A rising asset class

Ed Hickman explains the legal and commercial issues surrounding the securitisation of trade finance assets

As Basel III and other banking sector reforms such as CRDIV are making trade finance more expensive from a regulatory capital perspective,[1] banks are increasingly looking at securitisation.

This enables banks to achieve regulatory capital relief on loans that they have made while retaining the upside of trade finance transactions, such as servicing and arrangement fees as together with the amount by which interest payments by borrowers exceeds the securitisation's senior funding costs.

The Basel III changes have also restricted bank lending both to commodity houses and to sub-investment grade corporates. We are seeing an increase in non-bank commodity houses and corporates raising funding backed by their loan books or their global trade receivables.[2]

In addition, there is a renewed interest in inventory securitisation. Stocks ranging from champagne to diamonds have been securitised, with the producers accessing the capital markets. Another variant is emerging market banks securitising future trade finance payment rights under letters of credit.

Objective of securitisation

A key objective of true sale securitisation is to isolate receivables from the originator's insolvency risk. So, holders of the rated securisation notes should still get paid back if the original lender of the trade finance loan – for example a commodities trading company – went bust.

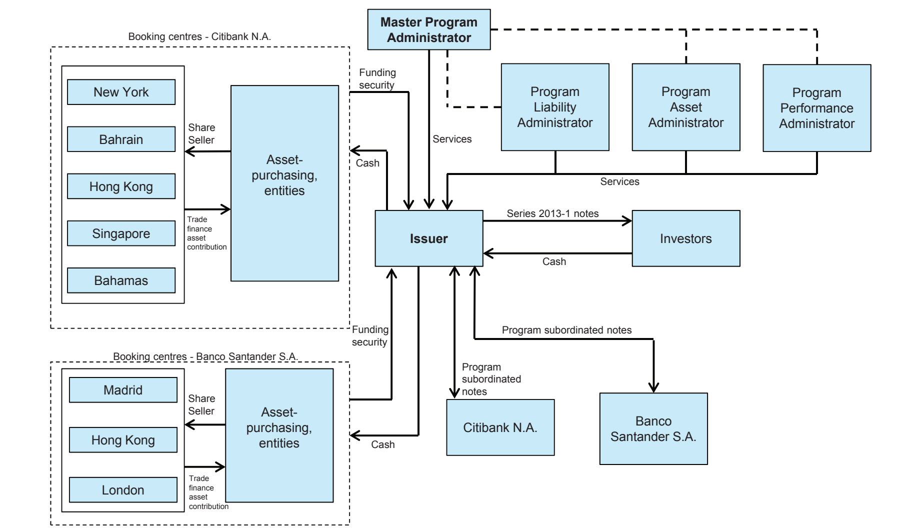
This approach is entirely different to an unsecured loan and also avoids possible restrictions on enforcing security granted by an originator during insolvency proceedings in respect of the originator. Instead, securitisation investors take the risk of the underlying trade finance loans.

To achieve this, a bankruptcy-remote special purpose vehicle (SPV) is typically created. This vehicle is not allowed to conduct any other activities apart from the particular securitisation. Furthermore, creditors are not allowed to wind up the issuer and they agree that the amount payable to them is limited by the assets of that particular SPV.

The originator will service the securitised receivables (for example, collect payments). And, as and when new receivables are originated that meet various eligiblity criteria (in other words, minimum requirements that are designed to ensure that only high quality receivables are securitised), the originator will then go on to sell these further receivables to the SPV.

> **"The key objective of securitisation is to isolate receivables from the originator's insolvency risk"**

Figure 1: Trade MAPS 2013–1



1. Seller retains a share of the trade finance assets sold to the asset-purchasing entities (APEs).
2. APEs that purchase trade finance assets from Hong Kong booking centres will issue APE funding securities to offshore trusts, which will hold the APE funding securities for the Issuer's benefit. Those offshore trusts will issue pass-through certificates to the issuer so that it has the same economic experience as owning the APE funding securities.
3. APEs will not be permitted to directly hold trade finance assets with Indian obligors. Those trade finance assets will instead be held by an offshore trust on which the related APE will be the beneficiary, so that the APE has the same economic experience as owning the trade finance assets directly.

Investor pros and cons

Increasingly, investors are appreciating the historically low defaults and the potential diversity and granularity of trade finance loans. They are looking at opportunities to gain exposure to this asset class, without becoming lenders themselves, and also with the ability to transfer their investment easily and without borrower consent. And securitisation enables investors to choose different risk profiles – the more senior the notes, the less risky the investment but the lower the yield.

However, some of them do perceive the following disadvantages:

- significant originating bank risk, in its capacities as ongoing servicer, programme administrator and account bank;
- potential for adverse selection (a form of moral hazard), which is the ability for originating banks to 'cherry-pick' which replacement receivables are securitised from time to time as the original portfolio churns (so long as such receivables are satisfying a list of base eligibility criteria and not exceeding specified concentration limits), rather than an independent collateral manager selecting which receivables the securitisation vehicle should purchase;
- the low yield payable on stable trade finance assets – the low margin historically charged on trade finance assets can make it hard to generate sufficient yield to attract new investors;
- lack of standardisation of trade finance products and documentation;
- dilution risk – but this risk is reduced by limiting eligible receivables to where (a) the risk in the commodity has passed to the consumer, (b) the buyer has an unconditional payment obligation and (c) the buyer has undertaken to purchase the commodity; and
- lack of precise comparative data for investors to assess relative performance.

Techniques to securitise trade finance loans

There are two main alternative techniques to securitise trade finance loans:

- the true sale structure, where one or more originating banks sell their rights to receivables to a bankruptcy remote, special purpose vehicle (SPV), in a way that isolates the receivables from originator insolvency risk. Under English law, the underlying debtors generally do not need to be notified for there to be a valid true sale (through an equitable assignment). The SPV issues classes of notes; different investors will have different risk appetites, with the senior notes having a lower yield than the mezzanine and junior notes, which generally absorb losses on the receivables portfolio in reverse sequential order. The SPV uses the note proceeds to purchase the receivables from the originating bank; and
- the synthetic structure, where a bank purchases credit protection (in the form of a credit default swap) from an SPV, which in turn issues credit-linked notes. Again, different investors with different risk appetites will take the junior, mezzanine or senior credit risk.

The true sale structure also results in the originator obtaining funding at the time of the true sale. Recent examples include: BNP Paribas' Lighthouse Trade Finance Issuer 1 Ltd (www.tfreview.com/node/9467) and Citibank's and Santander's Trade MAPS 2013-1 (www.tfreview.com/node/9851), as well as Trafigura's securitisation in 2012 (see note 2). By contrast, the synthetic structure only pays the originator upon a credit event (for example, bankruptcy or failure to pay) occurring. Figure 1 summarises the structure of Trade MAPS securitisation.

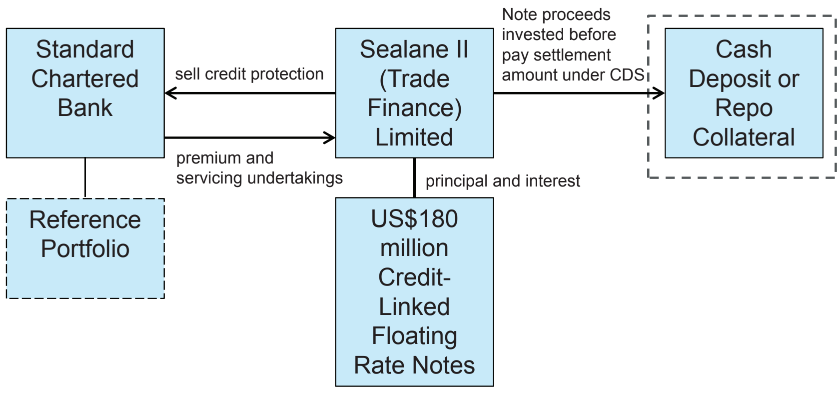
The synthetic structure is more versatile. These enable banks to transfer their credit risk under, for example, standby letters of credit rather than merely loans. Also, because there is no sale of the loans under a synthetic structure, less legal due diligence is required in respect of the relevant portfolio – such as checking transferability, any set-off rights, ability to pay SPV gross interest – and free of exchange control restrictions. An example of a synthetic securitisation of trade finance assets would be Standard Chartered Bank's Sealane issuances.[3] This is summarised in Figure 2.

The notes under each structure are typically rated and listed.

Under each structure, the originator will typically 'service' the receivables in accordance with a servicing standard designed to protect the interests of the noteholders. The servicer will have the day-to-day contact with the underlying trade finance loan borrowers. The trustee for the noteholders will have rights to audit the servicing and pool performance and either (in true sale structures) the right to replace the servicer, or (in synthetic securitisations) not to pay for a credit event 'settlement amount' if there has been a material breach of such servicing standard.

A standby (or backup) servicer may need to be appointed to achieve the desired ratings for the senior securitisation notes. This backup servicer will agree to take on the servicing of the securitised portfolio if the originator's appointment as initial servicer is terminated (for example because of material breach by, or insolvency of the originator).

Figure 2: Sealane I & II (Standard Chartered)



- CDS over portfolio of loans, L/Cs, commercial bonds, guarantees, PNs, bills of exchange issues by list of reference entities in one of 40 countries, as recorded in a register
- Sealane will pay cash settlement amount if losses on a US$3 billion portfolio exceed first loss threshold ($30 million) following a credit event (bankruptcy, future to pay, restructuring)
- Outstanding principal balance of Notes will reduce accordingly
- Portfolio can be replenished daily

Source: Dentons

Credit enhancement

Rating agencies and investors will analyse the portfolio credit quality (including receivables that are permitted to be substituted, taking into account, for example, country exposure, obligor industry, group obligor concentration limits), historic payment delinquencies and dilution performance, and then stress their model. On the basis of this model and the desired rating of the senior notes, the rating agencies will approve minimum levels of subordination and reserves to support each class of rated note. The reserves will often be dynamic, taking into account portfolio default and dilutions for the securitised portfolio from time to time.

If a credit event or performance breach by an originator occurs, then this can result in the end of the substitution revolving period, and therefore the early amortisation of the notes.

Investors will be focused on the 'weakest link' in the cashflows deriving from the securitised assets. Therefore collections should be paid into an A1/P1-rated SPV bank account as soon as possible to reduce commingling risk and account bank insolvency risk.

As with UK residential mortgage securitisations, master trusts and accumulation reserves can be used in trade finance securitisations to support bullet redemptions, rather than pass-through amortisation.

Cashflows may also be smoothed using, for example, hedging, liquidity facilities or guaranteed investment contracts.

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Risk retention and due diligence requirements

Broadly, an originator (whether it is a bank or a non-bank) must retain a 5% net economic interest in the securitised portfolio on an on-going basis, so as to enable EU credit institutions, insurers and alternative investment fund managers (AIFMs) to invest in trade finance loan securitisations efficiently. They must also before investing, carry out due diligence and, following investment, regularly perform their own stress tests on their securitisation positions.

Regulatory capital relief for originator

Both the true sale and synthetic securitisation structures enable the originating bank to achieve regulatory capital relief if (in the case of EU banks) significant credit risk transfer and the other relevant conditions in the EU Capital Requirements Regulations 2013 – with proper structuring, these requirements can be satisfied.

An originator or sponsor must not, to reduce losses to investors, provide support to the securitisation beyond its contractual obligations. A transaction does not provide support if executed on arm's length terms and taken into account in the assessment of significant risk transfer. TFR

1. See www.tfreview.com/node/10004 for a summary of the current Basel III position

2. See 'Trafigura launches trade finance securitisation scheme' at www.tfreview.com/node/7796

3. Completed in August 2011. The Asian Banker summary of this can be found at http://tinyurl.com/pwmk8hg

This article summarises a seminar held on securitisation of trade finance assets delivered by the Dentons team on 12 December 2013.

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