



Methodology  
*U.S. Trade Receivables*

DECEMBER 2009



*Insight beyond the rating.*

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# U.S. Trade Receivables Methodology

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## Summary of Methodology

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Trade receivables have historically been securitized primarily in Asset Backed Commercial Paper (ABCP) conduits. However, term securitizations of trade receivables are not uncommon and will be covered in detail in this report. Many sections herein will expound on the DBRS rating of U.S. Trade receivables both from an ABCP perspective as well as from a ‘term’ perspective. Further, this report will not cover every possible variable that can be found in trade receivable securitizations. The purpose of this report is to explain how DBRS views the primary risks found in most trade receivable transactions. Risks that are outside the scope of this report will be reviewed on a case by case basis.

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## Nature of Trade Receivables

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Two key features of trade receivables are that they are short term and non-interest bearing. Naturally, there are more characteristics of trade receivables that will be covered in the eligibility criteria section in Annex A in this report. These receivables arise as per a sale from the ‘seller’, typically a corporation, to the ‘obligor’, typically a corporate customer.

**Short Term Receivables** – The receivables ‘turn fast’, typically Days Sales Outstanding (DSO) are under 60 days. The short term nature of this asset class is a strength in that if material triggers are breached and an amortization is invoked, the losses are limited to a defined time period. This is known as the ‘Loss Horizon’ (more on this later). Conversely, the short term nature of this asset class presents risks that must be mitigated, namely commingling risk (also more on this later).

**Non-Interest Bearing Receivables** – Trade receivables do not accrue interest. They reside on a balance sheet over time at the same balance until they are paid or are charged off. The investors of securitized trade receivables, however, expect interest on their investment. So how is the interest covered? Trade receivable securitizations ‘overcollateralize’ receivables. For example, the investor may advance \$80 while the eligible trade receivables are \$100. The ‘advance rate’, made up of number of credit enhancement reserves, in this case, would be 80%, while the ‘overcollateralization’ on the eligible receivables would be 20%. More specific to interest rate coverage, within this advance rate is an interest rate reserve specifically designed to cover the interest element of what the investor expects with respect to yield (more on advance rate later).

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## Risks of Trade Receivable Securitizations

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DBRS believes that the risks inherent in trade receivable securitizations can be categorized as follows:

- Credit Risk
- Liquidity Risk
- Legal Risk
- Operational Risk



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# Credit Risk

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## SUMMARY

Generally credit enhancement for trade receivable securitizations is sized by taking into account both: (1) trade deals within the context of an ABCP conduit where liquidity facilities cover seller risks and (2) trade deals rated to a term or stand-alone standard. The key factors that are considered include, but are not limited to, the following:

- Eligibility criteria characteristics.
- The history of delinquencies and defaults.
- The historical payment characteristics (e.g. seasonality).
- Obligor concentrations.
- Terms of the trade securitization.
- The originator's risk profile.
- The quality of the servicer.
- Seller-customer relationship.
- Underwriting procedures and policies.
- The quality of the data.
- Idiosyncratic factors specific to the particular industry within the realm of trade receivables.
- Industry competition.

## Revolving Nature of Trade Receivable Deals

Predominantly, US trade receivable securitizations revolve<sup>1</sup>. A revolving transaction continually finances its receivables, typically through an ABCP conduit, until the date at which it terminates. Principal payments from old collateral finance new collateral on an ongoing basis. During the revolving stage, interest is covered via sized over-collateralization (more on this later in this report). Transactions of this nature can theoretically finance their receivables indefinitely. Trade receivable assets in revolving transactions must conform to specific eligibility criteria that will be reviewed by DBRS.<sup>2</sup>

Generally, revolving transactions are characterized by having amortization triggers that are typically checked monthly, but can be checked more frequently. These triggers are generally in place to ensure that the transaction has the proper credit enhancement on an ongoing monthly or reporting period basis. If breached and left uncured, an amortization of the transaction will occur. The reserves built into the advance rate are specifically sized for the maximum amortization period that can occur, also known as the Loss Horizon (more on this on Pg.8).

## 'Topping Up' the Reserve in Revolving Transactions

Generally, the most prevalent monthly credit trigger in a trade receivable revolving transaction is known as the borrowing base test. This test ensures that the assets and the necessary credit enhancement are fully intact on a go-forward basis. Any depletion of the credit enhancement resulting from asset deterioration is typically cured by the seller in the form of contributing more receivables to the transaction. This ensures

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1. In the US, on rare occasion, there could be a static discrete pool of trade receivable assets that could be securitized. In those instances, DBRS will ascertain the maximum amortization period or 'Loss Horizon' and in general, size the reserves as per the criteria in this report.

2. Please refer to Annex A.



that after each monthly or reporting period report, the transaction's credit enhancement is fully intact. This procedure of restoring the necessary credit enhancement each month or reporting period is called "topping up" the reserve. If the reserve is not topped up, the transaction will wind down and amortization begins.

## Ascertaining the Loss Horizon in Revolving Transactions

The key to accurately sizing the credit enhancement in a trade receivable deal focuses on the Loss Horizon, which is the maximum time during which the transaction's collateral can experience losses.

For revolving transactions, as noted above, the credit enhancement is typically 'topped up' on a monthly basis. Therefore, revolving pools in effect have a fresh start each month or reporting period because the credit enhancement is restored to its requisite level. If the credit enhancement is not topped up, the deal is precluded from purchasing new assets and from issuing new liabilities supported by the transaction, thus causing the transaction to amortize.

The Loss Horizon is typically calculated by adding the time it takes for the assets to naturally amortize to the length of the reporting period.

## DYNAMIC ADVANCE RATE

The dynamic advance rate determines the maximum percentage allowable of receivables that are can be advanced from investors relative to eligible assets. For a trade receivable securitization, the dynamic advance rate is typically comprised of, but is not limited to, a loss reserve, a dilution reserve and a carrying cost reserve. It is important to note that these reserves are fungible. In other words, one reserve may fall short in credit enhancement for 'A' underwriting while another may make up the difference. DBRS considers the dynamic advance rate taken as a whole. Therefore, our viewpoint on specific reserves in this report should be viewed as benchmarks for particular underwriting standards.

## DEFAULT RISK

### Loss Reserve

DBRS analyzes the Loss Reserve the same way for trade deals that are within an ABCP conduit and from a term standard perspective. The Loss Reserve is the primary mitigant to addressing default risk which is the risk of obligor default.

Typically, the Loss Reserve is the greater of the: 1) Dynamic Loss Reserve or 2) Concentration Floor Reserve.

### Dynamic Loss Reserve

The Dynamic Loss Reserve is generally in the form of dynamic overcollateralization and is typically a function of three components:

- The Loss Stress Factor (multiplied by)
- The Default Ratio (multiplied by)
- The Loss Horizon



### *The Loss Stress Factor*

The Stress Factors used in the US to help determine the dynamic portion of the Default Reserves are generally:

- 2.50 (AAA standard)
- 2.25 (AA standard)
- 2.00 (A standard)
- 1.75 (BBB standard)

Generally, DBRS views the above stress factors as minimum benchmarks. It should be noted that negative qualitative factors may increase them. An example of this would be, if the quality of data presented was not up to the standards that DBRS expects.

### *The Default Ratio*

The Default Ratio is generally described as the highest three month rolling average Loss Ratio for any monthly period over the twelve preceding monthly periods. The Loss Ratio is the fraction of the monthly defaults divided by the sales that originated them. It is important to properly match the defaults with the month of sales that originated them.

### *Loss Horizon Ratio*

The Loss Horizon Ratio generally captures the maximum amount of sales that can be embedded in the trade receivable portfolio at any given time divided by Net Eligible Receivable Balance<sup>3</sup>.

### **Concentration Floor Reserve**

As outlined earlier, typically the Loss Reserve is the greater of the: 1) Dynamic Loss Reserve or the 2) Concentration Floor Reserve. Concentration limits for obligors that are rated and unrated are typically built into trade receivable documents. The floor of this reserve is based on a matrix as seen below:

<b>Rating Threshold Obligor Rating</b>	<b>AAA Coverage</b>	<b>AA Coverage</b>	<b>A Coverage</b>	<b>BBB Coverage</b>
A-1+/P-1/R-1 (high, med)	0	0	0	0
A-1/P-1/R-1 (low)	1	1	0	0
A-2/P-2/R-2	2	2	1	0
A-3/P-3/R-3	3	3	2	1
Non-Investment Grade / Unrated	5	5	4	3

3. The Net Eligible Receivable Balance is the current amount of receivables in the portfolio at any given time that have not been excluded from the borrowing base due to non-adherence to the eligibility criteria. The excluded receivables are those that no longer meet the standards of the eligibility criteria or those that have been excluded due to obligor concentration limits. These excluded receivables are still available as overcollateralization in the deal, but are not advanced against for the borrowing base calculations. These 'excess concentrations' represent extra enhancement in trade receivable transactions.



For example:

If an issuer of trade receivables wanted to be rated AAA, the floor of the Loss Reserve would have to cover the greatest of:

- The largest A-1/P-1 seller
- The two largest A-2/P-2 sellers
- The three largest A-3/P-3 sellers or
- The five largest unrated sellers

## CREDIT SELLER RISKS

A DBRS rating addresses the mitigation of the credit seller risks listed below. However, DBRS analyzes these risks differently depending on whether the trade deal is within the context of an ABCP conduit or a term transaction.

- Dilution Risk
- Carrying Cost Coverage
- Commingling Risk

### Dilution Risk

Dilution Risk arises when the amount invoiced is reduced due to reasons other than default or payment. Examples of dilutive items are the return of goods, fast pay rebates, volume rebates, invoice errors, product disputes over quantity, quality, or delivery, advertising allowances and customer programs just to name a few. Assuming the seller undergoes bankruptcy proceedings, these dilutive items represent a shortfall of funds that must be mitigated.

Generally, companies grant dilutions to remain competitive. A primary consideration to understanding dilution risk is that the characteristics of dilutive items can vary. Some dilutive items are quantifiable like fast pay discounts. Some are more variable in nature like the return of goods. Moreover, changes in competitive industry practice and changes in company policies can further make sizing reserves for dilutions problematic. Because of the aforementioned concerns, DBRS recommends a dynamic reserve to mitigate dilution risk. It should be noted that dilution risk is typically fully mitigated by liquidity facilities coverage when trade receivables deals are within the context of an ABCP conduit. Nonetheless, in this case DBRS views a well thought out dilution reserve as added comfort. The following section describes the DBRS analysis of the mitigation of dilution risk both within the context of an ABCP conduit and as a term trade receivable deal.

### *Dilution Risk within the Context of an ABCP Conduit*

#### *Liquidity Facilities*

Similar to other credit seller risks, dilution risk is typically covered by the conduit's liquidity facility. The liquidity funding formula, via document language, will include funds due from the seller that have not been received (deemed collected). Liquidity funding formulas typically only reduce for defaults. The definition of 'defaults' typically excludes any diluted items. Therefore, the liquidity facility will take dilution risk. Thus, the risk to the CP investor reflects the rating of the liquidity bank.

#### *Reserve Account*

The DBRS rating typically will rely on the liquidity provider to cover dilution risk in the context of an ABCP conduit. However, a conduit has an incentive to properly address dilution risk because in cases where the bank sponsor is also the liquidity provider, it does not want to take a loss if liquidity funds and the reserve is sized improperly. If liquidity is drawn, cash will be available from the dilution reserve to



reimburse the liquidity provider. If liquidity does not fund, which is unlikely, cash is available from the reserve fund to pay the CP investors. In rare cases, some transactions may not cover this risk via liquidity. In these cases, and for term transactions, DBRS would size the reserve at a standard commensurate with the internal assessment of the transaction.

### *Dilution Risk Mitigation within a Term Transaction*

#### *Dilution Reserve*

Again, it should be noted that the following is a benchmark to cover dilution risk at specific rating levels. The variability from industry to industry may dictate more efficient dilution reserves and as such, DBRS will consider all dilution reserves to mitigate dilution risk. In DBRS's view, the deal should have a dynamic reserve with the appropriate stress factors commensurate to the rating sought which captures the comprehensive risks that dilution risk represents for that particular industry.

A common dilution reserve that DBRS is comfortable with may have the following components:

- The Dilution Stress Factor (SF)
- Dilution Ratio (DR)
- Dilution Volatility Factor (DVF)
- Dilution Horizon (DH)

The Dilution reserve in this case would be:  $((SF * DR) + DVR) * DH$

#### *The Dilution Stress Factor*

The stress factor used in the US to help determine dilution reserves are generally as follows:

- 2.50 (AAA standard)
- 2.25 (AA standard)
- 2.00 (A standard)
- 1.75 (BBB standard)

#### *Dilution Ratio*

Generally, the goal is to accurately match the dilutions with the sales that originated them. A 12-month average is typically used in the formula above. However, matching dilutions to sales that originated them is not always an easy task and sometimes is not available from the sellers as dilutions are not typically tracked like defaults. An audit sample process has been used by which credit memos are analyzed and tracked back to the sales that originated them. In this case, DBRS should be comfortable that the sample taken is comprehensive and representative of the dilutions as a whole for the deal.

#### *Dilution Volatility Factor (DVF)*

The DVF is there to address volatility in a particular portfolio. Specifically, it is utilized in many deals because of the concerns that dilutions present in: 1) tracking dilutions back to the sales that originated them to arrive at a precisely accurate average dilution ratio and 2) ascertaining the exact dilution horizon. DBRS examines this cushion for reasonableness relative to the history of the portfolio and rating level sought.

#### *Dilution Horizon*

The dilution horizon generally captures the likely amount of dilutions in the portfolio at any given time divided by the ending eligible receivables. This is achieved by ascertaining the average time lag between



the point of sale and the point at which the dilution occurs. Because of the variance in the types of dilutions from industry to industry and within certain industries, the dilution volatility factor is analyzed in conjunction with the variability of ascertaining an accurate dilution horizon.

## Carrying Cost Coverage

Carrying cost reserves are generally made up of a: 1) yield reserve which incorporates interest rate risk and ongoing conduit fees and expenses and 2) reserve for the replacement of a servicer.

Similar to other credit seller risks, such as dilution, it should be noted that the reserves on the following page represent a benchmark to cover the carrying costs of trade receivable programs at specific rating levels. As such, DBRS will consider all carrying cost reserves to cover this risk. In DBRS's view, the deal should have a dynamic reserve with the appropriate stress factor commensurate with the rating sought in order to effectively mitigate the risks associated with carrying costs. Also, similar to how DBRS views other credit seller risks, it should be noted that carrying costs are typically fully mitigated by liquidity facilities when trade receivable deals are within the context of an ABCP conduit. Nonetheless, in this case, DBRS views well thought out carrying cost reserves as added comfort. The following section describes the DBRS analysis of the mitigation of carrying cost coverage both within the context of an ABCP conduit and as a term trade receivable deal.

### *Carrying Cost Coverage within the Context of ABCP an Conduit*

#### *Liquidity Facilities*

Generally, DBRS relies on the transaction liquidity banks to fund the interest accrued at the time of funding and the interest that will accrue to the maturity of the CP. Typically, language in liquidity funding formula in the transaction documents specifically covers this risk. Further, liquidity facilities fund for defaults in excess of the total reserves. Since the conduit fees are imbedded in the carrying cost reserves (more on this below), liquidity also covers off conduit fees and expenses. Thus, the risk to the CP investor reflects the rating on the transaction liquidity provider. Typically, the sponsor bank provides the liquidity facilities for each transaction.

#### *Reserve Account*

DBRS typically relies on the liquidity provider to cover interest rate risk and conduit fees. However, conduits have incentive to properly address carrying cost coverage because, in cases where the sponsor bank is also the liquidity provider, the bank does not want to take a loss if liquidity funds and the reserve is sized improperly. If liquidity is drawn, cash will be available from the carrying cost reserve to reimburse the liquidity provider. If liquidity does not fund, which is unlikely, cash is available from the reserve fund to pay CP.

### *Carrying Cost Coverage within a Term Transaction*

Carrying cost reserves are generally made up of two components:

- Yield Reserve
- Backup Servicer Reserve

#### *Yield Reserve*

The yield reserve typically reserves for interest rate risk plus other general conduit fees.

A typical yield reserve is:  $((A*B*C) / 360)$



Generally:

A = The annual coupon plus fees (Rate + Margin + Cushion)

B = Days Sales Outstanding (DSO)

C = The Interest Rate Stress Factor

#### *The Interest Rate Stress Factor:*

The Stress Factor used in the US to help determine interest rate reserves are generally as follows:

- 2.00 (AAA standard)
- 1.75 (AA standard)
- 1.50 (A standard)
- 1.25 (BBB standard)

It is important to note that the above stress factors are benchmarks and can vary depending on the assessment of reset risk. For example, a trade receivable deal with a maximum amortization period (Loss Horizon) of 2 months will present less reset risk than a trade receivable deal with a maximum amortization of 7 months.

#### *General Conduit Fees*

General conduit fees are comprised of ongoing servicing fees, trustee fees and conduit expenses. These fees are all sized and represent a known quantity over a sized amortization period.

#### *Interest Rate Risk*

A DBRS rating addresses the timely interest payment on the debt issued. An interest rate reserve is necessary because, as stated earlier, trade receivables do not accrue interest. Therefore, the coverage must be imbedded in the total advance rate. An interest rate reserve should consider the nominal rate on the debt issued, whether via ABCP or terms notes, as well as the turnover rate of the receivables (DSO). The typical yield reserve previously mentioned addresses both. The stress factor, along with the cushion as represented in the yield reserve formula above, mitigates reset risk during a potential amortization period. The total maximum amortization period in trade receivable securitizations is typically less than six months which limits the amount of times the debt issued can reset.

#### *Backup Servicer Reserve*

In the preponderance of trade receivable securitizations, the seller usually serves as the servicer. The servicer plays a vital role in the ongoing operation of the conduit. The specifics of the seller/servicer's role will be reviewed in the Operational Risk section of this report. With respect to credit, a reserve and/or provisions for a back-up servicer must be made in the event that the seller, or present servicer, can no longer perform its duties.

DBRS will analyze the reserve for a backup servicer. The reserve for a backup servicer should be reasonable with respect to comparable fees, possible market conditions, and any idiosyncrasies that may be specific to a particular industry. In some cases, a live backup servicer may be warranted. In all cases, DBRS will review the trustee's provisional plans in the event a servicer can no longer perform its duties. DBRS will review the reserve for a back-up servicer on a case by case basis.

#### **Commingling Risk**

Commingling risk relates to the collections which could be lost in case of a bankruptcy of the seller. The seller, who typically has a lower rating than the rating sought in the securitization, could have its funds commingled with the deal's funds. If the seller were to go bankrupt, which is presumed, the deal's funds



would be caught up in the bankruptcy of the seller. This risk is relatively more important in asset classes that have a quick turnover, like trade receivables, simply because the funds that could be commingled could represent a higher percentage of the receivables in the portfolio. For example, if a deal has a DSO of 25 days and securitized funds are commingled with the seller's funds for the 5-day work week, being swept every Friday, assuming an even distribution of payments, the commingling funds could represent 20% of the portfolio. The shorter the DSO and the longer the securitization funds are commingled with the seller's funds as a procedure, the greater the commingling risk in the deal.

Also, similar to how DBRS views other seller risks, it should be noted that commingling risk is typically fully mitigated by liquidity facilities when trade receivables deals are within the context of an ABCP conduit. Nonetheless, in this case, DBRS views well thought out mitigation of commingling risk, typically via the use of lockboxes, as added comfort. The following section will describe the DBRS analysis of the mitigation of commingling risk both within the context of an ABCP conduit and as a term trade receivable deal.

### *Commingling Risk within the Context of an ABCP Conduit*

#### *Liquidity Facilities*

Generally, the liquidity funding formula, via document language, will include funds due from the seller that have not been received, (deemed collected). Typically, liquidity funding formulas only reduce for defaults. The definition of "defaults" generally does not include funds that are commingled due from the seller. Therefore, liquidity banks typically cover commingling risk. Thus, the risk to the CP investor reflects the rating of the liquidity bank.

#### *Reserve Account*

DBRS typically relies on the liquidity provider to cover commingling risk. However, conduits have incentive to properly address commingling risk because, in cases where the sponsor bank is also the liquidity provider, the bank does not want to take a loss if funds have been commingled and the policies and processes followed did not address commingling risk. If liquidity does not fund, which is unlikely, the processes and policies followed, and possibly a reserve, should mitigate commingling risk.

### *Commingling Risk Mitigation within a Term Transaction*

#### *Lockboxes*

The most common way to mitigate commingling risk is via the use of lockboxes. The following strict obligor procedures are typically observed:

1. Obligors are instructed to make payments directly to lockbox accounts.
2. All lockboxes are transferred, typically in the name of the conduit or SPE, for the benefit of the investors. The lockbox should be segregated from the seller.
3. All lockboxes should be swept daily.

#### *Commingling Reserve*

Using the example mentioned above, a trade deal that didn't have lockboxes, had a DSO of 25 days and by which the funds were swept every 5 days, would have to have a properly sized reserve. In this case, DBRS would like to see a reserve that addresses the volatility imbedded in the lumpiness of payments, based on the historic portfolio, along with the math required to calculate the probable percentage of commingled funds at any given time. DBRS will analyze commingling reserves on a case by case basis.



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## Liquidity Risk

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### SUMMARY

It should be noted that the vast preponderance of trade receivable deals in the US are rated within the context of an ABCP conduit.

### LIQUIDITY RISK FOR TRADE RECEIVABLES WITHIN THE CONTEXT OF AN ABCP CONDUIT

As has been presented, liquidity facilities generally cover the credit seller risks within the context of an ABCP conduit. The risk of liquidity not funding is directly related to the short term credit quality of the liquidity provider who is usually the sponsor bank. There are usually reserves in place, the liquidity provider's rating is of vital importance when assessing the credit risk associated with a trade receivable deal that resides in an ABCP conduit.

### LIQUIDITY RISK AS RELATED TO TERM TRADE RECEIVABLE TRANSACTIONS

This report details the vigor of the DBRS analyses for term trade transactions throughout. However, DBRS will pay special attention to the following details:

- The credit seller risks (no reliance on liquidity facilities)<sup>4</sup>.
- The asset/liability management of the servicer.
- The timely payment of interest.
- The frequency of borrowing base calculations.
- Early amortization triggers that are tied to the borrowing base calculations.
- The seasonality of receivables.
- Any possible negative carry scenarios.
- Any possible seller guarantees in conjunction with early amortization triggers upon a seller bankruptcy.
- The credit quality of the seller/servicer.
- The servicing acumen of the seller/servicer (also covered in the Operational Review section).
- An operational review of the seller/servicer.

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## Legal Risk

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### SUMMARY

A common touchstone of all securitizations is the isolation of the seller's assets from the seller. For trade receivable programs, sequestering the assets from a low rated or unrated seller is at the forefront of legal analysis. True sales and/or First Priority Perfected Security Interests (FPPSI) should be obtained at every level of transfer ultimately isolating the receivables into a bankruptcy remote vehicle that will issue securities, via ABCP or otherwise, to investors.

As stated in the above paragraph, paramount to a successful trade receivable securitization is the proper transfer of assets. The transfer is conducted either via a sale or pledge of the seller's assets without con-

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<sup>4</sup> Depending on various factors considered in the analysis of a term trade receivable securitization, DBRS may ask for partial or full liquidity facilities, rated appropriately, in order to arrive at a rating.



sideration of the seller's creditworthiness. Moreover, the DBRS analysis starts with the assumption that the seller of the trade receivables undergoes bankruptcy during the securitization. That said, there are germane risks, along with some legal language that DBRS reviews as part of the legal analysis around trade receivable securitizations. They are as follows:

- Preference Risk
- Stay Risk
- Safeguard Legal Language Reviewed for Trade Receivables in ABCP Conduits
- Legal Opinions

## Preference Risk

Preference risk, in general, is the risk that upon a seller bankruptcy, a bankruptcy court would rule that the creditor received funds that constitute a preference payment within the applicable preference period<sup>5</sup> due to its preferential position. The payments can then be avoided under section 547 of the bankruptcy code and therefore required to be clawed back (returned to the bankruptcy estate of the seller).

The legal review for the trade deal entails a review of the asset transfers at each level of transfer. One of the few risks that relate to a seller bankruptcy which liquidity facilities typically do not absorb is preference risk. Liquidity facilities can be structured to absorb this risk, but it is an uncommon solution (please refer "Liquidity Solution to Preference Risk" section below). The deal would therefore suffer a loss and timely payment to the investors could then be in jeopardy.

### *Mitigants to Preference Risk*

The proper transfer of assets is vitally important to addressing the mitigation of preference risk with respect to trade receivables. The idea is that a bankruptcy judge would not likely consider payments to be preferential if he/she was convinced a proper transfer had taken place. DBRS will generally place reliance typically on any of the following to verify the proper transfer of assets:

#### *Preference Risk Mitigation within the Context of an ABCP Conduit*

- The Issuer can submit an Officer's Certificate which certifies that the issuer (collateral agent or trustee) has obtained its own counsel and counsel has advised that there is either a true sale and/or a First Priority Perfected Security Interest (FPPSI) at each level of transfer.
- DBRS will rely on Article 9 representations and warranties. In most cases, they adequately address concerns that the issuer (collateral agent or trustee) has a valid, perfected, first priority security interest in, and is fully secured by, the underlying collateral.
- DBRS will review an opinion as to preference risk as necessary.
- DBRS will review Liquidity Solutions<sup>6</sup> as necessary.

#### *Liquidity Solution to Preference Risk*

In the event that the above can not be obtained, the liquidity agreement can be used as a means to mitigate preference risk by including language to the effect that any avoided payment and any interest (to the maturity of the CP) that may accrue on that payment, will be funded by the liquidity provider. For example, if a payment were to be clawed back, the liquidity facility would be responsible to pay the amount of the payment that had to be returned. Sponsor banks are sometimes reluctant to cover this risk via liquidity facilities because the liquidity provider can not be subject to the general liquidity commitment limits in order to mitigate preference risk. In other words, preference risk is difficult to size and

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5.The preference period is 90 days unless the seller and the issuer are affiliated, in which case it is 1 year.

6.A liquidity solution is only available to those trade securitizations that are funding via ABCP conduit.



thus liquidity providers would have to supply a ‘blanket’ coverage, as opposed to a purchase limit of the typical 102% of the commitment.

#### *Preference Risk Mitigation in a Term Trade Receivable Transaction*

DBRS will require true sale opinions at each level of transfer to mitigate stay risk in a term trade receivable transaction. In contrast, true sales or FPPSI's are acceptable within the context of an ABCP conduit. If a seller were to enter bankruptcy, a judge would likely not deem the payments as preferential because of the true sale.

### **Stay Risk**

If a seller in a trade deal were to become insolvent, a bankruptcy court would likely impose an automatic stay on all payments from the seller and review any preferential payments potentially paid by the seller. The impact to the trade securitization would include all collections on the receivables due to the investors being delayed, thereby jeopardizing the DBRS rating.

#### *Mitigants to Stay Risk in the Context of an ABCP Conduit*

For those trade receivable deals in ABCP conduits, the liquidity facility typically absorbs stay risk. Typically, the liquidity funding formula will fund for either an asset base or a capital base minus the excess of defaulted receivables over credit reserves. Both formulas, via document language, include funds due from the seller that have not been received, but deemed received. Thus, liquidity funding formulas fund for deemed collections. Said differently, since liquidity funding formulas typically only reduce for defaults, and the definition of defaults will not include deemed receivables, liquidity facilities will fund amounts stayed but not defaulted.

#### *Mitigants to Stay Risk for a Term Trade Receivable Transaction*

DBRS is comfortable with true sale opinions at each level of transfer to mitigate stay risk in a term trade receivable transaction. In contrast, true sales or FPPSI's are acceptable within the context of an ABCP conduit. If a seller were to enter bankruptcy, a judge would likely rely on the true sale of the assets securitized.

#### *Safeguard Legal Language Reviewed for Trade Receivables in ABCP Conduits*

- Excess Funds/Limitations on Payments
- Limited Recourse
- No Proceedings/Non-Petition
- Rating Agency Notification (RAN)

#### *Excess Funds/Limitation on Payments*

This clause generally states that the conduit shall not be obligated to pay (any relevant entity)<sup>7</sup> unless it has excess funds (over and above) those required to retire CP. All conduit counterparties, other than CP investors, must agree to this excess funds language.

#### *Limited Recourse*

The recourse that the liquidity bank has to the conduit is limited to the assets in the case of a Liquidity Asset Purchase Agreement (LAPA) and the cash flows from the receivables in the case of a Liquidity Loan Agreement (LLA). The limitation is present to provide a disincentive for liquidity banks to file claim against the conduit.

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<sup>7</sup>The entity is typically any entity that could possibly be owed funds from the conduit in the normal course of its operations.



### *No Proceeding/Non Petition*

Generally states that counterparties, other than CP investors, agree not to institute or join any filing of the conduit into bankruptcy for one year and one day after the last maturing CP is retired.

### *Rating Agency Notification (RAN)*

Generally, all material amendments should be reviewed by DBRS before they become effective. DBRS will ask for an appropriate lead time to ensure a proper review while maintaining an efficient execution for the CP issuer. This notification is a protection against the risk that program amendments could be to the detriment of the CP investors.

## Legal Opinions

Each trade transaction is reviewed considering all risks that may jeopardize full and timely payment to its investors. DBRS will consider each deal on a case by case basis and ask for the legal opinions it deems necessary to ensure full and timely payment of the liability rated. Common opinions that may be sought include, but are not limited to:

- True Sale
- Non-Consolidation
- Perfection
- Tax

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## Operational Risk

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### SUMMARY

A servicer of trade receivables, who is usually the seller also, plays a vital role in the success of a trade receivable securitization. Operational risk arises when procedures described both during the operational review and in the transaction documents are not properly adhered to. DBRS conducts operational reviews as necessary depending on whether the trade securitization is within the context of an ABCP conduit or whether it is a stand alone term securitization.

### OPERATIONAL RISK WITHIN THE CONTEXT OF AN ABCP CONDUIT

DBRS conducts an operational review of the sponsor/administrator of the CP conduit as necessary. A trade receivable securitization within the context of an ABCP benefits from more protections than stand alone trade securitizations. The key protections are as follows:

- Liquidity facilities that cover many risks. These risks often have reserves in conjunction with liquidity coverage.
- Liquidity Facilities that cover any timing mismatches between asset collections and liability payments.
- Program Wide Credit Enhancement that is available to all deals within an ABCP conduit that suffer losses in excess of the sized reserves.

It is for these reasons that DBRS typically relies on the sponsor/administrator's operational review of the servicer. DBRS may however, at its discretion, conduct an operational review on the seller/servicer as it deems necessary.



## OPERATIONAL RISK AS RELATED TO TERM TRADE RECEIVABLE TRANSACTION

Prior to the close of a transaction, DBRS will meet with senior managers of the seller at their premises to conduct an operational review of their business strategy, industry risks, obligor risks, historical receivable performance, credit and collections policies, information systems and servicing capabilities. Additional time is typically spent discussing treatment of certain large customers, problematic business lines, pockets of risk and other areas of concern for DBRS. The goal of the operational review is to develop an understanding of the seller's tolerance for risk, management of its receivables process, including its information technology capabilities, as well as a strategic overview of its marketplace.

Part of the review undertaken by DBRS also includes an analysis of the validity, collectability and enforceability of the receivables. All these aspects are covered by representations and warranties of the seller when the receivables are transferred to the SPV. As noted before in the previous section, DBRS, at minimum, also reviews the administrator if the transaction is in the context of an ABCP program.

To the extent that several divisions within the seller underwrite and collect receivables in a different manner, DBRS may request a meeting with these separate groups. Aging data, absent of credit memos, should be provided for distinct business lines.

### SAMPLE OPERATIONAL REVIEW DISCUSSION POINTS

#### *Seller Information*

- Ownership structure and transaction counterparties (corporate structure).
- Product lines and market trends.
- Recent or upcoming changes to company.
- Head office and other business locations.
- Key sales divisions, product descriptions, and organizational charts.
- Senior personnel - sales, credit, collections, finance.
- Audited financial statements (recommended 5 years).
- Discussion of funding alternatives and "fit" of securitization.

#### *Customer Information*

- Customers - nature and stability.
- Industry trends for customers.

#### *Sales Process*

- Discussion on receivables types.
- Processing orders.
- Interface between credit approval system and order delivery capabilities.

#### *Risk Management Process*

- Terms and conditions of receivables.
- Credit and collection policies and frequency of individual reviews.
- Credit approval process and limits.
- Overrides and controls.
- Separation of sales and credit functions.
- Billing process and timing of invoice issuance.
- Payment terms, application of policy, and marketplace practices.



### *Collections*

- Ongoing monitoring of receivables.
- Application of payments received.
- Dispute resolution.
- Policy for collections on delinquencies.
- Charge-off and provisioning policies.
- Consistency of application of policy on accounts.

### *Systems*

- Integration of credit policies into system.
- Storage and disaster recovery.
- Security processes.
- Management source reports for reported portfolio data.
- Historical information sources.

## **SURVEILLANCE**

The purpose of the ongoing evaluation of a trade receivable securitization is to ensure that the risk profile of the particular deal has remained unchanged, within the rating grade assigned. For trade deals within the context of an ABCP conduit, DBRS expects monthly reports from conduit administrators that outline any changes to any of the deals in the conduit, including the trade deals, along with any possible credit deterioration (i.e. borrowing base breach). For term trade deals, DBRS expects monthly servicer reports to be provided from the servicer of the trade receivable deal. The data will be more extensive but should, at a minimum, be enough information for DBRS to ascertain whether the risk profile of the deal is unchanged within the rating assigned.

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## **Annex A - Eligibility Criteria**

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The fundamentals of any trade receivables securitization are that the sale and assignment of the receivables are valid, that the obligations of the obligor are enforceable and that the receivables were originated and are serviced in accordance with the credit and collections policies of the seller. In addition, trade receivable transactions tend to only purchase receivables that are current and meet predetermined obligor and other concentration limits. To provide assurance that the securitized portfolio meets the criteria, the seller represents and warrants that they have examined the portfolio and it meets the agreed eligibility criteria.

A typical transaction includes the following key eligibility criteria, although more may apply depending on the risks that may be specific to the transaction. On each sale of receivables, the seller typically represents and warrants that the receivables comply with the eligibility criteria. Some key eligibility criteria are as follows:

- The obligor is not an affiliate of the seller.
- The receivable is not delinquent or defaulted.
- The receivable is for goods and services already rendered in full.
- The receivable constitutes an account, as defined in the UCC and is not evidenced by an instrument or chattel paper.
- The receivable represents an extension of credit by the seller in the ordinary course of business to an obligor payable in cash by that obligor.
- The receivable is payable in full, is not subject to offset rights, arises under a legal, valid, and binding contract and is fully assignable by the seller.



- The receivable is denominated and payable in a specific currency; Hedges and other mitigations must be in place if foreign exchange or sovereign risk is present in the deal.
- The receivable does not contravene applicable laws, rules, or regulations.
- The receivable has payment terms consistent with the relevant legal documents.
- The receivable satisfies, in all material aspects, all applicable requirements of the seller's credit and collection policy.
- The receivable will not cause the seller to breach any representations and warranties as dictated in the relevant legal documents.
- The receivable by which payments are to be made to a permitted lockbox account or collection account.
- The receivable is not the subject of any disputes, counterclaims, repurchase obligations, or set off.
- The obligor of the receivable has not defaulted or been delinquent on receivables that comprise more than a small percentage of the aggregate receivables owed by that obligor.
- The sale of receivable does not cause any breach of any concentration limits set forth in the relevant legal documents.

If at any time it is determined that the purchased receivables did not meet the reviewed eligibility criteria at the time they were purchased, the seller will be obligated to either repurchase such receivables at face value or substitute eligible receivables of an equivalent amount into the SPV. Any breach of this will cause an amortization of the deal.

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