

FORWARD FLOW TRANSACTIONS — A KEY TOOL IN FUELLING PRIVATE CREDIT GROWTH

FORWARD FLOW TRANSACTIONS

The mature Fintech ecosystem and prominence of non-bank specialist lenders have radically transformed the landscape of credit lending markets. This has been driven by the ability of these lenders to leverage technology to quickly adapt their offerings or offer new products to businesses and consumers and the retrenchment of banks in particular lending markets.

With a forward flow arrangement, such lender companies generally do not need to advance their own funds to their borrowers. Forward flows are therefore highly attractive for these lenders given that they do not take deposits and often do not have much capital, particularly in the early stages of their lifecycle.

This non-bank lending market has found strong demand for its originations both from private credit funds seeking exposure to specific lending markets and from banks with renewed appetite for whole loan exposure. These funders in turn may or may not themselves leverage their exposures.

The result has been the widespread use of forward flow and asset-backed structures, often as part of wider partnerships between non-bank lenders on the one hand, and private credit funds or banks on the other. The private fund side has seen a significant number of billion dollar plus transactions, such as Klarna's \$26 billion multi-year US deal with Nelnet and KKR's multi-year agreement to acquire future consumer credit receivables originated by UK credit card lender NewDay.

Notably, forward flows are often at the core of many of the mammoth strategic partnerships between banks and lenders in relation to credit products, for example Citi's \$25 billion direct lending tie-up with Apollo and the Blackstone - Barclays partnership on credit card products.

Forward flow technology is flexible and can be adapted for a wide range of sectors and products. Our recent experience includes transactions covering consumer lending (e.g., personal loans and hire purchase agreements), commercial lending (e.g., trade receivables, equipment leases and SME loans) and mortgages.

Below is an overview of forward flow transactions and some key considerations for both originators and funders.

WHAT IS A FORWARD FLOW?

The term covers a broad range of transactions where a third party funder as purchaser acquires financial receivables from an originating lender as seller on an ongoing basis.

The funder will usually only hold beneficial title to the receivables and either acquire this immediately upon origination of the receivables (i.e., 'wet funding' where the receivables are originated using pre-advanced amounts from the funder) or on a periodic basis (i.e., 'dry funding' where the receivables are first originated by the seller using other funds and then sold). Typically this is structured as a true sale of the receivables.

Structures can vary due to tax, regulatory and other drivers with the receivables either being held by the funder directly on its balance sheet or by an SPV. Where an SPV is used, the funder instead advances sums to the SPV to fund the purchase price.

Under a forward flow, the funder is the entity which is subject to the credit risk of the portfolio with exposure to both upside return and downside risk.

WHY USE IT?

There are different drivers for the originating lender and its funder to utilise a forward flow structure rather than rely on traditional warehouse with securitisation structures.

Funder

A funder can leverage the origination platforms and proprietary technology of an originating lender, avoiding barriers to entry such as high start-up costs or the need to first obtain specific regulatory licences or approvals.

Specific risk profiles can be created by tailored eligibility criteria or even funder specific new products.

Being exposed to the credit risk of the receivables means the funder will receive any excess spread (i.e., receivable receipts less purchase price and any fees, deferred consideration payable to the seller and other expenses).

The increased risk profile faced by a funder compared to a warehouse also generally provides funders with a higher yield.

Asset lender

Emerging lending businesses may not have the internal capability to execute a traditional warehouse and lack a network of willing funders. A forward flow provides a liquidity source other than equity which is dilutive and traditional corporate loans which burden the group with restrictive covenants and security.

Originating lenders can use forward flows to optimise their funding mix. They can provide funding solutions for any receivables ineligible for existing warehouses and put pressure on the pricing of other funding sources.

Wet funding in a forward flow allows an originating lender to use its funder's balance sheet for origination while generating additional origination and servicing fees from the increased volume of receivables originated.

The forward flow sale itself is generally outside the scope of the UK and EU Securitisation Regulations, removing risk retention, reporting and other requirements under the Securitisation Regulations, although see 'Key Considerations - Back leverage and Exit' below. Forward flows are also generally not credit rated, leading to the deals being document light compared to a traditional warehouse, with faster execution.

KEY CONSIDERATIONS

Back leverage and exit

It is important for the forward flow seller to know what the intentions of the funder are at the term sheet stage. If the funder is getting leverage against the receivables, then this might impact the regulatory analysis and documentation.

The UK and/or EU Securitisation Regulations could potentially apply to the funder's leverage even if such debt is in the form of a credit facility. It is not necessary for the debt to be in the form of bonds, loan notes or other financial instruments, nor to be credit rated or publicly issued or listed, for the rules to come into play. The determining elements are whether the debt is limited recourse and tranching.

Where the Securitisation Regulations apply, the forward flow will need to be structured so an entity can qualify as an appropriate risk retainer for the transaction (see 'Alignment of Interests' below). This will typically also necessitate the seller preparing Securitisation Regulation level reporting despite the forward flow sale itself being out of scope.

These are material considerations for an originating lender and may impact the choice of funder or pricing of the financing.

Volume and allocations

A funder commonly requires a guaranteed minimum level of originations to ensure the transaction is economically viable for the funder. This can take the form of an absolute number or a percentage of originations and extend to include a right of first refusal for the funder in relation to financing new products or providing new facilities.

The seller must have a clear roadmap of its originations and funding sources before agreeing the above or its ability to enter into new financings may be prejudiced. That said, an emerging originating lender may see the benefit of developing a long-standing partnership with a single funder.

Navigating multiple funders and their allocations also means the originating lender needs to have robust cash management systems in place, together with an account structure that both limits commingling and allows for funders to take security over receivable collections and any pre-funding amounts.

Alignment of interests

To the extent that no risk retention is held by the seller, the seller may be seen as having no economic 'skin in the game' in the ongoing performance of the assets. To keep the seller incentivised to continue to originate high quality assets and properly service the receivables, the funder often agrees earn-outs such as

deferred consideration or additional servicing fees. These are payable upon the receivables exceeding agreed performance hurdles.

The above does not change the standard position that the origination risk should remain with the seller; that is the originating lender has to repurchase sold assets that failed to meet the eligibility criteria. Any liability caps and the length of the claim period are subject to negotiation.

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.

FOR MORE INFORMATION

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 the authors Jacky Kelly or James Crook or to the other contacts listed below.



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