The Rating Process For Trade Receivables

In an age of continuous innovation and creativity, attempts are constantly being made to securitize almost anything that generates cash flow. In order to provide sellers of these securities with the ability to tap diverse funding sources and to enable investors to conduct their activities with greater confidence, a rating is assigned. As a result, ratings play an important role in the structured finance market.

The process for rating securities backed by trade receivables begins when a banker or seller contacts Standard & Poor’s to request a rating. A conference call or brief meeting is then arranged so that an overview of the selling proposal can be presented. This type of presentation may include information about the seller or a draft of transaction documents. If no impediments to the transaction are apparent, a review will be performed.

Review

Rating analysts perform an on-site review for each trade receivable transaction. Ideally, a preliminary information memorandum outlining the proposed transaction, the seller, the seller’s business and industry, and portfolio information will be prepared prior to the on-site visit (see box). Each visit may address:

■ The seller’s business, including financial performance, organizational structure, background, history, and recent significant developments;
■ The seller’s competition, including market share statistics and prospects for the future;
■ Credit and collection policies, including an overview of the credit department, experience of credit personnel, procedures for granting new credit, aging policy, special programs, return policies, collection procedures, and write-off policies;
■ Management of the portfolio;
■ Receivable and invoice generation, including a detailed explanation of the billing cycle and the interaction with the receivable system (supported by documentation...
including standard agreements, standard bills of lading, purchase orders, and sales invoices);
- Receivables reserves and bad-debt write-offs;
- Dilution review, including a detailed description of the causes of dilution and any reserves established for dilution (supported by appropriate documentation);
- Dilution horizon analysis in both an anecdotal and statistical manner;
- Cash management;
- Concentrations and management of concentrations;
- Receivable performance statistics;
- Receivables systems;
- Disaster-recovery procedures; and
- Proposed changes to the systems.

This list serves only as a core list of topics to be discussed. Depending on the information presented, the scope of the review may be broadened to cover additional items, or the scope may be narrowed and focus in greater detail on several particular items.

In addition to reviewing information provided by the seller or banker, the Structured Finance Ratings analyst will consult with the Corporate Rating analyst responsible

Data Requirements

The following core information is requested when a transaction is submitted for rating. Note that depending on the characteristics of the transaction, additional information may be required.

- Monthly receivable balances (excluding credit memos) for the last three years;
- Monthly sales figures for the last three years;
- Monthly delinquency statistics for the last three years with an explanation of the aging process (aged from the invoice date or the due date) as well as any reconciliation of the receivables aging to the general ledger;
- A summary of payment terms offered and an historical analysis of the percentage of the receivables pool subject to a particular payment term, including weighted average payment terms figures if receivables are aged on a past due rather than a past invoice basis;
- Monthly dilution figures for the last three years;
- A summary of the items giving rise to dilution and an explanation of each of the items;
- Sample of credit memos aged back to the invoice date, including the reason for the dilution and the dollar amount of the dilution;
- Historical portfolio turnover (day's sales outstanding) variance analysis;
- A breakdown of the top customer concentrations and their related ratings, if any; and
- Audited financial statements and annual reports.

If this information is not available, analysts will work with available data and make conservative assumptions where gaps in information exist. In some cases, this may lead to artificially high credit support levels until adequate data is available.
for the seller or for the seller’s industry if the seller is not rated. The corporate analyst
may be able to provide additional insight into the seller’s business practices and the
risks associated with the accounts receivable pool including the impact of a seller
bankruptcy on receivable performance.

Legal And Structural Analysis

The rating of structured financings is based primarily on the creditworthiness of
isolated assets or asset pools, whether sold or pledged to secure debt, and without
regard to the creditworthiness of the seller or borrower. The structured financing
seeks to insulate transactions from entities, such as receivables sellers, that are
either low rated or unrated. A worst-case scenario assumes the bankruptcy of
each transaction participant that is not a bankruptcy-remote entity and that is
rated lower than the transaction.

As is common to most securitizations, in which the receivables are originated by
an entity subject to the bankruptcy code, the seller will transfer its trade receivables
to a special-purpose entity (SPE). The SPE will then transfer or pledge the assets to a
trust that will issue the rated securities. The SPE, generally a subsidiary of the seller,
must satisfy bankruptcy-remote criteria. The articles of incorporation and bylaws
will be reviewed to determine the bankruptcy-remote status of the SPE. As in other
asset-backed transactions, in rating trade receivable-backed securities higher than
the rating of the issuer, seller, or borrower, the analyst seeks assurance that the
following legal considerations are satisfied:

■ The owner of the assets is a bankruptcy-remote entity, also referred to as an SPE;
■ Transfers of assets to the SPE are “true sales;” and
■ The trustee for the security holders has a first priority perfected security interest in
the assets.

In addition, certain additional legal criteria may apply as a result of the nature of
trade receivables or the structure of the transaction.

Depending on the legal issues, the analyst may request opinions of counsel to
address these legal concerns. In broad terms, among the legal opinions that may
be requested are:

■ Nonconsolidation. If the bankruptcy-remote entity is wholly owned by a parent
that is not bankruptcy remote, an opinion to the effect that in an insolvency of the
parent, the assets and liabilities of the SPE would not be substantively consolidated
with those of the parent under applicable insolvency laws. Similarly, if the bank-
ruptcy-remote entity is a limited partnership or a limited liability company, an
opinion to the effect that the entity would not be consolidated with a bankrupt
partner or member.
- True sale. An opinion to the effect that transfers of receivables by entities that are not bankruptcy-remote would be viewed as true sales and, therefore, not be viewed as property of the bankruptcy estate of the transfer or under Section 541 of the Bankruptcy Code, or be subject to the automatic stay under Section 362 of the Bankruptcy Code. Furthermore, an opinion may be required to the effect that the assets transferred and the related debt service payments to the security holders would not be recoverable as preference payments or be deemed a fraudulent conveyance.

- Perfection. An opinion to the effect that the trustee has a first priority perfected security interest in the receivables and other property pledged to secure the rated issue.

- Tax status. An opinion to the effect that the trust will not be treated as an association taxable as a corporation.

**Rating Committees And Surveillance**

Information from the business review as well as legal research, credit analysis, and structural analysis will be compiled into a committee presentation. Once the rating committee meets to review the presentation and make its decision, the results will be conveyed to the banker. If the decision is positive, a rating letter will be issued upon closing and the satisfaction of all committee issues.

Once the transaction has been rated, the seller will submit monthly surveillance reports containing prespecified information. The Structured Finance Asset-Backed Surveillance Group maintains surveillance on all rated transactions. The purpose of surveillance is to ensure that the rating continues to reflect the ongoing performance and structure of the transaction. Performance information is usually disclosed in a servicing report that is prepared by the servicer assigned to the transaction.

Prior to the closing of a transaction, analysts will review the form of servicer reporting to assure that all necessary information has been included. For most trade receivables transactions a monthly report is required by surveillance, however in some instances surveillance may also require daily reports. A contact name and telephone number of the party preparing the surveillance reports should be provided to the analysts by the servicer or trustee. Accompanying the final servicing report provided for the transaction, a notice should be attached verifying the final payment to investors and the date that this payment was made.

Analysts must be informed of any changes concerning the original structure of the transaction, including management, credit policy, system changes, or any change in status of the initial parties involved with the transaction. All information will be used as part of normal surveillance maintenance for the transaction. If there is a rating change during the course of the transaction, the seller and the trustee will be notified.
Lockbox Account Structure

While it is preferable for collections on receivables in securitized transactions to flow to trustee-controlled lockboxes, this practice cannot be followed in health care securitizations. A health care securitization must comply with Medicare’s and Medicaid’s anti-assignment provision. This provision requires that all governmental payments for services furnished by a provider be made directly to the provider (or to a separate provider-controlled lockbox account), except for payments made to a government agency or under a court order or to a billing agent. The provider’s bank should have standing instructions to sweep the account into a transaction’s collection account, which is controlled by the trustee and is in the name of the transaction.

Compliance with the anti-assignment provision entails some potential commingling of provider monies with collections on sold receivables. Commingling in the account of the seller results in a potential ultimate loss risk of the funds held in that account on the date the seller files for bankruptcy. Accordingly, the analyst seeks to ensure that commingling at the provider is as brief as possible, at most 48 hours, and additional credit enhancement is sized to cover this bankruptcy-related risk.