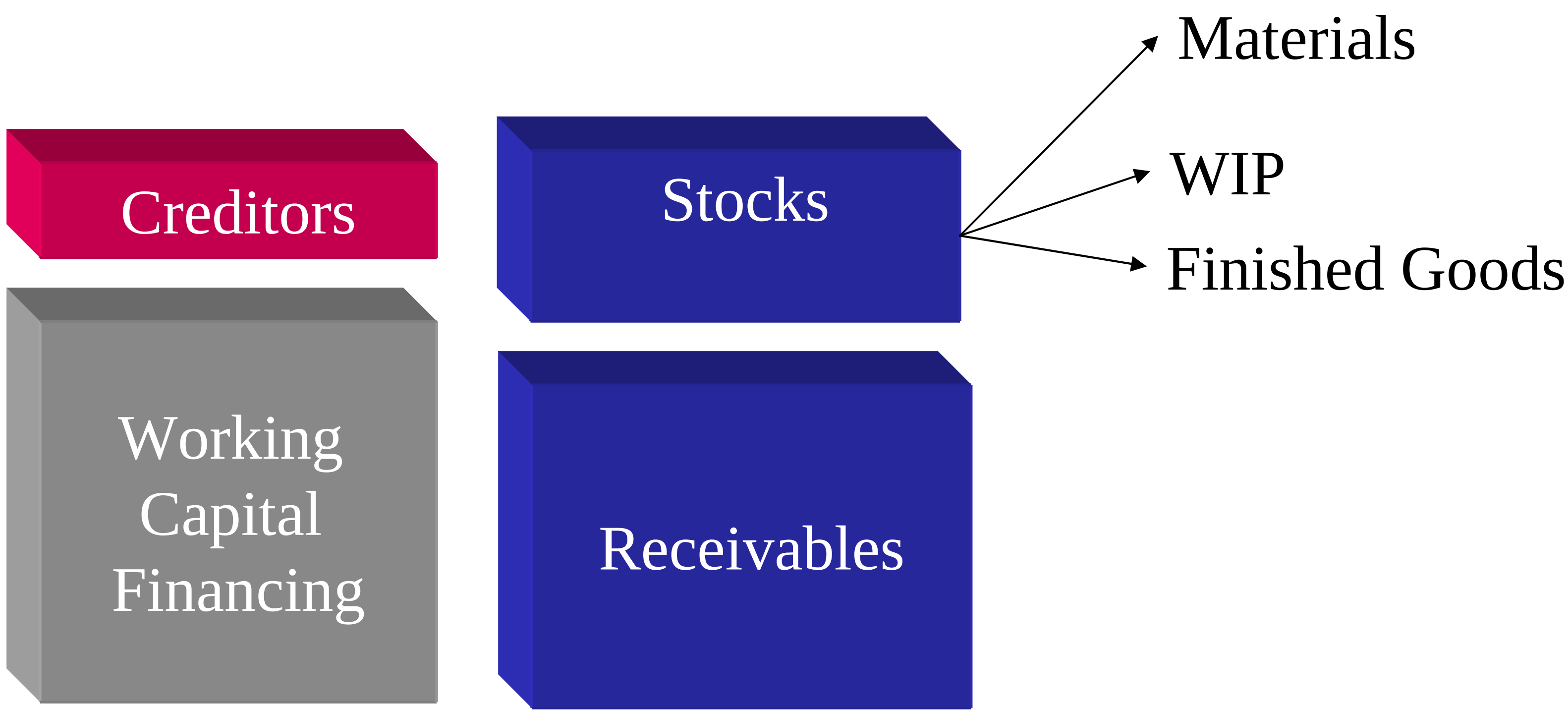
    "The risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems, or from external events."

Challenges in Embracing FSC Management

- **Operational Risk**
  - All processes within organizations are subject to Operational Risks Exposures.
  - Not many organizations (non-bank) participating in the FSC have properly set-up systems and processes to evaluate and manage such operational risks, and hence are subject to unmanaged losses resulting from such risks.
  - Some of these exposures can prove fatal!

Supply Chain Financing

Working Capital Requirement



WCF = Stocks + Debtors - Creditors

To Reduce the amount of WCF

↓WCF =↓Stocks +↓Debtors -↑Creditors

Reducing Inventory of Raw Materials and WIP

– Outsource many parts of manufacturing and distribution activities to external members the supply chain.

– Suppliers now manufacture more and therefore hold more work in progress and finished goods inventory.

– Part of the balance sheet now shifted to the supplier.

Limitations

Materials & Inventory

- Amount of supplier financing available is limited due to financial strengths of supplier

- This limit the amount of inventory that it can carry on behalf of the company.

Reducing Inventory of Finished Goods

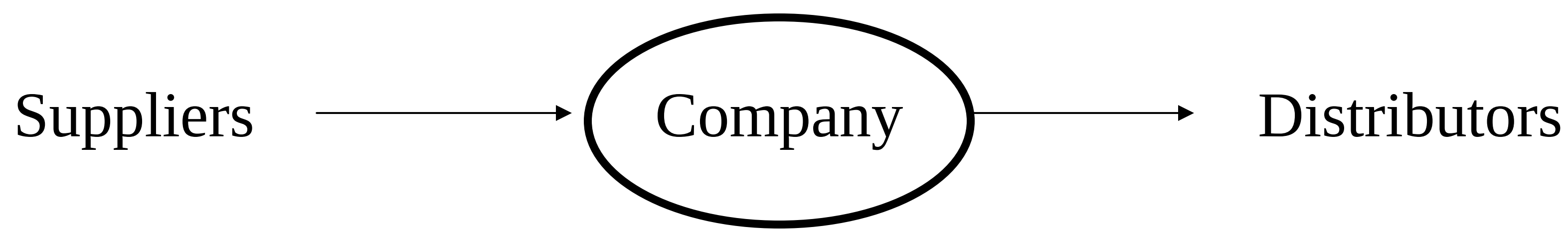
- Companies also push finished goods to their distributors as soon as possible, so that goods can be held closer to the consumer.

Limitations

- Distributors have limited financial capacity to hold inventory.
- Their own bank lines may be limited credit due to their credit standing.
- Company is limited by the credit exposure it is prepared to take on its distributors.

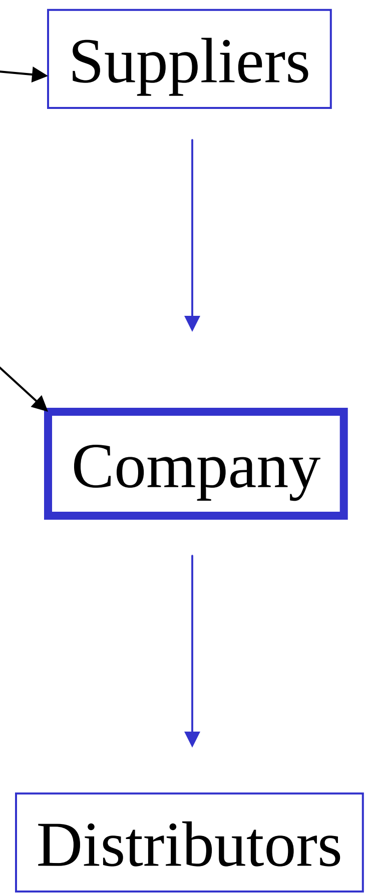
The Solution
– Supply Chain Financing

- Bank examines the company's supply chain and provides finance to key suppliers and distributors (Collectively described as channel partners)



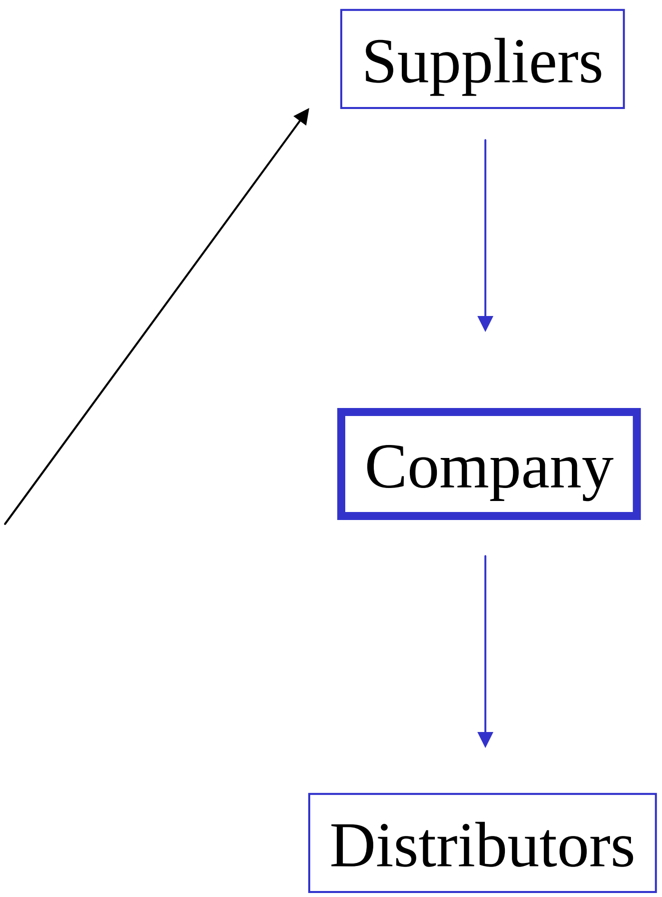
Supply Chain Financing

- The bank involved does not evaluate the individual channel partners on a stand-alone basis.
- It evaluates the company in terms of its
  - financial strength
  - market position
  - effectiveness of its supply chain management practices.



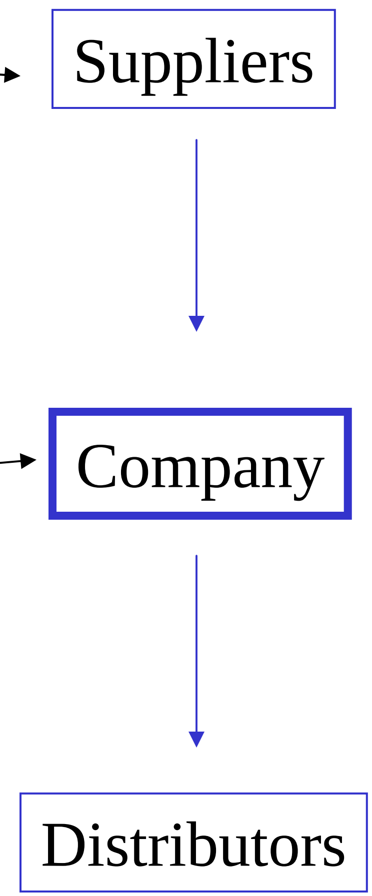
Supply Chain Financing

- If there is demonstrable 'stickiness' in the company's supply chain, the bank could set up facilities for the channel partners without any significant financial assessment of the individual links in the chain.
- Individual partners are assessed on:
  - position and importance in the overall supply chain and
  - their past trading history with the company.



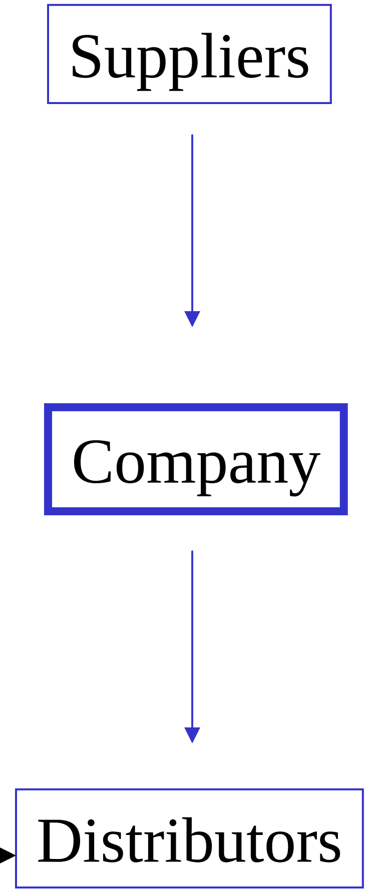
Supply Chain Financing

- Financing is provided only for that portion of the channel partners' business that has a direct transactional link with the company.
- By shifting the risk paradigm from the individual partners to the company, banks are prepared to finance the channel partners at better rates which in turn leads to better pricing



Supply Chain Financing

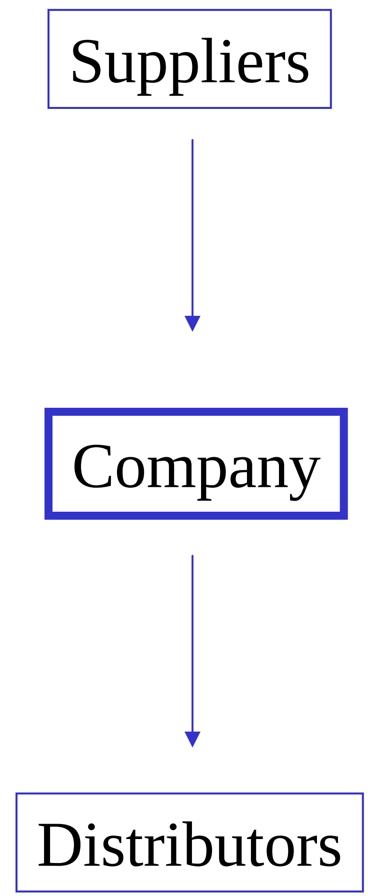
- One of the ways companies can increase sales through their distribution channel is by giving trade credit.
- Increasing sales by increasing the credit period can lead to higher risk for the company.



Supply Chain Financing

To mitigate the risks of trade credit given to distributors

- Export Factoring
- LC
- Silent Guarantees



Silent Guarantee

- Seller's bank tie in with a financially strong bank with a large presence in the buyer's country to provide silent payment guarantees in favour of the seller

- This guarantee will be issued without the express knowledge or consent of the buyer and will cover the seller against buyer insolvency and country risk.

A Brief Look At A Changing World

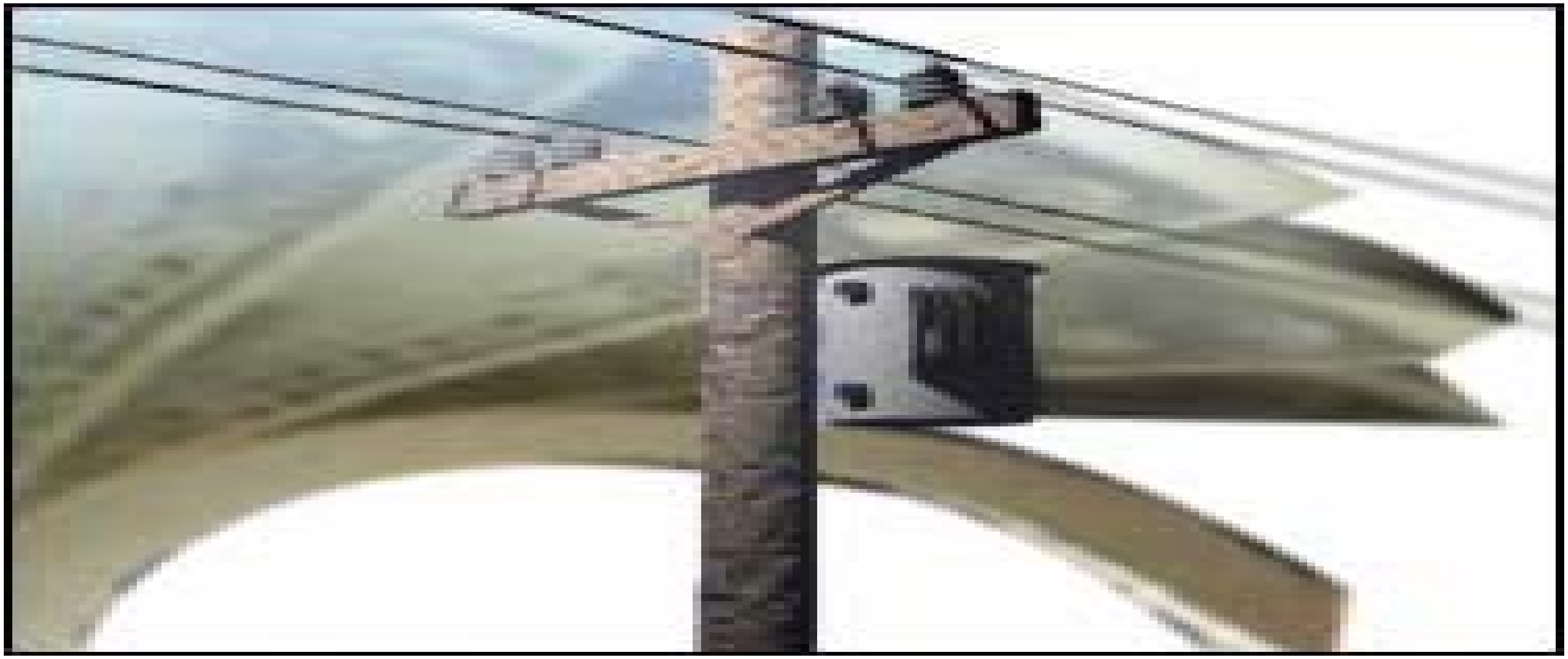
- **The Reuters Story**
  - **In the beginning,**

A Brief Look At A Changing World

- **The Reuters Story**
  - In 1849 Paul Julius Reuter, a German-born immigrant, first started transmitting stock market quotations using homing pigeons to fly stock prices between Aachen and Brussels, a service which operated for more than a year until the gap in the telegraph link was closed.

A Brief Look At A Changing World

- **The Reuters Story**
  - In October 1851,

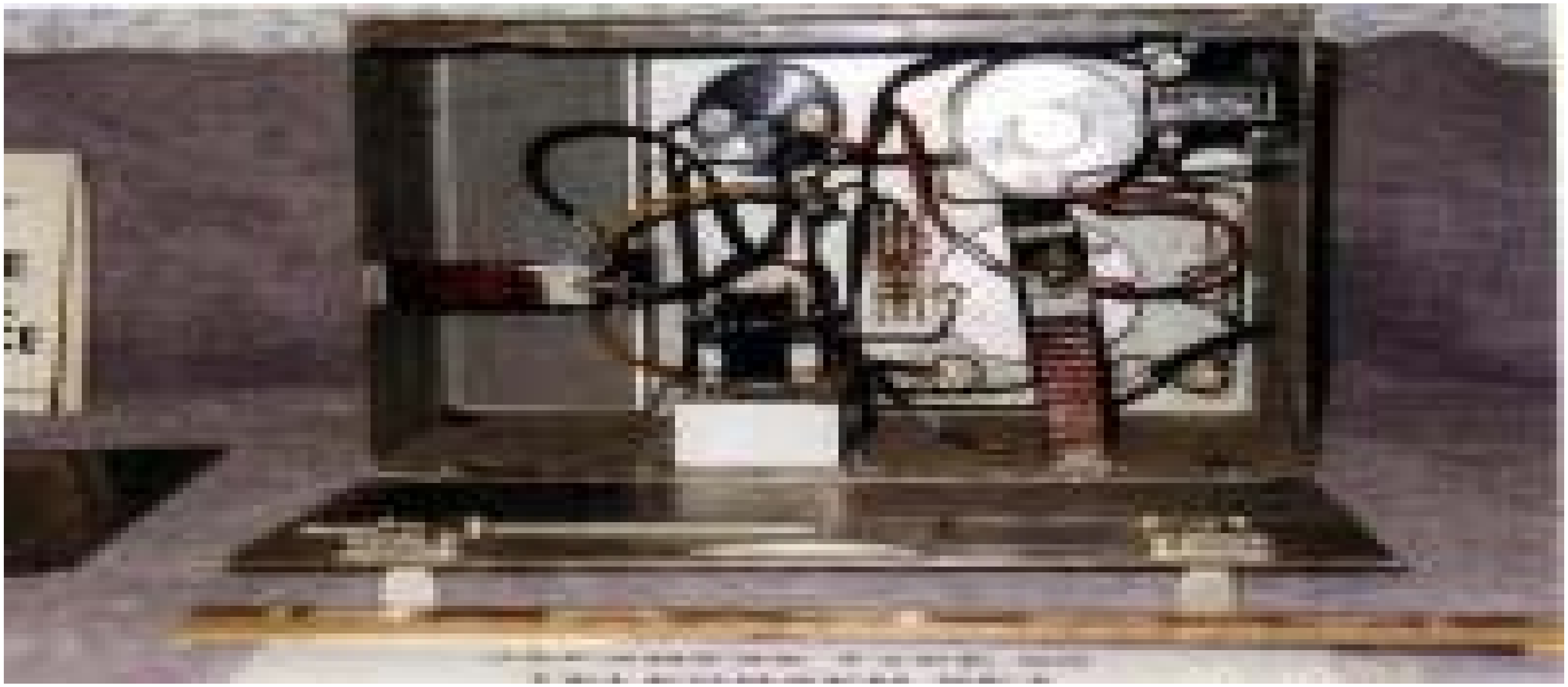


A Brief Look At A Changing World

- **The Reuters Story**
  - Paul Julius Reuter, the German-born immigrant, opened an office in the City of London which transmitted stock market quotations between London and Paris via the new Calais-Dover cable.

A Brief Look At A Changing World

- **The Reuters Story**
  - The Radio Telegraph



A Brief Look At A Changing World

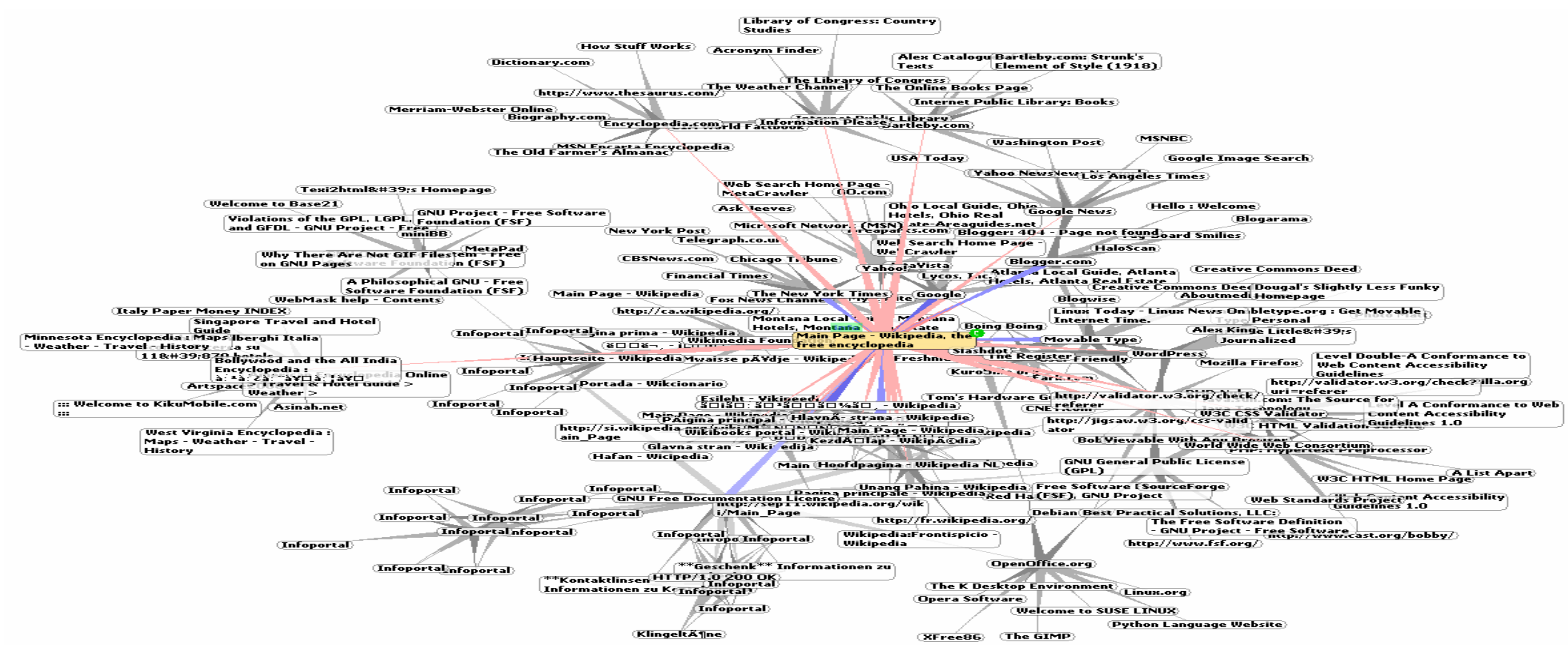
- **The Reuters Story**
  - As overland telegraph and undersea cable facilities developed, the business expanded beyond Europe to include the Far East in 1872 and South America in 1874.
  - In 1883 Reuters began to use a ‘column printer’ to transmit messages electrically to London newspapers and in 1923 pioneered the use of radio to transmit news internationally.
  - In 1927 it introduced the teleprinter to distribute news to London newspapers.

A Brief Look At A Changing World

- **The Reuters Story**
  - Mobile Technology

A Brief Look At A Changing World

- **The Reuters Story**
  - Internet Technology



A Brief Look At A Changing World

- **The Reuters Story**
  - Today, with the advent of the Internet age, whilst Reuters has embraced the new era, utilizing it to deliver its news in a faster and more efficient manner, reaching billions around the world; nonetheless, the internet has also made its business more challenging as news has become more readily available from other sources, and hence they have to find a niche for themselves.
  - A real challenge!

A Brief Look At A Changing World

- **Changing Rules of Engagement**
  - The Internet and Wireless technology has made the world a very different place to live in as compared to the world before.
  - The same technological advances whilst helping us to improve our processes, have also provided many added challenges.
  - We have less time to be reactive, and we need to be truly **proactive** in order to survive.

Managing Foreign Exchange Risk Exposures

- Organizations need to have a properly set-up framework, system, people and processes to manage Foreign Exchange Risk exposures.
- Mismanagement of such exposures can definitely lead to increased costs in running the business, and wiping out already thin profit margins.
- In extreme cases, entire businesses can be wiped out!

Managing Foreign Exchange Risk Exposures

- The larger organizations have already set-up Internal Treasury centres to assist in the management of Foreign Exchange Risk exposures.
- Centralizing the management of Foreign Exchange Risk exposures also allows the organization to enjoy the netting effect (where possible) and to enjoy better bulk quotation rates.

Introduction To Hedging Techniques

- **What does hedging mean?**
- ***Hedging*** is the act of entering into a financial transaction meant to eliminate risk or loss due to price or rate changes in currency, interest rate, security or commodity trading. A *perfect hedge* is a transaction which is not speculative in nature, and is meant to fix a specific rate or price level. Most hedges however are not perfect as there is usually still an element of risk left over.

Introduction To Hedging Techniques

Some common hedging techniques:

1. **Direct Hedge** - This technique requires one to hedge an underlying position with financial instruments that share similar price movements and trade in similar fashions.

Introduction To Hedging Techniques

Some common hedging techniques (cont'd):

2. **Cross Hedge** - This technique requires one to hedge an underlying position with financial instruments that are unlike the underlying.

Introduction To Hedging Techniques

Some common hedging techniques (cont'd):

3. **Dynamic Hedge** - This technique requires one to hedge an underlying position with strategies which are constantly being monitored and adjusted, hence the term *dynamic*.

Introduction To Hedging Techniques

Some common hedging techniques (cont'd):

4. **Static Hedge** - This technique requires one to hedge an underlying position with a strategy which attempts to completely "remove" the determinable risk exposure at the onset, and to leave the hedge to run the course without further adjustments, hence the term *static*.

Managing Interest Rate Exposures

- Organizations need to have a properly set-up framework, system, people and processes to manage Interest Rate Risk exposures.
- Mismanagement of such exposures can definitely lead to increased costs in running the business, and wiping out already thin profit margins.
- Often times, organizations are also “guilty” of using short-term financing for long-term working capital needs. This leads to unnecessary costs.

Managing Interest Rate Exposures

- There should be a measurement of base-line capital requirements and matching this with long-term financing.
- The larger organizations have already set-up Internal Treasury centres to assist in the management of Interest Rate Risk exposures.
- Centralizing the management of Interest Rate Risk exposures also allows the organization to enjoy the netting effect (where possible) and to enjoy better quotation rates.

Utilizing Technology to Better Manage Financial Supply Chain

- **The only way to keep up with an ever changing world (due to ever changing technological advances) is to fully embrace the use of technology to keep up the fight, and win in this technological world.**
- **However, systems on their own are “brainless”, it’s humans that have the benefit of brains!**

Utilizing Technology to Better Manage Financial Supply Chain

- **In order to thrive, Humans have to understand their environments in-depth, understand their own *realistic* requirements for survival, understand all the various tools available, and be able to assemble the necessary solutions to meet their real requirements for survival in the environments they operate in, utilizing the available tools in the most optimal manner possible to thrive.**

Utilizing Technology to Better Manage Financial Supply Chain

- **Failure is imminent to all who choose not to do so!**

PI ETA Consulting Co

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- Also, to learn more about our products and services in the Financial Risk Management area, you may wish to visit our website at :

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