WHITE PAPER

Dynamic discounting – Reshaping corporate banking?

Preparing for disruption in corporate banking business models

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Alert: Looming disruptions ahead in the net interest income maximization paradigm of corporate banks

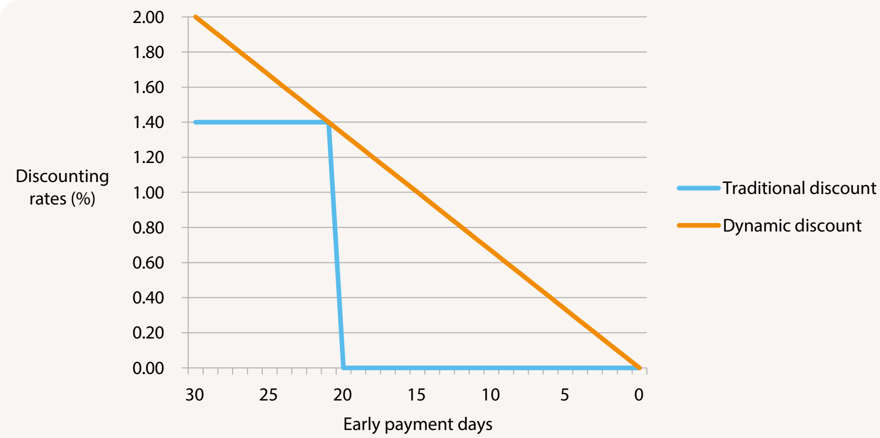
Corporate bankers accustomed to the time-tested practice of lending at X percent, paying depositors at Y percent, and living off the spread, i.e., (X-Y) are in for a rude awakening in the near future. A relatively new breed of dynamic discounting fintech platforms could be disrupting fundamentals of the banking industry by downsizing volumes of short-term corporate bank deposits, while simultaneously reducing accounts receivable credit disbursements.

Though skeptics may ignore such suggestions of disruption without a second thought, it might be prudent to consider a few salient data points pertaining to dynamic discounting platforms:

- More than 1,000,000 buyer-supplier relationships were enrolled in Taulia's network, a dynamic discounting platform, as on September 20, 2016
- US$1.4 billion transferred as early payments on Taulia's platform during six months ending July 31, 2016
- Taulia reported 200 percent y-o-y growth in new bookings in Q2 2016
- Collaborative Cash Flow Optimization (C2FO), another dynamic discounting platform, reported 425 percent y-o-y growth in working capital flows in Q3 2015

Why dynamic discounting, and why now?

While the concept of discounting is certainly not new, traditional 'X/Y net 30' discounting models have been hamstrung by the relative inflexibility of zero discounts for early payments beyond the Yth (cut-off) day. Significant adoption of electronic invoicing, enhancements in automation, self-service capabilities, and integration with enterprise resource planning (ERP) systems have created an enabling ecosystem for the emergence and growing popularity of technology-driven, dynamic discounting platforms. These platforms calculate discounts dynamically on a sliding scale, driven by early payment days and a pre-agreed annualized percentage rate (APR), thereby clearly offering a flexible alternative to traditional discounting as shown in Figure 1.



Camparing discounting rates across 1.4/10 net 30 traditional discounting vs. 24% APR dynamic discounting with 30-day early payment period

Figure 1: Comparison between traditional and dynamic discounting

Dynamic discounting, despite having been around even before 2010, has recently moved closer to mainstream in the US and continental Europe, while being in an early adoption stage in the Asia region (refer Figure 2).

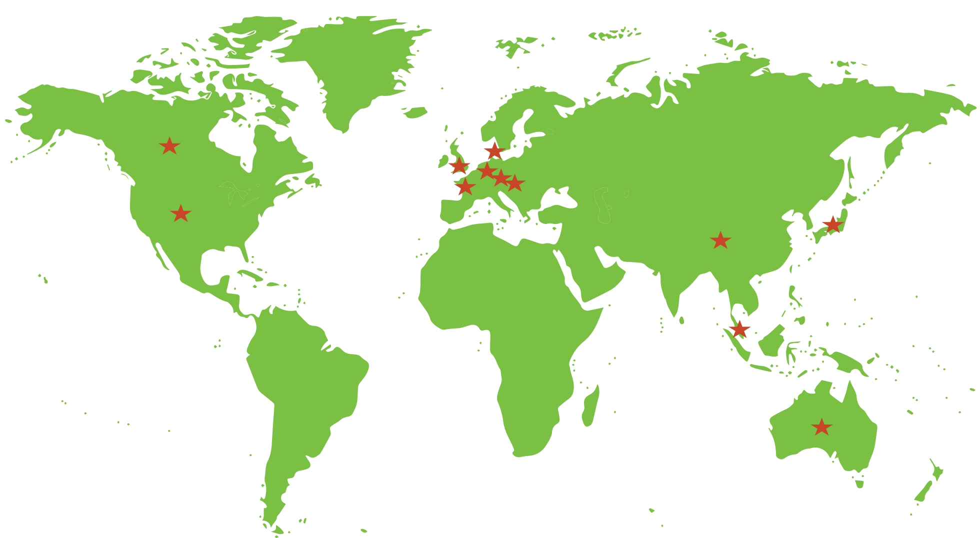


Figure 2: Global dynamic discounting adoption footprints

Adoption has been aided by competitive yields from early payments (refer Figure 3), coupled with enabling regulatory tailwinds in Europe in the form of EU's e-invoicing in Public Procurement Directive 2014, which stipulates that all public bodies have to accept electronic invoices by 2020, a pre-condition for dynamic discounting.

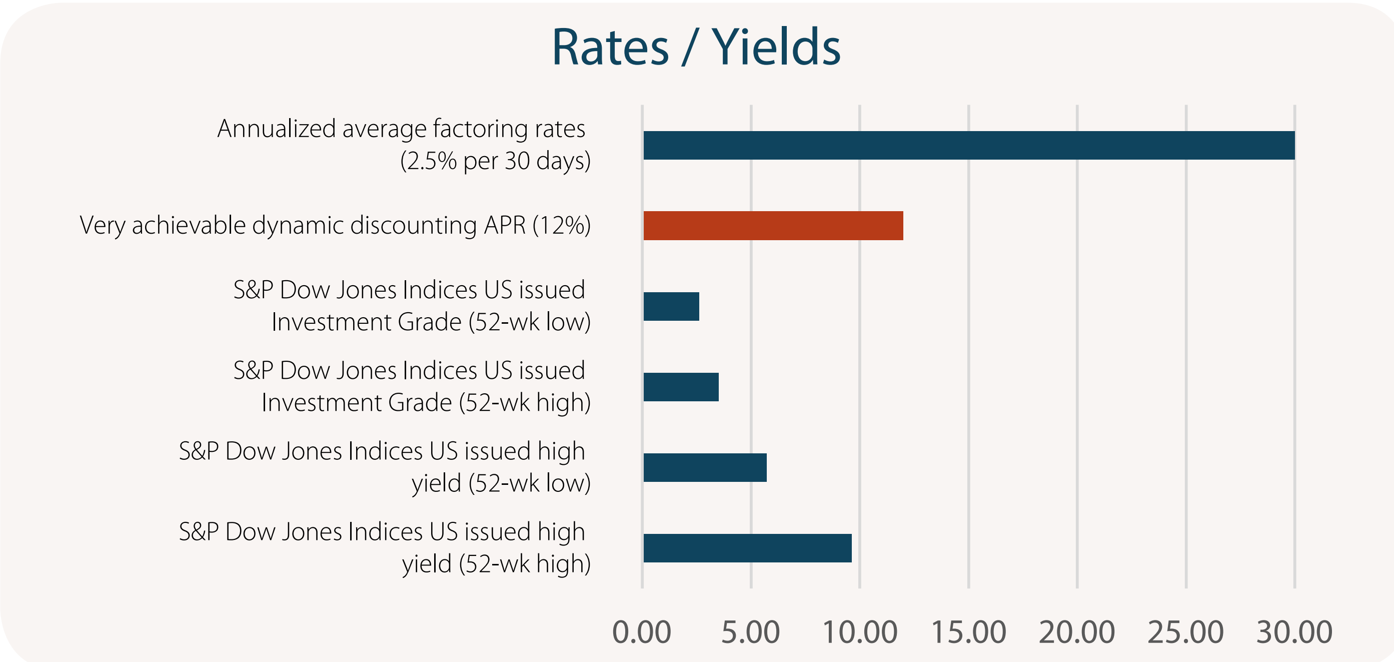


Figure 3: Comparison of investment yields

Discounting is a win-win proposition for both buyers and suppliers alike. Buyers benefit from superior yields on early payments, while suppliers benefit from a substantially improved liquidity position as a result of reduction in days sales outstanding (DSO) metrics. Further, many suppliers are small enterprises and have to rely on high-cost factoring or expensive bank credit reflective of their weak credit profiles. For such suppliers, dynamic discounting provides an affordable financing alternative.

Ascertaining the impact on banks

Banks could face twofold adverse impact on their balance sheets due to dynamic discounting transactions. Advance payments, made by buying organizations, to avail discounts pose a threat to short-term deposits, which buying organizations would otherwise have deployed with banks. Likewise, suppliers who have received early payments may no longer choose to avail funds for post-shipment working capital. This leads to a drop in outstanding loans, which in turn, would result in lower interest income affecting profitability (refer Figure 4).

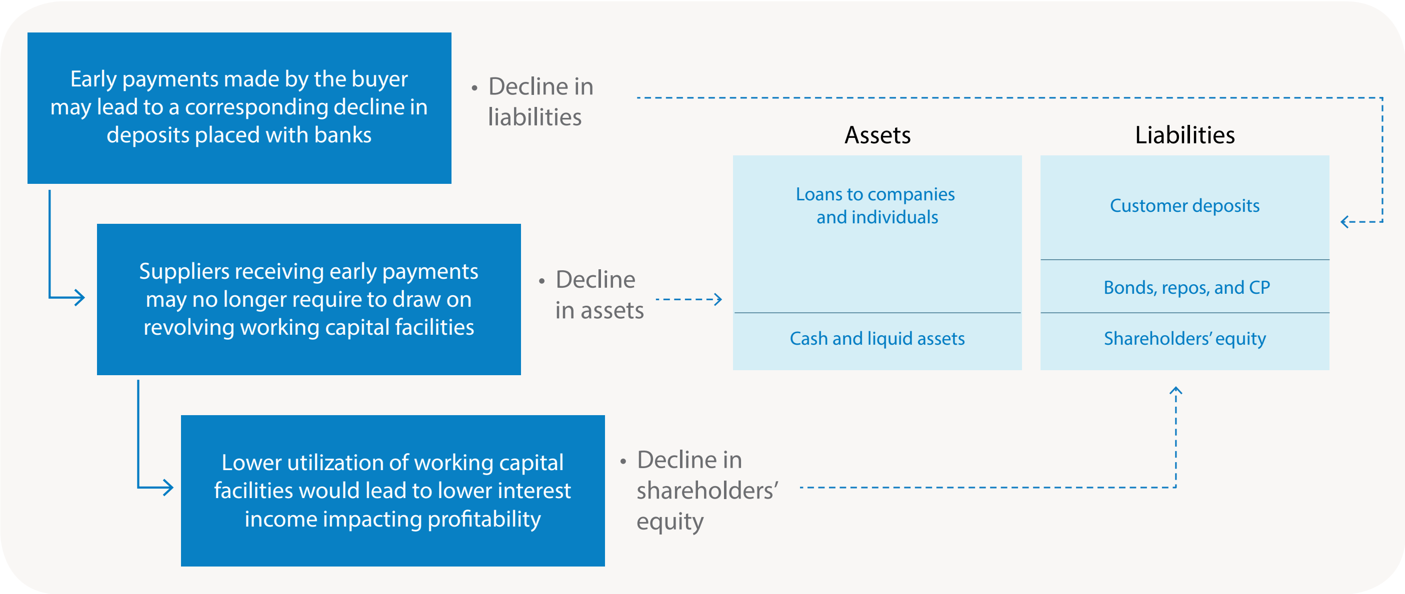


Figure 4: Impact of dynamic discounting on bank balance sheets

Of course, not all banks will be impacted to the same extent by the advent of dynamic discounting platforms. Overall impact on banks would be a function of the composition and profile of deposits and loans in the bank balance sheet. Answers to the following questions could help provide a qualitative estimate of the impact of emergence of dynamic discounting platforms:

- What is the percentage of corporate deposits of the total deposits held by the bank as on the latest reporting period end date?
- What is the percentage of working capital post shipment loans of all loans and advances made by the bank as on the latest reporting period end date?

The matrix in Figure 5 provides an impact assessment estimate for banks.

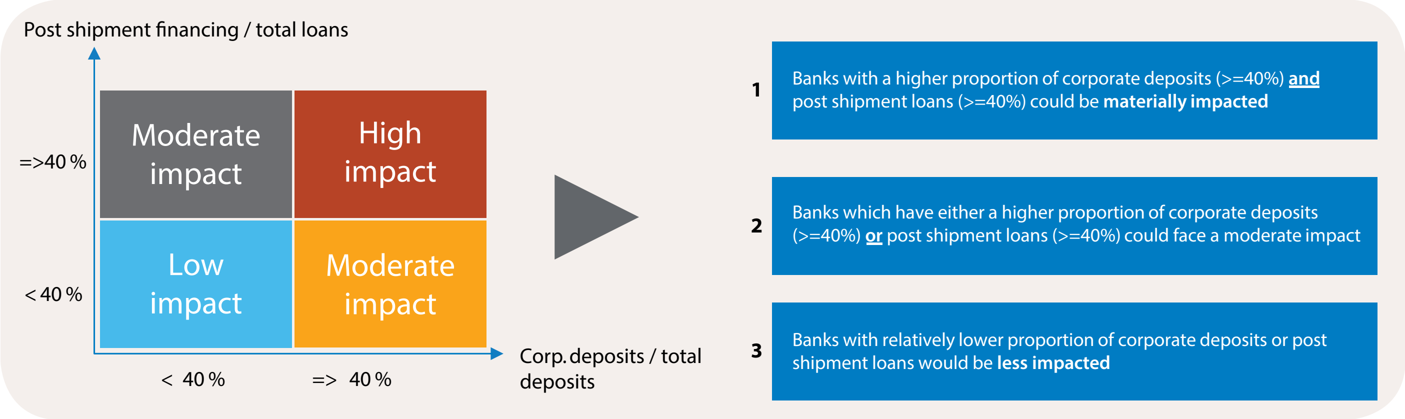


Figure 5: Impact assessment matrix

Banks which may be classified as having a high likelihood of impact due to dynamic discounting, but operate in geographies without meaningful electronic invoicing adoption, are probably at a lesser risk of disruption in the near term. However, as e-invoicing adoption spreads across the globe, likelihood of disruption remains high for such banks in the medium- to long-term. The advent of dynamic discounting would also impact factoring companies, which could lose out to dynamic discounting programs.

For banks, the time to act is now

The traditional corporate banking business model is at an inflection point and banks must choose to act. Following are the three possible strategies open to banks:

- Create discounting platforms
- Partner with existing discounting platforms
- Acquire existing discounting platforms

Each of the strategies has its own set of benefits and challenges as detailed below:

Creating proprietary discounting platforms

Pros	Cons
• Identify supply chain financing opportunities where buyer uses third-party funds for advance payments • Bank retains control of features • Generate fee income	• Significant in-house technology capabilities required • Large investment • High cost of regulatory compliance in certain geographies may make this proposition unattractive

Partnering with existing discounting platforms

Pros	Cons
• Recognize supply chain financing opportunities where buyer uses third-party funds for advance payments • Minimal investment required • Benefit from proven technical expertise generation • Income generated from revenue-sharing agreement	• Solution road map driven largely by discounting platform

Acquiring existing platforms

Pros	Cons
• Detect supply chain financing opportunities where buyer uses third-party funds for advance payments • Benefit from proven technical expertise • Bank retains control of features • Fee income generation	• Large initial investment, long break-even period, and risk of overpaying • High cost of regulatory compliance in certain geographies may make this proposition unattractive

It is important to note that there is no, one, right approach to be adopted. Each bank should carefully assess the following factors before deciding on its strategy:

- Investment threshold
- Risk appetite
- State of technological expertise
- Overall regulatory requirement and the cost of compliance in geographies in which the bank operates

The divergence in strategies adopted by banks is reflected in:

- Danske Bank developing its own unique DynamicPay solution, which is positioned as a bank-independent platform supporting dynamic payments
- RBS partnering with Taulia since October 2014 for electronic invoice submission and dynamic discounting capabilities
- Santander InnoVentures, the venture capital fund of Santander Group, investing in Tradeshift in December 2016
- JPMorgan acquiring Xign Corporation, which arguably pioneered dynamic discounting, way back in 2007 before shutting down the unit in 2013

Conclusion

Banks must choose from the create / partner / acquire options judiciously. Not preparing a road map to respond to dynamic discounting is clearly not an option. Banks which do not plan ahead will be left behind by dynamic discounting platforms and other banks alike, leading to a self-perpetuating downward spiral, which could eventually render them irrelevant in tomorrow's digital ecosystem.

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