

## Chapter #

### Nudging the Financial Supply Chain



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David Loseby, currently the Chief Procurement Officer at Inchcape, has more than 25 years' experience as a senior executive, driving organizational transformation through procurement. David is also working on research to earn his Ph.D., focusing on "Behavioral Procurement", a concept that runs parallel to the related field of Behavioral Economics.

#### **Summary**

The rationale behind the adoption of any given framework can easily be assumed to be based in logic and reason. For execution, however, we must be prepared to understand and accommodate more emotionally driven behavioral effects. While the Financial Supply Chain

may be a conduit for currency and cash, it is still subject to the whims and imperfections of the human beings in charge. For that reason, investments in the relationships between supply partners of varying sizes and structures are as critical to customer value and profitability as any other organizational effort.

*Interview conducted July 5, 2016*

David has provided us with the following definition for Behavioral Procurement:

*Behavioral Procurement (BP) and the related field of Behavioral Economics (BE) study the effects of psychological, social, cognitive, and emotional factors on the commercial decisions of individuals and institutions and the consequences for competitive advantage, innovation and resource allocation. BP is primarily concerned with bounds of rationality of commercial agents and factors. BP models typically integrate insights from BE, psychology, decision sciences, social sciences, and market theory, as well as implicitly nudging; in so doing these behavioral models cover a range of concepts methods and fields.*

As a result of the above explanation, the associated training and development are likely to focus on the following key areas;

- Organizational behaviors and their impact
- Avoidance mechanisms for buyer/supplier stress
- Relationship lifecycle management
- Decision architecture
- "Nudging" or achieving standardization by consensus or policy adoption

Magnus: Why is it so important that we take a behavioral approach to procurement - especially in the context of the Financial Supply Chain?

David: Other functions are exploring the behavioral potential of their capabilities. Behavioral finance has already been established and is a parallel to behavioral economics. The people in marketing and sales have been using some of the elements of behavioral economics in the way in which they've done things, particularly in terms of 'nudging' or pushing a behavior gently and gradually.

Governments have done it too. In the U.S. and the U.K. in particular, governments are using what is sometimes called a "behavioral insights team" to help shape and form policies. So the application of behavioral studies in procurement are hardly new news.

I recently gave a keynote to members of the marketing community. They said, "*Wow, the competition is now really on because if procurement is going to get ahold of behavioral economics then the game's up for us!*" It's quite interesting that they realized that we can take the lessons learned and apply them in different ways. They suddenly recognized that this different way of doing business, the show that they had all to themselves for so long, suddenly was no longer going to be reserved for marketing alone.

My Ph.D. is focused around the behavioral sciences, which encompass psychology, social science, and decision science. It is built upon the principles established in behavioral economics, so according to the parallel, into humans too. It includes all the different branches such as supplier relationship management, supply chain finance, risk management - all the things that are analyzed in the broader spectrum of procurement as a discipline.

Magnus: How can we relate Behavioral Procurement to supply chain management? And in particular to the Financial Supply Chain?

David: Well, I think the connection is in looking at how you can manage the risks, and risks come in lots of different formats and from different directions. A risk could be anything from a physical risk to a financial risk to a political risk, etc. We look at all those aspects in theory, but also at the way in which a lot of things actually work. One good example of this is the recent Brexit vote [where 52% of Britons cast a vote to leave the European Union in the summer of 2016]. The actual result of the referendum deviated largely from the advance polls, most of which had projected a "remain" [in the EU] outcome.

So, how did this happen? When we approach a choice we expect logic and rationale to rule, when the reality is that all of the votes were cast on the basis of emotions, behaviors, and experiences. The polling institutions forgot to include all the emotional and behavioral aspects of the voter decision making process. In the same way, when people are making economic predictions, the construction of the model itself may get in the way of an accurate result because traditional economic models are based primarily upon linear projections and rationale.

The reality is that more often than not people make big decisions not just based upon what I call 'hard rationale and facts,' but also including a level of behavioral and other emotional components that play a factor in the way decisions are made.

Magnus: How would that model apply to engaging the entire ecosystem involved in one demand and supply chain? If we want to introduce a whole interconnected chain we must be able to use what you are talking about to make people feel related to each other. How should they cooperate, for instance? The relationship between the buyer and seller is usually a bit strained because there are reasons not to be completely transparent. For instance, a supplier tries not to say to the buyer that his company has scarce liquidity, because he is concerned that the buyer might be concerned about having a financially shaky supplier. How do you create a relationship of trust in an ecosystem that naturally includes both shared and independent incentives?

David: Exactly, that's why I'm saying, it's not linear. I think this is where being able to define at what point in the supply chain you might want to improve working capital, liquidity, and all of those things is a key step. I believe that once you have established a relationship - after going through a competitive process to select the supplier and put proper contracts in place - from there, the relationship development phase starts. That is where most of the value is actually created, as opposed to during the RFP, or tender process. At this point we should be looking at

how we can optimize processes, innovation, cash flow, investments, risk management, and working capital.

Magnus: This sounds very much like comparing how General Motors and Toyota handled their supplier relationships ten years ago. General Motors was renowned for its supplier 'bullying' while Toyota chose to support and invest in their suppliers, which turned out to be the most profitable approach in the long run.

David: You know a company has the wrong focus when they think they're being very smart in how they conduct business, but their approach is actually costing them more money. Even having a sufficient understanding of how suppliers' markets work can make a huge difference in a company's ability to work with them. By putting a proposal on the table right from the outset and saying, "We will work with you to develop supply chain finance solutions combined with management strategies, corporate-social responsibility efforts, and more". In my opinion, this is about procurement becoming more sophisticated and mature as a function. I think that's what some of the more successful organizations are doing, but it requires a different level of skill and competence to do that.

Magnus: Is the aim of your Ph.D. to structure and model frameworks that allow organizations to become more emotional or empathetic?

David: In a manner of speaking. What we're trying to do is to avoid putting into place what I call 'rigid' rules, systems, and processes. It's more about building frameworks and competences - both of which are critical to how procurement works. In fact, this takes us back to the roots of Behavioral Procurement where one size most certainly does not fit all. If you're going to develop a Supply Chain Finance program, for example, you'll have to have a variety of frameworks that allow different segment sizes and corresponding mechanisms for each to leverage the program. If you don't, you're going back to the traditional banking system which is 'it's our way or no way' - exactly what has blocked and complicated access to currency and cash throughout the value chain.

Magnus: Say you are in a big company. You have your first tier of suppliers and then you want that level of suppliers to work in the same way with the second tier and then third tier and so forth. How can you create an ecosystem that includes all tiers equally, regardless of their proximity? Do you create some kind of behavioral ecosystem or will it be only those that are closely surrounding you that benefits from this?

David: Yes, what you create is actually more of a behavioral support structure. Rather than simply dictating what you want, you have to make it accessible and easy to understand. Typically you will find this where you've got suppliers or supply chains with intrinsic value to the company, ideally leading to innovation and competitive advantage. This is not the sort of thing that you would typically find within the manufacturing space, where, for instance common component parts can be supplied by a multitude of people.

In some ways you actually step away from the supplier you're contracting with to manage its supply chain because it is the design piece of what they provide that is in essence what you're buying from the company. Breaking into a supplier's supply chain to access the second or third tier may disrupt their ability to innovate.

The preferred approach is to incentivize tier one and tier two providers to dig into their own supply chains. I think that is more appropriate because you'll have some companies that are cash-poor and others that are cash-rich. You have to make a support provision available and accessible and then leave the company to decide which path they need support, be it finance or otherwise. Letting people decide which fit is most appropriate for their business and vision ensures that the cost of finance will be determined by a number of different factors. Businesses need to piece out the more different parts of their business to finance, because the things that are financially toxic either won't get financed or will be deemed too expensive and unlikely to be of real advantage to the business.

**Comment [1]:** Good quote

To truly work, I think you have to have more emphasis on business relationship management that goes alongside new financing options and approaches, because financing is often not what is missing from a traditional bank.

Magnus: In 2016, American Express did a study of 250 small and medium sized businesses in Australia that failed to invest enough in innovation. Their reasons included both an inability to develop innovation and research plans as well as challenges around securing funding. The effect was that the large companies had to accept a disproportionate amount of the innovation efforts and costs.

**Comment [2]:** Footnote, can you please add?

David: Yes, this is often a problem. You know as well as I do that the big problem with the whole process of design and piloting and bringing a new product or innovation to market is that it is very, very costly. That's often than not the area where banks want to invest. Innovation and research are the lifeblood of the supply chain. More often than not, they are only funded by businesses with sufficient profits to be able to make those investments in their future.

If Supply Chain Finance is really going to take off, then there has to be a way of finding solutions to some of those sorts of problems. That's where I think we will see a massive step change in the way in which financing is provided.

Magnus: And when it's an issue of innovation, we need to steer so the money is flowing down in a timely fashion directed into innovation. The funding and steering has to be maintained through many tiers, even into the smallest companies.

David: Absolutely, because the smaller companies are often more agile. If you think about it in procurement terms, we talk about the same ability and need for ethical procurement as before.

Back to your point again, though, this is about making sure that the capital gets into the right hands quickly so that you can free up the cash flow of those investments in innovation. That value is what will make businesses very healthy and eventually the whole economy healthy.

Magnus: In fact, you may discuss how the current rate of disruption in most industries is picking up in pace because the strength of the large incumbents often lies in the brand and the global organization. Many incumbents are currently being unbundled by start-ups who use social media to build a brand and the Internet to sell directly instead of through large sales organizations or distributors. Large incumbents risk death by a thousand cuts. One line of defense for these companies could be to leverage the innovation capabilities of their own supply base.

David: That's why operating models based upon behavioral science as opposed to rigid, traditional structures and linear thinking can be superior. This is where the excitement is, and that's where the sort of benefit we can start to accrue stems from. The challenge remains in linear behavior that forces us to say, 'We'll be happy to structure this part of the business or that subsidiary this way but we need to see proof that it will work'. If, instead, we can approach it in a 'behavioral' way that is transparent and measurable and structured we could create a different operating model altogether. That's what we need to get our heads around.

## What David taught us

1. How do we increase collaboration and sharing in the supply chain?
2. Behaviorism is the theoretical perspective in which learning and behavior are described and explained in terms of stimulus-response relationships. The key assumptions of behaviorism are: The environment influences behavior.<sup>1</sup>
3. What's Behavioral Procurement and how can it add value in the financial supply chain?

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<sup>1</sup> "Behavioral, Cognitive, Developmental, Social Cognitive & Constructivist Perspectives," Study.com, Accessed November 22, 2016, <http://study.com/academy/lesson/behavioral-cognitive-developmental-social-cognitive-constructivist-perspectives.html>.