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THE SPEAKING ARROW

Trade Receivables Discounting System (TReDS) : A digital boon to MSME

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Background

Micro, Small and Medium Enterprises (MSMEs) have played an imperative role in the economic activities of advanced industrialized countries like Great Britain, Germany, Japan, and the United States of America. In developing countries like India, these industries or Enterprises have an enormous importance due to its high-level employment potential with low capital cost. MSMEs are also supporting in industrialization of rural backward areas. This sector is also called the nursery of entrepreneurship. From last two decades MSMEs have been growing in a satisfactory pace as per circumstances of the state. However, these enterprises are facing different hurdles in overall growth and development like poor infrastructure, shortage of electricity, political instability and financial problems.

So, the last MSME Census (2015-16) finally reported that there were 6,33,88,000 MSME units employing over 11 Crore people.

Definition of micro, small and medium enterprises

The definition of small-scale industries varies from country to country or varies in same country from time to time. In India, new classification of small-scale industries was done on the basis of investment in Plant and machinery. Definitions of Micro, Small & Medium Enterprises in accordance with the provision of Micro, Small & Medium Enterprises Development (MSMED) Act, 2006 the Micro, Small and Medium Enterprises (MSME) are classified in two Classes:

1. Manufacturing Enterprises- Here the enterprises engaged in the manufacture or production of goods pertaining to any industry employing plant and machinery in the process of value addition to the final product having a distinct name or character or use. The Manufacturing Enterprise are defined in terms of investment in Plant & Machinery.

2. Service Enterprises: The enterprises engaged in providing or rendering of services and are defined in terms of investment in equipment.

Manufacturing Sector

Enterprises	**Investment in plant & machinery**
Micro Enterprises	Does not exceed twenty-five lakh rupees
Small Enterprises	More than twenty-five lakh rupees but does not exceed five crore rupees
Medium Enterprises	More than five crore rupees but

	does not exceed ten crore rupees

Service Sector

Enterprises	Investment in equipments
Micro Enterprises	Does not exceed Ten lakh rupees
Small Enterprises	More than Ten lakh rupees but does not exceed two crore rupees
Medium Enterprises	More than two crore rupees but does not exceed five crore rupees

Benefits and Schemes provided to MSME's by the Indian government

Indian government has provided many benefits for small scale units or medium small and micro enterprises (MSME). In order to be eligible to get these benefits, any entity should register itself as MSME/SSI enterprise under MSMED Act. Following is a list of such advantages of obtaining SSI/MSME registration in India.

- Collateral Free loans from banks:

The Credit Guarantee Fund Scheme for Micro and Small Enterprises (CGS) was launched by the GOI to make available collateral-free credit to the micro and small enterprise sector.

- A hefty 50% subsidy on Patent registration:

Enterprises that have MSME Registration Certificate can avail 50% subsidy for patent registration by making application to respective ministry.

- 1% exemption on interest rate on overdraft

Enterprises that have MSME Registration can avail benefit of 1% exemption on interest rate on OD as mentioned in the scheme (this is bank dependent).

- Eligible for Industrial Promotion subsidy

Enterprises that have MSME Registration are eligible for Industrial Promotion Subsidy as may be prescribed by the government in this behalf.

- Protection against delayed payments

The Ministry of Micro, Small and Medium Enterprises gives protection to Micro and small Registered Business against delay in payments from Buyers and right of interest on delayed payment through conciliation and arbitration and settlement of dispute be done in minimum time. If any micro or small enterprise that has MSME registration, supplies any goods or services, then the buyer is required to make payment on or before the date agreed upon between the buyer and the micro or small enterprise. In case there is no payment date on the agreement, then the buyer is required to make payment within fifteen days of acceptance of goods or services. Further, in any case, a payment due to a micro or small enterprise cannot exceed forty-five days from the day of acceptance or the day of deemed acceptance. In case of failure by the buyer to make payment on time, the buyer is required to pay compound interest with monthly interest rests to the supplier on that amount from the agreed date of payment or fifteen days of acceptance of goods or service. The penal interest chargeable for delayed payment to a MSME enterprise is three times of the bank rate notified by the Reserve Bank of India.

- Concession in electricity bills:

Enterprises that have MSME Registration Certificate can avail Concession on electricity bill by making application to electricity department along with MSME Registration Certificate.

- Facility of Trade receivable discounting system (TReDS)

In order to increase the ability of the MSME's to convert their receivable into liquid fund the RBI has set-up this facility. Let us know more about this facility.

Trade Receivables Discounting System (TReDS)

Before we start with this topic lets have basic understanding about some of the common terms which will be used during the discussion.

- **Discounting**:

Discounting is a source of working capital finance for the seller of goods on credit. discounting is an arrangement whereby the seller recovers an amount of sales bill from the financial intermediaries before it is due. Such intermediaries charge a fee for the service. Discounting is mostly applicable in scenarios when a buyer buys goods from the seller and the payment is to be made through letter of credit.

- **Factoring:**

It is a financial transaction and type of debtor finance in which a business sells its accounts receivable (i.e., invoices) to a third party (called a factor) at a discount. A business will sometime factor its receivable assets to meet its present and immediate cash needs.

Now the question which arises is what is the difference between Discounting and Factoring?

The term **factoring** includes entire trade debts of a client. On the other hand, **bill discounting** includes only those trade debts which are supported by account receivables. In short, bill discounting, implies the advance against the bill, whereas factoring can be understood as the outright purchase of trade debt.

Introduction

Micro, Small and Medium Enterprises (MSMEs), despite the important role played by them in the economic fabric of the country, 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 pan-India issue through setting up of an institutional mechanism for financing trade receivables, the Reserve Bank of India had published a concept paper on "Micro, Small & Medium Enterprises (MSME) Factoring-Trade Receivables Exchange" in March 2014.

Scheme

The TReDS will facilitate the discounting of both invoices as well as bills of exchange. Further, as the underlying entities are the same (MSMEs and corporate buyers) the TReDS could deal with both receivables factoring as well as reverse factoring so that higher transaction volumes come into the system and facilitate in better pricing.

The transactions processed under TReDS will be "without recourse" to the MSMEs which means a formula used to disclaim responsibility for future non-payment.

Here it means that even if the buyer defaults then the financier cannot make the MSME liable for such default.

Participants

MSME sellers, corporate buyers and financiers – both banks and non-bank (NBFC factors) will be direct participants in the TReDS. The TReDS will 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 MSMEs and corporate 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.

Currently there are two companies which provides the platform of TReDS:

1. Receivable Exchange of India Limited (RXIL)-

It was incorporated on February 25, 2016 as a Joint venture between National stock Exchange (NSE) and Small Industries Development Bank of India (SIDBI). It is the first entity to receive the approval from RBI on December 01, 2016 to launch India's First TReDS Exchange. Hindustan Aeronautics Limited (HAL) became the first ever Public sector undertaking to transact on TReDS through RXIL

2. A. TREDS Ltd-

A. TREDS Ltd., a joint venture between Axis Bank and mjunction services, is an entity approved by the RBI to operate its TReDS platform. The platform is named "Invoicemart". It is a digital platform which connects MSME suppliers (sellers) and their corporate buyers to multiple financiers. It enables sellers to sell their invoices to financiers, thus unlocking working capital quickly, without impacting their relationship with buyers.

Process flow

The objective of the TReDS is to facilitate financing of invoices / bills of MSMEs drawn on corporate buyers by way of discounting by financiers. To enable this, the TReDS has to put in place suitable mechanism whereby the invoice / bill is converted into "factoring units".

In the first phase, the TReDS would facilitate the discounting of these factoring units by the financiers resulting in flow of funds to the MSME with final payment of the factoring unit being made by the corporate buyer to the financier on due date. In the second phase, the TReDS would enable further discounting / re-discounting of the discounted factoring units by the financiers, thus resulting in assignment in favour of other financiers.

The process flow of the TReDS has to enable at the minimum the uploading of invoices/bills and creation of factoring units by the MSME sellers; its acceptance by the corporate buyers; discounting, rating and re-discounting of factoring units; sending of notifications at each to the relevant parties to the transaction; reporting and MIS requirements; and finally, generation and submission of settlement of obligations.

The TReDS may also introduce some random audits to ensure that there is no window dressing and that factoring units uploaded on the exchange are authentic & based on genuine transactions.

TReDS would put in place a standardized mechanism / process for on-boarding of buyers and sellers on the TReDS. This 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 corporate and the MSME seller who would be provided IDs / Passwords for TReDS authorisations (multi-level). Indemnity in favour of TReDS, if required, may also be given if it is made part. of the standardized on-boarding process. Here the KYC documentation/process, may be simplified as it requires confirmation of the banker of the MSME seller / buyer corporate as the case may be.

Agreements

There would be a one-time agreement drawn up amongst the participants in the TReDS:

a) Master agreement between the financier and the TReDS, stating the terms and conditions of dealings between both the entities.

b) Master agreement between the buyer corporate and the TReDS, stating the terms and conditions of dealings between both the entities. This agreement should clearly capture the following aspects:

i. The buyer's obligation to pay on the due date once the factoring unit is accepted online.

ii. No recourse to disputes with respect to quality of goods or otherwise.

iii. No set offs to be allowed.

c) Master agreement between the MSME sellers and the TReDS, stating the terms and conditions of dealings between both the entities. The agreement should also have a declaration / undertaking by the MSME seller that any finance availed through the TReDS would not be part of existing charge / hypothecation of its Working Capital bankers. A NOC may also be required from the working capital bankers to avoid possibility of double financing.

d) In case of financing on the basis of invoices, an assignment agreement would need to be executed between the MSME seller and the financier. Alternatively, this aspect may be incorporated in the agreement between the MSME seller and the financier, to the effect that any financing transaction on TReDS will tantamount to an assignment of receivables in favour of whoever is the financier.

e) The TReDS will be in custody of all the agreements.

Settlement process

Critical to the operations of the TReDS is the mechanism that ensures timely settlement of funds between the financiers and the MSME sellers (when the factoring unit is financed) and the subsequent settlement of funds between the corporate buyers and the respective financiers on due date of the factoring unit. In order to ensure a smooth process of such payments, the TReDS would be required to:

a) Trigger settlement between financier and MSME for accepted bids - In respect of all factoring units financed on a given day, the TReDS will generate the payment obligations of all financiers on T+2 basis and send the file for settlement in any of the existing payment system as agreed among the system participants. The TReDS would have a separate recourse mechanism to handle settlement failures in respective payment systems.

b) Trigger settlement between corporate buyer and ultimate financier on due date - The TReDS would generate the payment obligations file and send the same for settlement on due date to the relevant payment system.

The TReDS will generate the settlement files and send the same to existing payment systems for actual payment of funds. This would ensure that the inter-bank settlement (between the bankers representing MSMEs, corporate buyers and the financiers) will take place and defaults, if any, by the corporate buyers will be handled by the buyer's bank and will not be the responsibility of the TReDS. Hence, the settlement process ensures payments to relevant recipients on due date, thus, facilitating the smooth operations on the TReDS, it would not entail a guaranteed settlement by the TReDS.

The TReDS would be required to put in place adequate arbitration and grievances redressal mechanism.

Regulatory framework for TReDS

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. 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. 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.

Procedure of Flow of transaction in TReDS

- Corporate buyer sends purchase order to MSME seller
- MSME seller delivers the goods along with an invoice. There may or may not be an accepted bill of exchange depending on the trade practice between the buyer and the seller.
- Thereafter, on the basis of either an invoice or a bill of exchange, the MSME seller creates a 'factoring unit' on TReDS. Subsequently, the buyer also logs on to TReDS and flags this factoring unit as 'accepted'.
- The TReDS will standardise the time window available for corporate buyers to 'accept' the factoring units, which may vary based on the underlying document – an invoice or bill of exchange.
- Supporting documents evidencing movement of goods etc. may also be hosted by the MSME seller on the TReDS.
- The TReDS will have separate modules for transactions with invoices and transactions with Bills of Exchange.
- 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"
- The standard format / features of the 'factoring unit' will be decided by the TReDS – it could be the entire bill/invoice amount or it could a pre-defined face value (say in multiples of 1,000 or 10,000 or 1,00,000). However, each factoring unit will represent a confirmed obligation of the buyer corporate, and will carry the following relevant details – details of the seller and the buyer, issue date (could be the date of acceptance), due date, tenor (due date – issue date), balance tenor (due date – current date), amount due, unique identification number generated by TReDS, account details of seller for financier's reference (for credit at the time of financing), account details of buyer for financier's reference (for debit on the due date), the underlying commodity (or service if enabled).
- The TReDS should be able to facilitate filtering of factoring units (by financiers or respective MSMEs / corporate buyers) accordingly any of the above parameters. In view of the expected high volumes to be processed under TReDS, this would provide the necessary flexibility of operations to the stakeholders.

- The buyer's bank and account details form an integral feature of the factoring unit. The creation of a factoring unit on TReDS shall result in automatic generation of a notice / advice to the buyer's bank informing them of such units. Similarly, financing by a financier should generate another notice / advice to the buyer's bank to enable a direct debit to the buyer's account on the due date in favour of the financier (based on the settlement obligations generated by the TReDS).
- These factoring units will be available for financing by any of the financiers registered on the system. The all-in-cost quoted by the financier will be available on the TReDS. This price can only be viewed by the MSME seller and not available for other financiers.
- There will be a window period provided for financiers to quote their bids against factoring units. Financiers will be free to determine the time-validity of their bid price. Once accepted by the MSME seller, there will be no option for financiers to revise their 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 will be as outlined under the Settlement section.
- On the due date, the financier will have to receive funds from the corporate buyer. The TReDS will send due notifications to corporate buyers and their banks advising them of payments due. The actual settlement of such funds will be as outlined under the Settlement section.
- Non-payment by the buyer on the due date to their banker should tantamount to a default by the buyer and attract penal provisions and enable the banker to proceed against the corporate buyer. Any action initiated in this regard, will be strictly non-recourse with respect to the MSME sellers.
- Once financed, these instruments will be rated by the TReDS on the basis of an external rating of the buyer corporate, the nature of the underlying instrument (invoice or bill

of exchange), previous instances of delays or defaults by the buyer corporate w.r.t. transactions on TReDS etc.

- The rated instruments may then be further transacted / discounted amongst the financiers in the secondary segment.
- Similar to primary segment, 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. In parallel, it will also generate a 'notice of assignment' intimating the buyer to make the payment to the new financier. In the event that a factoring unit remains unfinanced, the buyer corporate will pay the MSME seller outside of the TReDS.
- In order to meet the requirements of various stakeholders, the TReDS should ensure to provide various types of MIS reports including intimation of total receivables position, financed and unfinanced (to MSME sellers); intimation of outstanding position, financed and unfinanced with details of beneficiaries and beneficiary accounts to be credited (for corporate buyers); total financed position for financiers; etc. Similarly, data on unfinanced factoring units in the market should also be made available by the TReDS. The system should generate due date reminders to relevant parties, notifications to be issued to bankers when a factoring unit is financed, notifications to be issued to buyers once a factoring unit related to their transaction is traded in the secondary segment, etc.

Tax Implications

The interest or factoring charges earned by the financer is not subject to TDS as per the decision of Hon'ble Supreme Court in the case of Bombay Steam Navigation Co. Pvt. Ltd. Vs. CIT (1963) 56 ITR 52 (SC), wherein it is held that, where interest on unpaid purchase price was not treated as interest on loan. It is clear from the definition that before any amount paid is construed as interest, it has to be established that the same is payable in respect of any money borrowed or debt incurred. According to this, discounting charges of Bill of Exchange or factoring charges of sale cannot be termed as interest. As it not considered as interest it cannot be charged under sec 194A for TDS deduction.

Eligibility criteria to set up and operate the TReDS

Entities desirous of setting up and operating the TReDS should fulfil the following criteria.

(a) Financial Criteria

i. Since the TReDS will not be allowed to assume any credit risk, its minimum paid up voting equity capital shall be Rs. 100 crore Any additional voting equity capital to be brought in will depend on the business plan of the promoters. Further, the TReDS should have a net worth of Rs100 crore at all times.

ii. The promoter's minimum initial contribution to the paid-up voting equity capital of TReDS shall be at least 40 per cent which shall be locked in for a period of five years from the date of commencement of business of the TReDS. Shareholding by promoters in TReDS in excess of 40 per cent shall be brought down to 40 per cent within three years from the date of commencement of business of TReDS. Further, the promoter's stake should be brought down to 30 per cent of the paid-up voting equity capital of TReDS within a period of 10 years, and to 26 per cent within 12 years from the date of commencement of business of TReDS. Proposals having diversified shareholding and a time frame for listing will be preferred.

iii. The foreign shareholding in the TReDS would be as per the extant FDI policy.

iv. Entities other than the promoters will not be permitted to have shareholding in excess of 10 per cent of the voting equity capital of the TReDS.

(b) Due diligence of promoters

The entities and their promoters/promoter groups as defined in the SEBI (Issue of Capital & Disclosure Requirements) Regulations, 2009 should be 'fit and proper' in order to be eligible to operate as TReDS. RBI would assess the 'fit and proper' status of the applicants on the basis of their past record of sound credentials and integrity; financial soundness and track record of at least 5 years in running their businesses. RBI may, inter alia, seek feedback on the applicants on these or any other relevant aspects from other regulators, and enforcement and investigative agencies like Income Tax, CBI, Enforcement Directorate, SEBI etc. as deemed appropriate.

(c) Technological capability

The TReDS should have sound technological basis to support its operations. As such, the TReDS should, at the minimum, fulfil the following technological requirements.

- TReDS shall be able to provide electronic platform for all the participants
- Information about bills/ invoices, discounting and quotes shall be disseminated by the TReDS in real time basis, supported by a robust MIS system.
- The TReDS shall have a suitable Business Continuity Plan (BCP) including a disaster recovery site.
- The TReDS shall have an online surveillance capability which monitors positions, prices and volumes in real time so as to check system manipulation.

Notification on 2nd November 2018

The Central Government issues the instructions that all companies registered with the Companies Act, 2013 with a turnover of more than **Rs. 500 crore** and all Central Public Sector Enterprises shall be required to get themselves on boarded on the Trade Receivables set up by the reserve bank of India. The Registrar of Companies in each State shall be the competent authority to monitor the compliance of these instructions by companies and the Department of Public Enterprises, Government of India shall be the competent authority to monitor the compliance of such instructions by Central Public Sector Enterprises.

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