Making trade securitisation work

Finacity's JEREMY BLATT examines the process of creating a trade receivable securitisation, including the ongoing monitoring and reporting requirements.

While there has been much debate over securitisation in general, there is often very little attention paid to the actual process through which securities are created, and the operations involved in monitoring and maintaining those securities.

These topics are fairly standard and well-understood for most asset classes; but, for trade receivable securitisations, the specifics of each situation can have a great influence on the time, effort and costs involved. This article will walk through the process of creating a trade receivable securitisation and the ongoing monitoring and reporting requirements, which has enabled many companies to enjoy the advantages of efficiently monetizing their invoices.

First, the likely investors must be determined as far as possible and, indeed, consulted as much as possible. Deals are generally constructed to a relatively standard template, but the particulars of the deal may be customised to the needs of an asset-backed commercial paper (ABCP) conduit or bank, if known; alternatively, the placement agent may provide some direction. Term securitisations may be fixed for between, say, three to five years. Conduit deals, however, are usually subject to renewal every 364 days, as longer commitments necessitate significantly larger capital requirements.

Second, the target rating level is set. The investor (or syndicate) likely has a minimum requirement. Even a single investor may need a rating from more than one rating agency, and a placement agent is likely to deem a particular rating to be a market requirement. If an explicit rating is not needed, the deal may still need to be structured to the requirements of such a rating. This is often the case for conduit transactions, where a 'shadow' rating is sought – technically, the trade receivables transaction itself is not rated, but the conduit's rating is reaffirmed given the addition of the trade receivables transaction.

Getting a rating brings another party into the negotiations and can slow down the process and add more expense. However, it does not necessarily complicate the end result, because the ratings criteria are typically observed even if a rating is not required.

Due diligence typically requires a site visit, a financial review of the originators, and a performance review of the trade receivables historically. Based on the results of these, it can be determined exactly which receivables can be included in the program and at what funding levels. For instance, it may be determined that receivables must be originated in certain jurisdictions, or that receivables must be for products and services, but not interest charges.

These are not often automatic decisions, but practical ones. Quebec receivables, for example, present certain legal challenges that do not apply to the rest of Canada, so a common solution is simply to permit Canadian receivables except from Quebec. However, these legal hurdles are not insurmountable, so if there are enough receivables from Quebec, it justifies the extra legal work and expense needed to include them.

Site visit

The site visit is particularly important in a trade receivables securitisation. The investor will want to evaluate not just the company itself, but also the receivables origination practices, and the credit and collections policies. For trade receivables securitisations, the originator is not only involved in creating the receivables, but also in servicing and collecting on them, hence the investor's desire to see a quality operation.

Once a securitisation is in place, the receivables are no longer legally owned by the originator, yet in practice, the operations continue as they always did. There are several possible legal arrangements, such as the originator assuming the role of sub-servicer to the new owner of the receivables under the securitisation.

The site visit may, in fact, involve multiple locations if the receivables are originated in multiple jurisdictions, with different platforms, and so on. Efforts can be made to combine site trips or do some of these via email and phone. What is important is that the origination process and invoice management and tracking systems be well understood.

In some cases, the reporting requirements may be handled by a specialist company. Part of the site visit then is an opportunity to devise an information exchange protocol permitting the relevant information to be sent automatically to the reporting company, relieving the originator of this challenge.

The financial review of the originator is very similar to the process involved in obtaining a corporate rating; however, it is not nearly as burdensome. Of particular note is that the rating of the originator need not be as high as the rating target for the trade receivable securitisation.

The credit performance of the receivables is primarily a function of the credit quality not of the originator but of the obligor pool; moreover, there is credit enhancement in the deal in the form of additional receivables. Still, the originator's financial strength is important not only in terms of the ability to continue to generate receivables but also in its ability to support their value.

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The performance review of the trade receivables typically involves looking at the monthly performance over the past three years. The most recent twelve months are certainly the most important, but trends or anomalies over the longer period should be understood and explained.

The typical analysis examines losses, dilutions, sales, and ageings for each month. These numbers and a generally accepted formula are used to size a loss reserve and a dilution reserve which, in turn, typically form the biggest determinant of the advance rate for a given pool of outstanding receivables.

The loss reserve is a percentage of eligible outstanding receivables that must be set aside to handle expected losses in a stressed scenario. The methodology is based on the historical ageing. In particular, say, the 91-120 days past due 'ageing bucket' over the past year. This means that ongoing performance will affect this percentage: improved performance will reduce the size of the loss reserve percentage and impaired performance will increase its size.

Note that what constitutes a loss is a rather strict cut-off, a certain number of days past due. There is some expertise involved in properly setting that cut-off, and there are ways to accommodate certain general business problems with this. However, by design, this is meant to avoid giving the originator any discretion; for example, based on particular knowledge of a given obligor.

Dilution reserve

The dilution reserve is, similarly, a percentage of eligible outstanding receivables that must be set aside to handle

expected dilutions in a stressed scenario. Dilutions are non-cash reductions to the amount an obligor owes. Generally speaking, the big concern is unexpected credits, which arise from shipping errors, product defects, pricing mistakes and so on.

Some credits are not of concern at all if they are merely artifacts of the technical receivables platform. For example, credits arising simply to correct invoicing within an accounts receivable system (as part of a cancel/re-bill operation) are only significant to the extent (if any) that they reduce the actual amount owed by the obligor.

Other credits are of mild concern, if they are contractually limited in nature and therefore cannot greatly increase in the stress scenario. For example, credits arising from discounts based on early pay or volume rebates. These are predictable and contractually limited in nature and therefore do not need to have a stressed reserve to handle them. Instead, the preferred approach is simply to avoid funding against them in the first place. Treating an invoice subject to early pay discount as an already-discounted invoice actually works to the advantage of all parties.

This classification of dilution can be extremely beneficial to the transaction, permitting technical credits to be ignored, contractual dilution to be removed from funding, and only the remaining, actual dilution of concern to be reserved against.

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However, this prospect can be rather daunting and may not even be possible, historically. An expert third-party may be able to assist in this effort by targeting research efforts to the most productive items. In any event, the dilution reserve percentage is determined each month and therefore reflects recent performance, usually over the preceding 12 months.

Additional reserves are also determined. A reserve is maintained to cover a few months of interest paid to the investor. A reserve is maintained to cover a few months of fees paid to any party supporting the deal, most notably the sub-servicer, which is usually the originator itself. There may also be other reserves depending on the particular nature of the transaction, such as a currency reserve to the extent that there is unhedged exchange risk in the deal.

There are other factors to consider in doing the quantitative analysis on the historical performance of the pool. For instance, obligor concentration presents a risk to the investor, which can be addressed in a number of ways. One is to have a concentration limit for funding and a reserve floor based on the concentration limit. This way the investor is always protected against a simultaneous failure of a certain number of large obligors. The optimal concentration limit can be determined based on many factors, and can even be optimised on a daily basis!

Another method is to add trade credit insurance to the transaction. Even if the individual obligors are not viewed as great credit risks, the presence of trade credit insurance may permit larger concentration limits and/or smaller loss reserves. In fact, sometimes a loss reserve is replaced entirely with a far smaller premium/deductible reserve.

Next steps

Once the quantitative and qualitative analyses are complete, the parties all agree to a particular set of formulas for calculating the reserve percentages on an ongoing basis, and applying those reserve percentages to the pool. The percentages are typically updated every month and applied to the pool on a monthly, twice-monthly, weekly, or even daily basis.

More frequent funding permits the originator faster access to funds – it may be possible to originate an invoice on Monday and get funding for it as soon as Tuesday. The investor is happy with this arrangement as it also affords a more immediate view of the collateral.

With everything agreed, formal approval is required. Lawyers draw up the contracts, which include, at a minimum:

- A first-step agreement detailing the sale of receivables from the originator (or originators – each division may have its own agreement, especially if different jurisdictions are involved) into a special purpose entity (SPE);
- A second-step agreement detailing the note issuance or further sale of receivables to the investor(s);
- Various servicing, administration and trustee agreements as needed to ensure that the collections and receivables are properly managed; and,
- Various opinions, most notably a true sale opinion, assuring the parties that the sale of receivables in the first-step agreement is a true sale, and the receivables and corresponding collections would not be considered assets of the originator should there be a bankruptcy event.

Given these documents and approval of the credit committees of the investors and rating agencies, the deal can be closed. Usually, on a single day all

the deal documents are signed, the originators sell the outstanding pool of receivables, the SPE issues a note, and investor funds flow to the SPE and through to the originator, completing the initial payment of the sale.

This initial payment is a highly deal-specific percentage, such as 80%. The remaining 20% (less fees and actual performance deductions) is paid as the remaining portion of the receivable sale, and occurs effectively when the obligor pays.

Once the transaction is up and running, the behaviour is most easily understood if it is funded on a daily basis. Obligors are usually directed to pay into an SPE-owned collections account (in practice, this may be the same account they have always paid into, with an appropriate blocked account agreement). This gives the transaction a mechanism for keeping the deal in balance. Simply, the updated pool is re-evaluated against the investor's exposure and reserve percentages.

To the extent that the transaction does not have enough eligible receivables to cover the note and reserves, collections are held to make up the difference; any excess is wired to the originator as payment for receivables (partially initial payment for new receivables and partially remaining payment for previously purchased receivables).

The securitisation requirements are not arbitrary burdens but are disciplines of value themselves.

The effect of this is that changes in the pool can be realised as soon as the next day. A new invoice created on Monday is funded on Tuesday. A collection on Wednesday results in a release of reserves and payment of the remaining portion of the receivable on Thursday. Conversely, issuing a credit memo results in a reduction of cash flow the next day.

To the extent that the transaction has excess eligible receivables, it may be possible to increase the size of the note, or to decrease the size of the note if the SPE is consistently trapping cash. This is possible as frequently as several times a month in a conduit transaction, although not at all in a term deal. This ability to control the note size may be especially valuable if there are significant swings intra-month based on billing cycles and payment patterns, often seen around month end.

On a monthly basis a report is required to describe the activity and performance of the receivables and the collections accounts, to demonstrate that the deal remains in compliance with all requirements, and to determine the new reserve percentages. If the transaction is monitored daily by a third party, most of this information has already been transmitted and thus this report can be readily outsourced. These reports become the basis for review by auditors and credit committees, so it is critical that the information presented be accurate and supportable by detailed receivables data.

On a periodic basis, typically once per year, the transaction is audited, in which a third party conducts both an on-site and a data analysis to ensure that the deal remains in compliance and that everything reconciles and any unusual items can be supported. If the transaction has been monitored daily, then the third party doing the daily monitoring is in a position to readily answer most of the auditor's questions.

Conduit transactions are generally subject to annual renewal, usually timed to coincide with an annual audit. These are often uneventful approvals, but they do provide a convenient opportunity for any party to adjust the transaction if they feel it is in need of fine-tuning.

Additional receivables

Finally, a trade receivable securitisation can be expanded by the addition of receivables into an existing program. This can happen, typically as a result of a merger, through the addition of a new business unit where the originator was already in the programme; or, by the addition of an originator to the first-step agreement.

If the new set of receivables is small and similar to the pool, this can be done with minimal due diligence, although larger pools may require more analysis, similar to that required for a new transaction. This gives a means for the securitisation to grow with the business, whether through increased sales and/or acquisitions.

One important note is that the information required for a securitisation is information that can or should be readily available. If it is not, it is worth getting this information simply as a means of understanding the pool of receivables and to improve business practices. To the extent that information is provided to a third party for daily monitoring, it can be repurposed to provide insights about pool performance independent of the securitisation. The securitisation requirements are not arbitrary burdens but are disciplines of value themselves.

Trade receivables securitisations have become an increasingly desirable way for investors to fund, especially given the very short durations involved. Hopefully, this brief tour through what's involved in the creation and operation of a trade receivable securitisation helps you visualise the process and determine if a securitisation may be right for your organization. ❑

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