Study on the Function of Supply Chain Finance for SMEs Financing

HU Guohui, LI Fei
School of Economics
Wuhan University of Technology, P.R.China, 430070
whuthgh@yahoo.com.cn

Abstract The main purpose of this paper is to probe into the supporting function of supply chain finance for China’s SMEs financing. We firstly illuminate the background of supply chain finance and briefly describe its characteristics, and then discuss the operational modes of support chain finance, mainly analyzing three main financing operations; finally, we discuss the developmental situation of support chain finance and its applicability in China’s SMEs financing.

Keywords Supply chain finance; Small and medium-sized enterprises (SMEs); Financing

1 Introduction

As we all know, SMEs have become an important pillar of economic development and social stability of China. However, the shortages of funds have seriously affected their continuous growth and restricted the further development of China's economy.

One of the main reasons of SMEs financing problems is that the loan conditions of commercial banks are too strict. In order to reduce the credit risk, China’s commercial banks have established credit rating system, and only the customers of A, AA level and above can have access to obtain new loans. The banks have also generally raised the minimum capital conditions and loan conditions for their customers. However, the majority of SMEs is difficult to meet such high requirements and thus excluded from the banking credit system. In addition, China’s state-owned commercial banks have been operated as administrative organization in a long run, focusing on the state’s macroeconomic objectives, providing loans for the state-owned enterprises and are reluctant to grant loans for non-state-owned enterprises. This situation has changed in recent years, but still universal.

According to the traditional practice of bank credit, SMEs are considered as high-risk borrowers who need to pay higher costs. SMEs often obtained funds from the banks only through secured loans or mortgages, which have more complicated procedures, shorter terms and higher fees. Some guarantee institutions have tougher conditions than that of bank loans and even demand the counter-guarantees. It is estimated that the fees of handling a mortgage are generally around 0.5%-1%, and the average guarantee rates are around 1%-2%. These factors greatly increase the costs of funds and restrain the financing capacity of SMEs.

Seen from a deep insight, the problems of financing difficulties of SMEs not only affect themselves but also impose a limitation on the entire economic development. Due to large appearance of SMEs, China is gradually shaping a new organizational system of production based on the precise division of labor within industries, which have improved the production efficiency and reduced the cost of manufacturing. However, if the financial costs become too high, the competitive advantages of the new system compared to the traditional mode will be weakened and even lose. Therefore, how to change the modes of financing and reduce the financial cost of entire supply chain has become an important challenge to the new organizational system of production, and thus we can seek a solution for SMEs financing from the perspective of the entire supply chain.

In 2005, Shenzhen Development Bank, the domestic leader of supply chain finance, introduced the “1+N” service mode of supply chain finance in view of the situation of lack of funds of the domestic logistics enterprises and signed a overall strategic cooperation agreement with Sinotrans, CMST and the COSCO logistics. In the so-called “supply chain finance”, the three logistics companies exerted expertise in the transport of goods, warehousing, quality of supervision and management, while Shenzhen Development Bank provided the SMEs with innovative financial services based on cooperation partners controlling the cargo, logistics and the fund flows. Through the establishment of mutually beneficial and complementary core competencies of logistics financial platform, the bank and
logistics enterprises not only created a new mode for logistics enterprises in the financial services, but also shed a light on how to solve the problem of financing for the vast number of SMEs.

2. The characteristics and operational modes of supply chain finance

The "supply chain finance", simply put, is a financing mode that banks provide flexibility in the use of financial products and services through linking the core business with the upstream and downstream enterprises. Shenzhen Development Bank describes it as the "N + 1" model. From the purchase of raw materials to the manufacturing of intermediate and final products made, finally to the hands of consumers by the sales network, a specific commodity supply chain combine the suppliers, manufacturers, distributors, retailers and end-users up into a whole. In the supply chain, more competitive, large-scale core enterprise becomes the core of "1" due to its favorable position, and the upstream and downstream enterprises are precisely the "N". Supply chain finance is seeking a core business in the supply chain as the starting point to provide financial support for the supply chain. On one hand, funds will be effectively injected into SMEs which has relatively weak position, helping SMEs solve the financing difficulties and improve the balance of the supply chains; on the other hand, the banks’ credit will be integrated into purchase behavior of the upstream and downstream enterprises, strengthening its commercial credit and promoting SMEs to establish long-term strategic synergic relationship with core business to enhance the competitiveness of the supply chain.

Under Shenzhen Development Bank's "N + 1" model, the operational modes of supply chain finance can mainly be divided into three types: valet clearing business, warehouse receipts pledge business and confirming warehouse business. Next we will analyze each of these three businesses.

2.1 Valet clearing business

The process of valet clearing business is: in the course of shipping, the ownership of the cargo is transferred to the bank, the bank provides financing by a certain percentage according to the market. The consignor uses the funds to produce or purchase goods and then order the third-party logistics service providers to deliver, and the third-party logistics providers advance or deduct the cost of some or all of logistics costs. After the consignee repaying bank loans, bank sends the delivery signal to the third-party logistics providers, and the cargo will be returned to consignee. The third delivery logistics providers deliver the goods to consignee and charge accounts receivable according to the commission of consignor, and at last the third-party logistics providers and consignor settle the money.

2.2 Warehouse receipts pledge business

The process of warehouse receipts pledge business is: above all, the owners, banks and warehousing enterprises sign various cooperation agreements. The financial institutions grant certain
amount of credit to intermediation warehouse storage center according to its size, performance, operational status, the proportion of assets and liabilities as well as the credit level. The owner sends goods to the designated storage in accordance with the agreed number. When receiving the notice, warehousing enterprises offer a special warehouse receipt after confirming the goods; the owner has the warehouse receipt made for a pledge endorsement on the spot, and deliver a pledge loan applications to the bank after being signed by the warehouse. After auditing, bank sign the loan contract and warehouse receipt pledge contract, and sending the funds to the opened supervision accounts of the owner in the bank in accordance with a certain proportion of the value of warehouse receipt. If there will be a normal duration sale of the loan, the sale money will be assigned to the supervision account, and the bank will issue the bill of lading to the owner according to the money reached to the account and warehouse deliver the goods after verification by agreement; when loans are restituted due to maturity, the balance may belong to the discretionary funds of the owner.

![Figure 2.2 Warehouse receipts pledge business](image)

In the warehouse receipts pledge business, because the production and business activities of SMEs involved in the purchase of raw materials and the sale of finished products universally exists sales volume and seasonal characteristics, such materials stocks often take up a large quantity of valuable resources. Intermediation warehouse attract SMEs in the circumjacent region with its good warehousing, distribution and trade conditions. As the third-party storage center, the third-party logistics providers integrate the social storage resources and even their own warehouses to conduct pledge supervision to the nearest according to different customers, which greatly reduce the cost of pledge of customer, and help enterprises to obtain loans financing from financial institutions by the chattel deposited in the intermediation warehouse. And during the actual operation, owners repay the money for one or more times, which greatly ease the owner’s pressure of short-term capital flows.

### 2.3 Confirming warehouse business

The process of confirming warehouse business is: manufacturer, dealer, third-party logistics provider and bank sign "confirming warehouse" operational cooperation agreement. Dealer sign "purchase and sales contracts" with manufacturer and pays a certain percentage of deposit to the bank, the payment should not be less than the delivery price that dealer plans to deal with the manufacturer, and applying for opening a bank acceptance draft which be earmarked to pay loans to manufacture, the third-party logistics provider provides acceptance security and the dealer offer counter-guarantee to the third-party logistics provider. The third-party logistics provider determines the proportional amount of underwriting and collects regulatory fees according to the control of the sale of goods and inventory. After bank opening a acceptance draft to the manufacturer who will deliver the goods to the confirming warehouse, then the process turn to “warehouse receipts pledge business”. In the process above, manufacturer bear repurchase obligations.
In the confirming warehouse business, confirming warehouse takes on the business of acceptance security for manufacturer and delivering goods for dealers, financing enterprises can obtain the right that loans are paid and goods are picked-up in batches under the help of confirming warehouse business, which couldn’t require enterprises to pay for the full loans in one-time and effectively ease the pressure on the business of short-term funds.

From the bank's point of view, since confirming warehouse business needs repurchase commitment to the upstream enterprises, thus lowering the bank's credit risk; at the same time, the business not only can help the bank to discover new customer resources but also the opening acceptance draft can be provided jointly and severally liable guarantee by provider and can also be guaranteed by the cargo, which further reduce the risks borne by the bank.

3 The financing advantages of supply chain finance for SMEs

On the analysis of the three operational modes of supply chain finance above, we believe it has a great significance for supply chain finance to solve the financing problem of SMEs. For SMEs in the supply chain, the lines of bank credit of the core enterprise can be a great help to SMEs to activate their operations and obtain more business opportunities. For commercial banks, after taking full account of the movements in market demand and the characteristics of different types of products such as intermediate products and consumer goods, through linking domestic trade enterprises with foreign trade enterprises, linking consolidated credit with individual credit, they can provide financing portfolio for SMEs and promote their trade activities. The advantages of supply chain finance for SMEs perform can be specifically put as the following three aspects:

(1) Help SMEs solve the problem of lack of credit. In supply chain finance, the bank won’t only calculate the creditworthiness of one business but the trade relationships between enterprises. By providing finances to the whole supply chain, the funds will infiltrate into every tache of this transaction chain and activate the functioning of the whole industrial chain.

(2) Help SMEs solve the problem of collateral. The lack of collateral and the difficult implementation of collateral are the biggest problems encountered by SMEs to obtain funds from financial institutions. In the valet clearing business, SMEs can use the cargo as security. In the warehouse receipts pledge and the confirming warehouse business, the warehouse receipts and the goods can be used to be secured respectively. These securities have greatly lowered the risks of the third-party logistics and the bank, and thus became SMEs’ effective financing tools.

(3) Help SMEs solve the problem of information asymmetry and high cost. In the supply chain finance, bank can conduct the operational procedure and seek repayment guarantee on the basis of trade itself, and thus the credit business is closed, self-compensated and sustainable. This financial innovation adapt to the new system of production organization because it helps to reduce operating costs of SMEs in supply chain. At the same time, commercial banks can get better understanding of the credit and operating conditions of SMEs in the search for the whole supply chain, which will lower the cost to find information, and make it possible to overcome the obstacles of information asymmetry. On the other hand, the banks can be more reasonable to set the interest rates of lending, which can help to reduce enterprises’ financing costs and banks’ credit costs.
4 The development situations of supply chain finance

After 2005 when Shenzhen Development Bank introduced the supply chain finance, during a short span of one year, nearly 100 logistics enterprises have shared the financing facilities and the value-added benefits of the logistics financial platform. At the end of September 2006, Sinotrans, the COSCO logistics and CMST have obtained a total value of additional logistics and pledge supervision of 50 billion yuan. Many SMEs such as Chongqing Yongan Accessories Company and Chongqing Yongye Iron and Steel Company have also got great help from the supply chain finance.

Chongqing Yongan Accessories Factory produces accessories for a famous motor enterprise named Feixiang Motor. A few years ago, it has just completed the construction of a basic production line, and the production capacity has been improved. Due to the exports increasing, Feixiang Motor has signed a long-term supply contract with Yongan. However, the infrastructure construction had caused the shortage of the liquid funds, Yongan was desperate for raw materials to fulfill the orders, or it may go bankrupt. When Yongan feel helpless, Shenzhen Development Bank give loans to it on the basis of the core enterprise credit, accounts receivable and the inventory, raveling it out of the financial trouble; Chongqing Yongye Iron and Steel Company had mainly used cash to clear with upstream steel factory-PISC before the cooperation with Shenzhen Development Bank. The tight liquidity made it unable to pay in advance to PISC. By the end of 2005, the company began to contact Shenzhen Development Bank. The Chongqing branch of Shenzhen Development Bank designed a set of options to give the company 45 million yuan line of credit in a very short period of time after deep understanding the operational condition of the company.

Similar to the above two companies, there are thousands of enterprises across various regions benefiting from supply chain finance of Shenzhen Development Bank, which has successfully established the "professional trade financing bank" image through trade finance to the upstream and downstream SMEs around the core business. Now, Shenzhen Development Bank has integrated dozens of products (services) into the “supply chain finance”. Each enterprise on the supply chain node, such as raw materials suppliers, manufacturers, distributors and retailers, etc, can choose proper mode through a mortgage or pledge for its good or commercial paper.

In recent years, the new business of supply chain finance had attracted SPD Bank, ICBC, BOC, etc. These banks have begun to realize that the development of SMEs’ financing business is not only the demand of national policy but also the requirement of expanding bank markets and cultivating new profit growth point, and they have quickly embarked on the supply chain financing business. SPD Bank launched an “enterprise supply chain financing solutions”, ICBC introduced the “Wal-Mart vendor financing solutions” and BOC cooperated on supply chain finance with the Royal Bank of Scotland. However, as far as we know, during the operation, domestic banks have usually enlarged core business’s credit to support more enterprises in the supply chain. The real problem is that if these large enterprises have 10 banks to conduct similar credit, and the credit of the core business was extended 10 times, which may compel China into a period of credit expansion in trade area. Whether the enterprise is able to cope with such a huge credit growth? How could banks manage such so tremendous growth risks? These problem triggered by supply chain finance need be solved properly.

5 Conclusion

SMEs have played a significant role in China's economic development. However, due to some defects of its own and the imperfect of China’s financial system, both direct and indirect financing of SMEs are underdeveloped. At this time, the new financial product of “supply chain finance”, caters to the present market, substantially solves the financial problems of some SMEs and give others hope. The modes of supply chain finance increase the option of financing methods and opportunities for SMEs and greatly reduce the risk of participants in the business. Along with the participation of more commercial banks as well as the appearance of more businesses, the “supply chain finance” will get a broader development to meet the needs of SMEs and thus promote economic development in China.
References