Supply Chain Finance Inside Out
Reducing MSME credit risk

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Typically when a bank offers "supply chain finance," it discounts accounts receivable due to small businesses from well-known corporations, relying on the corporation's credit-worthiness. This invoice discounting approach recognizes the importance of micro, small, and medium enterprises (MSMEs) as ***sellers*** of goods and services.

Trefi, a Netherlands-based fintech initiative (www.trefi.com), is turning this equation around by also facilitating finance based on MSMEs as supply chain ***buyers***. In the process, it is significantly reducing banks' risk in lending to MSMEs.

Trefi is now applying this approach in Peru. It identifies companies ranging from MSMEs to well-known corporations that ***sell*** to local businesses. It then provides tools to manage credit to MSMEs and helps unlock the knowledge that these companies have about their buyers. Imagine collecting such data from an MSME's entire network and supply chains – a treasure trove of data that demonstrates its creditworthiness.

The Trefi platform serves as rating agent, credit bureau, collateral registry, and clearinghouse for MSMEs and financial institutions, eliminating much of the risk associated with lending to MSMEs in emerging economies.

Trefi's approach is much more comprehensive than just invoice discounting. Furthermore, an MSME's access to credit is not dependent upon having large corporate customers. In fact, the system is designed to assist small businesses whose suppliers are other small companies. Trefi starts with lead firms just as a means to reach smaller firms.

Trefi believes that the most important factor in MSMEs' access to finance should be how well they operate, rather than only their collateral and cash flow. Trefi's platform provides the tools to incorporate such operational performance data into credit decisions.

Significant benefit to MSME banks

The predictive power of this information far surpasses conventional sources of credit data. In addition, Trefi can help financial institutions capture the benefit of data they already own into the system, further enhancing the system's accuracy.

In the Netherlands, where Trefi has been operating a similar platform for more than 10 years, participating banks report a 75% regulatory and economic capital savings over traditional working capital portfolios due to:

- Significantly lower probability of default – Trefi clients become more credit-worthy by using Trefi
- Lower losses and significantly higher recovery rates in the case of default, attributable to the Trefi platform
- Less exposure when approaching default, because Trefi can provide the right funds at the right time

In Peru, banks using Trefi in their underwriting are finding that it can reduce defaults by 35%.

So how does this MSME-centric system work?

When entering a new market, Trefi and its local partners approach large corporations to obtain their suppliers' contact information on a confidential basis, often by agreeing to integrate enterprise resource planning systems or provide invoice-to-cash tools. As suppliers agree to participate, they provide information on their suppliers, and so on through the supply chains.

Trefi's confidentiality guidelines are designed to ensure that all companies – large or small – feel safe sharing their information. Participating companies establish their own rules about the level of detail they share. The database collects information on purchases made, payment terms, and tracks how promptly companies pay their bills. It then establishes probability of default, payment behavior, and trust scores for each SME that can be used by banks to inform their lending decisions.

Trefi's big data analytics can accept all kinds of data, including traditional credit bureau data, bank and other accounts data, internet and social media data. The greater the number of factors available, generally the more accurate the scores.

Participating MSMEs can use the system's information to negotiate terms such as extending payment periods or interest rates. The more cooperation between MSMEs, the more liquidity is available. The system starts with the presumption of trust and cooperation between buyers and sellers, which grows as the relationship between buyer and supplier intensifies. In this way Trefi helps banks provide the right amount of financing to the right MSME at the right time.

Relevance to emerging markets

Can this type of platform and lending be used in an emerging market? Trefi is demonstrating in Peru that it is feasible. It partnered with a national development bank to provide key funding. Trefi established the data platform and covered start-up costs, which include initial data collection costs, legal costs to adapt to local regulations, and setting up a local office. The project has been supported by the G20, IDB, FMO, and World Bank, also Capital Tool Company, which developed the platform.

Financial institutions in Peru are now integrating Trefi's data into their underwriting and lending processes. Because lending based on invoice discounting is already available in the market, Trefi's complementary products expand credit beyond supply chain relationships with the lead firms. The preliminary results are very encouraging. In addition to a 35% reduction in bank loan defaults, one of the financiers on the Trefi platform is financing SMEs at an average net effective interest rate of 12%, 10% less than the average in the market.

Governments and development banks can be the catalysts for this kind of innovative solution to long-standing obstacles to MSME finance. They can lead country-wide development of the database system, cover the start-up costs, and harmonize invoice discounting and e-invoicing regulations.

Innovations like Trefi's demonstrate the value and opportunity in rethinking current approaches to SME finance and exploring alternate methods of providing credit to this underserved segment.

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