Trade Receivable Discounting System (TReDS)*

Genesis of TReDS

Micro, Small and Medium Enterprises (MSMEs) plays an important role in the economic development of India. The Indian MSME sector is the backbone of the national economic structure and has unremittingly acted as the mainstay for the Indian economy, providing it resilience to ward off global economic shocks and adversities. With around 63.4 million units throughout the geographical expanse of the country, MSMEs contribute around 6.11% of the manufacturing GDP and 24.63% of the GDP from service activities as well as 33.4% of India's manufacturing output. They have been able to provide employment to around 120 million persons and contribute around 45% of the overall exports from India. But despite their mammoth contribution towards stoking up the economic growth and contribution to Gross Domestic Product MSMEs, continue to face constraints in obtaining adequate finance, particularly in terms of their ability to convert their trade receivables into liquid funds. In order to address this vital issue through setting up of an institutional mechanism for financing trade receivables across India, the Reserve Bank of India published a concept paper on "*Micro, Small & Medium Enterprises (MSME) Factoring-Trade Receivables Exchange*" in March 2014.

Based on the public comments received on the Concept Paper and the subsequent draft guidelines issued for setting up and operating the system, and interactions held with relevant stakeholders, guidelines were issued regarding setting up and operating the trade receivables system in the country. These Guidelines were issued by Reserve Bank of India under Section 10(2) read with Section 18 of Payment & Settlement Systems Act, 2007 (Act 51 of 2007).

In 2018, the Government made it mandatory for all companies with a turnover greater than Rs.500 crores to register with TReDS. As on February 2020, while 8211 MSME sellers were registered, only 1530 buyers were participating on the platforms.

Trade Receivable Discounting System (TReDS) Scheme

Trade Receivables Discounting System or TReDS is an initiative undertaken by Reserve Bank of India to safeguard the interest of micro, small and medium enterprises (MSMEs) as they always finds it very hard to convert their trade receivables into liquid funds in short period. TReDS is an electronic platform for facilitating the financing / discounting of trade receivables of MSMEs through multiple financiers. These receivables can be due from corporates and other buyers, including Government Departments and Public Sector Undertakings (PSUs).

The TReDS facilitates the discounting of both invoices as well as bills of exchange. Further, as the underlying entities are the same (MSMEs and corporate and other buyers, including Government Departments and PSUs), 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. The transactions processed under TReDS will be "without recourse" to the MSMEs meaning that MSME vendors need not be responsible for non-payment of the trade receivables amount (from buyers).

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Participants under TReDS System

MSME sellers, corporate and other buyers, including the Government Departments and PSUs, and financiers (both banks and NBFC factors) are direct participants in the TReDS. The TReDS provide the platform to bring these participants together for facilitating uploading, accepting, discounting, trading and settlement of the invoices / bills of MSMEs. The bankers of sellers and buyers may be provided access to the system, where necessary, for obtaining information on the portfolio of discounted invoices / bills of respective clients. The TReDS may tie up with necessary technology providers, system integrators and entities providing dematerialisation services for providing its services

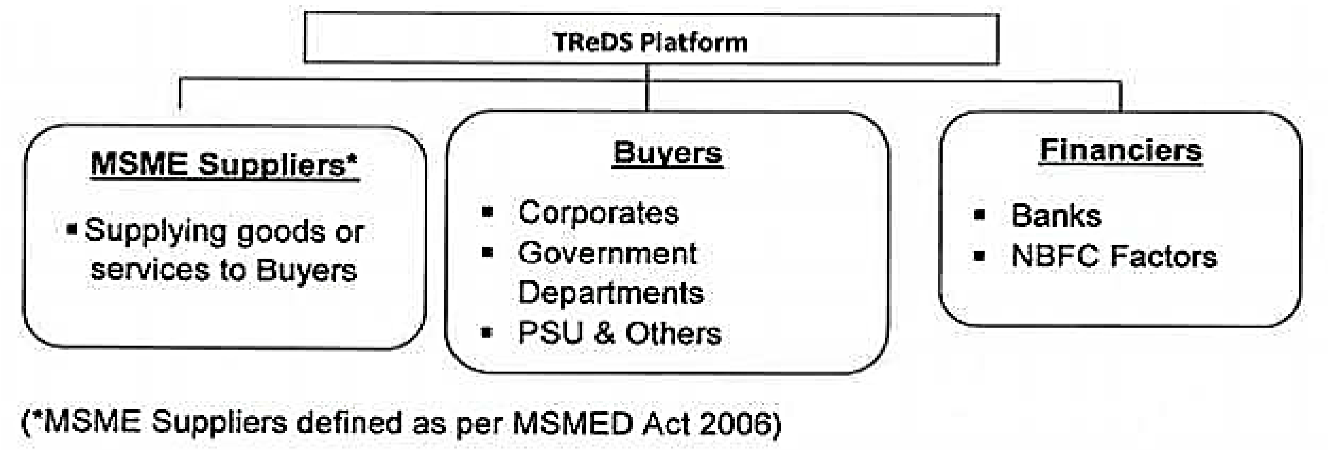

Image Source: Economic times

Working mechanism of TReDS

A seller has to upload the invoice on the platform. It then goes to the buyer for acceptance. Once the buyer accepts, the invoice becomes a factoring unit. The factoring unit then goes to auction. The financiers then enter their discounting (finance) rate. The seller or buyer, whoever is bearing the interest (financing) cost, gets to accept the final bid. TReDs then settle the trade by debiting the financier and paying the seller. The amount gets credited the next working day into the seller's designated bank account through an electronic payment mode. The second leg of the settlement is when the financier makes the repayment and the amount is repaid to the financier.

To summarize, following steps take place during financing / discounting through TReDS:

1. Creation of a Factoring Unit (FU) - standard nomenclature used in TReDS for invoice(s) or bill(s) of exchange - containing details of invoices / bills of exchange (evidencing sale of goods / services by the MSME sellers to the buyers) on TReDS platform by the MSME seller (in case of factoring) or the buyer (in case of reverse factoring);
2. Acceptance of the FU by the counterparty - buyer or the seller, as the case may be;
3. Bidding by financiers;
4. Selection of best bid by the seller or the buyer, as the case may be;
5. Payment made by the financier (of the selected bid) to the MSME seller at the agreed rate of financing / discounting;
6. Payment by the buyer to the financier on the due date.

The TReDS platform providers in the country

RBI has given license to three entities and they are governed by the Payment and Settlement Systems Act, 2007. These are Receivables Exchange of India (RXIL), which is a joint-venture between National Stock Exchange and SIDBI; A.TReDS, a joint-venture between Axis Bank and Mjunction Services and Mynd Solution.

Process flow and procedure

Once registered on one of the three TReDS platforms, here's how the process flow works, supported by RBI data:

1. The corporate buyer indicates the intention to buy by sending a purchase order to the MSME seller.
2. The MSME delivers the goods and generates an invoice. At this stage, there may or may not be an accepted bill of exchange between the buyer and the seller.
3. Based on the invoice or bill of exchange, the MSME goes on their registered TReDS platform creates a 'factoring unit.' The buyer also logs on to TReDS and accepts this factoring unit.
4. Based on the invoice or bill of exchange, the TReDS will standardise the time window available for corporate buyers to 'accept' the factoring units.
5. The MSME seller may decide to go on the TReDS platform and upload documents supporting evidence of the movement of goods.
6. The TReDS will have separate modules for transactions with invoices and transactions with Bills of Exchange.
7. Factoring units may be created in each module as required. Each such unit will have the same sanctity and enforceability as allowed for physical instruments under the 'Factoring Regulation Act, 2011' or under the 'Negotiable Instruments Act, 1881'.
8. The standard format and features of the 'factoring unit' will be decided by the TReDS platform. But each unit will represent a confirmed obligation from the buyer to pay. The unit will have all details such as information of the seller and the buyer, issue date, due date, amount due, etc.
9. The TReDS platforms should be able to filter these factoring units by any of the above parameters. This provides flexibility of operations to the stakeholders.
10. A notice or advice is created and automatically sent to the buyer's bank once the factoring unit and all the details have been generated.
11. These factoring units can be financed or bid for by any of the financiers registered on the TReDS platform. The final amount quoted by the financier can be viewed only by the MSME seller and not other financiers.
12. There will be a window period provided for financiers to quote these bids against factoring units. Further, financiers are free to choose how long their bids are valid.
13. The MSME then chooses and accepts any bid. The financier then gets the notification that their bid has been accepted.
14. Once a bid is accepted by the MSME seller, financiers cannot revise or change their bid.
15. The factoring unit will then get tagged as 'financed' and the funds will be deposited in the MSME seller's account by the financier on T+2 basis (two business days after the date of

acceptance). However, TReDS platforms can choose to speed up the time taken for payment. For instance, MSMEs on the M1xchange platform receive payment in T+1 days (one business day after the acceptance).

16. Simultaneously, financing by a financier generates another notice to the buyer's bank which enables a direct debit from the buyer's account to the financier's account on the due date. These are based on the settlement obligations generated by the TReDS platform.

17. On the due date, the corporate buyer transfers the due amount to the financier. All the while, the TReDS platform sends due notifications to corporate buyers and their banks reminding them of the amount due.

18. If the buyer doesn't pay on the due date, it will attract penal provisions and enable the banker to proceed against the corporate buyer.

19. Any action in this regard will be strictly non-recourse with respect to the MSME sellers.

20. After financing, these instruments are rated by the TReDS platform and may be further transacted or discounted among financiers in the secondary segment.

21. Any successful trade in the secondary segment will also automatically result in a direct debit authority being enabled by the buyer's bank in favour of the financier.

22. In case any factoring unit is unfinanced, the buyer corporate will pay the MSME seller outside of the TReDS platform.

Image sources: M1Xchange

Regulatory framework for TReDS

The TReDS, which undertakes clearing and settlement activities, is 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 functions 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 are governed by the relevant legal and regulatory provisions applicable to various stakeholders in the system. As such, the 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.

Article

Conclusion

Trade Receivables Discounting System (TReDS) is a digital platform to support micro, small and medium enterprises (MSMEs) to get their bills financed at a competitive rate through an auction where multiple registered financiers can participate.

The RBI, thus by undertaking Trade Receivables Discounting System (TReD), has mechanized the financing of trade receivables of MSMEs from corporate buyers through two or more financiers. All the registered MSMEs can discount their bills of exchange or invoice through TReDS with a quoted price. This system will ensure the competitive pricing offer from the financer. The seller can opt for a financer of his choice. TReDS deals with discounting of both invoices and bills of exchange. It has been well-equipped with discounting and re-discounting of trade receivables thus facilitating higher volumes of transaction with better pricing.

The concept of TReDS, an institutional mechanism for financing trade receivables on a secure digital platform has been introduced by RBI with an intention to decrease the financing concerns faced by MSMEs in India,. Trade Receivable Exchanges, standardizes the process of funding MSMEs via Invoice Discounting and this will help the MSMEs in the long run to compete in the market.

In the Union Budget 2020-21, the Government has announced app-based invoice financing products to obviate the problem of delayed payments of MSME. The mechanism may prove complementary to the TReDS platform and would further alleviate the problem of delayed payments.

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