# Trade Receivables Discounting System an Emerging Financial Service

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**Abstract :** In this paper we have tried to bring forth how the setting up of an institutional mechanism for financing Trade Receivables helps Micro Small and Medium Enterprises (MSMEs) in converting their Trade Receivables into Liquid Funds. The process that will be required to be followed for registering at TreDS is also discussed. The benefits accrued by this system to various participants is brought forth. This paper also throws light on the other side i.e the difficulties posed by this system to the participants of TReDS.

## INTRODUCTION

The role of Micro, Small and Medium Enterprises (MSMEs) in the economic development of India needs no reiteration. Given the potential of this segment to unlock growth, employment and inclusion in the economy and society, it is indeed the need of the hour to address concerns related to financing of this segment. Despite all efforts of the government and banks, the MSME segment continues to be belaboured with the problem of delayed payments, mainly due to the dependency of these MSMEs on their corporate buyer/s as well as their inability to take up the problem of delayed payments through appropriate institutional setup created for the purpose.

One of the key constraints impacting the Micro, Small and Medium Enterprises (MSMEs) is inadequate finance, particularly working capital. In the case of MSMEs, the need for quick conversion of trade receivables, an important component of current assets of business entities, into cash assumes great importance since the lack of opportunities affects their liquidity and thereby their business, quite significantly. However, despite of all the initiatives taken by the Govt. of India and RBI to address the issue of delayed payments of MSMEs, the problem continues to persist primarily because of the dependency of the MSMEs on the corporate buyer and the inability of the MSMEs to take up the problem of delayed payments through appropriate institutional setup created for the purpose. Thus, need was felt to build a suitable institutional infrastructure which will not only enable an efficient and cost effective factoring / reverse factoring process to be put in place, but also ensure sufficient liquidity is created for all stakeholders. To this effect RBI has recently issued guidelines under section 10(2) read with Section 18 of Payment & Settlement Systems Act, 2007 (Act 51 of 2007) for **setting up of and operating the Trade Receivables Discounting System (TReDS)** on 3rd December 2014.

**SCHEME of Operation :** RBI has given the scheme for setting up and operating the institutional mechanism, for facilitating the financing of trade receivables of MSMEs from corporate and other buyers, including Government Departments and Public Sector Undertakings (PSUs), through multiple financiers is known as Trade Receivables Discounting System (TReDS). This scheme is expected to facilitate the discounting of both invoices as well as bills of exchange. Further, the TReDS could deal with both receivables factoring as well as reverse factoring so that higher transaction volumes come into the system and facilitate better pricing. All the transactions processed under TReDS are to be "without recourse" to the MSMEs.

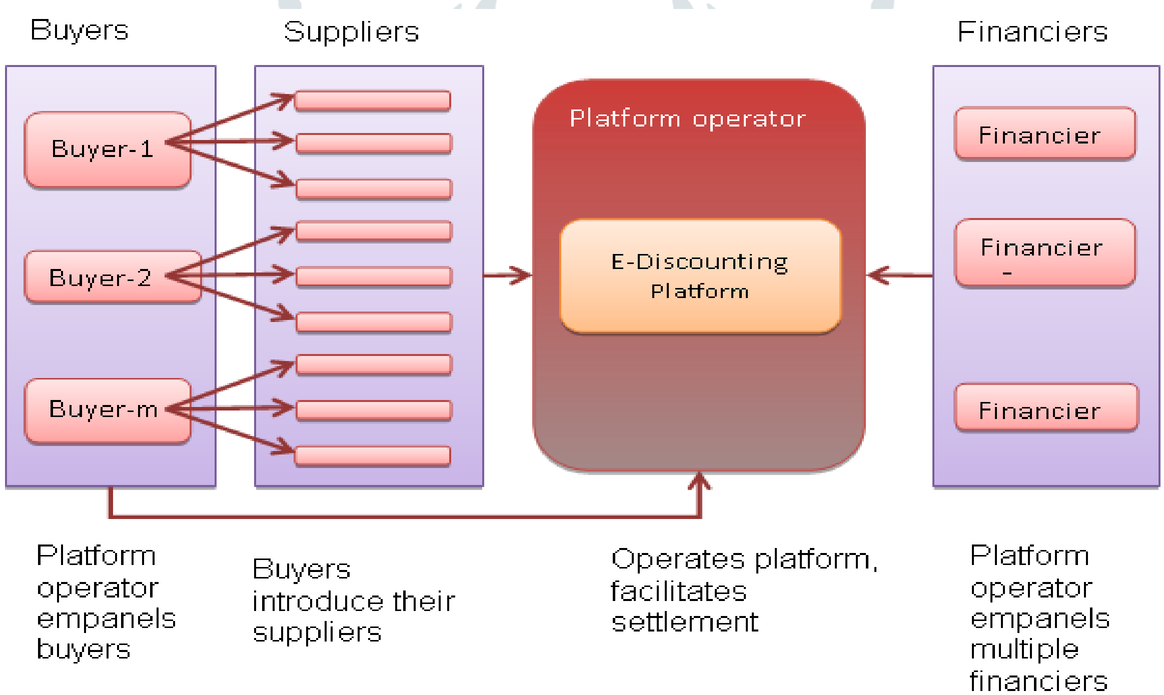
The TReDS thus provides a platform to bring the various participants namely MSME sellers, Corporate and other buyers, including the Government Departments and PSUs as well as Financiers together. It facilitates uploading, accepting, discounting, trading and settlement of the invoices / bills of MSMEs. The backend support is provided by various technology providers, system integrators as well as entities that provide dematerialisation services for providing its services.

For the purpose of this scheme a Factoring Unit is defined as an invoice or a bill on the system. These can be created by the MSME seller (in case of Factoring) or by the Coperate and other buyers (in case of Reverse Factoring) as the case may be. Government

Departments and PSUs can also create factoring units in case of reverse factoring. Another very important term here is Financier which herein refers to a Bank as well as an NBFC factor participating in the TreDS and accepts the factoring unit for financing purposes.

**Operating Procedure of TreDS :** The operating platform or mechanism put in place to facilitate financing of invoices / bills of MSMEs ia as given below. It is an electronic platform provided to all participants where all information about bills/invoices is disseminated by TReDS on r**eal time** basis. It is envisaged to have a online surveillance capability to monitor position, prices and volumes in real time in order to check system manipulation.

**Figure 1: The platform of Trade Receivables Discounting System**




Source: RBI – Concept Paper on Trade Receivables and Credit Exchange for Financing of MSME

The major steps involved in the flow of this process are :

- The process for **on-boarding of buyers** and sellers on the TReDS requires the entities to submit all KYC related documents to the TreDS along with resolutions / documents specific to authorised personnel of the buyer and MSME seller. The authorised personnel would be provided with IDs / Passwords for TReDS authorisations (multi-level).

- There is a One –time agreement among participants in the TReDS
  - * Firstly there is a Master agreement between the financier and the TReDS stating the terms and conditions of dealings between both the entities.
  - * Secondly a Master agreement between the buyers and the TReDS stating the terms and conditions of dealings between both the entities. This agreement should clearly mention the buyers obligation to pay on the due date once the factoring unit is mentioned online. There is no recourse to disputes related to quality of goods and otherwise.
  - * Thirdly a Master agreement between the MSME sellers and the TreDS . this agreement has a declaration / undertaking by the MSME seller that, in respect of goods and services underlying the factoring unit, no finance is extended by the working capital financing bank and such goods and services are not charged to the working capital financing bankers.
  - * In case of financing on the basis of invoices, an assignment agreement would need to be executed between the MSME seller and the financier.
  - * The TReDS will be in custody of all the agreements.

- The MSME seller on the basis of an invoice or bill of exchange creates a factoring unit on TreDS. The buyer also logs on the TReDS and flags this factoring unit as accepted. However this process of creation of factoring unit could be initiated by the buyer in case of reverse factoring.
- Creation of an factoring unit automatically generates a notice / advice to the buyers bank informing it about this.
- A window period is given to financiers to qoute there bids against factoring units. Once it is accepted by the MSME seller there is no option for revising the bids quoted online.
- The MSME seller is free to accept any of the bids and the financier will receive the necessary intimation. Financiers will finance the balance tenor on the factoring unit.

- Once a bid is accepted, the factoring unit will get tagged as "financed" and the funds will be credited to the seller's account by the financier on T+2 basis (T being the date of bid acceptance). The actual settlement of such funds is as given in the Settlement section.

**Settlement Process of TreDS:** once a bid is accepted then comes the issue of timely settlement of funds between the parties involved. In order to ensure smooth payments the TReDS will be required to

- Generate payment obligation of all financiers of all factoring units financed on a given day in order to start the process of settlement between financier and MSME for accepted bids. This file is send for settlement in any of the existing payment system as agreed by the participants.
- Settle the payments between the buyer and financier on due date. The TreDS generates the payment obligations file and send the same for settlement on due date to the relevant payment system.
- These settlement files generated by TReDS are sent to existing payment systems for actual payment of funds. This ensures that inter-bank settlement will take place and defaults, if any, by the buyers will be handled by the buyer's bank. Thus this settlement process ensures payments to relevant recipients on due date, thus, facilitating the smooth operations on the TReDS. A word of caution here that it would not entail a guaranteed settlement by the TReDS.
- The TReDS is required to put in place a mechanism for bankers to report defaults in payments by buyers. This would ensure adequate arbitration and grievances redressal mechanism to be put in place.

**Regulatory Environment**

- The TReDS, would be governed by the regulatory framework put in place by the Reserve Bank of India under the Payment and settlement Systems Act 2007 (PSS Act).
- It will function as an authorised payment system under the PSS Act 2007.
- The activities of the TReDS as well as those of the participants in the TReDS would be governed by the relevant legal and regulatory provisions applicable to various stakeholders in the system.

- Processes and procedures of the TReDS should be compliant with such legal and regulatory provisions which may be issued and amended from time to time by respective authorities.

**Advantages of TReDS:** the major benefits provided by the trade receivables discounting system are as follows:

- The TReDS will provide the platform to bring MSME sellers, corporate and other buyers, including the Government Departments and PSUs, and financiers (both banks and NBFC factors) participants together for facilitating uploading, accepting, discounting, trading and settlement of the invoices / bills of MSMEs thus **speeding up the process of obtaining Finance.**
- The TReDS may tie up with necessary technology providers, system integrators and entities providing **dematerialisation services** for providing its services which reduces paper work.
- The TReDS uses factoring which is an effective and relatively **low-risk and low-cost** means of expanding access to **working capital finance**.
- Even the small, risky enterprises that lack access to formal credit will be able to use their receivables from big buyers to secure working capital finance. In effect, their credit risk is transferred to their lower-risk customers.
- Factoring transactions are completed through TReDS's electronic platform, which will definitely reduce transaction costs and improve security.
- This platform also facilitates the participation of all commercial banks in the program and thus introduces the element of competition for suppliers' receivables.
- This system will bring in more transparency as its one-time on-boarding process will require the entities to submit all KYC related documents to the TReDS, along with resolutions / documents specific to authorised personnel of the buyer, and the MSME seller. Such authorised personnel would be provided with IDs / Passwords for TReDS authorisations (multi-level). It will require one-time **agreement** drawn up amongst the participants in the TReDS which will remain in its custody.

**Limitations of TReDS:** It requires the factor to collect credit information on a large number of buyers which would be difficult and costly as the MSME sector does not have robust credit bureaus. Any legal proceedings to be initiated by one entity against another, if at all, will be outside the purview of TReDS. As the transactions processed under TReDS will be "without recourse" to the MSMEs it will be more costly as the fees charged by the factor for undertaking risk may be high. There is a threat that factors purchase the accounts receivables of only the large, more credit worthy buyers which will leave the micro and small industries problems unaddressed.

**Conclusions:** In this paper we have brought forth the nitty gretties of the TReDS. How it is designed and the process that is to be followed in order to get requisite funds that are needed for managing the working capital. The advantages that this system provides to the MSMEs are tremendous and will help them in resolving their financial issues to a certain extent. Just as any other system this also has its own limitations. However In order to address the issue of non-availability of adequate finance by MSME's, particularly in terms of their ability to convert their trade receivables into liquid funds, setting up of an institutional mechanism for financing trade receivables is a very good initiative which can take India a step ahead in the direction of our mission **"Make in India".**

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