Briefing
August 2023

Tightening rules on payment terms will create a severe cashflow crisis for retail & wholesale

This document provides insight into the severe problems many retailers and wholesalers - especially SMEs - will face if the upcoming revision of the Late Payments Directive further tightens the rules on payment terms. It complements our previous position paper of 17 March 2023 (summarised here).

EuroCommerce stands by a culture of prompt payments. A key differentiation must be drawn between late payments (which occur beyond the terms agreed by the parties) and business-to-business contractually agreed longer payment terms, which form part of the economic decision of the parties and reflect the financing needs of both sellers and buyers.

Why payment flexibility matters

The slower your stock rotates, the more critical payment flexibility becomes

Bankruptcies happen when a person or business cannot pay its outstanding debts or obligations. Sometimes, perfectly **viable businesses enter into bankruptcy** not because they are not profitable but **because of a timing issue**, where the **lag between costs and income is too long**.

Many **retailers and wholesalers are particularly vulnerable to this type of bankruptcy** because of their specific cost-intensive, high-volume, low-margin business model. This **risk is compounded** when an **external shock** like a pandemic or an inflation crisis **slows consumer spending**.

As a general rule, **the slower your stock rotates, the more vulnerable** you are to this mismatch in the timing of cash flows. This means that, on average, **Fast-Moving Consumer Goods** (FMCG) retailers, like supermarkets, may in certain cases **suffer less from this issue than non-food retailers**[1] because FMCG stocks rotate quickly and continuously. Also, certain payment terms in the food supply chain are already regulated.[2]

Non-food retailers may need working capital to finance their inventory because of a longer lag between purchases and sales. This makes **non-food** retail and wholesale SMEs **particularly vulnerable** to bankruptcy without **flexible supplier payment arrangements**.

Better matching cash flows is a win-win for buyer & supplier

Suppliers benefit from good and viable customers not going bankrupt because of external shocks. This mutual understanding led to **a** long-held tradition of suppliers and buyers collaborating to better

[1] Non-food retail covers textiles, consumer electronics, footwear, DIY, toys, school and desk accessories and health & beauty, amongst others. Their suppliers can be of all sizes (large multinationals, local businesses, etc.) and sometimes work via agents. Rotation periods for non-food goods often exceed one hundred days: 126 days for DIY, 115 for toys, 152 for decoration, 208 days for lighting, 160 days for carpeting, 165 for garden products, 123 for electricity products and 121 for tools.

[2] Payment periods are regulated at the EU level in Directive 2019/633 on unfair trading practices in the food supply chain. This *lex specialis* should remain and its effectiveness and efficiency assessed in the review of the Directive in accordance with the timetable already set. This will also give an opportunity for the Commission to assess whether the outcome of the strict payment periods also had detrimental effects to cashflow in the supply chain.

match the timing of costs and revenues along the supply chain and **acceptance by suppliers of longer payment terms for retailers** (see Annex 1).

In practice, when retailers & wholesalers order non-food goods (not just seasonal goods), they may in some cases opt for a plan of partial payments, that is to say:

- **Order months in advance, pre-paying a percentage** to suppliers before the delivery of any goods. **This helps suppliers** finance their costs (e.g. raw materials), improving the timing of part of their cash flow.
- At delivery time, retailers and wholesalers **pay another percentage** of the invoice.
- **Another percentage is paid later** (e.g. after 60 days) **when the retailer may have sold** (at least part of) the order **and generated some cash**.

Theoretically, **other ways to solve** most cash flow timing issues are to agree on a commission-agent system (where the supplier continues to own the goods until they are sold) or switch to a **'just-in-time' approach**, with small production runs and a very short time between order and supply. However, as explained below, these approaches may not be feasible, especially for SMEs.

Why retailers and wholesalers need the freedom to negotiate payment terms

Payments should be made on time, but the freedom to negotiate the timing of payments is important to retain. Removing this valuable option from the contractual negotiations with their suppliers will constrain the cash flow of retailers and wholesalers. **The fact that the culture of using payment intervals in non-food is widespread and centuries old is not a coincidence. It reflects an economically optimised solution that benefits both parties in the long run.**

- **Fixing strict payment terms will affect all elements of negotiations, including prices**. The purchase price of a good derives out of a combination of elements, including payment terms, other fees, original prices, discounts, and other payment conditions (currencies, administrative fees). Fixing one condition by law in too strict a manner will influence all others.

- **Payment intervals are an important source of finance for SME buyers.** SME retailers and wholesalers are neither attractive prospects for traditional bank finance nor the usual targets for EU funds or national support schemes. This difficult access to external sources of finance, combined with a business model that inevitably ties up a lot of financial resources in stock and expensive real estate, makes having enough cash flow a constant concern.

- **A payment reform that contains strict payment deadlines reduces cash flow to SME buyers. This will cause a wave of bankruptcies and exits from the market**. Even previously healthy SMEs depleted their reserves during the COVID-19 pandemic and the subsequent inflation crisis.[3] Depriving supply chain partners from negotiating payment terms suitable to their needs shift financing needs from several suppliers to a single retailer at the end of the supply chain.

- **1 in 4 of all SMEs in the EU are active in retail & wholesale**. SMEs account for two-thirds of the retail ecosystem's employment and generate almost 60% of its value added. **The size of our sector creates a big risk of knock-on effects for other sectors**. Most companies we work with are SMEs, still reeling from the Covid-19 and inflation crises. Quite a few do not have the financial runway to deal with losing one or more important customers.

- **If retailers and wholesalers cannot negotiate their payment periods, their options would be to a) switch to a more costly and specialised just-in-time-supplier, b) switch to commission-agent structures or c) buy in bulk** to achieve the savings that scale can offer. Option a) is cost-prohibitive – especially for SMEs – given the low margins in the sector and the low number of just-in-time suppliers. Such an approach drives up most underlying costs for producers, losing efficiencies of scale and timing on the production side in acquiring raw materials, planning, production and

[3] EU bankruptcy filings jump to 8-year high as pandemic aid ends | Financial Times (ft.com)

logistics. It is also a business model that is far more complex and is far less shock resilient. As a result, it has a high barrier to entry. Option b) is also a very complex alternative. Option c) can strain cashflow even more and is often not feasible if storage is not available or the cost of storage exceeds any savings that could be made. All options also mean losing the discounts for placing an order early.

- It also **forces retailers and wholesalers to limit their in-stock offering to the most popular products, only placing other orders at a cost premium for customers, limiting their ability to offer a range of products** that differentiate them and leaving them vulnerable to online alternatives that offer quicker delivery. It will create more difficulty in introducing new innovative products. Consumers will have fewer choices, and less popular products will become more expensive or only available online.
- **This also hampers SME retailers' and wholesalers' competitiveness**, making it more difficult to compete with larger companies that may more easily reap the benefits of buying at scale and who can more easily offer better prices, wider choice, and greater availability. **It also removes an element of negotiation that can enable a better deal between buyers and suppliers**. Contracts vary, and payments can be agreed to be made in two or three stages and after varying days, and the sums paid upfront and after delivery can vary. It puts smaller suppliers in a weaker position, as they would receive a lower price because they can no longer offer better payment terms in return. Conversely, it puts larger suppliers into a position of power as it removes an element for retailers to negotiate better conditions with large suppliers on behalf of consumers.
- **This would particularly affect SME retailers and wholesalers operating in smaller towns or rural areas,** where there is naturally a lower turnover. Even more shops outside big cities will close, move or severely limit their assortment. This will negatively impact the quality of life outside big cities across the EU. It will lead to more geographically concentrated markets and more towns and rural areas with depressingly high vacancy rates of commercial buildings and longer shopping trips with more car traffic.
- **It would affect retailers and wholesalers' ability to get external financing for their higher inventory costs**. As keeping more inventory for longer is not profitable, banks and investors are unwilling to fund such investments. This means they must outsource some inventory via master contracts with agents. Retailers then get service-level agreements enabling them to order later and never run out of stock. This solves their cash flow issue but comes at a high cost for a low-margin sector by introducing another link in the value chain. Paying an agent to accept some inventory cash flow risks is sensible, but it inevitably drives up consumer prices.
- **Suppliers may have different arrangements with their buyers about payment terms – which would be eliminated if strict rules were imposed**. Some suppliers choose to negotiate to get paid 100% within two weeks after delivery. This clause is part of the contractual agreement and affects the overall price. This mutually beneficial option that uses shorter payment terms in return for a lower price would be made more difficult; on the contrary, many suppliers would prefer to keep prices higher, but to give incentive to their clients to longer payment terms.
- **Imposing strict caps by law would have negative effects on positive financing tools such as supply chain financing**: supply chain financing is a business that in Spain amounts to €100,000 million euros and which has increased from 23% in 2016 to 35% in 2020. Suppliers who now are paid within 5-7 days thanks to supply chain financing may be harmed and be paid with longer deadlines, having to assume more financial risks to cashflow. This would result in an immediate reduction in the number of days of stock of goods and a reduction of in-store assortments. Suppliers would also lose the collection guarantees that are currently articulated under Spanish law and the public administration would lose millions of euros in taxes due to guarantees.

In conclusion, cash flow matching along the value chain is a mutually beneficial solution. For retailers and wholesalers, agreeing on long payment dates gives them more time to make sales before they pay back their suppliers. For suppliers, such agreement is valuable as it allows the supplier to sell to the customer, giving him credit and avoiding bankruptcies. If a partial payment plan is chosen, that helps suppliers fund the purchase of components or materials.

What we propose

We believe it is **better** to tackle late payments via:

1) **better enforcement of existing rules** to ensure parties have better access to existing legal remedies and alternative dispute resolution tools such as mediation and arbitration;
2) **soft policy tools such** as factoring, supply chain financing, e-invoicing and B2B portals to increase ease of finding back invoices and important dates; further education for SMEs and the use of associations to empower SMEs in supporting the uptake of digital skills.
3) **more transparency**, rather than via a revision of payment terms, so we can **obtain the intended policy goals** while **preserving** the freedom of contract that enables **custom-tailored, mutually beneficial contract clauses** (see Annex 2). This includes further work of the EU Late Payments Observatory.

We also set out a series of questions in Annex 5 that could help assess how to build a more effective strategy to tackle late payments.

Annex 1

Collaboration in the value chain is a natural check and balance for large and small players, enabling efficiencies from mutually beneficial solutions.

Example

- A retailer orders a summer clothing collection in December, instantly paying part of the invoice.
- The supplier manufactures the goods in January and delivers them in February. Another percentage of the invoice is paid.
- The goods are stored in a distribution centre for 6-8 weeks (c. March/April) and delivered for the spring/summer. As goods begin to be sold, the buyer pays the rest of the invoice.

- The Commission's approach to regulating B2B relationships until now has been careful of the dangers of overregulating freedom of contract. For example, when preparing Directive 2019/633 on unfair trading practices in the food supply chain, there was a strong warning on the dangers of overregulating freedom of contract contained in the annexe to the Impact Assessment from DG COMP's chief economist and in the Staff Working Document accompanying the 2018 Retail Communication.

- In its technical report for the European Commission on unfair trading practices in the agri-food supply chain, economics professor Richard Sexton warned that '*proscribing behaviours that are efficiency enhancing will reduce the surplus to a transaction and likely harm both parties to it*.' This is because prohibiting efficiency-enhancing practices reduces the total gains from the transactions to be shared between the trading partners.[4]

- Where practices have been prohibited, limiting freedom of contract has caused problems and not achieved the objective (*see Annex 3*), as the following example can illustrate. In Germany, a ban on returns was introduced by the transposition of Directive 2019/633 on unfair trading practices in the food supply chain. That legislation aimed to strengthen the position of farmers and suppliers in the food supply chain. Regulating such practice proved counterproductive, with suppliers lamenting the impossibility to negotiate such terms.

- Several SMEs suppliers built their business model on returns. For example, a supplier may attach great importance to a constantly fresh assortment in order to be able to compete with larger brands. For this purpose, they built a sales team that regularly checks the freshness of the assortment and, if necessary, replaces products with fresher ones. With the ban on returns, such supplier would have to reduce the sales team and dismiss employees. In addition, they would be at a permanent disadvantage in competition with larger producers not falling within the scope of the law. If the scope were extended, competition would be further restricted, and consumers would have fewer fresh products on the shelves. The costs for the return service had been priced in by the suppliers and retailers as part of the overall price of the product.

[4] Commission Staff Working Document SWD(2018) 92 Impact assessment - Initiative to improve the food supply chain (unfair trading practices), paragraph 473, available here: EUR-Lex - 52018SC0092 - EN - EUR-Lex (europa.eu). Payment periods are regulated at the EU level in Directive 2019/633 on unfair trading practices in the food supply chain. This *lex specialis* should remain and its effectiveness and efficiency assessed in the review of the Directive in accordance with the timetable already set. This will also give an opportunity for the Commission to assess whether the outcome of the strict payment periods also had detrimental effects to cash flow in the supply chain.

- Supply chains are interconnected and interdependent by their nature. A real understanding of how the supply chain is interconnected is needed before the natural checks and balances they contact are interfered with, or freedom of contract is curtailed. This is particularly important when you get to the end of a value chain that is based on collaboration and where you find retailers and wholesalers.
- Issues of unfair imbalances of power between suppliers and retailers are already addressed by the current Late Payments Directive; other rules (such as competition rules or rules on economic dependency) already exist to address such issues and the forthcoming guidelines on the application of Article 102 TFEU to exclusionary conduct will bring these up to date with modern practices.
- Buyers both large and small, need reliable supplies as customers have expectations of what they want to see in a store or available to them.
- Brand loyalty in products is greater than store loyalty. Customers lack loyalty, so will cross the street to obtain the same product that others may have or seek the wider choice from other stores or online.
- In retail and wholesale, SMEs need to have good relationships with their suppliers so they can maintain choice, availability, and affordable prices to remain competitive especially when faced with fierce competition from online sales. In other words, they need their suppliers to be attractive to customers.

Annex 2: What we propose

1) Better enforcement

- Better enforcement of existing EU and national rules to ensure parties have access to existing legal remedies.
- Promotion by EU and national governments of voluntary uptake of alternative dispute resolution tools, such as mediation and arbitration (provided SMEs are capable of adopting them and they do not work to their detriment).

2) Soft policy tools

- Encouraging the use of tools that help SMEs with liquidity, such as factoring, supply chain financing, electronic invoicing, B2B portals to increase ease of finding back invoices and important dates, and use the findings and best practices that have just started to be collected by the EU Late Payments Observatory (see Annex 3).
- Further education of SME suppliers and buyers (through awareness-raising campaigns and training) to foster better understanding and enhanced access to alternative dispute resolution tools (mediation etc.) and supply chain financing.
- Using retail and wholesale associations who can play a key role in empowering SMEs and in supporting the take up of digital skills.

3) Transparency

- Ensuring the data points collected by the EU Late Payment Observatory are sufficiently detailed (e.g. on a product category basis) to understand payment terms and what is normal, to advise future action in particular, and to identify sector-specific issues.
- Continuing to fund and support the work of the EU Observatory on Late Payments.

Support for pursuing alternatives to strict payments terms

- A DG FISMA study finds that **reverse factoring is seen as a solution by many governments and authorities to late payments**. Reverse factoring is a tool that allows a buyer to simplify its payments and gives suppliers access to credit under better conditions than what they could obtain on their own. The study also concludes that further education (through information campaigns and training) of potential sellers, buyers and finance providers could increase awareness and demand for supply chain financing.
- A study (Confidential) (see Annex 4) explains how factoring is working in practice and helping to reduce payment terms.
- The OECD, in its recent paper recently issued recommendations on strengthening SMEs and entrepreneurs key to a strong, resilient economy - OECD. This paper confirms that SMEs (buyers) will face more pressure as Covid support is withdrawn, reducing further their ability to invest. Their recommendations also refer to the benefits/need for supply chain financing: OECD Legal Instruments.
- The insights from the representative of the French Late Payment Observatory, based on the data they have been collecting, expressed caution during the launch webinar of the Late Payment Observatory on action that could unbalance financing flows in the supply chain.
- Ideas shared at the 2nd Stakeholder Forum Meeting of the Late Payment Observatory on 13 July 2023, noted numerous ideas that could feed into thematic reports to examine alternatives including the influence of different payment methods on late payments, analyse cultural or sectorial aspects, the effectiveness of sanctions and the influence of different payment methods like electronic invoicing.

- The case report of the BLE (in German) explains the considerable problems in practice, resulting from the prohibition of returns (Art. 3 (2)(a)) in the transposition of Directive 2019/633 on unfair trading practices in the food supply chain as a consequence of interference with freedom of contract.
- In Spain, all business with an annual turnover of more than eight million euros are already obliged to issue electronic invoices in their commercial relations with other businessmen and professionals. The recipient and the issuer must provide information about the invoice statuses.

Annex 3 - Study on payments in textiles

Example

- A retailer orders a summer clothing collection in December, instantly paying part of the invoice.
- The supplier manufactures the goods in January and delivers them in February. Another percentage of the invoice is paid.
- The goods are stored in a distribution centre for 6-8 weeks (c. March/April) and delivered for the spring/summer. As goods begin to be sold, the buyer pays the rest of the invoice.

The Annex illustrates the effect of strict payment rules in the situation above.

Annex 4 – Confidential Study

Annex 5

Questions that the Impact Assessment should address to build a more effective strategy to tackle late payments.

1. **Causality**:

- The figure that 1 in 4 SMEs are bankrupt due to late payment pre-dates the Covid pandemic[5]. Bankruptcy for SME retailers and wholesalers are linked to the multiple crisis they have faced since 2020 (Covid, energy, inflation, rising rents, changes in consumer habits, inability to invest, etc.). Has this figure been adjusted? Is it the same across the EU?

- Has sufficient account been taken of the difference between long and late payments? Recent studies have confused this and conclusions drawn, without taking into account this distinction, could offer false positives.

- According to the 2022 European Payment Report, payment terms have decreased from 46 days in 2020 to 39 days in 2022. In Spain for example, retail is one of the sectors with the smallest delays in payment terms (13,54 days), a figure which has decreased by 5 days since 2011. What has been the reason for these improvements? Is it the introduction of strict payment caps? Or the result of other measures – for instance the existence of sector-specific rules or the uptake of supply chain financing?

2. **G2B payments:**

- Pharmaceutical wholesalers already face delays of hundreds of days on Government payments (G2B) that are illegal. This poor performance is perhaps the real problem that needs to be addressed?[6] What effect would a strict cap at 30 days have if the reason Governments do not pay on time is because they have no money?

3. **Scope:**

- Could a strict payment caps differentiate based on how payments are organised? For example, those that organise themselves based on regular payments or those that rely on payment when a project is completed?

- Will payment caps limit the ability for buyers to retain payments, for example, in the case of fraud? Or for quality control purposes?

4. **Sectoral competitiveness:**

- As the revision of the Late Payments Directive can affect the competitiveness of the SME retailers and wholesalers (who are 1 in 4 of all EU SMEs), does the impact assessment examine in detail the knock-on effects for example, on a sector’s capacity to offer products at a more competitive price (cost/price competitiveness) or its effect on competition in the market?

- The JRC study suggests that action addressing late payments would help two-thirds of SMEs invest. This is an important objective, as in a recent study with McKinsey, EuroCommerce quantified that SMEs need to invest up to €60 billion between now and 2030 on digital, sustainability and skills transformation. This shows the importance of investment, but if cash flow is compromised, will this remain an option for SME buyers?
    - Could it compromise supply chain finance that is reliant on stable liquidity levels throughout

[5] This figure dates to the SME Strategy adopted by the Commission on 10 March 2020.
[6] April Infringements package: key decisions (europa.eu)

the supply chain?

- Does it force SME buyers to resort to private finance? This could close the door on this investment where loans are particularly difficult to obtain from banks that with high interest rates and lack of return on investment (due to the situation that retail & wholesale SMEs face as a result of the Covid, energy, cost of living crisis to name but a few).
- How does this fit with the other objective of the SME Relief Package, which aims to increase access to finance?

5. **Potential lost efficiencies.**

- As set out in Annex 2, there are many tools available to the Commission to deal with imbalances in power (e.g. competition rules) and therefore, action on late payments should respect principles that warn that of risks to efficiency. 'P*roscribing behaviours that are efficiency enhancing will reduce a surplus to a transaction and likely harm both parties to it' (*Richard Sexton).

  The transactions and agreements that take place in retail & wholesale enable efficiencies to be gained for both buyers and suppliers in non-food. For example, slow moving consumer goods, seasonal products and supplier credits.

  - How will strict payments and the revision deal with these situations? Will they still be able to be used?
  - How does this affect the ability to negotiate with larger suppliers, who rarely negotiated on price, but do on other terms (e.g. delivery, payment terms, discounts)?
  - How does this fit with the Commission's 2018 Retail Communication that states, "*If public authorities regulate practices to protect vulnerable operators…they should not prohibit those contractual practices between retailers and suppliers which are mutually beneficial*"?

6. **Effect on remote and rural areas:** If cash flow is more limited, will the effect be felt in more remote and rural areas, could this result in fewer choices as it may not be particularly attractive to buy up front an assortment that may be less sellable or only interesting for a specialist few?

- Does this fit with the Commission's vision for rural areas, where it recognised that, *"**Retail,** doctors, pharmacies, banks, post offices, public transport, childcare facilities and schools are essential to rural life and jobs, as well as to ensure no-one and no place is left behind"*?
- Could it increase prices? As it becomes less affordable to buy large volumes of products upfront, to enable cost savings to be passed on to customers when more time is given to maximise sales before payment is due?
- Will this result in differences between the choice and affordability given to EU customers that live in areas that are better served by ecommerce? Could it result in shops closing their doors, as they no longer are as attractive to customers who can find more choice and better prices through other sales channels (e.g. online)?

7. **Reconciliation with the findings of the Late Payment Observatory:** The first meeting of the Late Payment Observatory took place on 26 April 2023, three years after the announcement by the Commission it intended to create it. What if the observations it makes provide contradictory evidence and the revision of the Late Payment Directive has already taken place? This may be possible given that it will create a repository of best practices and collect sector specific data to understand whether or not a horizontal rule is appropriate or not.