Unfair trading practices in the agricultural and food supply chain:

New EU payment regulation and the role of alternative finance

When the EU was first considering its new directive on Unfair Trading Practices (UTP) in the agricultural and food supply chain, COVID-19 was still years away.

Implementation of the directive, however, will now come at a time of heightened global economic uncertainty as companies around the world manage the largest economic shock in nearly a century.

During this time, healthy cash flow and the availability of finance are on the minds of economic policy setters and companies of all sizes. So what impact will the UTP regulation have on alternative financing programs like supplier finance and how could this affect both buyers and suppliers in the food supply chain?

The implementation of the EU's Late Payment Directive (LPD) since 2011 provides many lessons.

What is the Directive on Unfair Trading Practices?

The EU's latest directive to regulate supplier payment terms draws much from the voluntary European Supply Chain Initiative - a code of conduct that brought several EU level associations together from the Food & Drink, Retail and Agricultural sectors between 2013 and 2019.

In 2016 the European Commission created an agricultural markets task force of 12 members charged with enhancing the position of farmers in the food supply chain. The recommendations of this task force form the basis of the new UTP directive which was adopted in April 2019, with member states required to legislate by May 2021, and laws entering into force no later than six months after this. The primary aim of the regulation is to address the power imbalance faced by smaller farmers and distributors in the sector.

With this aim, the regulation takes a stepped approach depending on the relative size of the supplier and buyer, ensuring smaller firms are protected while firms of similar size have the freedom to negotiate. At the heart of the directive are sixteen specific unfair trading practices - ten are expressly prohibited while a further six are classified as 'grey' practices, which are allowed only by clear and unambiguous agreement beforehand. While the 'grey' practices relate to return of unsold products and marketing or promotion costs, expressly prohibited practices include short-notice cancellations of perishable goods as well as payment terms beyond 30 days for perishable goods and 60 days for other agricultural goods.

Although the application of the regulation is more narrowly defined by size of firm, it is arguably broader in its definition of agricultural products and its geographic application. The UTP aims to protect smaller firms along the entire agri-food supply chain covering all products as defined by the Treaty on the Functioning of the EU, including flowers, dairy, cereals and live animals, as well as any products directly processed from these such as chocolate or prepared meals. The regulation also applies to any relationship or contract involving a buyer or supplier in the EU, which means it will affect any firm that trades with the EU.

What existing laws are in place for the food supply chain?

Although the UTP is comprehensive in its aim to address the imbalance of power in the agri-food sector the EU is not the first to introduce regulation of this sort. New research by Taulia on payment terms in over 180 countries shows that half of the world's largest economies have some form of legislation to limit the payment terms on which large firms can pay their suppliers. While the majority of countries have introduced regulations that broadly cover all sectors, like the EU's Late Payment Direct that limits payment terms to 60 days, at least seventeen countries have already introduced laws that specifically regulate agricultural products. This includes Russia, Turkey, Belarus and the United States. In the US the Department of Agriculture Packers and Stockyards Act requires livestock sold on a grade-and-yield basis to be paid by the end of the next business day after the final price has been determined, and poultry is paid fifteen days after the week of slaughter. A host of local state laws in the US also limit payment terms for grains to generally around 30 days while dairy payments are scheduled through Californian state law or the Federal Milk Marketing Order.

Even in the EU many countries have gone beyond the Late Payment Directive and introduced stricter terms to regulate payments for agricultural products. The Czech Republic, Bulgaria, France, Hungary, Romania, Spain, Latvia, Italy, Lithuania, Portugal and Slovakia have already implemented local laws which restrict payment terms for all or some perishable goods to 30 days or less. France is an example of how detailed these laws can be: the French commercial code specifies individual terms for perishable foods and frozen meat, live cattle, alcohol, grapes, leather, agricultural equipment and sporting goods, among others.

What are the drivers behind the new regulation?

The fact that so many countries have already regulated payment terms for agricultural products highlights the unique set of working capital and cash flow challenges companies in the agri-food supply chain face. It may also lead some to ask why the EU needed to create additional regulation. In introducing the UTP Directive The European Commission, through the agricultural markets task force, has outlined the strategic and increasingly international nature of the agricultural sector, the importance of small farmers and the imbalance in power they experience, as well as the need for a more uniform set of rules.

It goes without saying that in most industries there is an imbalance of power between larger and smaller firms. In the agri-food supply chain however this imbalance is more severe than in many other industries. The sector is made up of a high proportion of smaller farmers interacting with often larger distributors and an increasingly concentrated number of large retailers. Farmers also face a unique set of risks with long production times and working capital cycles driven by biological processes, relatively inelastic demand and supply increasingly impacted by weather patterns and international drivers beyond their control.

While the UTP regulation aims to address some of the risks that globalisation of the food supply chain and the EU's more open market approach have brought it also highlights the strategic importance of this sector for the EU. In 2019, exports of agricultural goods outside the EU accounted for 8% of the EU's total exports, having more than doubled since 2002.

The final and probably most obvious driver for the new UTP Directive is the need for a common set of rules rather than the array of laws that currently exist. Much has been learnt from the implementation of the Late Payment Directive and the fact that divergence in regulation has the ability to not only distort competition domestically and cross-border within the EU, but it also creates complexity and uncertainty that impacts the ability of smaller firms to operate in such an integrated and international supply chain.

Lessons from the Late Payment Directive

There has been much debate over the years on the effectiveness of codes of conduct and regulation on payment terms. This is reflected in the different approaches EU member states have taken to implementing the LPD and so in 2018, the European Commission released a paper exploring and comparing the impact of different legal implementations of the directive.

One crucial finding which has clearly informed the UTP directive is that the establishment of stricter or maximum payment terms does not necessarily translate into shorter payment times, and in many cases, late payment has persisted. There are a number of reasons for this beyond the imbalance in negotiating power between firms of different sizes. Compounded payment delays in complex supply chains, temporary cash flow problems or bad invoice management can all play a part. One mechanism which was found to have a positive impact on payment times was 'naming and shaming' or payment practice transparency, which the UK, France and Spain have implemented. This is the approach Australia has also recently taken with new legislation aimed at changing payment culture.

The EU research found that alternative dispute resolution, penalties and sanctions beyond interest payments were also somewhat effective at reducing payment times, however, in many cases, fear of impacting business relationships held smaller firms back from taking the necessary action. This is a key change for the UTP directive which not only sets common maximum terms, but will also aim to set a common standard for enforcement.

The new regulation takes a stronger approach to enforcement

In implementing the Late Payment Directive only France, Croatia and the Czech Republic have included clear administrative sanctions through government enforcement agencies. The UTP directive, however, takes a much stronger approach to penalties and will require all states to designate an authority with certain minimum powers of enforcement. Authorities across the block will work in cooperation and in cross-border arrangements the supplier will have the choice of using either authority.

The designated enforcement authorities will have a range of powers that include the ability to investigate - through unannounced on-site inspections if necessary - initiate court proceeding and levy fines or other penalties, as well as terminating infringing practices. To overcome the fear that smaller firms may have of damaging business relationships the authorities will be able to act and investigate on their own initiative and complainants will be able to request that their identity be protected. Another key point which shows the learnings from the LPD research is that the authorities will have the power to publish enforcement decisions as a means of dissuading similar behaviour.

What impact will the UTP have?

The financial health of SMEs is at the core of the economic diversification, growth, and job creation challenges many countries are facing as they manage the largest economic shock in nearly a century. In Europe, SMEs account for 85% of all new jobs. In light of this, the UTP directive will go a long way in improving cash flow and working capital for many smaller firms in the agri-food supply chain. In comparison with the Late Payment Directive, the enforcement mechanisms in the new regulation are likely to ensure more significant commercial changes, including a reduction in payment terms.

While European Commission's own impact assessment acknowledges that it is unable to fully assess the quantifiable costs and benefits of the new regulation, the improvement in working capital for SMEs will need to come from somewhere and in many cases, this will be a cost for larger retailers. For example, a retailer with an annual spend of 30 billion euros, an average payment time of 55 days, and over 50% of its spend on perishable goods would require an additional working capital funding requirement of just over one billion euros within the next year.

The variety and complexity of payment practices in the food supply chain will however likely mean that a simple transfer of working capital to smaller firms in the supply chain will not be the reality in many cases. As a more efficient alternative many companies in the industry have already accelerated payment times using various forms of alternative finance such as invoice discounting and supplier finance. This raises the important question of what role alternative finance plays for the industry and particularly smaller firms.

Alternative finance growth compliments regulation

At the heart of the EU's objectives in supporting SME growth is financial health and inclusion. The European Commission's SME strategy specifically addresses the fact that access to finance is one of the most pressing issues for many small enterprises, and one of its responses to the Coronavirus pandemic has been to boost loan guarantees for SMEs through its COSME programme. This recognises that SMEs have historically struggled to access traditional finance, a situation that is worsened in economic downturns. In this environment, alternative finance is playing an increasingly important role.

Research by the University of Cambridge Centre for Alternative Finance shows that this source of finance has grown exponentially in Europe over the last few years. Between 2013 and 2018 alternative finance in Europe, excluding the UK, grew from 0.7 billion USD equivalent to 7.7 billion. The top three sources of alternative business finance are P2P lending, balancing sheet lending and invoice-based finance. This is an important point when we consider that during this time period we saw the implementation of the Late Payment Directive and regulation restricting payment terms to 30 days or less in eleven European states. This illustrated how alternative finance compliments payment regulation in supporting SME financial health and should give comfort that these programs, including invoice-based financing, will remain a crucial source of funding for both suppliers and buyers in the future.

Even the European Commission, while not specifically mentioning supply chain finance in its regulation, acknowledges that it is driven by the financing needs of both the supplier and buyer and is often motivated by risk mitigation in strategic supply chains. The commission provides a case study under 'Innovative Business Models for Global Competitiveness' which suggest European governments play a role in the uptake of supplier finance arrangements and specifically ensure late payment regulation does not include unintended legal complications for implementation of supply chain finance.

Win-win for buyers and suppliers

Invoice-based finance, such as Taulia's Supply Chain Finance and Dynamic Discounting solutions, align with the intention of the Late Payment and UTP directives of ensuring smaller firms in the supply chain are paid on time and have access to cost-effective finance when they need it. Interestingly, the research from the Cambridge Centre for Alternative Finance found that a good measure of the adoption of alternative finance, and of its potential sustainability in the long term are the rates of repeat fundraisers and funders. By this measure, invoice-based finance had the highest rate of borrowers returning to fundraise again within a year.

Supply chain finance programs which are implemented sustainably, with the inclusion of suppliers of all sizes, result in a win-win for both buyers and suppliers. While buyers ensure the financial health of their supply chain, smaller suppliers gain access to funding at a rate well below what they would achieve individually from a traditional loan and they have the ability to receive payment almost immediately rather than wait 30 or more days for payment.

In the current economic climate, this source of finance and cash flow benefit is critical for farmers and SMEs across Europe and we are likely to see alternative finance, including invoice-based finance, continue to grow.

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