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Trade as an asset class

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Businesses will need to become securitisation savvy if we are to plug the trade finance gap

Receivables resulting from the business activities of operating companies have traditionally been monetised through various techniques, including factoring and supply chain finance solutions.

However, these traditional techniques are not the only tools available to companies wishing to turn receivables arising from trade into immediate liquidity. Over the years, many different solutions to monetise trade receivables have emerged, the majority of these making use of securitisation technology. As companies navigate the uncertainty of the post-pandemic world, securitisation techniques should become an attractive option to companies seeking to maximise their balance sheets.

What is a trade receivables securitisation?

Securitisation is a technique designed to monetise income-generating assets, usually involving financing arrangements secured on the cash flows arising from those assets. This basic concept is then deployed in a manner tailored to the specific features of the assets and requirements of transaction parties.

Over the years, the securitisation market has developed certain types of structures which are seen to be particularly appropriate for financing trade receivable assets. These structures include asset backed commercial paper (ABCP), term securitisation and receivables financing in the context of warehouse transactions with revolving note or loan structures:

- ABCP involves the issuance of short term money market securities (with a maturity typically under 364 days) which are backed by trade receivables. This type of transaction is usually structured as a programme established and managed by a financial entity acting as sponsor that purchases trade receivables from various third-party entities. Some ABCP transactions are structured as "simple, transparent and standardised securitisations" in order to allow institutional investors to benefit from preferential

Securitisation

A type of structured finance that has been overcomplicated in the market. The most important element is receivables flowing from pools of economic assets. An example of these underlying products may be bonds or mortgages.

capital treatment when holding ABCP positions, and have, for that reason, become extremely attractive investments.

- Term securitisation (which tends to be more public than the other structures mentioned) will typically involve the issuance of debt securities with maturities in excess of 364 days and which are backed by a revolving pool of trade receivables.

- Warehouse financing usually entails a lender granting loan finance to a special purpose vehicle borrower secured on a revolving pool of trade receivables, usually structured as a private transaction similar to a bank financing but with more attractive pricing.

Different structures will attract different types of investors and funders, often resulting in pricing implications for the businesses who wish to finance their trade receivables through securitisation. Whether or not a particular structure is appropriate for a business will depend on the nature of the underlying trade receivables.

How can trade receivables securitisation help?

Trade receivables securitisation may help businesses with trade receivables currently on their balance sheets by providing enhanced liquidity, mitigating the accounting impact of overdue receivables and improving debt ratios (as securitisations generally do not classify as "debt" on a corporates balance sheet).

In addition to the liquidity upsides of monetising future receivables, transferring the economic ownership of certain trade receivables (and therefore the risk associated therewith) may enable businesses to limit the impact of exposure to credit risk relating to their counterparties and assist in managing their accounting and cash flow position, all of which can prove useful in context of the COVID-19 pandemic.

From a business relationship standpoint, securitisation of trade receivables may also allow businesses to keep their relationship with their own clients unchanged, as it is possible that the transfer of economic ownership of the trade receivables may remain undisclosed to the clients (subject to certain considerations and, in particular, the laws governing those trade receivables) and the seller is often allowed to remain responsible for the receivables collection process.

Securitisation may well be available to corporates even when other financing sources are not active (e.g. if banks are unwilling to provide traditional bank debt). There may well be pricing advantages too as securitisation is priced on the expected performance of receivables rather than the corporate's general rating.

How does it work?

In order to benefit from securitisation of trade receivables, businesses will need to sell their trade receivables portfolio to a third party, usually at a discount, to reflect the net present value of the relevant cash flow. The amount of this discount is, as is also the case with factoring and confirming, a matter for commercial discussion with the entities structuring or sponsoring the transaction. It should be noted that certain features may be implemented in transactions in order to mitigate risks and improve pricing, such as taking credit insurance over the pool of trade receivables from a specialised credit insurer or maintaining reserves for certain risks.

Securitisation is a type of non-recourse financing (similar to some types of factoring arrangements), meaning that investors in the debt securities or lenders, as applicable, will typically bear the risk of non-payment and will have no recourse to the seller if there is a non-payment by the obligor under the trade receivables. This non-recourse element is central to securitisation, given the transaction will typically be structured as a sale from the seller to a special purpose vehicle which should be designed to survive any challenges triggered by a potential insolvency of the seller (often called a "true sale").

Depending on the type of structure adopted, the associated legal, regulatory, and compliance burden may be more appropriate for the mid-size or large corporate than to smaller entities. However, it should be noted that the recent trend of increased digitalisation in the trade finance sector has prompted the emergence of platforms offering streamlined receivables securitisation solutions which enable smaller entities to participate.

What does it take to get started?

Performing comprehensive due diligence on the assets is key to engaging in this type of transaction, since the structural features of the transaction will largely depend on the characteristics of the asset pool.

To the extent that there is a substantial pool of relatively homogeneous income producing assets, a suitable sponsor or structuring entity should be identified and approached.

When determining which structure to adopt, various considerations will be driven by investors and by the sponsor or structuring entity. However, the seller will usually be able to input on a number of aspects, ranging from eligibility criteria for the securitised trade receivables to the existence of credit insurance protection and to the servicing and collection of the trade receivables.

The demand for securitised products has shown resilience during the height of the pandemic and this market is expected to remain buoyant. It is anticipated that trade receivables securitisation will become a key tool for plugging the funding gap between the financial markets and the real economy. It is therefore essential for businesses to become securitisation savvy in order to make the most of this thriving market. ■