

TReDS: A Facilitating Step towards Financial Inclusion of MSMEs in Economic Landscape

Despite being called as the backbone of Indian economy, MSMEs often struggle with adequate cash flows. The government of India and RBI identified this long prevailing problem and came up with the concept of TReDS (Trade Receivable Discounting System). Trade Receivables Discounting System is an interesting example of how digitisation is helping Micro Small and Medium Enterprises (MSMEs) get access to working capital by auctioning their receivables. TReDS is an electronic platform that allows businesses to auction trade receivables (invoices), and the platform serves as a transparent and quick medium for the small scale players to avail funds at cheaper rates, through banking and factoring companies. On 2nd of November, 2018 the Ministry of MSME issued a notification to the organisations having annual turnover of over ₹ 500 crore, in which the ministry made it mandatory for such companies to register themselves on an RBI approved TReDS platform.



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The November 2018 notification from Ministry of MSME, which made organisations having annual turnover of ₹ 500 crore to register them on an RBI approved TReDs platform, has had a positive impact on the corporate companies and Banks. Companies have become keen on registering on TReDS platform and the banks have developed faith in the platform. According to the latest data made available by M1xchange, the platform has enabled discounting of over INR 3226cr worth of invoices by the end of May '19. Forty per cent of the total funding on the platform has been done for the MSMEs in Tier II and Tier III cities of India.

An Introduction to TReDS

RBI's Trade Receivables Discounting System (TReDS) is an interesting example of how digitisation is helping Micro Small and Medium Enterprises (MSMEs) get access to working capital, by auctioning their receivables. TReDS is an electronic platform that allows businesses to auction trade receivables such as invoices, and the platform serves as a transparent and quick medium for the small scale players to avail funds at cheaper rates, through banking and factoring companies. The system is a game-changer. The benefits include quick turnaround, and lower finance cost owing to digitised information.

As an automated system driven platform, TReDS facilitates auction of trade receivables at competitive market rates through transparent bidding process by multiple financiers. This helps in quick realisation of receivables, banks sharing the risk of receivables with MSME and appropriate price discovery.

In a latest development, the Central Government (Ministry of MSME) issued a notification on 2nd November 2018, stating that all companies (with a turnover of more than INR 500 Cr) registered under the Companies Act, 2013 including PSU companies, shall be mandatorily required to get themselves registered on a Trade Receivables Discounting System (TReDS) platform. This development has and in coming times will enable the Suppliers to use this discounting facility, as the corporate buyers and PSU's have started to register on the exchanges. This compliance will practically accelerate availability of working capital finance for MSME suppliers.

Registration for corporate on a TReDS platform is a simple process and can be easily done with submission of application form, KYC and signing of agreement. This process gets completed within 2 days from the date of submission of necessary documents.

As the transactions on TReDS platform happen digitally; several risk-mitigating controls at various levels have been implemented. KYC & AML checks on participants getting on board, OCR technology comparing the invoice data with the data fed, Suspicious

Transaction & threshold breach alerts are implemented at various places to monitor the transaction behaviour vis-à-vis participant's profile and past transaction history. At each stage, all participants are kept informed of a transaction through various notifications and online dashboards. To enhance the security, digital signature has been made mandatory by the government to initiate any transaction on the platform.

How TReDS Work

The bill discounting process starts when the MSME Supplier raises the invoice and the Buyer validates the same. This permits the financiers which are the Banks or the Factoring Companies to bid against the verified invoice. Once the supplier accepts the bid, the payment is processed in T+1 day, where T is the day of transaction. This process gives flexibility to the Suppliers to choose the best financier on financing cost. Rate of interest and multiple bidding on an invoice varies from platform-to-platform. The platform with maximum bank ensures maximum bidding and better rate of interest against an invoice. As a result suppliers are assured of discounting at reasonable rates and quick turn-around time of bidding. On due date of the invoice, the discounting portal collects the proceeds from Corporate buyer and repay it to the bank that has financed the invoice. Therefore, Supplier does not need to follow up with Corporate buyer for collection of proceeds any more on due date. The risk

of collection is transferred to financing bank. The portal therefore enables tomorrow's collection of proceeds today and helps the suppliers maintain a healthy flow of working capital.

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Business Case

Here is a small real life business case where the cash flow problem of an MSME was solved with TReDS

AAA Industries (*name changed to maintain confidentiality*), a 9-year-old MSME is a manufacturer and supplier of electrical ancillaries to a pool of mid-size and large

companies. As part of the contract, its buyers have agreed to make the payments against the invoices within 45 days of order delivery. These clients have good corporate credit, so the MSME owner is assured of timely payments. However, there are a few slow paying invoices creating undesirable cash flow blockage.

AAA industries has a big order to fulfil in the next month. This requires purchase of materials and pay their small vendors. Most of the working capital of AAA industries is consumed in dealing with general expenses and payroll liabilities. The MSME owner soon realise that inadequacy of working capital has started to result in business failures at micro levels and can soon impact the overall business. The company will not be able to grow and acquire new clients until they build a meaningful financial reserve to support the current ones.

AAA Industries could solve their current cash flow problems using a working capital credit or a business loan from a bank. However, banks require collateral and guarantor to sanction a loan and offer limited amount to small businesses based on their past year performance. This lending process involves a lots of documentation and long turnaround time and yield limited results of amount of financing. Due to this AAA industries approach non-banking financiers and bear high interest rate of approximately 18% to fill the gap in working capital requirement for growth.

The Solution

One of the corporate buyers of AAA Industries, which has recently on-boarded one of

TReDS platform, asked the MSME to register with the same TReDS platform and upload its invoice for bill discounting. With one time documentation and some KYC formalities the MSME registers on platform in simple steps. The supplier, AAA Industries in this case, uploads an invoice on the portal which is approved by its corporate buyer. After the invoice is approved, it is open for bidding by various financiers on the platform. Once AAA accepts the best suited bid, the discounted amount is credited to its bank account within 2 days. AAA can discount all its invoices raised to its buyer and transform from a cash deficit company to a cash surplus organisation. There is no requirement of collateral or guarantor and past performance for the business.

In order to avoid any kind of duplicity of invoice, the transactions on the portal are secured using block chain technology and the process is completely transparent.

Benefits of TReDS

Key benefits of invoice discounting and exchange services -

1. Minimise cost for AAA industries.
2. It does not add borrowings or any additional liability on the balance sheet.
3. It does not use the cash flows of the buyer for the pre-payment.
4. Much faster turnaround than unconventional supply chain facilities by the banks. Payment is realised in 1 day from approval of invoice by Buyer.
5. Risk of collection from Buyer is reduced as there is no recourse on AAA industries.
6. Minimal paperwork one time and thereafter invoices are discounted digitally.
7. Security of digital platform for confidentiality of information.
8. Minimise the duplicate payments and other operational risks
9. Can be integrated with ERP systems and avoid manual processes

Impact of TReDS

The MSME is able to solve its problem of steady cash flow and working capital with TReDS. Funds are now received directly in bank account within one day of acceptance of the best bid by MSME. Invoice discounting on TReDS platform has drastically lowered the rate of interest for acquiring working capital to 6-7%.

The biggest benefit to AAA industries is that since they have easy access to working capital, they are able to acquire new clients. Now the MSME can buy new machinery, increase the headcount and pitch in for bigger orders.

TReDS has provided a collateral free and without-recourse financing with hassle free and paperless documentation through a secure and digital platform. The MSME Supplier now enjoy better working capital management all the while increasing the options of expanding the business faster.

Here are key advantages of registering on a TReDS Platform:

1. Reduced operational cost
- The cost of business between MSME seller and corporate buyer is reduced as there is an interest cost saving of at least 4-5% annualised.
2. No collateral required-
This adds to saves as there is always an opportunity cost attached to providing collateral.

The key advantages of registering on a TReDS Platform include Reduced operational cost, Non-requirement of collateral, One time documentation with the exchange, No increase in Borrowings and Cash is realised as soon as the bid is accepted by the supplier, and No reflection of borrowing in books of Corporate Buyer

3. One time documentation with the exchange- No separate documentation for availing discounting facility with multiple banks and for multiple corporate buyers.
4. Borrowings are not increased for MSMEs – Cash is realised as soon as the bid is accepted by the supplier, thus making it early income realisation instead of a borrowings in the books.
5. No reflection of borrowing in books of

Corporate Buyer as the transaction is initiated between MSME supplier and financing bank. For corporate buyer the payables is reflected on as-is basis.

Risk Mitigation

Although TReDS being a highly secure and transparent platform, the risk mitigation steps have to be taken to curb any possibility of fraud or illicit practice. There are several measures that can be taken by the platforms to curb accommodation of bills which is a common risk today that exists even beyond the TReDS ecosystem. While mitigating this although 100% may not be possible right away, it can be controlled with digital transformation of factoring process through TReDS. Below are certain controls measures should be taken by the TReDS Platforms

- **Pattern Analysis:** At the time of on boarding, business of past year is declared by Supplier with respective Buyer. This should be matched with Turnover of Supplier to see at high level if numbers makes sense. Basis the past year business between Supplier and Buyer, limit should be set as threshold for Supplier on the platform. If value of invoices comes to very high and unusual amount, system should stop the transaction and send the trigger to the respective platform's compliance team who checks the reason for increase. This may be due to more orders, larger volumes and accordingly PO copy and/or projections and/or written confirmations are taken from Buyer and Supplier.
- **Random Audit:** Random Sample audits should be

performed by the platform's audit team to ensure the authenticity of transactions on periodical basis.

- **GSTN Verification:** All invoices should be verified against the GSTN database as to verify the accuracy of genuine invoice. This in development and expected to be live very soon.

Control to Curb Double Financing

- At the time of on boarding of Supplier, Supplier declares the details of Working Capital Bank Account (The entity is legally bound to do so otherwise it will tantamount misrepresentation). TReDS platform should send intimation to working capital bank account providing the detail of Supplier. If there is any objection received, transactions should be stopped unless Supplier takes No objection from Working Capital Bank Account.
- Intimation to working capital bank account should be sent for every transaction at the time of discounting.
- Discounted proceeds should be credited to working capital bank account.
- Supplier should be legally bound to declare the details to working capital bank account and get its DP adjusted.
- OCR technology deployment can be done to help curbing mismatches in data punching and actual invoice detail to great extent.
- Through block chain utility, all three exchanges are integrated and one bill which gets discounted on one platform cannot be financed on other platform due to this check. ■