A Guide to Receivables Finance

3rd edition

7A Trade receivables securitisations: Background to trade receivables securitisation

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7A.1 Investible assets

Securitisation of various cash flow assets began in the 1980s. Trade receivables, while not the first asset class to be securitised, date back approximately 30 years. Trade receivables securitisations allow companies to raise capital by selling, on a revolving basis, a selection of receivables to a legally separate, bankruptcy-remote special purpose entity (SPE). The SPE, with the conveyance of the acquired receivables, can issue collateralised notes with the issuance proceeds flowing back to the original selling company. While comprehensive data as to the existing size of the trade receivables securitisation market is not available (much of the funding is done through individualised private transactions), existing outstanding securitisations amount to approximately USD80–100bn. Trade receivables from most industries and numerous geographies can be considered eligible for inclusion.

Transaction sizes generally range from USD50m to more than USD1bn. Larger transactions are often funded with multiple funding sources, a trend that accelerated after the Global Financial Crisis of 2008–9. While most transactions are funded in US dollars, depending on the pertinent invoicing countries and currencies, liabilities can also be denominated in euros, sterling, Mexican pesos or other currencies. Transactions can incorporate receivables originating from multiple countries and can involve both in-country and cross-border receivables. Sellers/issuers and/or obligors can be unrated or below investment grade, and yet as a consequence of the structuring process, the resulting securitisations can achieve investment grade ratings, thereby providing a positive credit arbitrage to the seller of the receivables.

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7A.2 Issuers/sellers

Public companies with disclosed trade receivables securitisations include companies as diverse as Archer-Daniels-Midland, Kongsberg Automotive, Public Power Corp, Cushman & Wakefield, Navistar, Delta Air Lines, CEMEX and Bunge, among others. Numerous private companies have been issuers, such as Trafigura, Ineos, Styrolution and Green Network.

Securitisations can make sense in a variety of circumstances for issuers with the following primary drivers:

1. All-in-cost minimisation;
2. Proceeds maximisation;
3. Accounting sale treatment;
4. Risk mitigation; and
5. Funding diversification.

While securitisations are designed to separate the risks of the seller as much as possible from the performance of the receivables, it is typical for the issuers/sellers to continue to service the receivables. As such, funding availability and pricing is somewhat correlated to the credit quality of the issuer/seller. Increasingly, transactions on behalf of weaker credit issuers/sellers are incorporating the requirement for a back-up servicer to ameliorate any potential servicer risk.

7A.3 Investors/financers

Securitisations can represent compelling assets for investors/financers for the following reasons:

1. The asset class typically performs very well with low loss experience (as demonstrated across numerous economic cycles, including the Global Financial Crisis);

2. Typical structural features allow for constant readjustment of reserve levels based on on-going monthly and even daily portfolio performance. Such dynamic protection has proven effective over a variety of economic environments;

3. Available yields relative to comparable risks are often attractive. This is especially compelling given the typically short duration of trade receivables;

4. For financers motivated to serve weaker credit customers, trade receivables securitisations can represent a more secure way of extending credit. These facilities help separate the credit risk of the seller/issuer from the securitisations. If structured properly, historical performance shows that a funding source should recover all of its investment, even in the event of a bankruptcy of the seller/issuer; and

5. For regulated institutions, the usually high implied or explicit credit ratings can result in the allocation of less regulatory capital than equivalent sized loans.

7A.4 Banks

In most cases, trade receivables securitisations are structured pursuant to at least investment-grade rating agency criteria (‘A’ rating criteria is probably the most commonly applied). Funding is typically provided by bank-sponsored commercial paper conduits, bank balance sheets, or traditional capital markets investors (e.g. pension funds, insurance companies, and fixed income asset managers).

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7A.4.1 ABCP conduits

Bank-sponsored commercial paper conduits mostly finance their activities through the issuance of asset-backed commercial paper (ABCP). In most cases, the bank sponsor provides credit and liquidity enhancement through a letter of credit (LC). While LCs are rarely invoked, the Global Financial Crisis proved to be a sufficiently adverse economic environment that ABCP investors were well served through the explicit credit protection of LCs. ABCP conduits are usually rated issuing vehicles and as such must pay attention to rating agency criteria when trade receivables securitisations are structured and added to their asset pool.

While an explicit rating is not necessarily required for each incremental securitisation, a re-affirmation from rating agencies of the conduit's rating is usually necessary. It is estimated that trade receivables securitisations represent more than 20% of the assets funded by ABCP conduits. Trade receivables are usually a desired asset class for ABCP conduits due to the inherently short duration of the assets and the past strong historic performance of these assets, especially when compared with consumer assets that severely underperformed during the Great Recession of 2007–09.

7A.4.2 Balance sheet

In recent years, several banks that used to sponsor ABCP conduits have unwound such vehicles and instead fund trade receivables securitisations on their balance sheets. Even some banks that sponsor ABCP conduits sometimes choose to use their balance sheets for certain types of transactions. To the extent that a bank is utilising its balance sheet, it may adhere to typical rating criteria, but it also has more latitude to apply its own in-house credit disciplines and flexibilities.

An example of a typical variance might be with respect to how excess obligor concentrations are facilitated. Bank balance sheet funded deals are capable of providing greater accommodation of large obligor concentrations, depending on a bank's credit analysis of a specific obligor risk. An important difference between ABCP conduit financing and bank balance sheet financing is the funding index. Commercial paper (CP) is the benchmark for ABCP conduits and typically LIBOR has been used for bank balance sheet facilities, although this is changing as banks transition to risk-free rates in the run-up to the phasing out of LIBOR.[16] ABCP rates have generally tracked LIBOR fairly closely, except during the Global Financial Crisis when CP rates spiked above LIBOR. However, it subsequently came to light that LIBOR was manipulated during this period; therefore, barring any future manipulation, ABCP and risk-free rates should track closely to one another.

7A.5 Capital markets investors

In emerging markets, due to less developed bank credit offerings and an absence of ABCP conduits, most trade receivables securitisations are funded in the capital markets. Some capital markets issuances of trade receivables securitisations have been successfully undertaken in the developed markets, but these are relatively infrequent. Given the overall regulatory capital pressures on banks, an increase in capital markets issuances is likely to ensue. This would serve to attract new sources of capital to the sector and reduce pressure on banks to serve as the primary source of trade financing.

Capital markets structures differ from bank or ABCP conduit facilities. Typically, capital markets investors cannot accommodate variable funding amounts, and therefore these deals usually involve a fixed size issuance amount that remains outstanding at a constant level during the revolving period. Bank balance sheet and ABCP conduit deals usually have a maximum commitment size but provide the seller/issuer flexibility to increase or decrease the finance amount over time. The concept of a utilised interest spread and an unused fee are common in such deals, whereas the capital markets placements usually only have a utilised interest spread. Another difference pertains to tenor. The typical capital markets trade receivables securitisations have longer terms, up to five years, whereas most bank financed facilities involve some type of annual renewal.

7A.6 Risk mitigation

While trade receivables, as an asset class generally perform well under various scenarios, impairments due to a variety of operational and credit characteristics are inherent. The reason why trade receivables securitisations can achieve higher ratings than the sellers/issuers and/or obligors is that the typical structures involve credit enhancements.

7A.6.1 Reserves

The most common type of credit enhancement is in the form of over-collateralisation, through the set aside of appropriate structural reserves. The typical reserve maths is somewhat complicated, but the primary components are based on the characteristics of trade receivables and follow a logical methodology.

7A.6.2 Loss

In a diverse portfolio of obligors, it is likely that some will experience credit stress and slow payment, or even failure to pay due to obligor default. Based on receivables ageing history, tracked and updated monthly, typical structures involve a reserve calculation to accommodate for the adverse consequences of slow pay or no pay receivables. As a simplified example of what is often applied, Standard & Poor's (S&P) 'A' rated criteria would suggest a reserve for credit losses of double the recent peak moving average loss experience (defined as a certain ageing window, e.g. 91–120 days past due plus actual insolvencies).

7A.6.3 Dilution

Dilution occurs when receivables are impaired for reasons other than an obligor's ability to pay. Some common causes of dilution include product defects, erroneous billing, commercial disagreements and volume discounts. While dilution impairments are typically addressed through recourse to the seller, investors/lenders need to be appropriately protected from any unanticipated dilution impairments and a dilution reserve is typically incorporated into the transactions. To simplify and provide an example, S&P 'A' rated criteria would typically suggest a reserve for dilution of somewhat more than double the recent peak moving average dilution experience.

7A.6.4 Yield/fee

Another reason to set aside a reserve is that trade receivables are not interest earning assets (any stated interest charge is generally viewed merely as a collection device), whereas securitisations involve interest paying liabilities. To accommodate the time value of money, trade receivables are essentially purchased at a discount (much like a US treasury bill is discounted) and the discount is intended to cover whatever yield and fees are payable in the securitisation. Relative to the credit loss and dilution reserves, especially in a low interest rate environment, the yield and fee reserves are generally quite small.

7A.6.5 Concentration risk

In order for trade receivables securitisations to benefit from obligor diversification, it is necessary to track and limit certain obligor concentration risks. Depending on the credit quality of each obligor, concentration limits will apply to a lesser or greater extent. For an S&P 'A' rated structure, it is common for there to be a minimum reserve level, equal to at least four times the obligor concentration limit for obligors that are either unrated or rated below investment grade.

7A.6.6 Trade credit insurance

Depending on the specific objectives of a seller/issuer and the potential requirements of a financer/investor, the incorporation of trade credit insurance might prove advantageous to a trade receivables securitisation structure. See *Chapter 4: The role of credit insurance in receivables financing*. Here are some of the most common motivating circumstances:

1. Involve transactions in which there are high obligor concentrations which would result in significant excess concentrations without the enhancement delivered through trade credit insurance;

2. Involve transactions in which country risks are considered an impediment (e.g. if the obligors are located in countries that are not investment grade); and

3. If a seller/issuer is trying to achieve the level of risk transfer necessary for IFRS de-recognition.

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Insurance constructs can vary from more traditional co-insurance (i.e. pari passu), to senior/subordinated arrangements with large deductibles, to 100% insured with small deductibles, depending on the motivations and constraints of either the seller/issuer and/or investor/financer.

7A.6.7 Representations and warranties

While trade receivables securitisations are intentionally structured so as to have no credit recourse back to the seller, the seller is usually required to make representations and warranties with respect to the receivables being sold. The primary risks addressed by such representations and warranties pertain to fraud, misrepresentation and dilution. While reserves are set aside to cover dilution risk, the seller is expected to cure any dilution event as it arises.

7A.6.8 Monitoring and reporting

Since trade receivables are typically short duration assets with many nuanced and rapidly changing performance attributes, the timely administration and reporting of these assets to investors/financers is critical to a successful trade receivables securitisation. Many would argue that the Global Financial Crisis was in no small part precipitated by a lack of transparency for investors/financers in securitisations. As a consequence, in recent years there have been increasing requirements for detailed reporting (often as frequent as daily). Such reports would generally track the receipts of cash from previously purchased receivables, provide details of the new receivables for conveyance, apply eligibility criteria and concentration limits, calculate appropriate reserves, adjust for currency risks as applicable, provide remittance instructions, etc. Monitoring and reporting by an appropriately experienced third-party can strengthen investor/financer confidence.

7A.7 Legal and regulatory

7A.7.1 Legal

Since securitisations are predicated on a first-step conveyance of the assets from the originator, usually to a bankruptcy-remote SPE, it is crucial that a so-called true sale opinion of counsel be provided. The second step usually involves some type of sale or issuance from the SPE to a funding source. A key element of a successful trade receivables securitisation is the separation of the receivables from the seller such that, in the event of a bankruptcy of the seller, the receivables are not somehow clawed back into the bankruptcy proceedings. A funding source does not want to become a creditor, but would rather simply be the beneficiary of an orderly self-liquidation of the funding facility, with repayment resulting from the trade receivables cash flows.

7A.7.2 Accounting

Accounting treatment of trade receivables securitisations varies by applicable accounting regime, and the choice of structural features incorporated, to facilitate a desired financial statement impact.

7A.7.3 GAAP

In the US, transactions are usually subject to GAAP. The primarily applicable accounting pronouncement is FASB Accounting Standards Codification Topic 860. To the extent that a company would like to achieve GAAP sale treatment, it is necessary for the trade receivables to be sold in both the first step (conveyance from the seller to the SPE) and second step (conveyance from the SPE to the funding source) to comply with the change of control requirements. Such structures typically involve payment consideration in the form of cash payments up front and deferred cash payments. The source of deferred cash payments is solely dependent on the collateral. Application of ASU 2016–15, starting in 2018, introduced a generally unwelcome complication for companies with existing off-balance sheet securitisations via the deferred cash payment structure. Per ASU 2016–15, the deferred cash payments, resulting from the retained subordinate interest, are required to be reported as cash flow from investments, not operating cash flow.

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Alternative structures to avoid ASU 2016–15 have emerged. While GAAP does permit the seller to continue to service the trade receivables, the seller is not permitted any other control or involvement in the assets. In the absence of intentioned steps to achieve GAAP sale treatment, the typical default accounting treatment is for the trade receivables to remain on balance sheet. It is important for a seller to involve its auditors throughout the structuring and documentation process, to make sure that the desired accounting treatment is achieved.

7A.7.4 IFRS

In most countries other than the US, IFRS has increasingly become the applied accounting regime. It is generally considered more difficult to achieve off-balance-sheet treatment (de-recognition) under IFRS. The primary accounting rules that apply are IFRS 9 (de-recognition)[17] and IFRS 10 (de-consolidation).[18] The pertinent minimum threshold for achieving IFRS de-recognition is for the seller entering into a securitisation structure to not substantially retain the volatility of risk and to forfeit control. There is no clear definition of what constitutes 'substantial', nor is there clarity on the frequency of reassessment of the extent of risk transfer. Modelling algorithms have been developed and multi-tranche structures have been successfully implemented that have achieved IFRS de-recognition. Broadly, structures may involve the sale of a second loss tranche and/or trade credit insurance, to address the requirement to substantially transfer the volatility of risk. In the absence of intentioned structuring, trade receivables securitisations would be considered on balance sheet under IFRS. For off-balance-sheet treatment, it is critical for a seller to involve its auditors throughout the process to confirm that a structure complies with IFRS requirements.

7A.8 Features of a typical transaction

Most trade receivables securitisations are executed privately with very little disclosure. Private funding is primarily provided by banks utilising their balance sheet or bank sponsored ABCP conduit vehicles.

Current variable rate spreads can be generally categorised as follows: investment grade sellers 50–100 basis points (bps), BB rated sellers 100–125bps, B rated sellers 125–200bps, very weak sellers 200+ bps. There is usually a non-usage fee applied to the difference between the maximum committed amount and the actual drawn amount, in the range of 25–100bps. Funding in these structures can be in one or more currencies, primarily USD, EUR and GBP. Multiple affiliated entities from multiple jurisdictions can convey trade receivables to collateralize a single securitisation issuance, providing scale and efficiency. Tenors are usually committed for one to three years. Most facilities are repeatedly renewed with many securitisations outstanding for more than a decade, proving to be reliable multiyear sources of liquidity for companies.

Public term issuances are infrequent and mostly associated with emerging market countries. For example, Mexico is a market where many deals are publicly registered with local capital markets regulator the Comisión Nacional Bancaria y de Valores (CNBV) with investors ranging from large pension funds to small retail investors. These trade receivables securitisations generally involve longer tenors (three to five years) and fixed-sized funding amounts. Amortisation is typically achieved via a soft-bullet structure, with the funded amount declining, sometimes per a defined schedule, over a short time window (e.g. six months).

7A.9 Market outlook

The market for trade receivables securitisations is expected to continue to develop and expand to include more companies worldwide. For sellers/issuers, trade receivables securitisations will likely continue to offer a cost-efficient way to maximise proceeds, improve working capital, and diversify funding alternatives. For investors/financers, trade receivables securitisations are likely to continue to provide a compelling risk/reward opportunity for deploying funds.