Democratising Supply-chain Finance for MSMEs

Could TReDS Be the Game Changer?

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Despite the significant contribution of micro, small, and medium enterprises, they face critical funding issues in the supply-chain process and are often at the mercy of large corporates or big manufacturers. MSMEs are not only financially weaker, with difficulties in sourcing capital, but they are also charged heavily by banks for the working capital fund. In this context, the introduction of TReDS as a price discovery mechanism for MSMEs is a significant step in ensuring financial stability in the supply chain.

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The Trade Receivables Electronic Discounting System (TReDS) is an online platform that has been introduced in the Indian financial system as a mechanism to enable micro, small, and medium enterprises (MSMEs) to access working capital by discounting their trade receivables.[1] MSMEs have been the backbone of the economy of the country, with significant contributions to the manufacturing process and employment generation. However, they continue to face capital and liquidity constraints. Under TReDS, MSMEs can avail financial assistance based on the invoices raised on large corporate buyers and without providing additional collateral security.

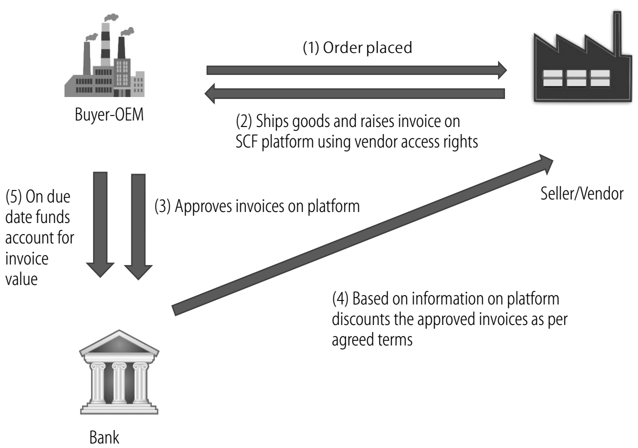
Historically, the availability of finance has always been a constraint for the growth of the MSME sector in India. It is estimated that only 10% of the total receivables market is presently covered under the formal bill-discounting mechanism in the financial system, while the rest is covered under conventional cash credit/overdraft[2] arrangements with banks. This is because the bill-discounting mechanism has its own challenges in terms of documentation requirements and operational procedures. Consequently, MSMEs face challenges in converting trade receivables into cash, directly impacting their liquidity and, thereby, their business. MSMEs find themselves vulnerable to larger corporations that often prefer to postpone their payments, allowing them to benefit from prolonged credit, which harms the interests of the former. Despite many policy initiatives, the issue of delayed payments experienced by MSMEs continues to persist, primarily because of the lack of appropriate institutional set-up, which helps with price discovery for MSME finance and is also independent of the corporate buyer's payment system. Therefore, an institutional infrastructure was required to build an efficient and cost-effective financing process to ensure sufficient liquidity for all stakeholders.

It is in this context that the TReDS was conceived by the Reserve Bank of India (RBI) to improve the gap between the demand and supply of finance by MSMEs and provide a level playing field using price discovery and non-recourse mechanisms. TReDS facilitates financing/discounting through multiple financiers like banks and non-banking financial institutions (NBFCs). It enables shifting the financing of MSMEs from individual banks to the marketplace structure driven by MSMEs. These receivables can be dues from corporates and other buyers, including government and public sector undertakings (PSUs). The Factoring Regulation Act, 2012 provides a regulatory framework for the financing of receivables as well as payables, and has emerged as an alternative method of provision of working capital finance. Using factoring products, TReDS has also gained significant volumes. In this context, we explain the operational framework of supply-chain finance (SCF) in terms of (i) the product model in which the MSMEs depends on banks for their finances; (ii) the anchor-based model where MSMEs get the advantage of bill discounting depending on the creditworthiness of the large corporate; and (iii) the marketplace model which is renowned for its price-discovery mechanism with the usage of TReDS. We also present a few facts to understand if TReDS is a success in terms of its usage.

Exploring the Operational Framework of SCF

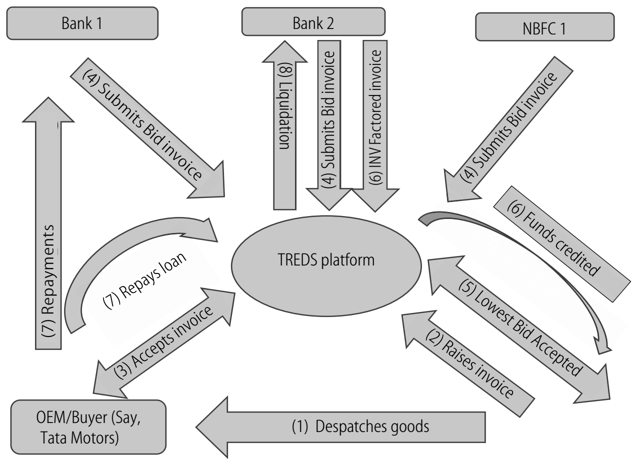
SCF refers to structures and products used for financing either the receivables or payables of an enterprise. In this article, we restrict our discussion to the financing of the receivables of an MSME vendor (the supplier) under SCF based on the payment confirmation by buyers who are often large corporates. The large corporates or original equipment manufacturers (OEMs) depend on MSMEs for an uninterrupted supply of components for manufacturing the final product. On the other hand, MSMEs depend on a timely and adequate supply of capital to

Figure 1: Programme Model—Anchor or OEM-led Model



Source: Compiled by the authors.

Figure 2: Marketplace Model—TReDS-led Model



Source: Compiled by the authors.

fulfil their commitments. The supply of capital is usually by way of financing the receivables by the MSME's bank. The bank, in turn, has the responsibility of ensuring the authenticity of the underlying transaction, in addition to credit appraisal and monitoring of the end use. Against this backdrop of cyclical dependency in SCF, we delve into three primary modes of delivery of SCF in the banking sector: (i) the product model involving the MSME and the financiers (banks); (ii) the programme model or anchor-based model where the financing is dependent on the creditworthiness of the OEM; and (iii) the marketplace model which provides the MSMEs a market where the financiers can bid on the receivables as per their risk appetite with the associated advantage of price discovery.

The product model requires an MSME vendor to submit the invoices accepted by the OEM (say Tata Motors) to its financier (bank). The bank discounts the bill upfront as per the limits sanctioned to the MSME vendor and credits the proceeds to the MSME's account. On the due date, the bill is liquidated by the receipt of proceeds from the OEM. This model primarily uses traditional trade finance products, like bill discounting, bill negotiation, and export finance.

On the other hand, the programme model is built around the OEM, which is designated as the anchor of the programme. Here, the OEM leverages its credit rating and invites the financiers or banks to finance all the MSMEs that are part of its supply chain. The banks complete the credit assessment and the onboarding of the MSMEs into their system, sanction the limits of receivables finance to the MSMEs. Here, in addition to the collateral/security available from MSMEs, there is a commitment on the part of the OEM to honour its payment commitment. This flow of finance is popularly known as vendor finance. The workflow of the programme model using the proprietary portals of the financiers is described.

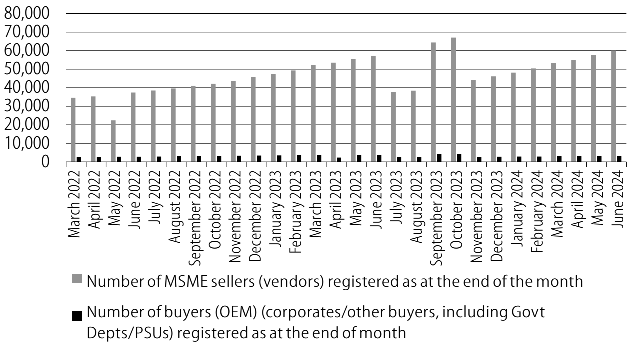
In Figure 1, we can see three stakeholders—the vendor/MSMEs, the buyer/anchor (OEM), and the financiers or banks who are registered on the portal[3] under their respective roles. The vendor dispatches the goods to the OEM and raises an electronic invoice on the portal. The OEM checks the invoices with its own enterprise resource planning (ERP) and either rejects them or approves them for payment with a 90-day (for example) credit period. Once the OEM approves the invoice on the portal, the invoice becomes available to the financier for discounting. Based on its sanction terms, the financier will block the limit of the vendor in its core banking system and credit the proceeds net of margin, interest, and charges to the working capital account of the vendor. Thus, the vendor, based on its cash flow requirement, can get its sales financed instead of depending on the OEM to pay on, say, the 90th day. On the 90th day, the OEM remits funds to the financier, thereby completing the transaction. In India, large companies such as Tata Motors, Mahindra and Mahindra, Bajaj Auto, etc, partner with banks like HDFC, Kotak, and State Bank of India under the programme model.

The third model is known as the marketplace model. It has been operationalised through TReDS. The buyers, sellers and financiers are the participants in the platform, and factoring is the underlying trade product that is used for operationalising the transaction. In this model, authorised operators, for example, A.TReDS Limited, Mynd Solutions Private Limited, Receivables Exchange of India Limited, etc, host platforms under the TReDS programme. They are responsible for the operational aspect of the platform and charge a fee for their services. These operators are additional stakeholders vis-à-vis the other two SCF models discussed above, ensuring the efficient functioning of the marketplace model by way of institutionalising the process of bill discounting. The detailed structural flow is described below.

Figure 2 reveals that under TReDS, MSME vendors are registered as sellers. OEMs are registered as buyers, and multiple banks and NBFCs are registered as financiers. Unlike the programme model or OEM-led model, here, multiple buyer–seller combinations are registered for their respective businesses. For example, if one MSME sells its products to Tata Motors as well as to Mahindra and Mahindra, it can raise invoices for different trade transactions under TReDS.

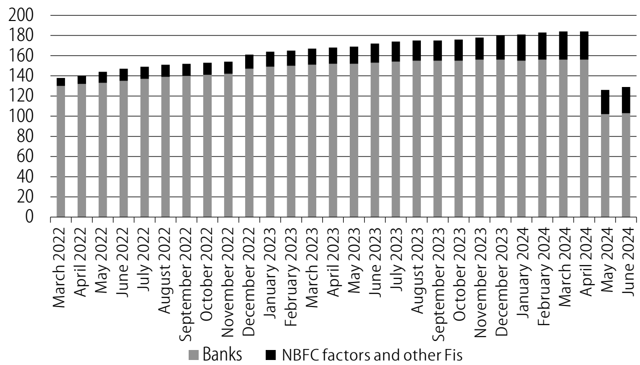
Figure 2 explains the TReDS flow for the seller ABC. Once ABC dispatches

Figure 3: TReDS—Number of MSMEs and OEMs Utilising the Market-based Platform



Source: Authors' compilation using RBI Database, downloaded from https://www.rbi.org.in/Scripts/TReDSStatisticsView.aspx, on 9 September 2024.

Figure 4: Financiers in TReDS—Banks and NBFCs



Source: Authors' compilation using RBI Database, downloaded from https://www.rbi.org.in/Scripts/TReDSStatisticsView.aspx, on 9 September 2024.

goods, it raises invoices on the TReDS platform, which flows to the mapped buyer (say, Tata Motors) for acceptance. Once Tata Motors accepts the invoice, the said invoice becomes available on the platform for financing. Once the accepted invoice is presented on the platform, the financiers (Bank 1, Bank 2, and NBFCs), who are already registered, start bidding by quoting the best rate that they can offer for financing the invoice. The bids are visible only to ABC (the MSME) who has the freedom to choose the best bid. Once ABC chooses the bid, the operator takes the onus of ensuring fund transfer from the financier (say, Bank 2) to ABC and repayment on the due date from Tata Motors to Bank 2. The entire structure is without recourse to ABC, which means that if there is non-payment from Tata Motors to Bank 2, ABC is not asked to pay back to Bank 2. This model provides a price discovery mechanism and frees MSMEs from the shackles of traditional banking arrangements, while addressing the risk and credit aspects of the structure. The RBI has further permitted insurance companies as the "fourth participant" to enable the other participants to insure against default risks, thereby further strengthening the structure.[4]

TReDS for MSME: A Success?

The establishment of an institutional infrastructure like TReDS has facilitated the price discovery mechanism for trade receivables through an efficient and cost-effective factoring and reverse factoring process, as the financiers are the ones who bid for the bills raised by the MSMEs represented by the factoring units. We examine the effectiveness of the usage of TReDS through recent trends of the buyers (corporates), sellers (MSMEs), and financiers (banks and NBFCs). This helps us understand the ease of access to adequate funds by MSMEs, especially concerning their limited ability to convert trade receivables into liquid funds. However, it may be noted that the volume handled by the platforms under TReDS has taken some time to gather momentum due to various reasons related to technology availability, the unwillingness to change existing arrangements, etc. To improve the participation of buyers, the Ministry of MSME, vide notification SO No 5621(E) dated 2 November 2018, instructed central public sector enterprises (CPSEs) and all companies with a turnover of ₹500 crore or more to get themselves onboard the TReDS platform, which has resulted in increased participation (Figure 3). While MSME sellers increased from approximately 30,000 to above 50,000 between March 2022 and June 2024, the number of buyers is still low. Also, considering the total number of MSMEs, which is more than 1.75 crore, we can surely conclude that TReDS is still out of the reach of a significant number of MSMEs. The response from large corporates, whose creditworthiness helps the financiers to discount the bill or bid for the bill of the MSMEs, is extremely low.

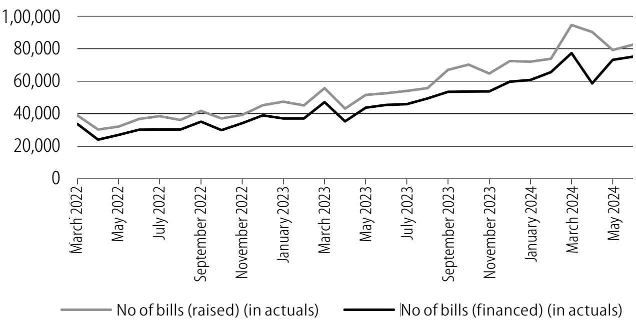
The Factoring Regulation (Amendment) Act was passed in August 2021, permitting NBFCs also to undertake factoring business and participate on the TReDS platform for discounting the invoices of MSMEs.[5] Figure 4 shows that the incorporation of NBFCs has helped improve the number of financiers in the platform. However, considering the requirements of the MSMEs, there is still scope for betterment.

The demand for bill financing via the TReDS platform among MSMEs shows a noticeable upward trend from August 2022 to May 2024, as illustrated in Figure 5 (p 19). However, it is important to note that the actual number of bills raised through TReDS remains relatively low. This is particularly significant considering that the total number of MSMEs in India exceeds 1.75 crore. Hence, it may be noted that with an extensive awareness programme, the bill financing for MSME may take a sharp rise. Interestingly, Figure 6 (p 19) reveals that more than 80%–85% of the total bills raised by MSMEs and more than 90% of invoice values raised through TReDS platform are financed. Overall, we can say that the monthly data available since 2022 shows a steady usage given the number of buyers, sellers, and financiers.

In Conclusion

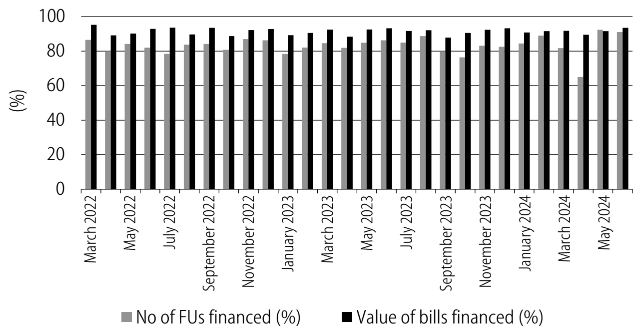
TReDS has strengthened the flow and access of SCF and has provided a level playing field by allowing a market-driven price discovery mechanism. Our analysis reveals that on average, 83% in number and 91.4% of the total amount of bills raised on TReDS platforms are financed. However, this may represent just a mere percentage of the total requirements of the MSME sector considering that there are close to 1.75 crore MSMEs registered on the Udyam Registration Platform as of July 2023. Further, the credit outstanding of the MSMEs with scheduled commercial

Figure 5: Demand and Supply of Bill Finance for MSMEs through TReDS



Source: Authors' compilation using RBI Database, downloaded from https://www.rbi.org.in/Scripts/TReDSStatisticsView.aspx, on 9 September 2024.

Figure 6: Financing of Factoring Units or Bills through TReDS



Source: Authors' compilation using RBI Database, downloaded from https://www.rbi.org.in/Scripts/TReDSStatisticsView.aspx, on 9 September 2024.

banks as on 31 March 2023 was ₹22,60,135.28 crore.[6] Thus, there is significant scope for bringing about cost and operational efficiency in the area of MSME finance. When commercial banks otherwise may charge very high interest rates for MSME bill finance, TReDS is a platform that allows the price discovery mechanism in a competitive market condition.

We conclude that more awareness about the TReDS may enhance the ease of access to finance. This has been given further impetus in the Union Budget 2025 wherein the reduction of the turnover threshold of buyers for mandatory onboarding on the TReDS platform was reduced from ₹500 crore to ₹250 crore. We expect the participation of the buyer–seller–financier to increase slowly but steadily, which will accelerate the path towards the ease of access to funds for MSMEs.

NOTES

1 Account receivables refer to the funds of the manufacturing concern invested in the business, that is, represented by goods sold on credit, which are yet to be realised. It is a prime component of the current assets of the company.

2 Cash credit is a credit facility sanctioned to the customer on the basis of security (inventory) provided by the customer. Cash credit is unique to India. In most other countries, it is referred to as overdraft. It is a perpetual credit with the loan amount remaining with the customer, subject to interest payment and commensurate cash flow routing through the account. It is a costlier method of working capital finance.

3 Portals refer to electronic proprietary platforms hosted on the bank's internet portals. MSMEs and OEMs are given access rights as per their roles and the data flows to the bank for financing.

4 *Times of India* (2023): "RBI Expands Scope of TReDS, Includes Insurers as Participants," 7 June, https://timesofindia.indiatimes.com/rbi-expands-scope-of-treds-includes-insurers-as-participants/articleshow/100828329.cms.

5 https://sansad.in/getFile/loksabhaquestions/annex/1711/AU4206.pdf?source=pqals.

6 https://sansad.in/getFile/annex/260/AU443.pdf?source=pqars.