Using Trade Finance to Diversify Suppliers and Reduce Supply Chain Risk

By Thomas Stapleton, People's United Bank

Even before the coronavirus pandemic swept the globe there were compelling reasons for middle market companies to diversify suppliers to de-risk their supply chain. In particular, the trade war with China and tariffs levied by President Trump got many business people thinking seriously about new sourcing strategies. Indeed, many types of events that could disrupt global supply chains seemed to suddenly come into sharp focus: civil strife, wars, and natural disasters from earthquakes to hurricanes to tsunamis.

But the COVID-19 crisis has accelerated this push to diversify. According to the Institute for Supply Chain Management, by the end of March severe disruptions were being reported in North America (9% for U.S. supply chains, 6% for supply chains elsewhere in North America), Japan and Korea (by 17% of respondents for each), Europe (by 24% of respondents) and particularly China (by 38% of respondents). "We're seeing further feedback that organizations who diversified their supplier base after experiencing tariff impacts, are potentially more equipped to address the effects of COVID-19 on their supply chains," said Thomas W. Derry, Chief Executive Officer of ISM, in a statement.

While expanding the number of suppliers and diversifying their geographic locations to mitigate risk makes perfect sense, adding new suppliers and switching from one country to another is not like hitting a light switch. There are tough issues to resolve involving the quality and quantity of goods being produced, as well as the logistics of shipping those goods to the US. There is also the issue of establishing the necessary trust between buyers and sellers to conduct large financial transactions.

Highlights

TRADE FINANCE TOOLS HELP MANAGE SUPPLY CHAIN RISK.

- The pandemic has accelerated the push to diversify business supply chains.
- Time-tested trade finance tools support new supplier transactions in developing countries.
- Letters of Credit (LOCs) and Documentary Collections help assure payment and shipment terms.

First consider the issue of quality, quantity, and transport. After decades of becoming entrenched at the center of global supply chains, China has well-developed manufacturing and transport infrastructures that make it relatively easy to manufacture and ship merchandise from within the country. It also has an enormous workforce that can meet demand quickly. By comparison, countries such as Vietnam have much smaller populations and much less developed manufacturing and transport infrastructures that need investment. While India offers a large, working population that provides cheaper labor than China, it too needs to upgrade its manufacturing and transport infrastructure significantly.

Beyond these issues of quality, quantity, and transport, is the fundamental issue of trust between buyers and sellers often separated by oceans and multiple time zones. There is naturally some uneasiness at the start of a new buyer/supplier relationship. Buyers are naturally worried if the supplier will fulfill the order on time and at the right specifications, and the supplier is naturally worried if the buyer is good for payment on time.

This is where a bank with a strong trade finance practice can help. The trade finance instrument of choice with a new supplier in a developing nation is the Letter of Credit (LOC). This time-tested tool is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount. In the event that the buyer is unable to make payment on the purchase, the bank covers the purchase. Due to the nature of international dealings, including factors such as distance, differing laws, and difficulty knowing each party personally, LOCs have been used for hundreds of years

For example, consider a hypothetical bank client that wants to import silk from a new supplier in Thailand. The supplier wants assurance of payment after shipment and the bank client wants assurance of shipment before payment. The LOC documents provided for payment show that the goods have been shipped and can be picked up upon arrival in the US.

Once a level of trust has been established, the buyer and supplier might opt for Documentary Collections instead of an LOC. Documentary Collections do not provide the same level of security as LOCs but their costs are lower. In this trade transaction the silk exporter would put its bank in charge of collecting payment for goods supplied. The exporter's bank sends the shipping documents to the importer's bank together with payment instructions. The shipping documents are exchanged for the payment, allowing the importer to pick up the goods in the U.S.

Eventually, these business partners might gravitate toward the near zero cost of direct wire transfers in what is known as an "open account". The bank no longer has a role except as a conduit for the transfer of funds through SWIFT and offers no guarantee. However, given that Documentary Collections cost as little as a few hundred dollars, even long-time business partners will often continue using Documentary Collections for peace of mind.

In the past, it may have seemed sensible and efficient to have just one or two supplier relationships to manage. But recent events have shown the dangers of this approach. Many companies essentially had all their eggs in one basket and they now realize they need to design a more resilient supply chain as quickly as possible. Trade finance products such as LOCs and Documentary Collections are valuable tools for companies as they expand their supplier base around the globe. ■

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