Speciality Finance Series: the Rise of Forward Flow

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The Rise of Forward Flow Agreements in Speciality Finance

Forward Flow agreements, whereby the beneficial interest of, and economic interest in, a loan is transferred to a funder in return for liquidity, have become an increasingly popular financing option for speciality finance participants. In this short note we look at the rise of this relatively new entrant to the financing landscape, and examine some divergences in terms we are seeing.

It is worthwhile considering the reasons why forward flow has been seeing a surge in popularity. Below are some high-level views on some of the reasons market participants are viewing forward flow favourably.

FUNDER ADVANTAGES

Try before you Buy

Challenger banks, boutique banks and alternative lenders, in particular, all have a growing interest in a diverse set of lending platforms. For some, funding companies with proven track records and strong management is enough. For others, the longer term plan will be to have their own platforms, either grown organically from their existing offerings or by taking equity stakes in speciality finance companies and streamlining back-office functions to leverage synergies and knowledge. Forward flow allows these lenders to effectively take the assets on balance sheet, by owning the beneficial interest. The granular level of reporting and monitoring will give those lenders an informed opinion of the asset class.

Origination Platform

Liquidity now exceeds pre 2007 levels. Deployment of that capital has now become many financial institutions' most pressing concern. Partnering with a speciality finance company via a forward flow agreement means a funder can leverage the benefit of the speciality finance company's origination and underwriting, bypassing the need for a specialist in-house function, whilst at the same time putting their liquidity to work.

Yields

As a result of the on balance sheet nature of forward flow arrangements (and therefore a greater proportion of the risk sitting with funders), funders will often find that the yields available to them through a forward flow agreement will be greater than if they financed the relevant company through a more conventional arrangement.

BORROWER ADVANTAGES

Dilution prevention

Speciality finance companies are becoming increasingly attractive propositions for acquisition. The extra liquidity provided by the new shareholders may be used to increase their market offering, and further the company's lending capability but at the expense of equity dilution. A forward flow agreement facilitates continued origination, but with no equity dilution.

Proving the Model

A lack of liquidity will operationally hamstring any speciality finance company, and if that occurs in an early phase of growth, the effects can be severe and stifle development despite the market offering being potentially competitive and effective. The forward flow model gives the company the opportunity to prove its underwriting capability, provisioning and servicing, by utilising the funder's balance sheet, subsequent to which raising equity stakes may well have a lower dilutive cost, and any further financings may also come at a lower cost.

Build relationships

Liquidity is clearly the lifeblood of a speciality finance company and the funding relationship is an important and potentially longstanding partnership. The forward flow relationship allows a funder to gain an in-depth knowledge of the company's operations, potentially opening up the possibility of a more diverse range of funding options.

Legal Considerations in Forward Flow Agreements

The forward flow product is still being developed and there are a number of divergent views on how a forward flow agreement should be structured. An institutions' view of how to set up a forward flow agreement will be informed by a number of different factors, but chief amongst these will be their view of where this product sits in the broader financing landscape.

It may be viewed as something more aligned to conventional loan agreements, which would entail LMA style covenants, events of default mechanics and some of the technologies (such as a repurchase mechanic) you might find in a typical bilateral/small club arrangement.

Alternatively if the product is viewed more as a pure asset purchase product, the document architecture is likely to be significantly different (and possibly more bespoke). Servicing, and the servicing agreement will come under differing levels of scrutiny, and how much diligence and negotiation the servicing agreement should be subject to may be a heavily negotiated point. Other areas of negotiation are discussed here.

REPURCHASE REGIME

How are loans, the beneficial and economic interest of which has been transferred, repurchased by the originator, and under what circumstances? At its heart, this is a question of where the risk sits. The underwriting risk will normally sit with the originator, the performance risk with the funder.

- One area of focus for all parties will be scenarios which give rise to the purchased interest in a loan can or will be pushed back to the originator. Often this will be in instances of fraud in the origination process, where the correct credit checks on the underlying borrower had not been completed, or the underlying documentation was deficient in some respect.
- Should any of the above scenarios occur, is any action open to the funder time limited, and if yes, when does that timing run from? The date of origination, transfer or discovery of the issue in question? The answer to these questions will impact the level of constant scrutiny the funder must be giving to the loans.

If the arrangement is that the interest in the loan cannot be pushed back on the borrower, the funder will need a much more fulsome and frequent reporting and monitoring regime. Borrowers can expect funders in this kind of arrangement to insist of in-depth monthly reporting and have greater ability to require access and insight to the borrowers' origination and underwriting platforms.

OTHER COMMON POINTS OF EXAMINATION AND NEGOTIATION IN FORWARD FLOW ARRANGEMENTS

Given that a funder is usually funding 100% of the loans meeting the relevant eligibility criteria (subject to any rights to require repurchase by the originator), forward flow agreements tend to be more bespoke, and therefore there is less of a 'market view' when compared to other funding products available to borrowers in this sector. Commonly negotiated provisions include the following:

Origination and underwriting

A combination of the fact that the majority of the loan economics would be taken by the funder, and the permutations of the repurchase mechanics already examined, mean that the diligence and control of the underwriting process acquires an even greater level of importance. As a result the underwriting process will be subject to a great deal of scrutiny both before the deal is entered into, and on an ongoing basis. Enhanced access rights will be requested and normally granted. If the borrower has a seed pool which will form part of the forward flow arrangement, examination of historic underwriting procedures and policies will be subject to the same level of scrutiny as those going forward.

SYSC8

Chapter 8 of the Senior Management Arrangements, Systems and Controls Sourcebook (SYSC8) applies where an institution is relying on a third party for the performance of operational functions which are critical for the performance of regulated activities, listed activities or, importantly, ancillary services. Where the regulated loans transfer to the balance sheet of the funder, parties must look carefully at who is, for example, servicing or administering a regulated mortgage contract and whether those servicing or administration arrangements are SYSC8 compliant. This is not unique to forward flow arrangements, but the remedies for a breach or failure to comply with SYSC8 will be different, and so a funding institution may want to apply a greater level of diligence to the servicing agreement and arrangements.

Representations

As you would expect, the representations under a forward flow arrangement will be under intense focus, particularly those given in relation to the underlying loans. Forward flow funders may require a granular, in-depth and extensive set of representations, which, in addition to and as an extension of the representations commonly found in speciality finance deals, will have particular regard to the origination process (including any broker introductions), and the status, type and nature of the underlying borrowers.

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Selected experience

SPECIALITY FINANCE AND FORWARD FLOW

BUY TO LET LENDER

Acting for the funder in relation to a forward flow agreement and associated equity investment in a buy to let mortgage lender

VEHICLE FINANCE COMPANY

Acting for the lenders in relation to their funding of a car, motorbike and van finance company

NORTON FINANCE

Advising the lender on its funding to first and second mortgage lending provider Norton Finance

MONEYBARN

Advising Octopus Investments on its funding to motor finance company Moneybarn

CRX MARKETS

Advising CRX Markets in relation to its SPV through which it purchases receivables from, among others Vattenfall and Nestlé

PRIME REVENUE

Advising Prime Revenue in relation to its supply chain finance programs

SECURITISATION

THE ARRANGERS

on the inaugural residential mortgage securitisation by OneSavings Bank plc (Rochester No.1 plc)

PARAGON BANKING GROUP

on all aspects of their mortgage securitisation platform, including in respect of their rated warehouses and public issuances (Paragon Mortgages No.17 to Paragon Mortgages N.24)

CO-OPERATIVE BANK PLC

on the securitisation of a mortgage portfolio, structured to enable Co-Op to achieve balance sheet de-consolidation and significant risk transfer

CLOSE BROTHERS GROUP

in relation to its inaugural public securitisation of auto lease receivables

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