FORWARD FLOW TRANSACTIONS

Forward flow transactions have been a periodically hot topic in the market for the past half a decade. During this time, their popularity has fluctuated due to market conditions and the general macro-economic environment. Whilst previously popular, current interest rates are making the economics difficult to balance for funders of mortgage loan forward flow transactions. By contrast, in the various transactions we have advised on recently we are seeing sustained activity in other areas, including with respect to unsecured SME loans.

KEY FEATURES

Structural Features and Funding Mechanics

A forward flow transaction represents a different economic proposition for the originator than a traditional ABS warehouse financing arrangement. Before exploring the deal economics, it is helpful to contrast the funding mechanics of the two deal types.

Warehouse Structures

In a typical warehouse structure, beneficial title to a pool of assets is transferred by the seller/originator to an SPV under the terms of a sale agreement. The underlying portfolio may be static or revolving, but at the time that any asset purchase price is paid by the SPV to the originator, the assets to be acquired already exist on the balance sheet of the originator (having been originated using the originator's own funds). The sale to the warehouse SPV thus allows the originator to re-leverage the relevant portfolio.

Once sold, the pool of assets is then held as security for the corresponding issuance of debt (in loan or note form) by the SPV. Funding in a traditional warehouse structure typically consists of senior, junior and potentially mezzanine tranches, with the junior funding often provided by the originator.

"On Balance Sheet" Forward Flow Arrangements

In a typical forward flow structure, by comparison, the origination of loans meeting the relevant eligibility criteria is pre-funded by the funder on an ongoing basis during the agreed funding period, with beneficial title in the underlying assets transferring to the purchaser immediately upon their origination (which may be as often daily). There may be structural variations (driven by tax, regulatory, reputational and other factors) including the use of an SPV vehicle as the lender of record. However, crucially, the assets that are acquired by the funder do not exist on the balance sheet of the originator at the time funds are transferred by the funder to the originator. As soon as an eligible loan is originated it is sold and title is transferred to the funder, at which point the loan will sit on the funder's balance sheet. Forward flow transactions allow an originator to use the funder's balance sheet to originate loans (rather than its own funds, which would be more limited in the case of newer Fintech originators).

Practically however, for regulatory capital and other reasons, funders may wish to structure their forward flow arrangement though an SPV vehicle, rather than the funder purchasing the relevant loans directly onto its own balance sheet. The funder instead advances sums to the SPV to fund its payment obligations (and may bring in leverage in the form of third party senior or junior financing).

To ensure certainty of funds with respect to the SPV, originators may require the funder to enter into a commitment letter. Under such a commitment letter, the funder commits to finance the SPV in the amount required for the SPV to meet its obligations to the originator to fund and acquire new originations. Where an SPV is used, consideration still needs to be given as to whether such SPV would be consolidated with the funder for accounting and/or regulatory purposes.

Transaction Economics

One of the principal advantages (and motivations) for originators in using a forward flow arrangement is that it can be structured such that the funder funds 100% of an asset's par asset value (potentially plus a premium, as explained further below). By contrast, third party warehouse funding is often limited to an advance rate in the region of 70-90% of portfolio value. This 100+% funding therefore makes forward flow structures attractive for both start-ups and seasoned originators.

Under a forward flow arrangement, the funder is the entity which is subject to the credit risk of the portfolio, and by providing 100% of the transaction funding (without a junior funding element from the originator) has exposure to both upside return and downside risk when it comes to asset performance. With this greater risk comes the possibility of greater yields for the funder.

The funder typically acquires the originated assets at par, and transactions may feature an initial purchase premium (representing an origination fee for the originator) and/or a deferred consideration element. Rather than having "skin in the game" through holding junior debt in a warehouse structure (a first loss tranche, but also the tranche that will receive residual collections), the presence of a deferred consideration element incentivises the originator to originate high quality assets. Such deferred consideration is then payable where certain performance conditions are met. However, the originator is not exposed to the downside risk of the portfolio in the same way as the funder.

Securitisation Regulation Compliance

Although it may be possible to structure a warehouse that does not need to be Securitisation Regulation compliant, typical ABS warehouse structures are required to be compliant with the EU Securitisation Regulation and/ or the UK Securitisation Regulation (as applicable) on the basis that the debt funding will typically be composed of a senior and a junior tranche. Such tranching therefore brings the transaction within the definition of a "securitisation" (as set out in Article 2(1) of the EU Securitisation Regulation and the UK Securitisation Regulation).

By contrast, Securitisation Regulation compliance may not necessarily be required for forward flow transactions that are structured with a sole funder providing 100% of the transaction funding, given the absence of a tranched equity/junior funding element. Where forward flow financings are not within the remit of the EU Securitisation Regulation or the UK Securitisation Regulation, the statutory requirements around investor due diligence (Article 5), risk retention (Article 6), reporting (Article 7) and credit granting (Article 9) would not be engaged.

KEY CONSIDERATIONS AND POINTS OF NEGOTIATION

Origination Risk to Reside with the Originator

While the funder (rather than the originator) will assume the credit risk with respect to performance of the relevant assets, origination/underwriting risk should remain with the originator. Transactions will feature carefully drafted and extensively negotiated eligibility criteria and asset warranties. Assets must satisfy such eligibility criteria and asset warranties at the time of origination, and the originator will be required to repurchase any assets that did not (subject to any negotiated limitations on originator liability, including time limits for bringing claims, and de minimis thresholds).

The increased exposure of the funder also results in greater levels of scrutiny and due diligence with respect to the loan underwriting process, and tighter controls on amendments and variations to standard form origination documentation, policies and assets. While originators require some flexibility to make amendments without the burden of obtaining funder consent (for example, where required by law/regulation, or minor/technical amendments), this will be tightly defined and controlled given the potential for amendments to impact the credit quality of assets. Straying beyond contractually permitted flexibility may result in funder remedies such as originator repurchase obligations or (for material, unremedied breaches) a stop purchase event.

Certainty of Funding

Akin to drawstop events in a traditional revolving warehouse structure, forward flow transactions feature specified stop purchase/funding events. These are heavily negotiated to ensure a satisfactory balance between funder protection and originator need for certainty of origination pipeline funding. Stop purchase events are bespoke to each funder's and originator's specific circumstances, but may include: insolvency; unremedied breach of representation / covenant; loss of required regulatory authorisations; change of control; key person events; unremedied breach of specified concentration limits; and unremedied breach of specified performance triggers.

Pre-Funding of Origination

Pre-funding in forward flow arrangements necessitates the inclusion of documentary protections to minimise the gap risk between funding and title transfer. These can include, by way of example, the taking of security over the pre-funded originator account, and the inclusion of an obligation to return funds not used to originate eligible assets within X days of receipt.

To the extent the funder uses an SPV vehicle as part of the forward flow structure, bespoke revolving facility mechanics will also be needed in order to track the origination pipeline of the originator over time. One method of pre-funding new originations is to divert a portion of principal collections from previously funded assets back to the originator.

Other Key Considerations and Points of Negotiation

- A forward flow may only make economic sense for the funder where the portfolio acquired is expected to ramp to a certain size. To the extent the funder is not providing the originator's only forward flow / asset financing arrangement, provisions regarding minimum allocation volumes and random asset allocation merit consideration.
- Funding on a forward flow basis means that funders must also have strategies in place to mitigate future interest rate changes. This can include hedging, as well as concentration limits or excess spread triggers linked to asset interest rates.
- Different funders will have different exit strategies for the portfolio built up through the forward flow transaction. Although the base case for some may be buy-and-hold, others will be looking to a future public securitisation take out. Consideration should be given to the associated assistance that may be required from the originator in relation to such a securitisation take out, and corresponding documentary provisions built in.

FOR MORE INFORMATION

This briefing provides an overview of some common features of forward flow arrangements and is not intended to be exhaustive. It does not constitute legal advice and is provided purely for informational purposes. We recommend that you seek specific legal, regulatory, tax and accounting advice for any transactions that you wish to undertake.

Our Structured Finance team is available to discuss any of these issues with you and answer any specific questions you may have. If you would like more information about the topics raised in this briefing, please speak to your regular contact at Weil or to any of the authors listed below:

JACKY KELLY

+44 20 7903 1045
jacky.kelly@weil.com

BRIAN MAHER

+44 20 7903 1292
brian.maher@weil.com

STEVEN ONG

+44 20 7903 1041
steven.ong@weil.com

EMILY FIRMSTON

+44 20 7903 1340
emily.firmston@weil.com