



A Guide to Receivables Finance

3rd edition



General Editor

Geoffrey Wynne, Sullivan & Worcester UK LLP
Tower 42, 25 Old Broad Street, London EC2N 1HQ
Tel: +44 (0)20 7448 1000
gwynne@sullivanlaw.com

Editorial Director

Clarissa Dann, Deutsche Bank AG, London
clarissa.dann@db.com

Design & Layout

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Assistant Editor

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Always consult a qualified lawyer about a specific legal problem.

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Preface

There is no doubt that owing to Covid-19, the period from March 2020 to mid-2021 has been challenging for every sector and every business. The need for the digitalisation of trade has been moved along a decade in perhaps one tenth of the time. Across the receivables finance world we have seen remarkable resilience. Coupled with the seemingly unending uncertainties around Brexit the changes to our industry have been myriad, and they are not finished yet by any stretch of the imagination.

As the editor of *A Guide to Receivables Finance*, it has been difficult to pick an appropriate time to finalise and publish the 3rd edition of this Guide, although, as contributors, we all knew it was long overdue. I am enormously grateful to a number of people who have been flexible and understanding with regards to drafting, revising, reviewing and editing copy on a moving timescale.

I would like to thank several people for their contribution to getting this Guide finished and published in time for the ITFA LIVE 47th Annual Conference being held in October 2021.

First, I would like to acknowledge the enormous support and contribution of the team at Deutsche Bank in making this guide happen. Without their input, both in terms of actual contributions as well as their invaluable editorial and logistical input, there is a chance we would not have got it over the line.



Second, this Guide would not be as comprehensive as it is without the support and input of the International Trade and Forfeiting Association (ITFA). Many of the contributors are ITFA Board Members and I am grateful to all of them for giving their time to this initiative, to help make it happen.

Third, and specifically, I would like to thank the chapter contributors: Christian Hausherr at Deutsche Bank, Sean Edwards at Sumitomo Mitsui Banking Corporation and ITFA, Paul Coles at HSBC Commercial Banking and ITFA, Silja Calac at Santander and ITFA, André Casterman at TradeTeq and ITFA, Adrian Katz at Finacity and Jonathan Lonsdale at Santander.

Fourth, I would also like to thank my team at Sullivan & Worcester in London for their input, in particular managing associate Hannah Fearn, who has updated and provided a very detailed chapter on credit insurance and helped me with the chapter on the legal treatment of payment instruments.

Should readers have any follow-up questions, I would encourage them to get in touch with the relevant author(s) directly.

Clarissa Dann, Editorial Director for Marketing at Deutsche Bank, has also done an amazing job in pulling the book together and editing it. Clarissa has been such a positive influence as well as a tough taskmaster on timing! I am also grateful to Kris Ellis at GTR Design for his design expertise and for ensuring the book was published on schedule.

And last, but by no means least I would also like to thank my Senior Administrator, Sue Cleary for keeping me in check and Will Hulbert, at Hulbert & Co, for his PR and marketing support.

Geoffrey Wynne
September 2021

Meet our experts

About the Editor

Geoffrey Wynne is head of the Trade & Export Finance Group and Sullivan's London office. He has extensive experience in banking and finance, specifically corporate and international finance, trade, structured trade and commodity finance, electronic banking and digitising trade finance, structured finance, asset and project finance, syndicated lending, equipment leasing, workouts and financing restructuring, leveraged and management buy-outs and general commercial matters.

Recognised as one of the leading trade finance lawyers globally, Geoff has advised many of the major trade finance banks around the world on trade and commodity transactions in virtually every emerging market including CIS, Far East, India, Africa and Latin America. He has worked on many structured trade transactions covering such diverse commodities as oil, nickel, steel, tobacco, cocoa and coffee.

The team which Geoff leads has won numerous awards and recognition for its work in the Trade and Export Finance industry. In 2021 Sullivan was named 'GTR Law Firm of the Year for Innovation', recognising the role the firm played during the initial stages of the pandemic in 2020 helping to ensure the trade finance industry was able to move to a secure digital environment from a legal perspective.



Geoffrey Wynne,
Head of the Trade &
Export Finance Group,
Sullivan & Worcester
UK LLP

[gwynne](mailto:gwynne@sullivanlaw.com)
[@sullivanlaw.com](mailto:gwynne@sullivanlaw.com)

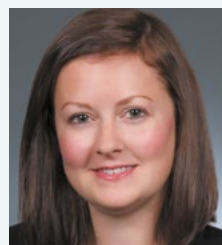
About the Contributors

Hannah Fearn is a managing associate in the Trade & Export Finance Group in the London office of Sullivan & Worcester UK LLP.

Her practice area covers trade finance and insurance, advising on a wide range of cross-border trade finance transactions in a variety of jurisdictions, with an emphasis on emerging markets. Hannah acts for leading banks in the market and her experience includes advising on syndicated and bilateral pre-export commodity financings, letter of credit facilities, commodity repo structures, trade instruments and receivables financings, including supply chain finance.

Regularly advising banks on risk sharing techniques, including the drafting of sub-participations and credit insurance policies, Hannah acted for BAFT on the 2018 update of its template Master Participation Agreement for Trade Transactions. She has extensive experience of advising on the eligibility of different credit risk mitigation techniques for capital relief purposes under Basel III.

Hannah also advises clients on regulatory issues, including sanctions issues arising out of cross-border finance transactions.



Hannah Fearn,
Managing Associate,
Trade & Export Finance
Group, Sullivan &
Worcester UK LLP

hfearn@sullivanlaw.com

Jonathan Lonsdale is Head of Trade & Working Capital Solutions, Private Debt Mobilisation, Santander.

Since April 2021 Jonathan has been globally responsible for the distribution of trade and working capital related risk at Santander. This includes underwriting, syndicating and distributing all asset classes across supply chain finance, documentary trade and structured trade. He has been involved in the trade finance and structured finance industry for over 15 years. Prior to his role at Santander, Jonathan was Head of Securitisation & Repackaging for Trade Finance assets at Deutsche Bank for seven years, and prior to that was part of structured credit and securitisation teams at UniCredit and Dresdner Kleinwort.

Jonathan read Mathematics at Oxford University.



Jonathan Lonsdale,
Head of Trade &
Working Capital
Solutions, Private Debt
Mobilisation, Santander

jonathan.lonsdale@santandercib.co.uk

About the Contributors

Silja Calac was born in Switzerland and studied in Paris, where she obtained a Maîtrise d'Ingénierie en Commerce International (Masters Degree in International Trade) at ILECI (Institute of International Economics and Commerce). She acquired her first taste of Forfaiting & Trade Finance when joining the secondary market distribution team of BDEI-Credit Lyonnais, Paris as a junior trader in 1996.

Before taking over in Munich the responsibility as Global Head of UniCredit Group's Center of Competence for Trade Risk Management, Forfaiting Financial Institutions and Secondary Market in 2007, Silja worked in Singapore where she assisted in the establishment of a new Forfaiting Department within Bayerische Hypo-und Vereinsbank.

In January 2015, Silja joined Swiss Re as Senior Surety Underwriter with the Credit & Surety team, based in Frankfurt, where she had the responsibility to further expand Swiss Re's Surety product offer for banks.

Presently, Silja is heading the private debt mobilisation team for global transaction banking (GTB) for Banco Santander in Continental Europe. She started this position in 2020 which is located in Banco Santander's Frankfurt branch.

Silja Calac is a Board Member of ITFA, Head of the Insurance Committee and Treasurer. She chaired the German Regional Committee of ITFA from 2010 to 2012. Further, she was also a member of the ICC Consultative Commission for the Drafting of the Uniform Rules for Forfaiting (URF) and Chairperson of the ICC URF task force until 2014.



Silja Calac,
Head of Insurance
Relations and Head of
Treasury, Banco Santander

silja.calac@gruposantander.com

Paul Coles is responsible for overseeing the development and deployment of end-to-end distribution functionality in the booking platforms supporting the HSBC Global Trade and Receivables Finance (GTRF) business. He has also been focused on creating greater consistency in the processes, documentation and investor management on a global basis, along with working with the regional teams on key multi-jurisdictional transactions.

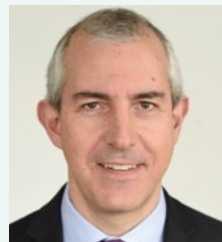


Paul Coles,
Head of Global
Transactional
Distribution, HSBC

paul.c.coles@hsbc.com

Prior to joining HSBC, Paul was the global coordinator and EMEA head for trade risk distribution at Bank of America Merrill Lynch. He has also worked in the trade credit distribution team at ABN AMRO, and subsequently at RBS as the trade asset management regional head for the NV business (part of the legacy ABN AMRO network). He started his career over 20 years ago at London Forfaiting Company (a specialist trade finance provider) where he held a variety of trade finance roles. Paul has a BSc in Management Studies from Royal Holloway, University of London and is a member of the Board of ITFA, where he currently chairs the Market Practice Committee.

Adrian Katz has been the President of Finacity Corporation since its inception in 2001. Finacity is focused on enhancing liquidity for trade receivables, with approximately USD100bn of funding facilitated by his company in the past 12 months. He has been involved in the asset-backed finance industry for 35 years, working in both the investment banking and specialty financing industry. As an investment banker, Adrian was a managing director at Smith Barney, responsible for all issuance of new asset-backed and mortgage-backed securities.



Adrian Katz,
President, Finacity
Corporation

akatz@finacity.com

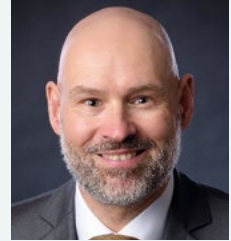
Prior to Smith Barney, Adrian worked for Prudential Securities where he was a managing director and Co-Head of the Mortgage and Asset Capital Division. He was also the Chief Operating Officer, Chief Financial Officer, and Vice Chairman of AutoBond Acceptance Corporation, a consumer finance company. Adrian graduated from Princeton University with a BSE in electrical engineering and computer science.

About the Contributors

Christian Hausherr is the European Product Head of Supply Chain Finance for Deutsche Bank's Payables Finance solution, bringing to the role over 20 years of experience in banking, in-house consulting and product management for cash management and supply chain finance. Christian has spent his career within Deutsche Bank in various divisions and regions, mostly spanning across Europe and the Transaction Banking business.

He holds a diploma in business administration from the University of Bayreuth and has worked in Germany, The Netherlands, Great Britain, Spain, the US, as well as in India and Uganda on Corporate Social Responsibility assignments in the financial and educational sector. Christian contributed to the *Standard Definitions for Techniques of Supply Chain Finance* and authored the open account section of the Wolfsberg Trade Finance Principles.

He also acts as the chair of the Global Supply Chain Finance Forum (<http://supplychainfinanceforum.org/>) and as a technical advisor for the supply chain finance section of the ICC Trade Register.



Christian Hausherr,
European Product Head
of Supply Chain Finance,
Deutsche Bank

christian.hausherr@db.com

André Casterman is the founder of Casterman Advisory which advises fintechs and financial institutions on trade finance, capital markets and digital asset technologies.

André spent 24 years at SWIFT, leading various innovations in the inter-bank payments, corporate treasury, and trade finance markets. During that time, he established an institutional partnership between SWIFT and the International Chamber of Commerce (ICC) and created the first digital trade settlement instrument embedding smart contract capabilities. André is a Board Member at ITFA and chairs the ITFA Fintech Committee with a focus on helping banks digitise trade finance and establish it as an investable asset class for institutional investors.

André is a non-executive director at Enigio and Tradeteq.



André Casterman,
Founder, Casterman
Advisory

acasterman@c-advisory.eu

Sean Edwards is an English lawyer, formerly with Clifford Chance, and is now Head of Legal at SMBC Bank International plc, part of the Sumitomo Mitsui Financial Group. He has a commercial role as Special Adviser to the Trade Finance Department of the bank and is a member of the bank's Trade Innovation Unit.

Sean is Chairman of the International Trade & Forfaiting Association (ITFA). He is one of the principal draftsmen of the Uniform Rules for Forfaiting (URF), a joint initiative of ITFA and ICC. The URF is the only set of international rules on any form of receivables finance to be recognised by UNCITRAL.

Sean was also a member of the drafting group for the Standard Definitions for Techniques of Supply Chain Finance published by ITFA, ICC, FCI, BAFT and the EBA. He is a former member of the Executive Committee of the ICC Banking Commission and led a work-stream on the ICC Working Group on Digitalisation in Trade Finance. Sean is a member of the World Trade Organisation (WTO) Trade Finance Expert Group. He is a non-executive director of KomGo S.A.

Sean has written articles on trade finance, particularly on different forms of receivables finance, for all the major trade finance magazines and is on the editorial board of Global Trade Review (GTR). He is a frequent presenter at trade finance conferences dealing with a range of subjects.



Sean Edwards,
Chairman, International
Trade & Forfaiting
Association (ITFA) and
Head of Legal, SMBC
Bank International plc

[sean_edwards@
gb.smbcgroup.com](mailto:sean_edwards@gb.smbcgroup.com)

1

An introduction to receivables finance

By Geoffrey Wynne, Head of the Trade & Export Finance Group, Sullivan & Worcester UK LLP

1.1 What is receivables finance?

This third edition of *A Guide to Receivables Finance* considers the current position in relation to receivables finance and seeks to update what has happened, and is happening, since the second edition.

There have been many changes. One thing that has not changed is what receivables finance comprises:

Any arrangement providing credit to a party, using an amount payable by one party to another for goods or services, should be included in the scope of receivables finance.

The generation of receivables is a key factor in any trade finance arrangement. A party (the seller) sells something to another party (the buyer), and the payment by the buyer, until the time when it is paid, is a receivable. It is an asset which the seller has, and a liability which the buyer has. The speed with which the seller converts the receivable into cash is important for their business; faster conversion of receivables into cash reduces the amount of working capital the seller needs to run its business. The measurement of how long that takes is often called 'days sale outstanding' (DSO). The seller will often be looking for solutions that turn its receivables into cash more quickly.

On the other hand, the buyer wants as much time as possible before they must pay the receivable. The more quickly it has to pay, the more working capital it needs for its business before it can utilise whatever it has bought. The longer the buyer has to pay, the better it is for the buyer. The measurement for the buyer is its 'Days payable outstanding' (DPO). See also *Chapter 8: Cross-border supply chain finance*.



Given this apparent conflict, it is possible to see how each party might seek help to achieve a shorter DSO period, in the case of the seller, and a longer DPO period, in the case of the buyer. It is for these reasons that the parties seek solutions in the arena of receivables financing.

1.2 How receivables arise

Receivables represent the culmination of most, if not all, trading arrangements where a product or service is sold, and which can result in some form of financing. It may well be the case that, in the time from producing a raw material to creating a finished product, there is more than one sale and purchase involved. The producer of raw materials sells them to a buyer. That buyer processes the raw material and sells the finished product to another buyer, and so on. Each of these sales and purchases would create a receivable, which could be the subject of a financing.

In all these cases, either of, or both, the seller and buyer might see the need to obtain financial support for such a transaction. Equally, such a transaction provides an opportunity for a financier to offer an arrangement to one or other party to improve its DSO or DPO position, whichever is relevant. In addition, other parties have become more involved in arranging for this to happen and more parties have become interested in participating in such arrangements. All of these scenarios are considered below.

1.3 Quality of the receivable

The quality of the receivable is a major determining factor as to what financing is available when it is produced in a trading arrangement. A financier might require, or offer, some sort of credit enhancement for that receivable. This might be by way of a guarantee of the payment obligation of the buyer, or by way of some other form of credit support like credit insurance or involving a surety. Another way of improving the quality of the receivable is by making it an irrevocable payment obligation. This can be in terms of the receivable itself, or because the receivable is replaced by something such as a separate irrevocable payment undertaking (IPU) or promissory note, which, by statute, constitutes an irrevocable obligation to make the payment. In order to achieve this, the buyer must give up its rights to stop payment if goods are faulty, although it may retain the right to claim against the seller.

Similarly, the timing and likelihood of a payment will affect the value of the receivable from a financing point of view. A financier may well be prepared to finance a seller who needs time to produce the product being sold and then further time to transport it to the buyer. The financier will look at the time from production to the time the buyer is obliged to pay and calculate the cost of financing that receivable and its value at various times until payment is due. By contrast, a seller who produces an invoice which states payment is due in, say, 30 days has a more valuable receivable.

1.4 How to finance a receivable

Once the quality of the receivable is ascertained, the question of how to finance it becomes simpler to answer. Where the receivable has not become an unconditional payment obligation, certain types of financing may not be available. For example, a financier may not want to purchase a receivable, or find a purchaser for that receivable, where the seller has to perform further actions to turn the receivable into an unconditional payment obligation. Whether the financier is taking any performance risk on the seller is a key element to consider in financing a receivable.

Once a receivable becomes an unconditional obligation of the buyer, then the credit risk of the buyer is the main issue to consider. In many ways, this is a more quantifiable risk.

1.5 Logistics affecting a receivable financing

A financier taking performance risk on the seller will need to look at what needs to be done to make that receivable unconditional and the extent to which the financier can control that risk. For instance, if the product needs to be transported, then the whole issue of the logistics of the mode of transport and handling of title documents to the commodity while being transported must be considered.

One example may be the transportation of goods by sea which results in the production of a bill of lading from the vessel concerned. If the financier has access to that document, it can present that document to the issuing bank, then that financier has control over changing the payment obligation of that issuing bank into an unconditional obligation. As will be seen in *Chapter 2: Legal treatment of payment instruments*, at this point, a payment obligation would arise even if that payment is deferred for a certain period pursuant to that letter of credit. In other words, it would be possible to finance a receivable once the relevant goods were on board a vessel.

The issues regarding other forms of transportation might not be as clear. Goods transported by air would work in a similar way. Goods transported by truck or otherwise over land (e.g. rail) have more difficult logistical issues to resolve. In most of these cases, having payment made by way of a letter of credit, and control over presentation under that letter of credit, often helps improve the quality of the receivable where there is seller performance risk.

In all these cases, it is assumed that the seller's receivable can be financed by relying on the certainty of the payment obligation of the buyer in the case of an IPU or its bank in the case of a letter of credit. Turning to consider the value to the buyer of this arrangement means looking at the possibility of extended credit terms to the buyer.



1.6 Assisting the buyer

Much of the above has looked at creating, for the seller, a means of converting its receivable into cash ahead of when the buyer might be prepared to pay. It is often possible to structure a receivables financing to give the buyer extended time to pay. This can be achieved where the financier is prepared to look at the quality of the credit standing of the buyer and to delay receipt of payment from the buyer beyond the period of credit that the seller might give. In these circumstances, the financier arranges for the seller to receive early payment and assumes the time delay from, and the credit risk of, the buyer. This Guide looks at some of the devices that can be used to achieve this.

Generally speaking, this type of arrangement depends on the buyer accepting the certainty of its payment obligation, while delaying the date when it arises.

There are issues to be considered in this delayed payment which means that the timing and structuring of the delayed payment could be crucial. Many involved in receivables financing want to ensure that the receivable remains trade debt. Also, parties including rating agencies have expressed concerns that extended payment terms to a buyer should turn trade debt into bank debt and be treated differently. These points are also considered in *Chapter 2: Legal treatment of payment instruments*.

1.7 How receivables finance has evolved

The chapter on forfaiting (*Chapter 9*) explores the historical context, the future of forfaiting and also considers factoring. A comparison of the two looks at the level of recourse to the seller of the receivable. In the case of forfaiting, the concept is to allow the sale of a receivable to be without recourse to the seller, but on the assumption that the seller has taken all steps to make sure the payment obligation is unconditional. At that point, the seller receives a discounted payment and no more, and the sale is without recourse to it.

In the case of factoring, the seller receives a discounted amount, but may well receive more once payment from the buyer is received. On the other hand, if the buyer does not pay, there may be recourse to the seller for all or part of the unpaid amount.

Variations between these products may result in different treatments, but essentially both are used where the receivable has come into existence resulting from a sale of goods or the provision of services.

In each case, financiers using these tools have sought to include other types of receivables within the product. Forfaiting talks of a payment claim as being the subject of a forfaiting transaction. That payment claim can arise not just from the sale of goods, but also out of a financial instrument, including a letter of credit or even a loan agreement.

“Extending electronic data to encompass bills of lading and other shipping documents further increases the potential for speedier creation of receivables”

Geoffrey Wynne, Head of the Trade & Export Finance Group,
Sullivan & Worcester UK LLP

Supply chain finance, as explained in *Chapter 8: Cross-border supply chain finance*, often uses an electronic platform to evidence the creation of a receivable. Depending on whether the programme is supplier-led (receivables) or buyer-led (payables) will determine the extent of the involvement of commercial parties. In all cases, the programme is designed to create a receivable which can be financed. It provides availability of credit to a seller/supplier and potentially extended payment terms to a buyer. A buyer might well use its programme to assist its suppliers in obtaining beneficial credit terms to support and enhance each supplier's business. Third party arrangers and platform providers can use structuring to achieve good results for both parties.

The use of electronic products has become more evident in recent times. Bank payment obligations (BPOs), which utilise matching electronic data to create an unconditional payment obligation of a bank, again increase the potential for receivables financing. The BPO (explained further below) has not proved as successful as many had hoped, due in some part to its inflexibility, but it has led to other electronic solutions including the Uniform Rules for Digital Trade Transactions (URDTT) which allow for a trade to be evidenced digitally including for its payment.¹

Extending electronic data to encompass bills of lading and other shipping documents further increases the potential for speedier creation of receivables. This has been apparent in the use of electronic letters of credit. There have been many developments in the fintech arena considered in *Chapter 10* with the law trying to catch up. English law changes are being led by the Law Commission. Other jurisdictions are seeking to embrace the UNCITRAL Model Law of Electronic Transferable Records (MLETR).²

1.8 Standard definitions

Initiatives from a number of professional and industry associations involved in receivables financing and, in particular supply chain financings, has resulted in a publication entitled *Standard Definitions for Techniques of Supply Chain Finance*.³ This examines different types of receivable financing. It remains to be seen the extent to which these definitions are indeed utilised. See also *Chapter 8: Cross-border supply chain finance*.

1.9 Trading receivables

Once a receivable has been created, and it meets the requirement of being an unconditional payment obligation of a buyer, then there are ways for a financier to trade that receivable as part of a financing or refinancing of those receivables.

Conceptually, the receivable needs to be in a form in which its holder can either continue to transfer it or can itself issue an obligation secured on that receivable. In the case of transferability, this can be achieved by making the receivable into a negotiable document such as a promissory note. That promise to pay can then be transferred by delivery, by endorsement or by a separate instrument of transfer. This is considered in *Chapter 2: Legal treatment of payment instruments*.

Pending changes in English law regarding the transfer of an electronic promissory note, an electronic equivalent called an electronic Payment Undertaking (ePU) has been developed by ITFA and is considered in *Chapter 2* and *Chapter 10: The involvement of fintech in receivables financing*.

Where the receivable arises from a sale of goods, or from an invoice from that sale or the provision of services, it can still be acquired directly or indirectly by a financier. This is normally by assignment of that debt and notice to the paying party. Again, this is considered in *Chapter 2*. Instead of the financier acquiring the debt itself, it can establish a separate company (often specially formed for this purpose – a special purchase company or vehicle (SPV)) to acquire the receivable. The SPV pays for the receivables by issuing its own promise to pay, which is secured on the receivables. Its promises to pay are evidenced often by promissory notes, or other forms of note, which can be freely traded. This structure is termed a ‘securitisation’ and both parts of *Chapter 7* covering trade receivables securitisation provide more detail on this.

Financiers often try to have other financiers join in their financings by this and other means. These arrangements are also considered in *Chapter 7*. However, having non-bank financial investors acquire receivables is currently a major initiative.

1.10 The business case for receivables finance

There are potentially advantages for all parties involved in the creation of receivables to enter into financing arrangements. From the seller's point of view, it has the potential to monetise receivables at an early stage of their existence, and even before they exist in certain cases. Where the seller has availed itself of a financing in respect of an acceptable buyer it might be able to offer that buyer extended credit terms while building the discount it receives from delayed payment into its sale cost.

For the buyer, the potential of extended credit terms may well be attractive. However, it may also lend its support to its seller by accepting a payment obligation that is unconditional. In all of these discussions, the financier may well see opportunities to arrange such financings.

Financiers should always be aware (especially when they are banks) of the regulatory capital cost of such financings and the opportunities to enhance their return by other means. In addition, there are other legal and regulatory issues to be considered in being involved in receivables financings. Some of these issues are considered in *Chapter 3: Legal and regulatory issues*.

Providers of credit support may well see the advantages of becoming involved in supporting transactions for a fee to be charged for that credit support. The use of credit insurance is considered in *Chapter 4* and surety in *Chapter 6*.

Well-constructed programmes which create the receivables may well be products that investors would seek without actually bearing the cost of structuring them.

In all these cases, there are reasons why instances of such financings will continue and, indeed, increase.

There are risks that over-zealous arrangers of receivables financings may extend the usual definitions, such as supply chain financing, to other financings that are not in reality trade receivables, as they do not represent a receivable that currently exists but one that may be created in the future. Structures promulgated by Greensill Capital before its demise may well have fallen into that category.⁴ These serve as a warning to be aware of what is offered and not that receivables financing is risky.

2

Legal treatment of payment instruments

By Geoffrey Wynne, Head of the Trade & Export Finance Group and Hannah Fearn, Managing Associate, Trade & Export Finance Group, Sullivan & Worcester UK LLP

There are many different payment methods used in the settlement of international trade transactions. As described in *Chapter 1: An introduction to receivables finance*, each method offers a different level of protection for the exporter (seller) and importer (buyer). Each payment method should create a receivable: a legally enforceable right to receive payment from another person, which the beneficiary of that receivable (usually the exporter) can sell or use as collateral for financing.

The enforceability, transferability and tradability of a receivable depends on its legal nature. This will influence the forms of receivables financing available to the exporter (as beneficiary) for a receivable.

2.1 Overview of key legal considerations

2.1.1 Enforceability

It is assumed for this purpose that the seller has done all that is required of it to create an enforceable payment obligation against the buyer. The buyer is then the debtor, owing the receivable, which is a payable in its books. As mentioned in *Chapter 1*, future payment obligations which have not yet been created are beyond the scope of this chapter.



2.1.2 Negotiability

There are broadly two types of receivables: those which constitute negotiable instruments (such as bills of exchange and promissory notes) and those which do not (such as invoices). Put simply, the transfer of negotiable instruments is more straightforward than the transfer of non-negotiable instruments. This is because the transfer of a negotiable instrument can be effected by delivery (together with an endorsement, if applicable), without the requirement for additional transfer documentation. Negotiable instruments are, therefore, very suitable for receivables financing and for further trading on secondary markets.

However, negotiability is a longstanding legal concept with its foundations in a paper-based world and the process for effecting the transfer of a negotiable instrument relies on the delivery of a physical instrument. In the ever-increasing world of fintech solutions, the legal limitations on the creation and transfer of electronic negotiable instruments under English law need to be, and are being, addressed. This is explored further below.

The transfer of receivables that are non-negotiable under English law must occur by way of assignment. This requires the parties to enter into appropriate transfer documentation and (generally) requires notice to be served on the debtor. Depending on the terms of the agreement creating the receivable, transfer may be prohibited, or the prior consent of the debtor may be required before it can be sold.

However, non-negotiable receivables are still frequently subject to receivables financings and financiers have devised innovative ways to streamline the process of satisfying the legal steps involved. For example, buyer-led supply-chain finance programmes (now often referred to as payables finance) are often entirely managed using electronic platforms which allow for the buying and selling of large numbers of receivables at any one time.

The nature of negotiable instruments, and the transferability of different types of receivables, are considered in further detail below.

2.2 'True sale': Transferring outright or financing against collateral?

A key issue when considering the transfer of receivables is determining whether a receivable has been transferred outright by the beneficiary. If a receivable is transferred outright, the purchaser of that receivable is protected from claims against the original owner's assets in the event of that party's future insolvency. This is known as a 'true sale'.

If a true sale of the receivable cannot or does not occur, then the beneficiary of that receivable could instead borrow, or be treated as having borrowed, money that is secured against that receivable. In other words, the beneficiary is still the owner of the receivable. In that instance, the receivable is used as security for the debt and, in the case of the beneficiary's insolvency, the financier ranks as a secured creditor (assuming it has taken valid security).

When it comes to recovery, this position is less attractive to the financier than true ownership, as the secured creditor's recovery in the insolvency may be subject to prior payment of mandatorily preferred creditors out of the insolvent beneficiary's assets. In addition, the security will be unenforceable against a liquidator or administrator of the beneficiary if (where the beneficiary is a company in the UK) it was not duly registered with Companies House within 21 days of its creation. Other jurisdictions may have equivalent registration requirements or other requirements for the creation of a valid security interest.

Registration of security might not have been carried out at all if the parties had intended for a true sale of the receivable to occur. If an intended true sale transaction is later re-characterised as a secured financing, the purported buyer of the receivable could be left in an unfavourable and unsecured position as a creditor of the beneficiary.

The distinction between the true sale of receivables and financing secured by receivables is relevant in many jurisdictions besides England. A party who intends to purchase receivables owed by foreign entities should always seek local advice on transferability and true sale issues.

“Arguably, ‘true trade debt’ is the debt arising from the sale and purchase of goods”

Geoffrey Wynne, Head of the Trade & Export Finance Group,
Sullivan & Worcester UK LLP

2.3 Independence from underlying trade transaction

It is a key aspect of receivables financing that the purchaser of the receivable will want to be paid regardless of any future dispute between the parties to the underlying trade transaction. In a financing where the purchaser of the receivable has no recourse to the seller of that receivable, the purchaser will need to be satisfied that the obligation to pay is not subject to performance by the seller or any other condition.

Some types of payment instrument are more independent than others. In other words, some payment instruments (such as bills of exchange, promissory notes, letters of credit and IPUs) create independent payment obligations which cannot be avoided solely by reason of a dispute between the underlying commercial parties. A financier can be more comfortable entering into a without-recourse financing arrangement in respect of these types of payment instrument.

An amount due under an invoice forms part of an underlying contractual agreement between commercial parties. Payment can therefore be subject to any defences the debtor has under that contract. A financier of the receivables can attempt to protect its position in these circumstances. For example, the financier could only buy the receivables once performance of the contract has occurred (and the debtor has expressly accepted this). Alternatively, the financier could buy the receivables on a ‘with-recourse’ basis, where it can require the seller to repurchase the receivable if the debtor has not paid as a result of the seller’s failure to perform.

The alternative is for the debtor to accept that its payment obligation is unconditional, or to give or arrange for the issue of an independent payment obligation, such as an IPU or a promissory note, or arrange for a letter of credit from a bank.

2.4 Credit enhancement techniques

As part of a financing package, a financier may require the seller of the receivable to provide certain credit enhancements. These often have the effect of replacing the risk of non-payment by the debtor with bank risk or transferring the risk to a party with a better credit rating. For example, a financier might ask for an independent and irrevocable payment guarantee from the debtor's bank or another corporate in its group. There are many other types of credit support which might be relevant in a financing. For example, corporate guarantees, security, export credit agency (ECA) coverage, or credit insurance or surety.

2.5 'True trade debt' or bank debt

There is debate about the nature of trade and even 'true trade debt' and its treatment on the insolvency of the debtor. Arguably, 'true trade debt' is the debt arising from the sale and purchase of goods.⁵

The genesis of this debate is the view that trade finance debt should be given more favourable treatment in the case of a debtor's insolvency or restructuring. There is no general precedent for this, although specific examples do exist where short-term debt (which is often trade-related) or other trade-related debt has been given priority in restructurings (for example, the 2009 restructurings of JSC BTA Bank and JSC Alliance Bank, both in Kazakhstan). The beneficiary of a receivable that looks like 'trade debt' should not rely on that debt automatically getting better treatment in an insolvency.

In addition, recent examples of how payment terms of the debtor can be amended and extended as part of a financing arrangement have given rise to the debate as to whether an amount owed by a debtor to a financier is still trade debt or should be classified as bank debt. Examples of these arguments can be found in the financial problems of companies including Abengoa and Carillion. Rating agencies, looking at how these receivables were created and financed, argued that the balance sheet of these companies (and others) should have reflected the obligations not as trade payables but as bank debt.⁶ Those involved in structuring these types of arrangements should bear these issues in mind.

2.6 Accounting treatment

There are issues to be considered in relation to the transfer of receivables from an accounting point of view. Effectively removing a receivable from the creditor's balance sheet is often a key driver in entering into receivables financing arrangements. The legal treatment for a seller of a transfer of receivables (i.e. has a true sale of the receivable occurred?) is not always the same as the accountancy treatment. For example, the legal analysis will focus on whether the arrangement would be construed by the Courts as being a legal transfer of the asset or whether it would be recharacterised as a financing, including considering how the transactions might be challenged on legal grounds in an insolvency situation. To achieve off-balance-sheet treatment of a receivable, the requirements of IFRS9 or equivalent accounting principles must be considered.

2.7 Negotiable instruments: Promissory notes and bills of exchange

2.7.1 Characteristics

The Bills of Exchange Act 1882 (the Act) sets out the requirements that an instrument must meet in order to constitute a bill of exchange or promissory note under English law.

Section 3(1) of the Act defines a bill of exchange as:

“an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer”.

Section 83(1) of the Act defines a promissory note as:

“an unconditional promise in writing made by one person to another signed by the maker, engaging to pay, on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person or to bearer”.

In the context of a trade transaction, a bill of exchange is an order by the exporter to the importer to pay a certain amount (i.e. the purchase price) either on demand, or on a fixed future date. Similarly, a promissory note is a written promise by the importer to pay the exporter a certain amount (i.e. the purchase price) either on demand, or on a fixed future date.

A key characteristic of bills of exchange and promissory notes is that they each create an unconditional and independent payment obligation of the debtor in favour of the beneficiary. This payment obligation is independent of the underlying trade transaction.

A final consideration to bear in mind is that physical possession of the instrument is central to its legal nature. Transferring possession of the instrument can transfer the rights and obligations it represents, and presentation of the instrument is required to enforce the right to receive payment under it. However, English law only recognises possession of tangible assets and not electronic documents and so, for the time being at least under English law, bills of exchange and promissory notes do not exist electronically.



2.7.2 Electronic solutions

These legal restrictions have held back the development of electronic solutions for the transfer of negotiable instruments. The Law Commission is actively considering this issue and in April 2021 published a consultation paper with recommendations for legal reform to allow for the legal recognition of electronic trade documents including bills of exchange and promissory notes, and to provide that electronic trade documents will have the same legal effects as their paper counterparts.⁷

Among the issues considered in the proposals is the question of exclusive control, being the principle of ensuring that only one person can “possess” the electronic instrument at any one time. Another key property of an electronic negotiable instrument is that, once that instrument is transferred, the transferor must have fully relinquished control of it and the transferee must have gained sole control. It is anticipated that parties can exploit distributed ledger technology to achieve this, where the creation of an electronic instrument is represented by a unique token which can be transferred between parties subject to a validation process to check the nature of the transfer (i.e. that both parties have consented to it) and the integrity of the instrument (i.e. that it has not been altered since its creation).

The consultation paper was accompanied by a draft Bill to embody the proposed reforms, and it is hoped that this might become an Act of Parliament in 2022 or soon after, so that the industry can start to reap the benefits of switching to electronic processes.

2.7.3 Transferability and tradability

A bill of exchange or promissory note that satisfies the characteristics of the Act will constitute a negotiable instrument under English law. A negotiable instrument expressed to be payable to the bearer can be transferred to a third party by delivery alone. If the instrument is payable to a specified person, it can be transferred by delivery together with an endorsement. As discussed above, transfer of possession currently requires delivery of a physical instrument.

The holder of the instrument may transfer it without recourse. This is likely to be the case in a forfaiting transaction. However, it is common practice for the parties to enter into a separate forfaiting agreement under which the seller of the instrument gives certain representations in respect of the instrument, allowing recourse to the seller in the case that any of those representations turn out to be untrue.

The transferee will obtain direct rights against the debtor for payment in accordance with the terms of the instrument.

Bills of exchange and promissory notes are easier to trade than other types of payment instrument and buyers of these instruments, such as forfaiters, can sell them on secondary markets.

Given the English law issues with regards to electronic bills of exchange and promissory notes, an electronic payment undertaking (ePU) has been suggested by ITFA and is discussed in *Chapter 10*. It is designed to have the equivalent rights as its paper equivalent, although such rights are created by a contractual framework, rather than under common law.

2.8 Credit enhancement techniques

The most common type of credit enhancement technique in the context of bills of exchange and promissory notes is the debtor's bank giving a transferable and irrevocable bank guarantee for the amount of the instrument. This can also be achieved by adding an 'aval' to the bill or note, although the concept of an aval is not expressly recognised under English law.

Many financiers will require such a guarantee, or aval, to be in place before agreeing to discount a bill or note.

2.9 Contract receivables

2.9.1 Characteristics

An exporter selling commodities under an export contract will generate receivables due from its importer. The amounts due from the importer might be set out in the contract itself (in which case the creditor will have a claim for payment against the debtor under the contract), or the exporter might deliver invoices to the importer representing payments due for each delivery (in which case the creditor can sue for payment of the invoice).

In comparison with negotiable instruments, the right to payment from the debtor is not necessarily independent of the underlying trade transaction. For example, payment might be conditional on performance of the underlying transaction, and, in case of a dispute, the debtor might be able to withhold payment and resolution of a dispute may result in the issuance of a credit note from the creditor (representing an agreed reduction to the contract price), which the debtor will set-off against the amount due under the invoice.

There are no specific legal requirements as to the form of a contract for payment, or for invoices, beyond the basic English law requirements for formation of a contract. As such, it is possible (and indeed common practice) for contracts to be entered into and invoices to be issued electronically.



Physical delivery of the contract or invoice representing the receivable is not required to effect transfer or to enforce payment. This, together with the ability to create receivables electronically, offers a high degree of flexibility to potential financiers.

2.9.2 Transferability

Under English law, receivables of this nature are transferred by way of assignment. There is a distinction between a legal assignment and an equitable assignment, the latter of which may give the assignee lesser rights in certain circumstances. A legal assignment has the effect of transferring to the assignee the legal right to the debt, meaning that:

- The debt no longer forms part of the assets of the assignor and so the assignee is protected from the claims of third parties against the assignor's assets;
- The assignee can sue for payment of the debt in its own name and without the need to join the assignor in any proceedings against the debtor; and
- The debtor can only discharge the debt by payment to the assignee and cannot exercise any right of set off it may have had against the assignor.

For a transfer of a debt to constitute a legal assignment, the requirements of Section 136 of The Law of Property Act 1925 must be met. These requirements are, briefly, that:

- The assignment must be absolute;
- The rights to be assigned must be wholly ascertainable and must not relate to part only of a debt;
- The assignment must be in writing and signed by the assignor; and
- A notice of the assignment must be delivered to the debtor.

“In comparison with negotiable instruments, the right to payment from the debtor is not necessarily independent of the underlying trade transaction”

Geoffrey Wynne, Head of the Trade & Export Finance Group,
Sullivan & Worcester UK LLP

The form of notice of assignment used by assignors can vary. For example, a notice of assignment might cover all receivables arising under a specific contract. Alternatively, a notice relating to a single receivable might be included on the face of the relevant invoice. It is common practice for the assignee to require an acknowledgement of the notice of assignment from the debtor, although failure to obtain an acknowledgement does not prevent the assignment satisfying the requirements of a legal assignment, so long as notice of the assignment was served.

2.10 Supply chain finance

It is possible, as a matter of English law, for a notice of assignment to be served on a debtor electronically. This is often the case in supply chain financing programmes, where invoices are issued and then selected for discounting using electronic platforms. The assignment is then notified to the debtor electronically through the same platform. As supply chain finance programmes generally involve multiple jurisdictions, it is important for the assignee to carry out due diligence as to whether such a notice is effective as a matter of local law.

In order to facilitate supply chain finance, a joint industry working group, the *Global Supply Chain Finance Forum*, has developed a set of standard *Definitions for Techniques of Supply Chain Finance*. First published in 2016, an agreed enhancement document was published in 2021.⁸ The intent of the initiative is to help create a common understanding about supply chain finance through the adoption of consistent terminology. We may well see the proposed definitions, which are likely to evolve with global practices, being used in supply chain finance and possibly also forfaiting and beyond.

2.11 Non-notified transfers

It is often the case that receivables financing arrangements are carried out on a silent basis, meaning that the debtor is unaware that its debt has been transferred to a third party. In this case, the financier, as assignee, would only have an equitable assignment until such time that notice was served on the debtor (assuming the other formalities set out above had been met). Until such time that a notice was served, the assignee would be at risk of losing priority to a third party to whom the assignor subsequently assigned the same debt and who served notice of assignment. To mitigate this risk, the assignor would usually be required to give undertakings to the assignee that it will not otherwise deal with the relevant debts.

When transferring contract receivables, the terms of the underlying contract are relevant, and an assignee should check that there are no contractual prohibitions on assignment.

2.12 Credit enhancement techniques

There are many possibilities here:

- A debtor could provide a variety of credit enhancement techniques in respect of its payment obligation, such as bank guarantees, corporate guarantees, or security. The extent to which these can be of benefit to a purchaser or financier of that receivable will depend on their specific terms. An irrevocable bank guarantee, for example, might be freely transferable to the assignee.
- The debtor could give certain undertakings to the purchaser of the receivable (usually as part of an acknowledgement of assignment). For example, the debtor might undertake to pay the debt into a specified account to allow the purchaser or financier to control the proceeds of the receivables once paid.



- A purchaser of receivables could get extra protection by entering into a ‘with-recourse’ arrangement with the seller of the receivable, allowing recourse for payment to the seller if the debtor does not pay. The purchaser may have full recourse, or limited recourse where it can only require the seller to repurchase the receivable if one or more specified excluded risk events has occurred.
- The parties could arrange for the debt to be substituted by a ‘better’ payment instrument, such as a letter of credit or a bank-guaranteed negotiable instrument. This has the effect of substituting the corporate risk for bank risk as in the first instance the purchaser or financier will claim payment under the payment instrument.
- The debtor could agree to waive any defences it might have in respect of its payment obligation, making that payment obligation unconditional and independent from the performance of the underlying commercial contract.

2.13 Documentary letters of credit and deferred payment undertakings

2.13.1 Characteristics

A documentary letter of credit is an irrevocable undertaking to pay a specified amount on presentation of specified documents, given by one party to pay another. In the context of trade finance, a letter of credit would usually be issued by the importer's bank in favour of the exporter, who would present documents proving it has shipped the relevant goods. The payment under the letter of credit would discharge the importer's payment obligation under the relevant commercial contract.

Letters of credit are usually made subject to the Uniform Customs and Practice for Documentary Credits, 2007 Revision, ICC Publication No. 600 (UCP 600). A letter of credit can be entered into on paper or electronically (for example, using platforms such as SWIFT).

2.13.2 Transferability

The beneficiary of a letter of credit has a direct right to payment from the bank that has issued the letter of credit. Where the letter of credit is a deferred payment letter of credit or an acceptance credit, the seller will not receive payment until the specified maturity date and so might want to sell its right to payment to a third party in order to realise the cash sooner. For a deferred payment letter of credit, this means assigning its right to receive payment to the relevant financier.

For an acceptance credit, transfer of the receivable is much easier. An acceptance credit requires the beneficiary of the letter of credit to present a draft (together with the other required documents). The acceptance of the draft by the issuing bank replaces its payment obligation under the letter of credit with a negotiable instrument, which the beneficiary can sell on to realise the receivable early.

2.13.3 Structured letters of credit

Letters of credit are traditionally an instrument of international commodity trading. However, there is a practice of using structured letters of credit, where deferred payment letters of credit are used as a tool to provide financing to the beneficiary, rather than as settlement of a true trade transaction. The case of *Fortis Bank (Nederland) N.V. v Abu Dhabi Islamic Bank* (decided by the New York County Supreme Court in August 2010) highlighted that the absence of a real underlying trade transaction (in this case, the letter of credit was synthetic in character) does not affect its nature as an independent payment undertaking.

2.14 Bank payment obligations (BPOs)

2.14.1 Characteristics

A BPO is an irrevocable conditional undertaking to pay a specified amount given by one bank to another. A BPO, when issued by an importer's bank in favour of an exporter's bank, can be used as a means of settlement between an importer and an exporter, discharging the payment obligation in the underlying commercial contract. BPOs are subject to the ICC's Uniform Rules for Bank Payment Obligations (URBPO). BPOs are created using electronic data-matching platforms and therefore exist entirely electronically.

On satisfaction of the conditions specified in the BPO (which broadly involve the parties submitting matching data about a trade transaction), the obligation to pay becomes unconditional and the bank that has given the BPO must either honour it, or incur a deferred payment undertaking and pay on maturity. The beneficiary bank has an enforceable right to payment, but the underlying exporter does not have any direct rights against the bank that has given the BPO.

2.14.2 Transferability

Once the right to receive payment from the bank that has given the BPO has become unconditional, the exporter could instruct its bank (as beneficiary of the receivable) to assign its right to receive payment under the relevant BPO. It might wish to do this for a deferred payment

BPO in order to receive a discounted payment in advance. However, the position under URBPO is that the obligor bank's consent is required for any assignment. The requirements and limitations of assignments are discussed further above.

Given some of the technical drawbacks of the BPO it has not found favour in the marketplace as an alternative to other payment instruments. It has, however, triggered much discussion about alternative electronic solutions for creating and transferring payment undertakings. Some of these alternatives are referred to in *Chapter 1* and others in *Chapter 10*.

2.15 Bank loans and SWIFT loans

2.15.1 Characteristics

Banks can create receivables from their own lending book where loans are made for trade purposes (trade loans), especially with short-term loans and loans made using loan agreements through the SWIFT system (SWIFT loans).

In either case, the loan is a receivable to the bank and the borrower is the debtor for this purpose. The evidence of the loan is generally the loan agreement, which sets out the repayment terms.

2.15.2 Transferability

Loans can be transferred in the same way as other non-negotiable receivables (i.e. by assignment). This is discussed further above. In some cases, the bank can transfer the risk and even the funding obligation by use of sub-participation agreements with other banks. These are considered in *Chapter 5: Distribution techniques and issues*.

2.16 Summary of key points

The approaches in this chapter reflect the English law position and concepts. Other legal systems will be relevant in many financings, and the parties to a receivables financing will need to carry out due diligence as to the legal treatment of the relevant receivables and the requirements for their transfer under local law. However, financiers will find that some of the concepts discussed above are applicable in many other countries.

3

Legal and regulatory issues

By Geoffrey Wynne, Head of the Trade & Export Finance Group, Sullivan & Worcester UK LLP

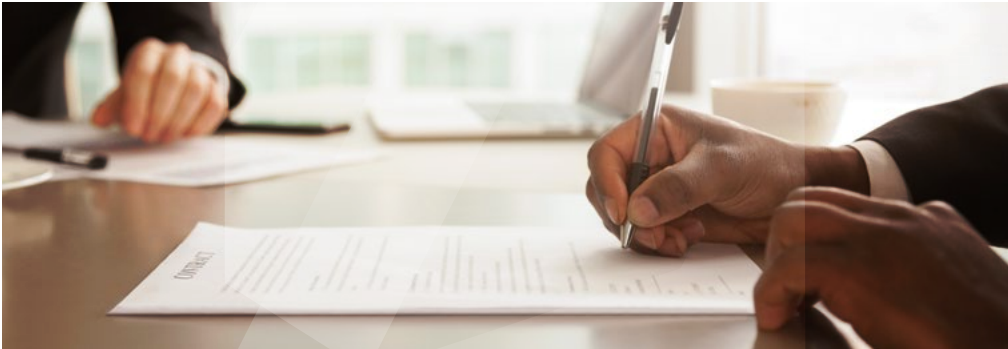
This chapter considers certain regulatory issues that are likely to affect banks, in particular, their involvement in financing receivables. It also looks at certain accounting treatment of receivables. Additionally, there are legal issues to consider when financing trade receivables, some of which are considered here. This chapter covers capital adequacy, particularly Basel III, the impacts of anti-money laundering and counter terrorist financing regimes, sanctions and fraud in relation to trade finance and financing trade receivables.

3.1 Basel regime and capital adequacy

Capital adequacy is the requirement that banks and financial institutions set aside a determined amount of capital relative to the risk associated with the business they undertake. A bank must hold a minimum ratio of capital to “risk-weighted” assets (i.e. the financial products it provides or participates in). Should those risk-weighted assets fall in value, the bank must have sufficient capital to absorb any losses while retaining the ability to repay all creditors and depositors, particularly during times of economic instability. This is intended to ensure the ongoing solvency of banks and thus protect the infrastructure and stability of the banking system.

3.1.1 Basel I and Basel II

The Basel Capital Accord (Basel I) was introduced in July 1988. The capital standards under Basel I related almost entirely to credit risk (i.e. the creditworthiness of a bank’s counterparty in any transaction), perceived to be the main risk incurred by banks. By 1999, the Basel Committee on Banking Supervision (BCBS) decided that Basel I lacked risk sensitivity. It did not identify differences in the default risk of different borrowers and failed to reflect how risks change over time and how banks actually manage their own risks. Therefore, BCBS published Basel II in June 2004 to address these deficiencies (“Basel II”).



Basel II was implemented across the European Union, with EU Member States being required to implement the provisions into domestic law by 1 January 2007.

In the UK, the primary responsibility fell on the Financial Services Authority (FSA) (the UK financial regulator at the time), to implement the requirements into the law of the UK. The FSA did so by publishing two sourcebooks: *The General Prudential Sourcebook for Banks, Building Societies, Insurers and Investment Firms (GENPRU)* and *The Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU)*. GENPRU and BIPRU came into force on 1 January 2007 and include the majority of UK provisions.

3.1.2 Basel III and CRD IV

The next instalment of the Basel framework, Basel III, has been partially implemented and, at the date of writing, there is momentum among the international financial community to implement the remaining parts of Basel III in as much of a coordinated way as possible.

Following the end of the Brexit implementation period on 31 December 2020, with the UK having left the EU on 31 January 2020, the UK started to review its financial services regulation. Some divergence between the EU regime on capital requirements and the corresponding onshored and amended UK capital requirements regime is starting to emerge. It is expected that the UK will lean towards implementation of the final Basel III elements to ally itself with the global requirements. In the UK, this is a complex area, not just of law, but also regulation and guidance. Directions on the matter have also been issued by HM Treasury and the financial regulators which are binding on regulated entities. Where a financier is structuring a transaction or making a commercial decision on the basis of capital adequacy, it should seek specialist advice.

Following the publication of Basel III by the BCBS, there was some concern from financial institutions and international organisations about the potential impact on trade finance and, consequently, the negative effect on the availability of financing to trade finance participants in emerging markets and elsewhere. Following consultations with the World Bank, the World Trade Organisation and the International Chamber of Commerce (the ICC), the BCBS evaluated the impact of Basel II and Basel III on trade finance and adopted some limited changes to the capital adequacy framework, including waiving the one-year maturity floor for trade finance instruments under the advanced internal ratings-based approach (under Basel I). However, the BCBS decided to leave the 100% credit conversion factor (CCF) for calculating the leverage ratio for contingent trade finance exposures untouched.

Following further campaigning from organisations such as the ICC, the final technical amendments to the leverage ratio requirements published by the BCBS in January 2014 included amended CCF rules for off-balance-sheet items such as letters of credit. Instead of using a uniform CCF of 100%, which had the effect of converting an off-balance-sheet exposure to an on-balance-sheet equivalent, the rules provided for a more flexible approach in recognition of the short-term self-liquidating nature of trade finance instruments. Under the Capital Requirements Regulations (CRR) (EU rules which are part of the retained EU law in the UK), the CCF for documentary credits is 50% or 20%, depending on whether it is classified as medium or medium/low risk. There have also been some changes during the Basel III implementation process in the calculation of the liquidity coverage ratio, allowing national authorities to apply a relatively low run-off rate of 5% or less to contingent funding obligations stemming from trade finance instruments such as documentary letters of credit.

Although the amendments to the Capital Requirements Directive IV (CRD IV) provisions have not gone as far as the industry might have hoped in recognising the specific characteristics of trade financing techniques, some positive steps have been made, which are encouraging.

There are some aspects of the Basel III regime that are particularly relevant to receivables financing techniques. One broad observation is that the capital constraints imposed on banks by the Basel III regime may mean banks are less willing or able to finance large receivables financing programmes where they will have large exposure to a single counterparty. Banks may need to structure transactions to allow the sell-down of risk to other financial institutions. In implementing the Basel III requirements for calculating the value of the exposures of a financial institution, jurisdiction-specific legislation will need to address how values are calculated for receivables purchased on a *with-recourse* or *without-recourse* basis. For example, the CRR sets out specific requirements that determine whether purchased receivables are treated as retail or corporate exposures, which involves looking at the nature of the sellers of the receivables, how the receivables were generated, and the diversification of the portfolio of those receivables. Where the financial institution has full recourse to the seller of purchased receivables, the exposure may be considered as collateralised exposure (and therefore eligible for more favourable treatment) in the calculation of risk-weighted exposure amounts. However, under CRD IV, factoring and invoice discounting facilities with recourse are classified as full risk off-balance-sheet items and have a CCF of 100%.

In calculating risk-weighted exposure amounts under CRD IV, financial institutions are permitted to take into account credit risk mitigation techniques to reduce the exposure value of the underlying exposure, which in turn reduces the amount of capital that the financial institution must hold for that exposure. Subject to meeting certain requirements, credit risk insurance, as an example, can be used as eligible credit risk mitigation, meaning that it will be more attractive to banks to finance insured receivables where the bank can take the benefit of the insurance. Credit risk insurance is looked at in *Chapter 4* and surety in *Chapter 6*.

Where a bank advances a loan secured on a pool of receivables, the bank's security over the receivables may be taken into account as credit risk mitigation when calculating the risk-weighted exposure value of the loan. However, CRD IV provides that only banks using the internal ratings-based (IRB) approach may use collateral over receivables as an eligible credit risk mitigation technique, which makes financing receivables by way of secured loans potentially less attractive for smaller financial institutions, in terms of capital cost.

Banks that provide credit enhancement for financed receivables, such as an aval on a bill of exchange or a standby letter of credit, will have exposure for the purposes of Basel III capital requirements. Under CRD IV, endorsements on bills and irrevocable standby letters of credit having the character of credit substitutes are classified as full risk off-balance-sheet items and have a CCF of 100%. This essentially converts those instruments into on-balance-sheet items for the purposes of calculating a financial institution's leverage ratio requirements.

Considering the points above, and in particular the inevitable increased costs for banks in providing financing techniques under the Basel III regime, it could be argued that the implementation of Basel III offers non-banks engaged in supply chain finance an opportunity to take advantage of being subject to fewer regulatory requirements than banks. See *Chapter 8 Cross-border Supply Chain Finance*.

Regardless of any improvements that have been, or could be, made to Basel III to assist with making trade and receivables finance available, ultimately the Basel III regime will require banks to put procedures in place and invest in adequate resources to comply with the range of prudential requirements. The increased regulatory costs, particularly for systemically important financial institutions, will undoubtedly increase the cost of making any financing available.

However, it has also been evident that following the financial crisis that started in 2007, increased regulation was necessary to address some of the failings of banks that contributed to market instability and ultimately required unprecedented support of the banking sector from public funds. Over time, with further input and activity from market participants, it is possible that future Basel standards, where widely implemented, will achieve a better balance between achieving the overall goals of the BCBS, while giving appropriate recognition to facilitate cross-border financing.

3.2 Effect of Brexit

On 31 January 2020, the UK repealed the European Communities Act 1972 and ceased to be a member of the European Union. On 1 February 2020, the Agreement on the Withdrawal of the United Kingdom of Great Britain and Northern Ireland from the European Union and the European Atomic Energy Community came into force and was incorporated into law by the European Union (Withdrawal) Act 2018 and European Union (Withdrawal Agreement) Act 2020, (together the WAA). Under the WAA, the UK entered into a transition period, expiring at 11pm on 31 December 2020, during which the UK was subject to the majority of EU laws without voting rights as an EU member state.

From 1 January 2021, the UK and the EU set out a framework for cooperation on financial services as part of the Trade and Cooperation Agreement between the two. However, financial services regulation in both the UK and the EU is under review and each is amending a few areas of the financial services regulation on an ad hoc basis making diligence in this area more complex until there is international agreement between them. A large part of the EU/UK rules are being maintained until March 2022.

To deal with the gaps in legislation at the end of the Brexit transition period the UK passed a large number of statutory instruments, relating to:

1. Passporting rights for EU regulated lenders operating in the UK;
2. The Financial Services and Markets Act (as amended) giving the Financial Conduct Authority, the Prudential Regulatory Authority and the Bank of England powers to delay regulatory requirements that change or apply;
3. Regulations required under the Market in Financial Instruments Directive (MiFID II) and Market in Financial Instruments Regulations (MiFIR) functions, and
4. Onshoring and amending the EU capital requirements regime to create a UK capital requirements regime.



3.3 Accounting treatment under IFRS9

Structuring trade finance receivables transactions may also have implications for the financial statements of a company depending on whether an item is shown as a debt or a trade payable.

International Financial Reporting Standard 9 (IFRS 9) can impact the ability of an entity to optimise its balance sheet, whether the party is a supplier or a buyer.⁹ See also *Chapter 5: Distribution and techniques* and *Chapter 6: Surety – how insurance companies can issue guarantees and risk participations*. A trade finance transaction, where the financier has a right to receive repayment or reimbursement at a future date, is considered to be a financial asset on the financier's books. The value of that asset can be measured in different ways. Though not considered in detail here, IFRS 9 sets out a two-step approach to classification of financial assets for the purpose of determining how such assets are measured on the books of a financier:

- (i) Solely payments of principal and interest; and
- (ii) Business model assessment.

3.4 Anti-money laundering and terrorist financing

In addition to complying with the applicable sanctions regimes referred to below, financiers also have duties to act in the prevention of money laundering (anti-money laundering (AML)) and terrorist financing (counter terrorist financing (CTF)). Money laundering is defined as “the process by which the proceeds of criminal conduct are dealt with in a way to disguise their criminal origins”. There are offences both of overt money laundering *and* failure to report suspicion of money laundering. This part of the chapter sets out some key issues but is not a comprehensive guide to the UK or international anti-money laundering regimes.

Under the Proceeds of Crime Act 2002 and the Terrorism Act 2000 (as amended), any financier, whether regulated or not, commits an offence if it allows itself to be used as the conduit for laundered funds or for moneys destined to finance terrorism. Banks and other financiers within a defined “regulated sector” would commit a criminal offence if they fail to report any suspicion of money-laundering activity or were to tip off suspects that an investigation is under way.

UK requirements for financiers’ internal procedures, training and customer due diligence (CDD) are set out in a number of AML and CTF regulations that are regularly updated. AML compliance is predicated on a risk-based approach whereby financiers must properly assess the risk that a given transaction presents to them based on a combination of factors such as the product, jurisdiction and nature of the counterparty in order to manage risk efficiently and prevent its services from being used for money laundering or terrorist financing. For all counterparties, the financier must carry out CDD. There are different levels of customer due diligence, including enhanced CDD for higher-risk customers.

“Any financier, whether regulated or not, commits an offence if it allows itself to be used as the conduit for laundered funds or for moneys destined to finance terrorism”

Geoffrey Wynne, Head of the Trade & Export Finance Group,
Sullivan & Worcester UK LLP

On 10 January 2020, the Money Laundering and Terrorist Financing (Amendment) Regulations 2019 (the “2019 Regulations”) came into force in the UK.¹⁰ Changes introduced by the 2019 Regulations included:

1. Extending the scope of persons subject to the 2017 Regulations to include cryptoassets dealers;
2. Extending CDD measures, in particular, introducing explicit CDD requirements for understanding the ultimate ownership and control structure of financiers’ customers; and
3. Reporting any discrepancies in beneficial ownership of UK companies to Companies House.

Trade finance often operates in higher-risk jurisdictions and may also involve high-risk counterparties or goods. In some jurisdictions, getting the documents or other information necessary to satisfy due diligence requirements can be difficult. Misuse of trade finance channels has been identified as a route favoured by money launderers. A key risk around trade finance business is that seemingly legitimate transactions and associated documents can be constructed simply to justify the movement of funds between parties, or to show a paper trail for non-existent or fraudulent goods. As a result of the diversity of practices in different jurisdictions, financiers may find it hard to be sufficiently familiar with local documentation to assess whether it is genuine. Other risks include over-invoicing, under-invoicing, multiple invoicing, short-shipping, over-shipping, deliberate obfuscation of the type of goods, and phantom shipping.

3.5 Sanctions

Sanctions are a package of measures taken at international or domestic level to encourage countries or regimes to change their practices where there is a perceived risk to global peace and security generally. They may comprise any trade sanctions or financial sanctions or a combination of both. The UK’s Office of Financial Sanctions Implementation (OFSI)¹¹ in its guidance for importers and exporters neatly set out an explanation of each as follows.

3.5.1 Trade sanctions

1. Controls on the export and import of certain goods and technology, such as military goods and technology;
2. Controls on the provision of certain assistance and services, such as financial services, related to controlled goods and technology;
3. Controls on other trade related activities, such as services relating to ships and aircraft.

3.5.2 Financial sanctions

1. Asset freezes which restrict access to funds and economic resources;
2. Restrictions on dealing with various financial markets;
3. Restrictions to cease business of a specified type, e.g. with suspected links to terrorism; and
4. Directions to cease all business with certain sanctioned individuals or organisations.

It is common for contracting arrangements to list a number of sanctions regimes with which the borrower or borrower group should comply (e.g. US, UN, EU and UK) and, in addition, other local regimes according to the jurisdictions involved in the transaction. Financers involved in trade finance in certain regions are likely to encounter sanctions issues in several ways, for example where they could be exposed to:

- Financings to designated persons;
- Being in a syndicate with designated institutions;
- Financing designated goods; and
- Being contractually obliged to pay designated persons (for example, as issuing or confirming bank under a letter of credit) or a supplier under a receivables purchase arrangement.

Regulators and counterparties will expect financiers to have procedures and policies in place that allow them to react quickly and appropriately to ever changing sanctions. These include:

1. Assessing the risk of sanctions;
2. Conducting appropriate and regular sanctions screening of lists issued by sanctions authorities in different international groups or countries;
3. Conducting due diligence to the correct degree to enable detection of whether designated persons, goods, payments and/or territories are involved;
4. Having appropriate training, technology and human resource to monitor and screen changes to the sanctions lists and to use the relevant technology;
5. Ensuring the appropriate freezing and notification measures are taken;
6. Permitting the financier to decide quickly whether to apply for a licence to deal where one is available;
7. Keeping paper trail evidence that the proportionate due diligence was carried out; and
8. Using provisions in documentation to permit the financier and requiring their contract counterparty to comply with all relevant sanctions requirements, for example, conditions precedent as part of the due diligence process, representations, undertakings on parties to comply with sanctions regimes and events of default for non-compliance or breach of representation.



3.6 Fraud

Fraud is a particular aspect of “financial crime” and the fraud offences are contained in the Fraud Act 2006 (Fraud Act). The offence of fraud (section 1) is punishable by imprisonment of up to 10 years or by a fine, or both. An offence of fraud can be committed in three ways, broadly (under sections 2, 3 and 4):

1. By false representation (a) to make a gain for himself or another, or (b) to cause loss to another or to expose another to a risk of loss;
2. By failure to disclose information that a person is under a legal duty to disclose and intends, by failing to disclose the information: (i) to make a gain for himself or another, or (ii) to cause loss to another; and
3. By abuse of position in which a person occupies a position in which he is expected to safeguard, or not act against, the financial interest of another person, dishonestly abuses that position, and intends, (i) to make a gain for himself or another, or (ii) to cause loss to another.

The nature of trade finance is such that it often employs a range of entities that may not be in direct or regular contact with each other. Frequently, transactions are cross-border, so personal knowledge of protagonists and counterparties may be limited. In a market where credit is less plentiful, trade finance transactions tend to increase—as do the incentives for perpetrating fraud. This underscores the critical importance of detailed and far-reaching due diligence and adequate internal policies to ensure knowledge of your customer or counterparty.

The trade finance transaction’s interfaces and structures can make it susceptible to fraud. The checks on documentation that a financier makes should be fine-tuned to include red flags specific to the firm’s business model and internal risk assessment results. Financiers must ensure thorough screening and scrutiny of payment requests as well as sensitivity to instructions that are: “one-off”; seem to bear little correlation to previous commercial dealings or requirements; or where particularly complex structures are used for transactions that on the face of it do not seem to merit their use.

4

The role of credit insurance in receivables financing

By Hannah Fearn, Managing Associate, Trade & Export Finance Group, Sullivan & Worcester UK LLP

As discussed elsewhere in *A Guide to Receivables Finance*, a receivable can be described as a right of one person to receive payment from another person at a future date. During the period of time until payment is made, the owner of the receivable is exposed to certain risks, such as the buyer's credit risk, currency fluctuation risk and, in the case of cross-border receivables, political risk. Both companies and receivables financiers use credit insurance as a tool to mitigate those risks.

4.1 Benefits of using credit insurance

For companies, credit insurance can offer various benefits, including:

- **Supporting sales growth.** Using credit insurance can enable companies to access new or overseas markets with a degree of confidence in the knowledge that the debtor and/or country risk is mitigated. Suppliers may be able to trade more competitively if they can rely on the insurance to offer open account or longer payment terms.
- **Enhancing credit controls.** Insurance policies impose certain credit control requirements on companies, which can serve to enhance or develop a company's internal credit control procedures.
- **Improving access to financing.** A company can leverage its book of receivables as collateral to obtain financing as an alternative to more traditional types of borrowing. Credit insurance can be used to enhance the quality of accounts receivable so as to obtain better financing terms and cheaper access to working capital.

“It is important that users of insurance understand the legal framework in which insurance policies operate”

Hannah Fearn, Managing Associate, Trade & Export Finance Group,
Sullivan & Worcester UK LLP

Receivables financiers may also obtain credit insurance directly, in respect of receivables they have purchased or financed. This may provide some additional benefits, including:

- **Managing internal exposure limits.** If a financier has reached its internal buyer or country limits, credit insurance may allow it to enter into additional financings.
- **Obtaining capital relief.** Banks are required to hold a certain amount of capital in respect of their exposures. This may be reduced where the financier enters into a credit protection arrangement, such as a credit insurance policy, that meets prescribed eligibility criteria.

As well as looking at the benefits, it is also important to consider the cost of obtaining credit insurance. The insurers will require payment of a premium for the coverage, calculated by reference to the risks involved. There may also be legal fees and broker commissions to pay. For companies, this will increase the overall cost of trading with their buyers. For financiers, the cost of obtaining the insurance will need to be factored into the profitability of the financing transaction.

The policy will also impose certain administrative responsibilities that must be managed by the insured. For example, the insured will have certain credit control procedures to adhere to and may be required to provide ongoing information to the insurers during the term of the cover. In a claim scenario, the insured may be required to cede management of the recoveries process to the insurers, which may impact its commercial relationships.



As such, it is necessary to balance the benefits of obtaining the insurance coverage against the financial cost and potential operational burden.

4.2 Role of the broker

A specialist insurance broker can provide invaluable expertise to financiers wishing to access the credit insurance market. A broker is instructed by the insured party and can advise financiers about the insurance products available and obtain pricing quotes from a range of insurers. The broker will also assist the financier with understanding and negotiating policy wording and can act as a funnel for comments from different insurers. As such, it is important to instruct a broker with in-depth market knowledge and experience of types of insurance products that the financier wishes to utilise.

Legally speaking, the broker acts as the agent of the insured. Once the terms of a policy have been agreed in principle between the parties, the broker will bind the policy on the financier's behalf by getting each insurer to put its stamp down on the policy, indicating that insurer's intention to insure the risk. During the term of the policy, the broker may assist the financier with ongoing queries about the policy or with negotiating any amendments to the cover.

The financier's broker will also typically assist with the claims process, handling communications between the insured and the insurers and helping the financier to negotiate the settlement of a claim.

4.3 Sharing the benefit of credit insurance

Where a credit insurance policy is taken out in the name of the financier's customer (being the underlying supplier who has a book of receivables it wishes to use to access financing) the financier may obtain the benefit of the policy in a number of ways:

4.3.1 Loss payee status

Where a policy has been taken out in the name of the supplier company, a financier of the insured receivables may be noted as "loss payee" on the policy. A loss payee is the party designated by the insured as the recipient of claims money. However, the rights of a loss payee are limited and the financier will be reliant on the insured company complying fully with its obligations under the policy. If the insured company breaches any of the policy terms, the insurers may be able to avoid the policy or deny a claim, meaning the financier will not benefit from any proceeds being paid. In addition, the financier is unlikely to be able to directly make a claim under the policy and will need to rely on the insured submitting a claim and any required supporting information within the time periods prescribed by the policy. Further, if the insured company becomes insolvent, a loss payee status may be vulnerable to priority claims by third parties.

— **Assignment of the insurance proceeds.** A financier might take an assignment over the supplier company's rights to any proceeds paid out under the insurance policy. An assignment may be taken in conjunction with loss payee status. As assignee, the financier will still be vulnerable to acts or omissions of the insured company that might prevent a valid claim being made. However, if the insured company becomes insolvent, an assignment should be effective to give the financier a priority over other creditors in respect of the assigned proceeds (subject to applicable insolvency laws).

An assignment of the proceeds of a claim should be distinguished from an assignment of the policy as a whole. An assignment of the whole policy would need to take place by novation with the insurer's consent and would result in the financier becoming the primary insured under the policy, and directly liable for the policy obligations.

— **Co-assurance.** In a co-assurance structure, both the supplier company and financier are identified as the insured parties and are treated as having separate contracts of insurance with the insurer in respect of their own interests in the insured subject matter. A co-assurance insurance policy might be used where the financier is purchasing some of the supplier company's book of receivables, meaning that it will have a direct interest in some of the insured assets. Each insured party has rights and obligations under the policy, however, the policy will be subject to a single claims limit and it will only be possible to claim once in respect of each insured loss.

A benefit of this structure is that the insured financier will be able to directly pursue claims under the policy. However, depending on how the policy is drafted, the financier's ability to make a valid claim may still be affected by acts or omissions of the co-assured company.

The financier may be able to mitigate some of the risks involved in sharing the benefit of an insurance policy by including protective provisions in the financing agreement. For example, covenants from the insured company to maintain the insurance policy, comply with all its obligations thereunder and pursue any claims in a timely fashion. However, if the company were to breach such covenants, and such failure resulted in the policy failing to pay out, the financier's recourse may be limited to seeking damages from the insured company. In practice this may require expensive litigation or may be of limited value if the company is in financial difficulty.

As an alternative, a financier might take out its own insurance policy in respect of receivables that it purchases or otherwise finances. As the insured party, the financier will be able to make a direct claim under the policy and control the claims process. However, it will also be solely responsible for the discharge of the policy obligations and liable for payment of the premium.

4.4 General legal considerations

As well as being governed by general principles of contract law, insurance policies are subject to specific rules of insurance law. It is important that users of insurance understand the legal framework in which insurance policies operate. Financers should seek advice on their obligations under the policy and how a breach of those obligations may impact the insurance cover.

Insurance policies are described as contracts of utmost good faith, a legal principle which imposes a positive duty on the parties to act honestly and openly and not to mislead each other. This overriding principle is relevant to how the courts will approach the interpretation of contracts of insurance and the obligations of the parties thereunder.

Two key insurance law principles often discussed in the context of receivables finance are the indemnity principle and the requirement for an insured to have an “insurable interest”.

4.4.1 Indemnity principle

The indemnity principle applies to insurance policies, such as credit insurance policies, where the insurers agree to indemnify the insured for a loss suffered by the insured. It provides that the insured cannot recover from the insurers any more than the amount of the loss it has actually suffered in relation to the insured event, and this can be a pitfall for the unwary in the context of receivables finance. For example, a financier purchasing receivables on a non-recourse basis from its customer may become loss payee on its customer’s existing credit risk insurance policy. If a debtor then defaults in payment of some of the purchased receivables, it may be held that the financier’s customer, being the insured party, has not actually suffered any loss as a result of the default as it no longer owns those receivables. This may preclude a claim under the policy. For this type of structure, a financier may be advised to become co-assured on the policy, or to obtain its own insurance, so as to ensure its own interests in the purchased receivables are covered.

4.4.2 Insurable interest

For certain classes of insurance, it is also necessary for the insured to have an “insurable interest” in the subject matter being insured. In general terms, this means that the insured must have a pecuniary interest in the subject matter of the insurance, such that it will suffer a loss or incur a liability if an insured event occurs. The consequence of not meeting this requirement is that the insurance policy will be unenforceable. Unfortunately, the law is not settled as to whether this requirement applies to indemnity insurance policies other than marine insurance policies, which creates some uncertainty for users of credit insurance.

Finally, it is important to note that English law-governed non-consumer insurance policies are also subject to the provisions of the Insurance Act 2015. This piece of legislation significantly reformed some key areas of insurance law, including in respect of disclosure of information, insurance warranties and fraudulent claims.

4.5 Key terms of insurance policies

Policy wordings differ significantly across the market. However, some types of provisions are common to most English law credit insurance policies taken out in respect of receivables.

— **Scope of cover and eligibility requirements for insured receivables.**

It is important to review the scope of cover being offered, including the triggers for being able to make a claim and any applicable policy limits.

It is often the case that an insurance policy will cover a changing pool of receivables arising from time to time during the policy period. For a receivable to be covered by the policy, it will need to meet certain eligibility requirements. For example, that the receivable is owed by an eligible debtor, that it originated in an eligible jurisdiction and that it relates to a genuine trade transaction. As such, a financier will need to carry out appropriate due diligence into the receivables it finances, in order to ensure any eligibility criteria is met.



- **Exclusions.** The exclusions in an insurance policy further define the scope of cover by providing that the insurers will not indemnify the insured for losses caused by certain specified events. For example, in the context of receivables finance, it is often the case that non-payment of a receivable due to a bona fide commercial dispute between the underlying supplier and buyer will not be covered. London market policies may also contain more general market standard exclusions, such as an exclusion for losses caused by radioactive contamination or chemical weapons.

When reviewing an insurance policy, a financier should pay particular attention to the exclusions to ensure these do not undermine the scope of the credit protection.

- **Fair presentation.** For English law-governed insurance policies, the Insurance Act 2015 provides that the insured has a duty to make a fair presentation of the risk to the insurers prior to inception of the policy and whenever the policy is amended. A “fair presentation” is one:

Which makes disclosure of every material circumstance which the insured knows or ought to know or, failing that, would put a prudent insurer on notice that it needs to make further enquiries;

Which makes that disclosure in a manner which would be reasonably clear and accessible to a prudent insurer; and

In which every material representation as to a matter of fact is substantially correct, and every material representation as to a matter of expectation or belief is made in good faith.

The Insurance Act 2015 sets out further detail on what circumstances would be considered as being “material” for this purposes, and what information the insurer “knows or ought to know”. Further, the insured has a positive duty to make certain enquiries in respect of the risk and not to turn a blind eye if it suspects certain matters. However, the duty of fair presentation imposed by the Insurance Act 2015 can be amended by agreement between the insurers and the insured, and so the scope of the disclosure duty applicable to a particular policy will depend on the policy wording.

In circumstances where the insured breaches its duty of fair presentation, the Insurance Act 2015 provides for a range of remedies depending on the severity of the breach. For deliberate or reckless breaches, or where the insurer can show that it would not have entered into the policy at all had a fair presentation been made, the insurer may avoid the policy and will have no liability for any claims. For less serious breaches, a policy may be interpreted as incorporating different terms (i.e. the terms the insurer would have included had a fair presentation been made) or the amount of a claim payable under the policy may be reduced.

Where it is the financier’s customer that will make the presentation of the risk to the insured, then the financier risks that its customer will fail to meet the required standard for a fair presentation of the risk, which could ultimately impact whether the policy pays out.



“If a warranty is breached, the insurer will have no liability under the policy in respect of any loss occurring”

Hannah Fearn, Managing Associate, Trade & Export Finance Group,
Sullivan & Worcester UK LLP

- **Warranties and conditions precedent.** A warranty in an insurance policy is a promise made by the insured to the insurer which requires exact compliance by the insured, even if it is not material to the risk. If a warranty is breached, the insurer will have no liability under the policy in respect of any loss occurring, or attributable to something happening, after the warranty has been breached but before the breach has been remedied (unless one or more of the limited exceptions set out in the Insurance Act 2015 applies).

Where a policy condition is expressed as a condition precedent to the insurer’s liability under the policy, then the insurer will be entitled to decline a claim payment if that condition is breached.

Given the potentially severe consequences of a breach, it is important for a financier to carefully consider the extent to which it can ensure compliance with each warranty and condition precedent. This will be more difficult where it is the bank’s customer who is responsible for compliance with the policy conditions. Before relying on a policy taken out by its customer as enhancing the quality of the financed receivables, the financier may need to carry out due diligence into its customer’s internal processes and operations, in order to satisfy itself as to whether the insured customer is likely to be able to comply with the critical policy requirements that may impact whether the policy pays out.

- **Dispute resolution.** It is common for London market policies to provide that disputes will be resolved by arbitration, meaning the outcome of a dispute between the insurers and the insured will remain confidential. However, it is possible for the parties to select alternative methods of dispute resolution, such as court proceedings, if preferred.

Where the financier is relying on a policy taken out by its customer, it may want to consider the extent to which it will have the contractual right to influence any dispute resolution proceedings. In particular, dispute resolution is typically costly and the insured may be reluctant to incur significant legal fees without the financial backing of the financier. Further, the financier may wish to take control over instructing legal counsel and have a role in decisions made during proceedings.

4.6 Claims under insurance policies

4.6.1 Key considerations

Once a loss event occurs, there are various considerations for the insured party to bear in mind when making a claim, and certain steps it can take to maximise the chances of recovery. Here are some of the key considerations:

- **Notification requirements.** The policy may contain reporting requirements that are independent of the claims process. These may include a requirement for the insured to notify the insurers within a certain timeframe of any events occurring that would give rise to a claim, or that may increase the likelihood of the insured suffering a loss even if a claim is not imminent. Depending on the policy wording, failure to comply with a notification requirement may prevent the insured from being permitted to submit a claim.
- **Trigger for making a claim.** It is important to carefully read the policy to understand when a claim may be made. This might be, for example, following non-payment of a receivable (subject to the expiry of any grace period), or on a debtor's insolvency.
- **First loss provisions.** Insurance policies covering pools of receivables often contain first loss provisions, meaning that the insured will bear the initial amount of any losses in respect of defaulted receivables, up to the specified amount.

- **Mitigation of loss.** Credit insurance policies will invariably include an obligation on the insured to take reasonable steps to minimise the losses caused by the occurrence of an insured event, or to prevent a loss occurring in the first place. Further, it is common for credit insurance policies covering purchased receivables to include a “stop financing” clause, which provides that any receivables purchased after the occurrence of specified credit events in respect of the debtor will not be covered by the policy. As such, the insured party may need to ensure it takes appropriate steps to monitor the status of the insured receivables and the debtors during the life of the policy.
- **Making a claim.** In order to make a claim, it is usually necessary to submit a proof of loss or notice of claim form to the insurers. The template for this will often be included in the policy wording. The insured may be required to include certain supporting evidence, such as evidence of the non-payment and communications with the debtor.

4.6.2 Claims process practicalities

Policies often impose an obligation on the insured to cooperate with the insurers in relation to any claims, or in circumstances which may give rise to a claim. This would typically include a requirement to disclose documents and records held by the insured that are relevant to the loss.

As a starting point when making a claim, the insured has the burden of proving it has suffered a loss within the scope of the policy, whereas the insurers are responsible for proving whether any exclusions apply. The policy may provide for a timetable for the insurers to consider the evidence provided by the insured and to request additional information. Common law has recognised that insurers cannot make unreasonable demands for information.

Subject to the insured making a claim and submitting any additional information required in a timely manner, the insurers would typically be required to pay a valid claim at the end of the applicable waiting period, which in the London market is usually 180 days or more from the date of loss. The amount of the claim paid will be reduced by the amount of any recoveries made in respect of the defaulted receivables during the waiting period. Payment of a claim is often conditional on the insured executing a release in favour of the insurer.

4.6.3 Role of the broker and loss adjuster

- **Role of the broker.** The placing broker, as the agent of the insured, will often have an important role assisting the financier throughout the claims process. Communications between the insured and the insurers will generally take place via the broker.
- **Role of a loss adjuster.** For larger claims, a loss adjuster may be engaged by the insurers to review and investigate the claim on the insurers' behalf. The loss adjuster's role is to report to the insurers, and it will advise on both legal issues (for example, whether there has been any breach of any policy conditions) and factual issues (for example, whether the quantum of the claim is accurate).

4.6.4 Recoveries and subrogation

After a claim is paid, any subsequent recoveries relating to the defaulted receivables will be shared between the insured and the insurers. Policies may provide that recoveries go first to the insurers, or that the recoveries will be shared pro rata to reflect how the insured and the insurers have shared the loss. The insurers will also have rights of subrogation that arise by the operation of law following payment of a claim. The principle of subrogation allows the insurers to effectively take the place of the insured as regards pursuing any avenues of recovery available to the insured. For example, this might allow the insured to start legal proceedings against the defaulting debtor in the name of the insured.

Alternatively, insurers may exercise a contractual right in the policy to request that the insured receivables are assigned to the insurers, such that the insurers have direct enforcement rights against the debtors.

4.6.5 Financier's ability to influence the handling of the claims process

Where the financier is not the insured under the policy, but merely a loss payee or assignee, it will need to consider whether it has any contractual right to influence the claims process.

4.7 Insurance and capital relief

4.7.1 Regulatory background

The amount of capital that a financial institution is required to hold in respect of its exposure to a receivables' debtor may be reduced where it obtains credit protection from a third party that meets certain eligibility criteria. Credit insurance has become increasingly popular as a tool for accessing capital relief.

The eligibility requirements that must be met for an insurance policy to be used to obtain capital relief are dictated by the laws in a financial institution's jurisdiction that implement the Basel Standards, being the minimal capital requirements for commercial banks developed and published by the Basel Committee on Banking Supervision. When interpreting the eligibility requirements, it is important to take account of relevant non-legislative guidance published by regulators as to how the requirements should be applied in practice.

For EU Member States, the currently applicable Basel Standards were implemented by the Capital Requirements Regulation (the "EU CRR") and the Capital Requirements Directive, both of which came into force on 1 January 2014. In the UK, the EU CRR, as it was in force as at 11.00 p.m. on 31 December 2020 (the "IP Completion Day") became part of domestic law of the UK pursuant to the provisions of the EU Withdrawal Acts (the EU CRR as implemented into domestic law being the "UK CRR"). Currently, the provisions of the UK CRR are substantially similar to those of the EU CRR, however, both the UK CRR and the EU CRR are under review by the relevant regulators and legislators and the regulations may diverge in future.

The eligibility requirements for unfunded credit risk mitigation such as credit insurance, as provided in the Basel Standards and translated into the EU CRR and UK CRR, depend on the approach used by the financial institution to calculate its capital requirements. The requirements are more onerous for institutions that use the "standardised" approach, and for institutions using more sophisticated approaches where the intention is to fully substitute the risk parameters applicable to the underlying obligor with those that the institution would assign to comparable direct exposures to the protection provider.



4.7.2 Key requirements applicable

Some of the key requirements applicable to credit insurance policies under the most stringent approach are considered below:

- **Legal certainty.** The policy must be legally enforceable in all relevant jurisdictions, such as the jurisdiction of the law governing the policy and the jurisdiction of the insurer. Institutions may need to obtain legal opinions to confirm satisfaction of this requirement.
- **Direct.** The financial institution must have a direct claim on the insurer. It is unlikely that this requirement will be satisfied if the financier only has loss payee status on its customer's policy as it will not have any right to make a claim in its own right under the policy.
- **Clearly defined and incontrovertible.** The scope of the credit protection provided by the policy should be clear and unambiguous, and the terms of the policy should leave no practical scope for the insurers to dispute, reduce or seek to be released from their liability.

In the context of an insurance policy, this requires the insured to consider the terms of the policy that define the scope of cover (including any exclusions from the cover). Further, as discussed above, there are certain terms of insurance policies where a breach by the insured may result in the insurers having certain remedies. For example, a breach of the duty of fair presentation may allow the insurers to avoid the policy or reduce a claim. A breach of a warranty means the insurers are “off risk” for the duration of the breach.

For these types of provisions to meet the requirement of incontrovertibility, it must be possible for the financial institution to control whether the requirements of those provisions are met. The financier will need to consider the warranties, conditions precedent and other relevant provisions to assess whether it is possible to control compliance or whether a breach would be outside its control.

As such, a financier will only be able to obtain capital relief where it is directly insured under the policy (as sole insured or co-assured). It is not possible to obtain capital relief where the financier is loss payee or has a security assignment of insurance proceeds, as in these circumstances the financier cannot control whether the relevant policy obligations are met by the insured.

- **Non-cancellable.** The insurer must not have a unilateral right to cancel the policy, except in the case of a breach of an obligation of the insured which is within the financial institution’s direct control. For example, insurance policies invariably permit the insurers to cancel for non-payment of premium.
- **Unconditional.** There should be no policy condition outside the direct control of the financial institution that could prevent the insurers from being required to pay a claim in a timely manner in the event that the underlying obligor defaults. In practice, this is similar to the “incontrovertibility” requirement above, as it requires an assessment of whether the fulfilment of any conditions that impact the insurers’ liability are within the financial institution’s control. In respect of the “timeliness” requirement, whether the typical waiting period for payment of a claim would meet this requirement would depend on the views of the financial institution’s regulator. For UK banks, there has been some positive indication from the local regulator that market standard waiting periods of 180 days would not render a policy ineligible.

- **No requirement to first pursue the underlying obligor for payment.**
The financial institution should not be required to exhaust available legal recovery processes against the receivables' debtor as a precondition to the making or payment of a claim. Loss mitigation provisions in the policy would need to be considered in this context.

- **Covers all types of payments due from the underlying obligor.**
The policy should cover all types of payment the underlying obligor is expected to make or the financial institution must adjust the value of the credit protection to reflect the limited coverage. For example, if an institution obtains an insurance policy in respect of only 90% of the amount of the covered receivables, then it would only be permitted to substitute the insurer's risk weighting in respect of the covered portion of the exposure.

4.7.3 Eligibility

As well as meeting the various requirements applicable to the terms of the policy, the insurers must be eligible protection providers under the applicable Basel rules. The eligibility of insurers that are corporate entities will depend on whether they meet the rating requirements prescribed by the rules. Other entities that offer credit insurance, such as export credit agencies and development finance institutions, are also eligible protection providers.

Where a policy meets the eligibility requirements, the method by which the credit protection is recognised by the financial institution will depend on the approach used to calculate credit risk. Under the "standardised" approach, capital requirements are calculated by applying prescribed risk weights to the relevant exposures. The applicable risk weight is intended to reflect the credit risk of the exposure. Where the financial institution has the benefit of eligible credit protection for an exposure, the risk weight applicable to the protection provider can be substituted for the risk weight of the underlying obligor, in respect of the portion of the exposure that is covered by the credit protection. Where risk weight applicable to the insurer is better than that which applies to the underlying obligor (for example, because the insurer has a stronger credit rating), this reduces the overall amount of capital the financial institution is required to hold for the exposure.

The “foundation” approach is a simplified version of the internal ratings-based approach, where the financial institution has the discretion to determine certain of the risk parameters applied to exposures to calculate its capital requirements. For financial institutions using this approach, credit protection can be recognised in a number of ways, including substituting the relevant risk parameter of the protection provider for those applicable to the underlying obligor or by applying a value for the risk parameter that is in between that applicable to the protection provider and that applicable to the obligor.

The “advanced” internal ratings based approach is the most sophisticated approach and allows a high degree of flexibility for financial institutions in recognising the effect of credit protection. The eligibility requirements applicable to credit protection instruments used by advanced institutions are less stringent where the method used by the financial institution to recognise the credit protection adequately reflects the risks involved in relying on the relevant instrument. Under the advanced approach, the financial institution can recognise the effect of the credit protection in a number of ways, including by adjusting different risk parameters to reflect the enhanced credit risk using internal models.

4.8 Due diligence

Credit insurance has an important and growing role in receivables finance. However, the specialist nature of the product means it is often useful for financiers to access the expertise of brokers and legal advisers to effectively utilise insurance as a risk mitigation instrument.

When relying on an insurance policy taken out by its customer to enhance the credit quality of financed receivables, or where a financier is relying on its customer to discharge certain policy obligations, it is vital that the financier carries out appropriate due diligence. This includes reviewing the policy terms to ascertain the scope of the cover and investigating the ability of its customer to meet any conditions of the policy that may impact the liability of the insurers to pay a claim. Failure to do this may greatly increase the risk of a policy failing to pay out. However, where used properly, credit insurance can offer valuable benefits for both corporates and financiers.

5

Distribution techniques and issues

By Paul Coles, Asset Distribution Lead, GTRF, HSBC Bank plc

This chapter looks at the sub-participation market, which enables an originating/financing institution to optimise its capital and exposure to credit risk, and for investors to participate in a variety of trade finance transactions without the need to perfect the transfer or assignment of the assets. As with most techniques, there are some advantages and disadvantages that are inherent to sub-participations (also known as distributions or syndication), together with considerations that come down to preference and business models.

5.1 Drivers of distribution

It is worth highlighting that the distribution of receivables finance transactions is not an essential component of all such facilities. In most cases, the institution that is providing the finance will do so on a 'book and hold' basis, where they maintain the transactions or facilities in their entirety and for their full lifetime. Increasingly though, the ability to distribute transactions provides added flexibility to the financing institutions, and in turn to their clients that are seeking the financing or risk mitigation that the trade products can offer.

A number of factors typically drive the need to distribute or sell down assets or risk:

- Defined credit risk appetite;
- Capital and risk weighted asset (RWA) targets or caps;
- A desire to increase returns without increasing pricing;



- Finding alternative sources of liquidity; or
- Delivering solutions to a wider audience than would otherwise be possible, such as when a client requests other banks to fund a bilateral programme.

Typically, it is a combination of the criteria listed above that need to be met on any given transaction or facility. So while the ‘book and hold’ approach would derive the maximum revenue, the reality is that financial institutions often need to seek partnerships when delivering trade solutions to their clients.

For example, a client requests a single interface in order to minimise the administrative requirements, but would also like to invite several key bank partners to participate in the facility for relationship reasons. The leading bank can therefore put together a single solution whereby they take on the responsibility of being the primary interface, and then coordinate with the other investors in the background. This can be achieved through sub-participations.

Another increasingly common scenario is where some transactions are too large to be accommodated by a single institution. Rather than declining these transactions, finding one or several investors to partner with makes it possible for the transactions to go ahead and for the risks to be shared between several parties.

5.2 Outright sales

The two previous examples demonstrate why risk distribution has become a popular technique, and an alternative to outright sales.

Outright sales via assignment, endorsement, or transfer (depending on the product) ultimately provide the cleanest way of removing a transaction – and the associated overheads – from an entity's portfolio and balance sheet, in turn recovering the funding that was originally utilised, and freeing up the credit limits and capital allocation. However, there are limitations on performing outright sales, which are typically logistical.

The transactions must be in a format that can be dissected into several distinct amounts and maturities with ease. Both the obligor and the investor need to be able to identify who is the lender of record of a payment obligation, so that the correct amounts are due and payable to the correct party at maturity. This is especially important for an investor, as they should have equivalent entitlements at maturity. If a payment obligation is divided and the obligor is subsequently only able to repay part of that obligation at its maturity, how can the investor ensure that they will receive a pro rata portion of the reduced payment? The risk is that another investor could receive full payment instead.

There must also be no need for a fronting bank. This can be a challenge for larger or more complex facilities, which often require an entity to assume a role similar to that of an agency function. The fronting bank acts as a single operational contact, thereby reducing the burden on the obligor to deal with multiple entities (potentially each with varying requirements). It is less common in the traditional trade finance market to see standard facilities with an actual agent though; this is more prevalent in the syndicated and structured finance markets.

Lastly, and quite importantly, each new investor in the case of an outright sale will typically need to be officially recognised by the obligor as the new bona fide assignee or holder. Obtaining this in a timely fashion can pose a challenge, especially for shorter-dated transactions, such as 30-day receivables. There may also be some jurisdictional constraints (e.g. onerous local law perfection requirements) that make becoming a lender of record in a facility comparatively unattractive.

“While being mutually beneficial, RPAs provide for two distinct ways of risk sharing: on a funded or unfunded basis”

Paul Coles, Asset Distribution Lead, GTRF, HSBC Bank plc

5.3 Risk participation agreements

Sub-participations have evolved in order to provide a flexible solution to these challenges. Banks that were active in the sub-participation market had drafted their own risk participation agreements (RPAs), either as a single-transaction document or as a master agreement. These bilateral RPAs enable the respective institutions to either be the buyer or seller of the risk on a transaction. The sellers remain the lender of record in all cases, and therefore also retain the ongoing management of the transactions that have been distributed.

5.3.1 Master RPAs

The use of RPAs, and more specifically master RPAs, often foster a two-way ongoing relationship between the institutions, encouraging a regular stream of business and mutual understanding of such flows. It can be seen as an additional component within a multi-product bank-to-bank relationship too, enabling both parties to increase their trade finance volumes and associated income streams. See also *Chapter 6*.

In practice, it is fair to say that the natural balance between the two parties is inevitably skewed, with one institution being a seller more frequently than the other. This reflects the mutual benefit derived from this type of relationship. One party will typically have a more established sales and origination network, in turn putting pressure on its ability to retain all the transactions it originates. The other party will often be keen to participate in transactions that it would not otherwise be able to originate itself, due to a more limited geographical footprint or coverage for example.

5.3.2 Funded vs unfunded

While being mutually beneficial, RPAs provide for two distinct ways of risk sharing: on a funded or unfunded basis. Each has its respective advantages and disadvantages, as discussed below.

Unfunded distributions enable an investor to provide a form of contingent obligation, akin to an on-demand guarantee, whereby they are only required to fund their position in the event of a default of the underlying transaction. This form of risk distribution is therefore relatively quick and simple to execute, and can cover any type of underlying transaction – including those with as yet un-crystallised amounts and maturities (e.g. a deferred payment letter of credit where the shipment has not yet taken place, or ongoing receivables or payables facilities with continuously varying levels of utilisation). This inherent flexibility is a great advantage. The downside is that the entity holding the underlying asset must assume a degree of risk on the investor. This is because they would need to make a claim in the event of a non-payment by the underlying obligor. They should have therefore assessed the investor's ability to honour that obligation to fund the claim at a future date.

While not always a key factor (especially for institutions with excess liquidity), it is also worth remembering that the funding is still being entirely borne by the original booking entity, not by the investors. Conversely, unfunded participations can be significantly more attractive to investor institutions that have a higher cost of liquidity, as they can arguably strip this component out of their pricing requirements at the time of entering into the risk participation.

Funded distributions are more attractive to the seller in many respects, as they reduce the residual risks that remain with the lender of record. The seller receives the investor's funding at the outset, and therefore carries no contingent risk on the investor in the future.

A consideration for the investor though, is to ensure that they are comfortable with having paid funds to the selling bank and not the obligor. In some cases, the insolvency of the selling bank could leave an investor without a clear channel of recovery, as they might be neither a secured creditor of the seller, nor a lender of record in the underlying transaction. There are, of course, ways to mitigate this risk too, and these will vary from one institution to another as to which approach they prefer or can mutually negotiate with the other party to the RPA. Examples can include ring-fencing the funds (e.g. via a trust structure or segregated accounts), adding 'elevation' wording to protect the investor by requiring the assignment of the asset in the event of certain trigger events, establishing acceptable risk criteria for the selling bank, or choosing to pass on the beneficial ownership interest on day one (even if the assignment is not perfected).

It should be noted that some solutions may also be influenced by jurisdiction-specific regulations and requirements. Some legal constructs may not be enforceable according to a local law, or equally that law may already have specific protections that remove the need to document them further.

There are a number of challenges for the seller too. They might need to break the funding on the underlying transaction and incur an additional cost in the process (although this is not always the case; much depends on their internal treasury procedures). They may also need to factor in the cost of paying for additional days of interest to the investor, bearing in mind that they will only release the funds back to the investor once they have sighted them from the obligor. Depending on time zones, this can sometimes add one or two days to the cost.

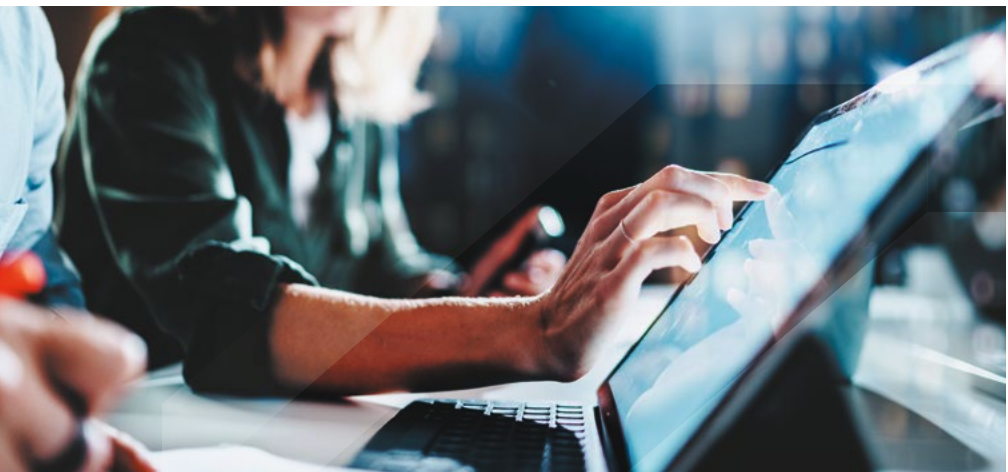
5.3.3 BAFT – Market standard forms

Moving back to the format of the RPAs, until a little over a decade ago they would come in many different forms, making it a challenge to negotiate these agreements when the respective institutions' starting documents were considerably different. The purpose of the RPAs was essentially the same, but the way that the clauses were drafted could come from very different perspectives, incorporating the multiple viewpoints of both the business and internal functions such as risk, legal, and compliance.

Realising that there were very divergent approaches, a number of banks heavily involved in trade finance agreed that the market as a whole would benefit from standard wording, which would at the very least, enable interested parties to use a template as a starting point for negotiations. In theory, this would simplify the process and in turn reduce legal costs when negotiating the document. This multi-bank initiative was supported by BAFT (Bankers Association for Finance and Trade), which felt that the agreement would help drive standards and market efficiencies, thereby providing the parties looking to execute the document with a level of consistency and uniformity which had not previously existed.

To this effect, the first form of the English law Master Participation Agreement (MPA) for trade finance risk was released in 2008, and subsequently a New York supplementary form was released in 2010. Consistent with the difficulties in negotiating the multitude of documents previously in existence, the task for the working groups involved in drafting the market standard documents was not an easy one.

In some cases, a consensus was not achievable because of the fundamental concepts incorporated and, amongst other issues, the jurisdictional implications of certain clauses. The final outcome was to create 'optional' wording, where the parties could mutually agree on which version to apply to the document.



To this day, there is still a lack of agreement in the market around the 'fraud clause' in the 2008 English law form. Certain proponents argue that the seller should retain the fraud risk on a transaction, on the basis that they are the party that will have the primary client relationship and therefore be in the best position to perform any necessary KYC checks and mitigate the risk of fraud. The counter-argument to this is that, in some jurisdictions, risk distribution might not be recognised if all the risks are not passed on to the investor, and more importantly, both parties should be sharing in all the risks (and of course the rewards too).

This leads us to the rationale for there being both an English and a New York law version of the MPA.

5.4 New York vs English law

As explained in 5.3.2 above, unfunded risk participation involves the investor providing their commitment to fund if claimed against. As such, there is no major difference between the interpretations under English or New York law (although there are some other differences between the agreements themselves, which the parties should consider before choosing one over the other).

The matter becomes more complex when the participation is concluded on a funded basis. Unless otherwise stated, English law does not recognise the participant as taking a beneficial interest in the underlying transaction, as an English law-governed sub-participation establishes a debtor-creditor relationship between the parties instead. This creates two potential issues, one for the seller of the risk and one for the buyer.

Depending on both local and internal accounting policies, the seller may not be able to satisfy the de-recognition criteria that need to be met for the asset to be no longer accounted for on their books. This can sometimes be the case for funded distributions under a debtor-creditor relationship (i.e. under English law).

Conversely, the investor runs the risk of any funds paid to the seller being co-mingled, and (as discussed previously) in the event of insolvency of the seller, it may not be able to enforce its position as an investor in the specific underlying transaction, even though the underlying transaction may still be a performing asset.

This is where the New York law form of the BAFT MPA, and contractual provisions built into it, can provide some benefit through the legal concept of 'true sale' in funded risk participation. The investor is seen to have taken a direct participation in the risk and reward of the underlying transaction, even though no assignment or transfer has been perfected. Arguably, providing any other necessary criteria have been met, this allows the seller to clearly remove the distributed portion of the transaction from their balance sheet, and the investor would also feel more comfortable with paying funds to the selling bank as it is unlikely that they would be included as part of an insolvent institution's estate. Alternatively, the investor could justify claiming the funds directly from the obligor at maturity, as their participation would be recognised by the courts in New York.

The biggest downside with the New York law MPA wording is that its use is less widespread outside of the Americas, as many institutions have more experience of, and ready access to, English law legal counsel.

5.5 Updated forms of MPAs

The secondary market for trade finance has not stood still since the BAFT MPA forms were originally released. There has generally been an increased demand to distribute more on a funded basis, and the rising popularity of open account solutions has also led to the need to distribute those products.

In addition, with the forms having been in circulation for a number of years, the extra experience gained from regular negotiation meant that making some updates to the MPAs would address some recurring issues and ensure that they remained relevant.

A survey of ITFA members highlighted the principal concepts or clauses that they felt should be updated, and a working group coordinated by BAFT set about debating these changes and drafting the documents accordingly.

The updated English law form was released in late 2018, with the New York law form following in early 2019. The forms are available on the BAFT website.⁴²

On the whole, the changes were evolutionary rather than revolutionary, with a focus on improving some of the drafting and adding flexibility, such as including references to payables finance and receivables finance structures. There were two very significant changes:

- The first was that the English law form moved to a basis of assigning a beneficial ownership interest in the underlying transaction (a so-called equitable assignment) for funded distributions, thereby becoming more closely aligned to the ‘true sale’ concept under New York law and providing a clearer connection to the underlying trade transaction.
- The second was removing the fraud clause from both forms. This does not remove the consequences of fraud risk, however it was determined by the working group that the consequences of fraud are sufficiently covered throughout the MPA, whilst also recognising that fraud is rarely an event that can be determined and attributed to a single party at the outset (as was the case in the older forms).

A further collaboration by BAFT with the International Islamic Financial Market (IIFM) led to additional forms being made available in 2019 that cater to the specific needs of Islamic Trade Finance.

Inevitably, the use of sub-participations entails an understanding of which objectives need to be met and which constraints may impact both parties involved, be it as buyer or seller. The natural complexities of trade finance are reflected in, and are sometimes increased, when adding another layer to a transaction in the form of a sub-participation. It is not always the best solution for selling a transaction. Alternatives such as outright sales and, more recently, a renewed desire to package trade asset portfolios to make them accessible to institutional investors through other instruments, have their place too. The increased involvement of parties such as funds and fintechs are also bringing a different dynamic, and as this area evolves, it is likely that further enhancements to the existing distribution techniques may be required to cater to their expectations. In many cases though, distributions through sub-participations in their various guises offer a flexible method for partnering with other institutions on an ongoing basis, and have ultimately facilitated trade flows globally in the process.

6

Surety – how insurance companies can issue guarantees and risk participations

By Silja Calac, Head of Private Risk Mobilization, GTB, Continental Europe, Banco Santander

Insurance has become an increasingly important part of international trade finance. There are many different insurance products which support banks in their task to forfait receivables, finance trade, or issue guarantees and letters of credit. But bankers, as well as brokers and insurers, often complain that this cooperation is not always as smooth as it should be: lack of information, misconceptions, regulations, internal barriers etc., often hinder insurance companies from providing efficient protection or transaction banking.

One big issue is the variety of insurance products available, and the terminology related to them with which bankers are often not familiar. Thus, it is not always known that besides the traditional credit or political risk insurance, there are other potential areas of cooperation between banks and insurers such as surety, for instance.

Cooperation between banks and insurers in this field only started at the beginning of this millennium. It began when insurance companies that had been active in the issuance of sureties for years, discovered that there was a large area of potential business to which insurance companies had no direct access, as certain markets/sectors were exclusively covered by banks.

6.1 What is surety?

Before looking at the cooperation between banks and insurance companies in this field, it is first necessary to look at what a surety actually is. The ICISA (International Credit Insurance & Surety Association) has defined it on its website:

“A surety bond is an agreement, issued by an insurance company, which (in most cases) provides for monetary compensation in case the principal fails to perform. Although many types of surety bonds exist, the two main categories are contract and commercial surety.”

Although guaranteeing performance of third parties has been done for nearly as long as humankind has existed – as a 5,000 year old Mesopotamian tablet guaranteeing the performance of a farmer proves – and has even been praised in poems (such as Schiller’s *Bürgschaft*), in its modern form it has its origins in US regulation. In most US states, it is required that a contractor provides a bond issued by an insurance company, guaranteeing to the project owner the completion of the construction, as per the contractual obligations.

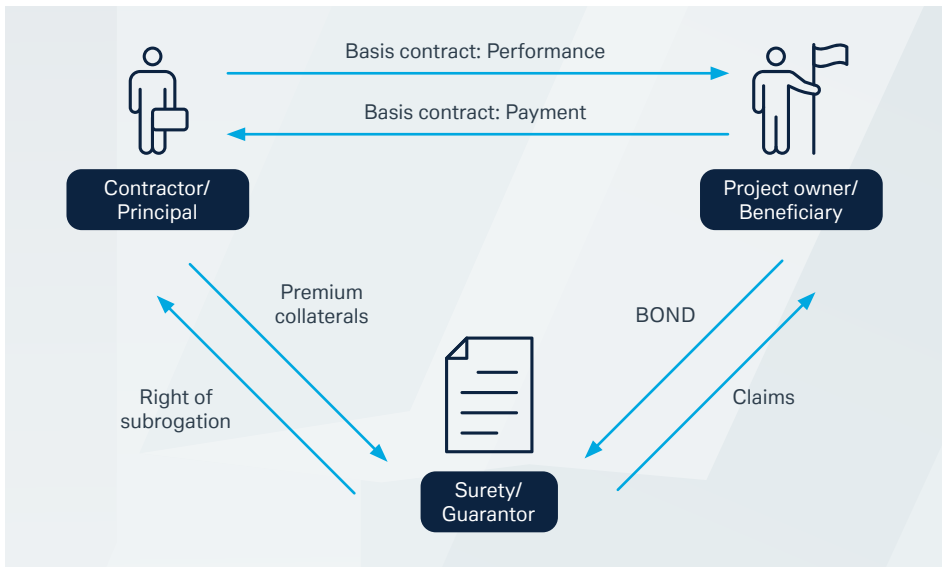
Surety has grown steadily over the last ten years to reach close to EUR700bn exposure according to the statistics of ICISA (see Figure 1).

Figure 1: Surety – Increased exposure, ICISA members (excl. reinsurance members)



Suretyship is therefore the obligation under which one party (the insurance company) undertakes to another party (the beneficiary) to guarantee the debts, obligations, or conduct of a third party (the contractor), as shown in Figure 2.

Figure 2: Suretyship



Source: Swiss Re

One example of a typical transaction would therefore be the following:

- A construction company enters into a contract with a US state to build a new highway.
- The insurance company would guarantee that the construction company will complete the project on time and in accordance with the terms and conditions of the underlying contract.
- The surety bond provided by the insurer (= surety) guarantees the performance of contractual or legal obligations entered into by two other parties (contractor and beneficiary).

By doing so, the insurance company signals to the beneficiary that it is confident about the financial capacity and technical ability of the contractor to complete the project. In case of non-performance or default, it compensates the beneficiary for losses incurred. It is often a mandatory requirement for public construction projects or in connection with payments of tax or customs duties. Both the surety and the contractor/principal are liable under the surety bond. For instance, in case of loss, the surety is entitled to fully recover the amount paid from the contractor/principal.

In a suretyship, each party has specific obligations. The obligations of the principal are:

- **Performance** in accordance with the terms and conditions of the underlying contract;
- **Payment of the premium** for the bond;
- **To indemnify the surety** for any payments made under the bond or other costs incurred as a surety of the relevant project; and
- **To provide all relevant information** to the surety.

The owner/beneficiary is obliged to:

- **Perform** in accordance with the terms and conditions of the underlying contract, including payment to the contractor;
- **Inform the surety** of all major changes agreed upon in respect of the underlying agreement, progress of work, as well as arising problems; and
- **Discharge the surety** from its liabilities after completion of the contract.

Last but not least, the surety/guarantor has the following obligations:

- **To abstain from making any payments** under the bond if the contractor/principal has a **valid defence**; and
- **Professional claims handling** with prompt payments if the project owner/beneficiary has sustained a **loss**.

So, from what has been seen so far, the key elements of suretyship are:

- **Accessory instrument** – It is an accessory to an underlying obligation, namely the construction contract or the obligation to deliver under an advanced payment.
- **Joint and several liability** – In a traditional surety, both the surety and principal are liable.
- **Limited liability** – The surety's liability is limited to the bond amount.
- **Right of indemnification** – The surety is entitled by law to be refunded for any payments made under the bond by the defaulting principal/contractor.
- **Non-cancellable** – Unlike other insurance products, a bond cannot be cancelled until the underlying obligations have been fulfilled, not even for non-payment of premium.
- **Subrogation** – As soon as the surety steps in due to failure of the contractor, all obligations and rights of the contractor are automatically inherited by the surety.

6.2 Benefits of surety

By reducing the uncertainty of performance, a surety bond benefits the project owner. It also increases the likelihood of a project being completed as initially agreed, as the surety will step in, in case a contractor is not able to perform.

The surety company's expertise in pre-qualifying the principal assures the project owner that the contractor it hires has the financial and technical capacity to successfully complete the project. Much like a bank line, or line of credit, having sufficient surety capacity available enables the principal/contractor to bid for public projects. The pre-qualification process eliminates unqualified competition.



6.2.1 Different types of surety

Insurance companies distinguish between two types of surety: contract surety and commercial surety.

Contract surety are bonds that guarantee the performance of a specific contract. They are generally issued under construction and service/supply contracts. Bond types include:

- **Bid bond** – Guarantees that the contractor is pre-qualified to undertake the contract and provide a performance bond;
- **Advance payment bond** – Guarantees proper use of advance payments made to the contractor;
- **Performance/completion bond** – Guarantees performance of the underlying contract;
- **Payment bond**– Guarantees the contractors' suppliers and subcontractors will be paid;
- **Supply bond** – Guarantees the performance of supply contracts;
- **Warranty/maintenance bond** – Guarantees the provision of workmanship and materials after the project is completed; and
- **Subdivision bond**– Specialised bond for homebuilders, which guarantees that civil infrastructure (streets, curbs, utilities) for housing tracts are completed.

“Besides the traditional credit or political risk insurance, there are other potential areas of cooperation between banks and insurers such as surety”

Silja Calac, Head of Private Risk Mobilization, GTB, Continental Europe, Banco Santander

Commercial surety comprises a broad spectrum of bonds written for a variety of industries, including:

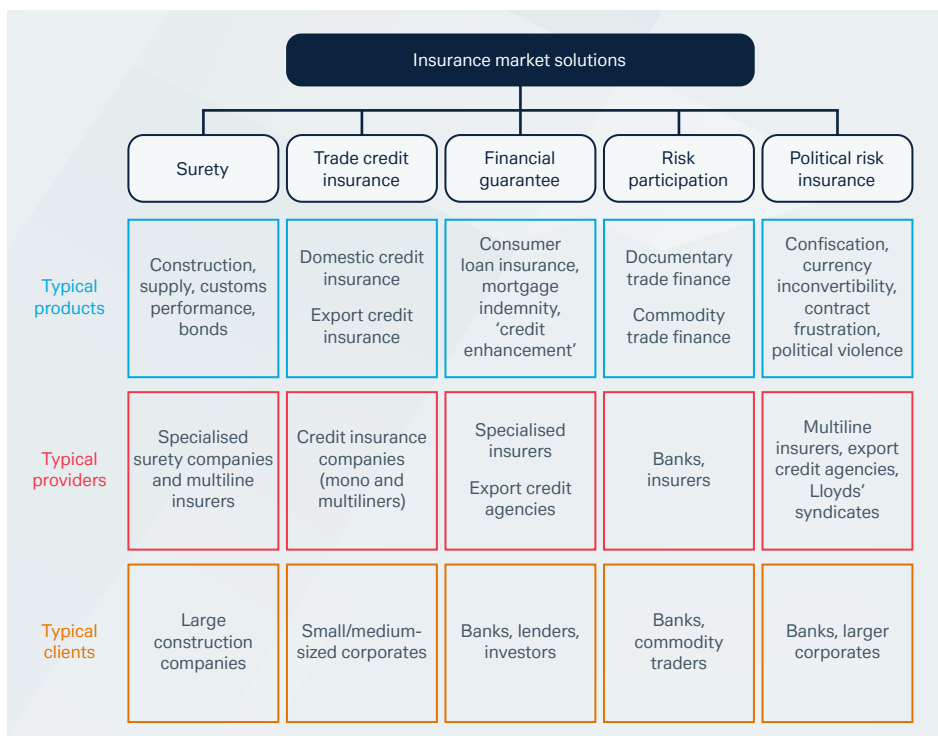
- **Licence and permit bonds** – Required to obtain licences/permits from governmental bodies;
- **Judicial bonds** – Bonds used in court systems, such as appeal bonds;
- **Fiduciary bond** – Guarantees faithful performance of court-appointed trustees;
- **Public official bond** – Guarantees faithful performance of public officials;
- **Customs and tax bonds** – Guarantees compliance and payment of tax or customs duties;
- **Reclamation/post-closure bond** – Guarantees that mines and landfills will be properly closed and the land restored at the end of their useful life; and
- **Miscellaneous bonds** – Bonds of this type include workers comp self-insurer bonds, lost instrument bonds, utility payment bonds, etc.

6.2.2 Underwriting surety – Analysis of credit risk

Unlike traditional insurance plans, such as life or property insurance, where the insurance companies evaluate the probability, frequency and severity of risk events, and where in case of a claim no recovery is possible, surety analyses the credit risk. Risk management here, is akin to what banks do when assessing risk.

Surety is not the only insurance activity involving credit risk. Figure 3 shows the main product offerings in this field.

Figure 3: Risk cover for credit risk



Source: Swiss Re

Therefore, when underwriting surety, insurance companies will proceed in a very similar way to banks when assessing credit. It is a risk selection process with a zero claims underwriting approach; insurance will not underwrite a surety where there is a true risk that the contractor will default. Thus the main aspects of risk analysis are:

- **Financial** – What is the credit worthiness of the principal?;
- **Transactional** – Does the project make sense/is the tenor adapted?; and
- **Security** – What indemnity/collateral is available to protect the surety?

In particular situations, insurance companies will be very careful before signing a surety, such as if the bonds are issued for principals who do not carry out the work themselves or if they cover risks beyond the control of the principal. Further, insurance companies are normally reluctant to write bonds guaranteeing pure financial obligations (financial guarantees) as this is too close to being a funding substitute.



6.3 Regulatory background for insurance companies underwriting surety

As per the Solvency II rules,¹⁹ insurance companies are licensed to provide risk cover for different products. These are listed in the regulations and transposed into national law. Thus, an insurance company needs to obtain a licence in the country in which it operates, for the insurance products that it wants to offer. The exact implementation into national law vary in detail, but mostly these classes of insurance product are maintained. Here are a few examples of where to find rules related to suretyship:

- EU regulation: Directive 2009/138/EC of the European Parliament and of the Council of 25.11.2009: Groups of non-life insurance classes for the purposes of Article 159 “Class 14 – Credit insurance and Class 15 – suretyship”.
- UK regulation: Article 15 of the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001 (RAO)/Article 15(2): “Suretyship” = “fidelity bonds, performance bonds, administration bonds, bail bonds or similar contracts of guarantee” which conform to certain requirements (effected by a person not carrying on a banking business).
- Other European law: Luxembourg law of 7 December 2015 on the insurance sector, Article 49.

Implementation therefore allows insurance companies to issue many different types of guarantee.

As per the above regulation and legislation, it is important to remember that suretyship contracts are not insurance contracts but fall within the definition of “insurance activities”.

6.4 Surety for banks

Following the 2008–09 financial crisis, regulators have become even tougher with regard to banks’ risk management, mainly through the introduction of strict requirements for banks to get a better grip on their use of capital (Basel III/CRD IV). New regulatory requirements have obliged banks to allocate more risk-weighted assets at higher costs for each transaction.

6.4.1 Capital relief

Historically, banks would have come to insurance companies to get rid of country or credit risks that they could not accommodate. With these new regulatory requirements, this has changed slightly, to using insurance to get capital relief. It is the perfect arrangement. Banks have the origination network, proximity to the transaction parties and liquidity, while insurance companies provide the balance sheet to accommodate the growing needs for capital and the expertise to deal with risk. As a result, cooperation between banks and insurance companies in the field of credit risk insurance has been growing continuously.

Surety is especially adapted to such cooperation, as surety providers are already accustomed to issuing cover under policies with wording very close to that of bank guarantees.

Additionally, while traditional surety often has a certain conditionality (the insurer would not pay if the principal has a valid objection and the insurer would subrogate itself to the contractor in case of a claim), this is not the case when providing insurance cover to banks. The participation agreements used here are on demand guarantees. Thus, surety cover for banks is mostly CRR compliant, therefore saving up to 80% of capital usage.

6.4.2 Which bonds can be covered?

All of the contract and commercial surety bonds mentioned above in 6.2.1, can be covered when banks issue them. This also includes the issuance of respective standby letters of credit.

6.4.3 A win-win situation

Cooperation in surety is beneficial for both parties. Banks can resolve credit limit and capital constraints. This means that capacities can be used for better priced business, instead of blocking lines with low priced guarantee/bond facilities. Thanks to insurance cover, banks can get access to positions such as key banker or lead arranger. The insurer allows banks to achieve their customer's capacity requirements and improve their relationship with their customers. Banks can thus win market share, improve strategic positioning, or even get access to new customer segments/markets.



This type of risk mitigation is often confidential/silent. The insurer is not a competitor of the bank, but a partner, as insurance companies cannot handle the cash and clearing needs of corporate customers. Using insurance cover allows the bank to diversify its distribution channels, for a more cost-efficient portfolio management. The credit capacity of insurers is not as correlated to that of a bank, particularly when compared to other secondary market players. Last but not least, the insurance cover improves the KPIs of the bank's retained share, thanks to commission on the covered part.

For the insurance company as well, cooperation with the bank is beneficial, in that it provides access to markets and products otherwise out of reach for an insurer. The insurer can rely on the product know-how and market access of its partner banks, and it can leverage on its existing product know-how and credit capacities.

6.4.4 Documentation

MRPA

The documentation is quite straightforward. The bank and the insurer will normally sign a bilateral framework agreement (the Master Risk Participation Agreement or MRPA) at the beginning of the business relationship.¹⁴ The MRPA defines the general terms and conditions which apply to all single transactions which will be concluded between the two parties (e.g. process of issuing guarantees, conditions for claiming, representations and warranties, applicable law in case of dispute, etc.).

For each single transaction, a short document (two to three pages) specifying the details of each individual transaction, including the amounts, tenors, pricing, etc. will be signed.

The bank will normally provide copies of the underlying documentation to the insurer, such as the bond facility or the credit agreement signed by the principal.

The ITFA surety MRPA

Due to regulatory requirements (the need for confirmation of legal efficiency of any security by an independent legal advisor as per CRR) and also in order to facilitate negotiation of participation documentation, members approached ITFA with the need to create a standardised MRPA for surety for banks. An ITFA working group of banks, surety underwriters and brokers, drafted this document on the basis of the BAFT MRPA. ITFA launched the Unfunded ITFA MRPA during its 2019 Annual Conference.

This document is designed to be a market standard document. It is aimed at market players who intend to do unfunded risk participations only, such as insurance companies. Just like the BAFT MRPA, it is a reciprocal agreement signed between two master parties which can have affiliates join the MRPA. However, having been adapted to accommodate the cooperation between surety insurers and banks the following points have been adapted:

- It can only be used for unfunded participation (although the underlying transaction can be funded, such as a receivables financing).
- The Unfunded ITFA MRPA provides for participation in facilities such as guarantee facilities, under which the participant takes an automatic share in all single instruments issued under such a facility during a specific time period.
- It allows for participation in the income interest.

ITFA members will be able to find a word version of the Unfunded ITFA MRPA in the insurance section of the membership area of the ITFA website, along with Guidelines for the use of the MRPA and a CRR compliance Legal Opinion.¹⁵

6.5 Example of surety in action

A guarantee facility of EUR1bn is granted to a construction company to issue bonds for their general business needs to various beneficiaries. The details of the transaction are as follows:

- Principal (applicant): Construction Company Bauhaus
- Rating: BB+
- Total facility amount: EUR1bn
- Type of bonds: 40% performance bonds, 30% bid bonds, 30% other
- Average utilisation: 85% (i.e. approximately EUR1.7bn)
- Bank's part: EUR200m
- Max tenor: 30.6.2019
- Margin: 250bps
- Commitment fee: 40 bps
- Bank's commission: 20%

The bank only has credit lines available for EUR100m, but in order to obtain a lead arranger position, it will obtain a 50% risk cover from the insurer, in order to bid for a EUR200m part in the syndicate.

Bank revenues per annum:

- Bank's part: $(\text{EUR}85\text{m} \times 250\text{bps}) + (\text{EUR} 15\text{m} \times 40 \text{bps}) = \text{EUR}935,000$
- Insured part: $(\text{EUR} 85\text{m} \times 250\text{bps} \times 20\%) + (\text{EUR} 15 \text{m} \times 40 \text{bps} \times 20\%) = \text{EUR}187,000$
- Total revenue: **EUR1.122m**
- RWA: EUR100m on BB+ at 250bps and EUR100m on AA- at 50bps

7A

Trade receivables securitisations: Background to trade receivables securitisation

By Adrian Katz, President, Finacity Corporation

7A.1 Investible assets

Securitisation of various cash flow assets began in the 1980s. Trade receivables, while not the first asset class to be securitised, date back approximately 30 years. Trade receivables securitisations allow companies to raise capital by selling, on a revolving basis, a selection of receivables to a legally separate, bankruptcy-remote special purpose entity (SPE). The SPE, with the conveyance of the acquired receivables, can issue collateralised notes with the issuance proceeds flowing back to the original selling company. While comprehensive data as to the existing size of the trade receivables securitisation market is not available (much of the funding is done through individualised private transactions), existing outstanding securitisations amount to approximately USD80–100bn. Trade receivables from most industries and numerous geographies can be considered eligible for inclusion.

Transaction sizes generally range from USD50m to more than USD1bn. Larger transactions are often funded with multiple funding sources, a trend that accelerated after the Global Financial Crisis of 2008–9. While most transactions are funded in US dollars, depending on the pertinent invoicing countries and currencies, liabilities can also be denominated in euros, sterling, Mexican pesos or other currencies. Transactions can incorporate receivables originating from multiple countries and can involve both in-country and cross-border receivables. Sellers/issuers and/or obligors can be unrated or below investment grade, and yet as a consequence of the structuring process, the resulting securitisations can achieve investment grade ratings, thereby providing a positive credit arbitrage to the seller of the receivables.

“In most cases, trade receivables securitisations are structured pursuant to at least investment-grade rating agency criteria”

Adrian Katz, President, Finacity Corporation

7A.2 Issuers/sellers

Public companies with disclosed trade receivables securitisations include companies as diverse as Archer-Daniels-Midland, Kongsberg Automotive, Public Power Corp, Cushman & Wakefield, Navistar, Delta Air Lines, CEMEX and Bunge, among others. Numerous private companies have been issuers, such as Trafigura, Ineos, Styrolution and Green Network.

Securitisations can make sense in a variety of circumstances for issuers with the following primary drivers:

1. All-in-cost minimisation;
2. Proceeds maximisation;
3. Accounting sale treatment;
4. Risk mitigation; and
5. Funding diversification.

While securitisations are designed to separate the risks of the seller as much as possible from the performance of the receivables, it is typical for the issuers/sellers to continue to service the receivables. As such, funding availability and pricing is somewhat correlated to the credit quality of the issuer/seller. Increasingly, transactions on behalf of weaker credit issuers/sellers are incorporating the requirement for a back-up servicer to ameliorate any potential servicer risk.

7A.3 Investors/financers

Securitisations can represent compelling assets for investors/financers for the following reasons:

1. The asset class typically performs very well with low loss experience (as demonstrated across numerous economic cycles, including the Global Financial Crisis);
2. Typical structural features allow for constant readjustment of reserve levels based on on-going monthly and even daily portfolio performance. Such dynamic protection has proven effective over a variety of economic environments;
3. Available yields relative to comparable risks are often attractive. This is especially compelling given the typically short duration of trade receivables;
4. For financers motivated to serve weaker credit customers, trade receivables securitisations can represent a more secure way of extending credit. These facilities help separate the credit risk of the seller/issuer from the securitisations. If structured properly, historical performance shows that a funding source should recover all of its investment, even in the event of a bankruptcy of the seller/issuer; and
5. For regulated institutions, the usually high implied or explicit credit ratings can result in the allocation of less regulatory capital than equivalent sized loans.

7A.4 Banks

In most cases, trade receivables securitisations are structured pursuant to at least investment-grade rating agency criteria ('A' rating criteria is probably the most commonly applied). Funding is typically provided by bank-sponsored commercial paper conduits, bank balance sheets, or traditional capital markets investors (e.g. pension funds, insurance companies, and fixed income asset managers).

7A.4.1 ABCP conduits

Bank-sponsored commercial paper conduits mostly finance their activities through the issuance of asset-backed commercial paper (ABCP). In most cases, the bank sponsor provides credit and liquidity enhancement through a letter of credit (LC). While LCs are rarely invoked, the Global Financial Crisis proved to be a sufficiently adverse economic environment that ABCP investors were well served through the explicit credit protection of LCs. ABCP conduits are usually rated issuing vehicles and as such must pay attention to rating agency criteria when trade receivables securitisations are structured and added to their asset pool.

While an explicit rating is not necessarily required for each incremental securitisation, a re-affirmation from rating agencies of the conduit's rating is usually necessary. It is estimated that trade receivables securitisations represent more than 20% of the assets funded by ABCP conduits. Trade receivables are usually a desired asset class for ABCP conduits due to the inherently short duration of the assets and the past strong historic performance of these assets, especially when compared with consumer assets that severely underperformed during the Great Recession of 2007–09.

7A.4.2 Balance sheet

In recent years, several banks that used to sponsor ABCP conduits have unwound such vehicles and instead fund trade receivables securitisations on their balance sheets. Even some banks that sponsor ABCP conduits sometimes choose to use their balance sheets for certain types of transactions. To the extent that a bank is utilising its balance sheet, it may adhere to typical rating criteria, but it also has more latitude to apply its own in-house credit disciplines and flexibilities.

6789	234	5678	890	2345	67	899	115	1155
335	355	886	908	234	6789	2678	978	457
550	623	8960	-588	62	6522	655	789	234
5	545	5511	552	3759	3648	489	688	188
	321	4598	564	5552	851	54	926	678
	9023	8734	789	654	321	351	233	1558
	322	1112	322	283	472	5692	3134	356
	355	886	652	322	1115	3225	852	2596
	45	3311	332	62	6522	655	2225	322
	63	6361	3113	3313	851	58	688	188
	6368	666	666	3131	332	255	1888	888

An example of a typical variance might be with respect to how excess obligor concentrations are facilitated. Bank balance sheet funded deals are capable of providing greater accommodation of large obligor concentrations, depending on a bank's credit analysis of a specific obligor risk. An important difference between ABCP conduit financing and bank balance sheet financing is the funding index. Commercial paper (CP) is the benchmark for ABCP conduits and typically LIBOR has been used for bank balance sheet facilities, although this is changing as banks transition to risk-free rates in the run-up to the phasing out of LIBOR.¹⁶ ABCP rates have generally tracked LIBOR fairly closely, except during the Global Financial Crisis when CP rates spiked above LIBOR. However, it subsequently came to light that LIBOR was manipulated during this period; therefore, barring any future manipulation, ABCP and risk-free rates should track closely to one another.

7A.5 Capital markets investors

In emerging markets, due to less developed bank credit offerings and an absence of ABCP conduits, most trade receivables securitisations are funded in the capital markets. Some capital markets issuances of trade receivables securitisations have been successfully undertaken in the developed markets, but these are relatively infrequent. Given the overall regulatory capital pressures on banks, an increase in capital markets issuances is likely to ensue. This would serve to attract new sources of capital to the sector and reduce pressure on banks to serve as the primary source of trade financing.

Capital markets structures differ from bank or ABCP conduit facilities. Typically, capital markets investors cannot accommodate variable funding amounts, and therefore these deals usually involve a fixed size issuance amount that remains outstanding at a constant level during the revolving period. Bank balance sheet and ABCP conduit deals usually have a maximum commitment size but provide the seller/issuer flexibility to increase or decrease the finance amount over time. The concept of a utilised interest spread and an unused fee are common in such deals, whereas the capital markets placements usually only have a utilised interest spread. Another difference pertains to tenor. The typical capital markets trade receivables securitisations have longer terms, up to five years, whereas most bank financed facilities involve some type of annual renewal.

7A.6 Risk mitigation

While trade receivables, as an asset class generally perform well under various scenarios, impairments due to a variety of operational and credit characteristics are inherent. The reason why trade receivables securitisations can achieve higher ratings than the sellers/issuers and/or obligors is that the typical structures involve credit enhancements.

7A.6.1 Reserves

The most common type of credit enhancement is in the form of over-collateralisation, through the set aside of appropriate structural reserves. The typical reserve maths is somewhat complicated, but the primary components are based on the characteristics of trade receivables and follow a logical methodology.

7A.6.2 Loss

In a diverse portfolio of obligors, it is likely that some will experience credit stress and slow payment, or even failure to pay due to obligor default. Based on receivables ageing history, tracked and updated monthly, typical structures involve a reserve calculation to accommodate for the adverse consequences of slow pay or no pay receivables. As a simplified example of what is often applied, Standard & Poor's (S&P) 'A' rated criteria would suggest a reserve for credit losses of double the recent peak moving average loss experience (defined as a certain ageing window, e.g. 91–120 days past due plus actual insolvencies).

7A.6.3 Dilution

Dilution occurs when receivables are impaired for reasons other than an obligor's ability to pay. Some common causes of dilution include product defects, erroneous billing, commercial disagreements and volume discounts. While dilution impairments are typically addressed through recourse to the seller, investors/lenders need to be appropriately protected from any unanticipated dilution impairments and a dilution reserve is typically incorporated into the transactions. To simplify and provide an example, S&P 'A' rated criteria would typically suggest a reserve for dilution of somewhat more than double the recent peak moving average dilution experience.

7A.6.4 Yield/fee

Another reason to set aside a reserve is that trade receivables are not interest earning assets (any stated interest charge is generally viewed merely as a collection device), whereas securitisations involve interest paying liabilities. To accommodate the time value of money, trade receivables are essentially purchased at a discount (much like a US treasury bill is discounted) and the discount is intended to cover whatever yield and fees are payable in the securitisation. Relative to the credit loss and dilution reserves, especially in a low interest rate environment, the yield and fee reserves are generally quite small.

7A.6.5 Concentration risk

In order for trade receivables securitisations to benefit from obligor diversification, it is necessary to track and limit certain obligor concentration risks. Depending on the credit quality of each obligor, concentration limits will apply to a lesser or greater extent. For an S&P 'A' rated structure, it is common for there to be a minimum reserve level, equal to at least four times the obligor concentration limit for obligors that are either unrated or rated below investment grade.

7A.6.6 Trade credit insurance

Depending on the specific objectives of a seller/issuer and the potential requirements of a financier/investor, the incorporation of trade credit insurance might prove advantageous to a trade receivables securitisation structure. See *Chapter 4: The role of credit insurance in receivables financing*. Here are some of the most common motivating circumstances:

1. Involve transactions in which there are high obligor concentrations which would result in significant excess concentrations without the enhancement delivered through trade credit insurance;
2. Involve transactions in which country risks are considered an impediment (e.g. if the obligors are located in countries that are not investment grade); and
3. If a seller/issuer is trying to achieve the level of risk transfer necessary for IFRS de-recognition.

“The incorporation of trade credit insurance might prove advantageous to a trade receivables securitisation”

Adrian Katz, President, Finacity Corporation

Insurance constructs can vary from more traditional co-insurance (i.e. *pari passu*), to senior/subordinated arrangements with large deductibles, to 100% insured with small deductibles, depending on the motivations and constraints of either the seller/issuer and/or investor/financer.

7A.6.7 Representations and warranties

While trade receivables securitisations are intentionally structured so as to have no credit recourse back to the seller, the seller is usually required to make representations and warranties with respect to the receivables being sold. The primary risks addressed by such representations and warranties pertain to fraud, misrepresentation and dilution. While reserves are set aside to cover dilution risk, the seller is expected to cure any dilution event as it arises.

7A.6.8 Monitoring and reporting

Since trade receivables are typically short duration assets with many nuanced and rapidly changing performance attributes, the timely administration and reporting of these assets to investors/financers is critical to a successful trade receivables securitisation. Many would argue that the Global Financial Crisis was in no small part precipitated by a lack of transparency for investors/financers in securitisations. As a consequence, in recent years there have been increasing requirements for detailed reporting (often as frequent as daily). Such reports would generally track the receipts of cash from previously purchased receivables, provide details of the new receivables for conveyance, apply eligibility criteria and concentration limits, calculate appropriate reserves, adjust for currency risks as applicable, provide remittance instructions, etc. Monitoring and reporting by an appropriately experienced third-party can strengthen investor/financer confidence.

7A.7 Legal and regulatory

7A.7.1 Legal

Since securitisations are predicated on a first-step conveyance of the assets from the originator, usually to a bankruptcy-remote SPE, it is crucial that a so-called true sale opinion of counsel be provided. The second step usually involves some type of sale or issuance from the SPE to a funding source. A key element of a successful trade receivables securitisation is the separation of the receivables from the seller such that, in the event of a bankruptcy of the seller, the receivables are not somehow clawed back into the bankruptcy proceedings. A funding source does not want to become a creditor, but would rather simply be the beneficiary of an orderly self-liquidation of the funding facility, with repayment resulting from the trade receivables cash flows.

7A.7.2 Accounting

Accounting treatment of trade receivables securitisations varies by applicable accounting regime, and the choice of structural features incorporated, to facilitate a desired financial statement impact.

7A.7.3 GAAP

In the US, transactions are usually subject to GAAP. The primarily applicable accounting pronouncement is FASB Accounting Standards Codification Topic 860. To the extent that a company would like to achieve GAAP sale treatment, it is necessary for the trade receivables to be sold in both the first step (conveyance from the seller to the SPE) and second step (conveyance from the SPE to the funding source) to comply with the change of control requirements. Such structures typically involve payment consideration in the form of cash payments up front and deferred cash payments. The source of deferred cash payments is solely dependent on the collateral. Application of ASU 2016–15, starting in 2018, introduced a generally unwelcome complication for companies with existing off-balance sheet securitisations via the deferred cash payment structure. Per ASU 2016–15, the deferred cash payments, resulting from the retained subordinate interest, are required to be reported as cash flow from investments, not operating cash flow.

Alternative structures to avoid ASU 2016–15 have emerged. While GAAP does permit the seller to continue to service the trade receivables, the seller is not permitted any other control or involvement in the assets. In the absence of intentioned steps to achieve GAAP sale treatment, the typical default accounting treatment is for the trade receivables to remain on balance sheet. It is important for a seller to involve its auditors throughout the structuring and documentation process, to make sure that the desired accounting treatment is achieved.

7A.7.4 IFRS

In most countries other than the US, IFRS has increasingly become the applied accounting regime. It is generally considered more difficult to achieve off-balance-sheet treatment (de-recognition) under IFRS. The primary accounting rules that apply are IFRS 9 (de-recognition)¹⁷ and IFRS 10 (de-consolidation).¹⁸ The pertinent minimum threshold for achieving IFRS de-recognition is for the seller entering into a securitisation structure to not substantially retain the volatility of risk and to forfeit control. There is no clear definition of what constitutes ‘substantial’, nor is there clarity on the frequency of reassessment of the extent of risk transfer. Modelling algorithms have been developed and multi-tranche structures have been successfully implemented that have achieved IFRS de-recognition. Broadly, structures may involve the sale of a second loss tranche and/or trade credit insurance, to address the requirement to substantially transfer the volatility of risk. In the absence of intentioned structuring, trade receivables securitisations would be considered on balance sheet under IFRS. For off-balance-sheet treatment, it is critical for a seller to involve its auditors throughout the process to confirm that a structure complies with IFRS requirements.



7A.8 Features of a typical transaction

Most trade receivables securitisations are executed privately with very little disclosure. Private funding is primarily provided by banks utilising their balance sheet or bank sponsored ABCP conduit vehicles.

Current variable rate spreads can be generally categorised as follows: investment grade sellers 50–100 basis points (bps), BB rated sellers 100–125bps, B rated sellers 125–200bps, very weak sellers 200+ bps. There is usually a non-usage fee applied to the difference between the maximum committed amount and the actual drawn amount, in the range of 25–100bps. Funding in these structures can be in one or more currencies, primarily USD, EUR and GBP. Multiple affiliated entities from multiple jurisdictions can convey trade receivables to collateralize a single securitisation issuance, providing scale and efficiency. Tenors are usually committed for one to three years. Most facilities are repeatedly renewed with many securitisations outstanding for more than a decade, proving to be reliable multiyear sources of liquidity for companies.

Public term issuances are infrequent and mostly associated with emerging market countries. For example, Mexico is a market where many deals are publicly registered with local capital markets regulator the Comisión Nacional Bancaria y de Valores (CNBV) with investors ranging from large pension funds to small retail investors. These trade receivables securitisations generally involve longer tenors (three to five years) and fixed-sized funding amounts. Amortisation is typically achieved via a soft-bullet structure, with the funded amount declining, sometimes per a defined schedule, over a short time window (e.g. six months).

7A.9 Market outlook

The market for trade receivables securitisations is expected to continue to develop and expand to include more companies worldwide. For sellers/ issuers, trade receivables securitisations will likely continue to offer a cost-efficient way to maximise proceeds, improve working capital, and diversify funding alternatives. For investors/financers, trade receivables securitisations are likely to continue to provide a compelling risk/reward opportunity for deploying funds.

7B

Trade receivables securitisations: Trade finance synthetic securitisation

*By Jonathan Lonsdale, Head of Trade & Working
Capital Solutions, Private Debt Mobilization,
Santander Corporate & Investment Banking*

After a decade of intense regulatory change and greater controls, synthetic collateralised loan obligations (CLOs), when used to transfer risk from bank lending portfolios to non-bank investors, have become something of a sought-after asset class.

So called 'significant risk transfer' (SRT) or 'capital relief' transactions have become a growing asset class, and while exact amounts of issuance are difficult to track, annual issuance is thought to be least USD5bn of first loss and mezzanine paper issued, likely referencing some USD50bn of underlying assets (Source: Structured Credit Investor deal database.)

In this changing paradigm, Basel reforms and the Capital Requirements Directive IV (CRD IV) have made trade finance increasingly expensive from a regulatory capital perspective, despite representations made by the industry that the asset class should not be treated the same as riskier asset classes. This has prompted banks to turn to securitisation as a way to obtain balance sheet and capital relief, and trade finance has naturally emerged as an asset class for which there is healthy demand from investors in securitised format.



7B.1 Niche market

This market has a limited number of players, but on the synthetic side there have been several repeat issuers, including Deutsche Bank and Standard Chartered, as well as other one-off issuers, typically placing risk on a private, bilateral basis. The market is currently still fairly niche in comparison to the wider SRT CLO market, largely because the barriers to entry are high, resulting from the need to set up the ongoing management of the CLO in a robust and efficient way.

There are several aspects to this. One is the difficulty of getting buy-in across the firm, as those responsible for trade finance are often in a separate division to those responsible for securitisation, and often 'speak different languages' with different terminologies and expectations. Another is that the short term nature of trade finance assets means that setting up the appropriate technological infrastructure to manage the replenishment of transactions and the amount of data processing involved, can require substantial investment.

Nevertheless, deals have been done referencing up to USD3.5bn of diversified trade finance assets, and demand appears to be strong for these transactions.

7B.2 Issuer benefits and investor appetite

The benefits for the issuer are twofold – regulatory capital relief and credit risk hedging. The Basel framework and the resulting implementations in law set out in quite some detail how the capital relief for a synthetic securitisation is calculated. Changes to the Basel framework that came into force in January 2019 have reduced the efficiency of synthetic securitisation as a tool for capital relief alone, though given the record issuance levels in 2019, there appears to be sufficient supply, indicating that this is still an economic and necessary tool for banks' management of their capital position.

Furthermore, the ability to lock in pricing for an extended period allows for certainty of execution when originating the underlying trade finance deals with a sell-down requirement. Although there are the aforementioned barriers and costs in terms of setting up the programme and necessary infrastructure to run the programme, once set up, the programme can reduce ongoing workload in terms of the operational aspects of de-risking each small asset that a bank originates. Finally, the scalable nature of this type of de-risking, with several billions of dollars being able to be executed and therefore hedged in each issuance, allows for efficient and rapid scaling up of the issuer's hedging abilities.

The other part of the economics of any transaction is the pricing achieved with investors. This varies quite considerably depending on the risk profile of the underlying portfolio, but it is generally accepted that paper prices at a lower yield than in other asset classes. There are three main reasons advanced to explain this:

- First, the portfolios themselves are considered to be a lower risk than other asset classes, due to the lower risks inherent in trade finance when compared with normal corporate lending. This stems from the self-liquidating nature of trade finance debt, as well as the strong incentives that companies have to prioritise repayments of trade debt, even when times are tight – as the immediate penalty of not doing so is the restriction of the ability to continue trading.
- Second, due to the scarcity of trade finance synthetic SRT deals, competition to access paper can drive down pricing.
- Third, it is generally felt that the asset class provides uncorrelated returns when compared with other asset classes, making it a good portfolio diversifier.

7B.3 Forerunners

The impetus behind creating these pioneering transactions really started just after the 2008 credit crisis and resulted in true-sale deals such as BNP Paribas' Lighthouse issue 1 and the Citi/Santander venture, Trade MAPS 2013–1. Standard Chartered's synthetic Sealane also hit the market around this time. Deutsche Bank issued two synthetic deals, TRAFIN 2011–1 and 2012–1, then after a break issued the record-sized TRAFIN 2015–1, which at USD3.5bn was the largest deal to date, which was then refinanced in 2018 via TRAFIN 2018–1.

Given the lack of publicly marketed follow-up transactions to the true sale transactions mentioned above, it appears that the synthetic route has been preferred, perhaps as a result of its volatility and the simplicity afforded by the fact that fewer steps are involved and the assets do not need to be transferred.

7B.4 Structural features and considerations

A number of different structures are used to create the synthetic CLO. One popular structure that was used historically and is still employed by some banks is, as explained in *Chapter 7A*, to create a bankruptcy remote Special Purpose Vehicle (SPV) otherwise known as a Special Purpose Entity (SPE), which issues notes to investors, investing the proceeds of issuance into low risk eligible collateral, for example government bonds. The SPV then enters into a financial guarantee or credit default swap transaction with the issuing bank. This has the advantage of disintermediating the counterparty risks of both the issuing bank and the investors, but has the downsides of requiring the set up and administration of SPVs, as well as a somewhat inefficient use of investors' proceeds in eras of record low government yields.

“Given the lack of publicly marketed follow up transactions to true sale transactions, it appears that the synthetic route has been the one preferred”

Jonathan Lonsdale, Head of Trade & Working Capital Solutions,
Private Debt Mobilization, Santander Corporate & Investment Banking

Another possible structure is a direct issuance of a credit linked note (CLN) from the issuing banks' balance sheet. This is efficient for those banks who already have an established CLN issuance platform, as well as offering a pricing advantage in that the proceeds of the issuance can generally be used for general corporate purposes for the issuing bank. The flip side of this is that for investors they are reliant on the solvency of the issuing bank for repayment. For many investors however, this is not a difficult risk to assess and manage, given that they are in the business of assessing bank portfolios in any case. There is the possibility of hedging this risk via the CDS market (though this reduces the pricing advantage of this form of issuance), or with innovative structural features that can be embedded into the transaction.

Other structures remain possible, including true sale or pure guarantee structures.

7B.5 An efficient hedging tool

While there has been limited public issuance of trade finance backed SRT transactions, it is fair to say that what issuance there has been, has been successful for both issuers and investors, as evidenced by the repeat issuance by the larger issuers. There are barriers to entry for new banks wishing to use this technology to hedge their trade finance exposure, which partially explains the relative limited issuance of these deals. However, due to pricing advantages with investors, relating to the scarcity of issuance and perceived low riskiness of the portfolios, and despite regulatory headwinds, this remains an efficient and useful tool for hedging trade finance assets.

8

Cross-border supply chain finance

By Christian Hausherr, Chair of the Global Supply Chain Finance Forum and Product Manager Supply Chain Finance EMEA at Deutsche Bank

In today's trade finance marketplace, there are few topics that raise greater interest among practitioners than supply chain finance. However, this ubiquitous term has been used in so many different ways to describe so many different things, that before we can explain what supply chain finance is, why it is becoming an increasingly important subset of trade finance, and how it works, there needs to be a definition that will help provide the proper context for the rest of this chapter.

8.1 Supply chain finance

Supply chain finance is a term typically used to define a broad range of financial products, structures, or solutions used to help practitioners (buyers and sellers) monetise the capital that is tied up in the various links of the physical supply chain, on a transactional basis.

The GSCFF Standard Definitions for Techniques of Supply Chain Finance define SCF as 'the use of financing and risk mitigation practices and techniques to optimise the management of the working capital and liquidity invested in supply chain processes and transactions. SCF is typically applied to open account trade and is triggered by supply chain events. Visibility of underlying trade flows by the finance provider(s) is a necessary component of such financing arrangements which can be enabled by a technology platform.'¹⁹

Within the category of supply chain finance can be found a wide array of specific products and solutions such as inventory finance and receivables finance, many of which have additional sub products such as payables finance.

While this seems simple enough, when one considers that one party's payable is another party's receivable, or that a confirmed payable is a subset of receivable finance solutions, it is easy to see how less experienced practitioners can become confused by names that have historically been used inconsistently or interchangeably, and as a result have made it difficult for them to understand what approach to monetising their supply chain would be the most appropriate given their specific circumstances and concerns. This recognition has driven the leading industry associations ICC, BAFT, FCI, ITFA and the European Banking Association to join forces under the name of Global Supply Chain Finance Forum (GSCFF)²⁰ to publish a set of common terms, definitions, and best practices to facilitate and expand the use of supply chain finance solutions.

The Standard Definitions for Techniques for Supply Chain Finance were published in 2016, aiming to establish a more standardised approach and to ensure a more consistent understanding by the regulatory authorities as well as by the capital markets and other institutional investors who see trade finance and supply chain finance as interesting areas into which they could deploy their investment capital. Within the supply chain finance range of products, the one that seems to be creating the greatest demand and attracting the most interest from regulators, investors, and practitioners is payables finance, the 'buyer centric' variant of the receivables finance set of products.

In a traditional receivables finance structure, the financier would normally engage exclusively with the seller, that is, the party who provided the goods or services from which a receivable is created, to monetise the receivable. In receivables finance structures, the financier does not have any direct engagement with the buyer and, as a result, has no direct validation from the buyer that the receivable is recognised as valid obligation. Because the engagement is driven principally if not exclusively through the seller, these types of transactions are commonly referred to as 'seller centric' structures or solutions.

8.2 Payables finance

Conversely, payables finance, which is also commonly known as 'approved payables' or 'reverse factoring', is a 'buyer centric' structural model, where the buyer actually provides validation that an invoice submitted by a seller is accurate, effectively confirming their obligation to pay the seller for the underlying goods or services delivered.

8.2.1 Buyer centricity

With this validation in hand, the financier can then approach the seller and offer to purchase the specific 'confirmed' receivable, at a certain rate of discount and without recourse. Fundamental to the buyer centric approach is that the financier relies on the buyer to validate and recognise the obligation owed to the seller, before the discounting takes place. It is important to understand that under a payables finance structure, when the service provider purchases a receivable from the seller, they are in effect taking on the credit risk of the buyer, which is also a reason why a buyer can also be referred to as 'obligor' in this particular context. Given that availability of credit capacity can be a very scarce resource, it is very much in the best interest of the buyer to make sure that the capacity is carefully targeted to those sellers that are most strategic and in greatest need of some financial support. The service provider should be able to share a best practices approach to the seller targeting and segmentation and, in close collaboration with the buyer, establish an appropriate strategy to help optimise the allocation of credit capacity to best achieve the programme objectives.

Now that at high level there has been established a basic differentiation between the buyer-centric payables finance model and the seller-centric receivables finance models, we can provide more detail around how the payables finance structure really works and the value proposition for each of the participants.



8.2.2 Working capital optimisation

As discussed in *Chapter 1: An introduction to receivables finance*, there is consideration of the basics of working capital optimisation in the context of payables and receivables.

As a general rule, a buyer will want to defer paying for their purchases, thereby retaining their cash for as long as possible. The key metric by which most account payable departments are measured on is DPO (days payable outstanding), which establishes how effective an enterprise is in slowing down its outflow of cash, and one of the metrics used by financial analysts to benchmark how effective a company is at managing working capital compared to their peers. Accordingly, the market has been seeing more and more strong companies pushing their payment terms further and further out, to improve their financial position.

Conversely, sellers look to get paid as soon as possible, with DSO (days sales outstanding) being one of the key performance metrics that measures how quickly they convert a sale into cash. In an environment where liquidity was readily available and cheap, buyers had less resistance to extending terms because sellers could access readily available and relatively low cost liquidity. However, with the onset of the financial crisis, the liquidity that supported the working capital needs of many companies suddenly dried up, making it more difficult for buyers to extend their payment terms without subjecting their strategic suppliers to significant financial stress.

8.2.3 Securing supply chains

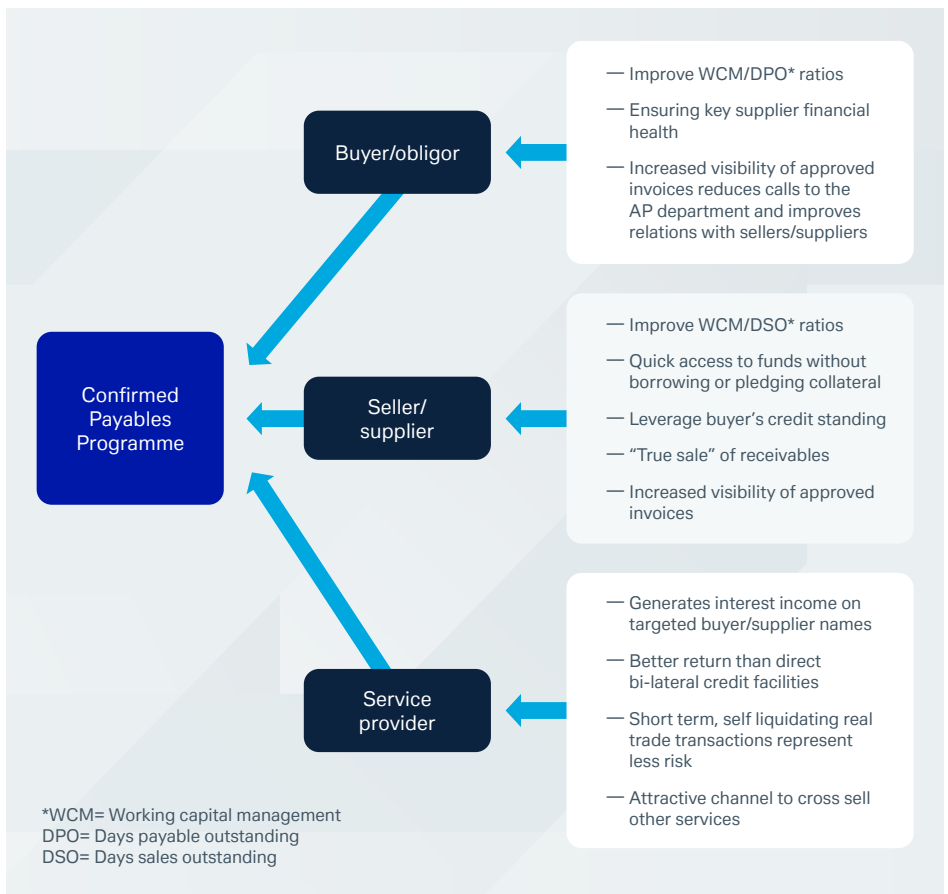
Payables finance was developed as a way for a strong buyer to make some of their credit capacity available to their key or strategic suppliers (in this article referred to as sellers), so that the buyer could meet their DPO targets, while providing competitively priced liquidity to their strategically important sellers, who discounted their receivables ahead of maturity to shorten their DSO.

Accordingly, if a buyer were to extend their payment terms from 60 days to 120 days, the seller would need to wait twice as long to get paid. If the seller is a smaller company, or is highly leveraged, the resultant impact on their working capital position could compromise their ability to deliver or even survive. With a payables finance solution in place, the seller could monetise the receivable as soon as it is approved by the buyer, without having to borrow or pledge collateral, by discounting it with the service provider almost immediately. In a fully automated environment, as soon as the buyer approves a specific invoice, the approved invoice data is transmitted electronically to the service provider, who then can notify the seller that the invoice is now eligible for discounting. The seller can then log into the service provider's system, and select the approved invoice for discounting immediately or at some other specific future date. In addition, many programmes offer an automatic or 'auto-discount' option, where the seller can opt to have the service provider automatically discount every approved invoice as soon as it is received from the buyer, assuming there is credit capacity available, automatically crediting the seller with the net discounted proceeds, without having to log into a system and select or request discounting. As a result, the seller who was getting paid in 60 days, but had his term extended to 120 days, may actually be able to substantially reduce their DSO. And, because the receivable is sold to the service provider without recourse, if the transaction is properly structured and documented, the seller can treat the transaction as a true sale, crediting cash and debiting accounts receivable with no impact on debt or leverage ratios. In this context, selecting a reputable service provider that can best explain the structural and documentary requirements as well as conducting a review with one's own tax and legal advisors is the best way to mitigate any reputational and financial risks that could result from a poorly structured or documented programme.

8.3 How does payables finance work?

Payables finance marries two separate and discrete relationships into a process flow that helps both the seller and the buyer meet their working capital objectives related to the physical supply chain. See Figure 4.

Figure 4: Summary of confirmed payables programme



Source: Deutsche Bank AG

It has already been established that Payables finance is a 'buyer centric' solution, meaning that the key element in making the solution work is the direct engagement with the buyer who establishes their obligation to pay a specific sum on a specific date for a specific invoice, by confirming the validity of the claim made by the seller through the invoice. In a traditional payables finance scenario, the service provider enters into an agreement to provide a specific service to the buyer.

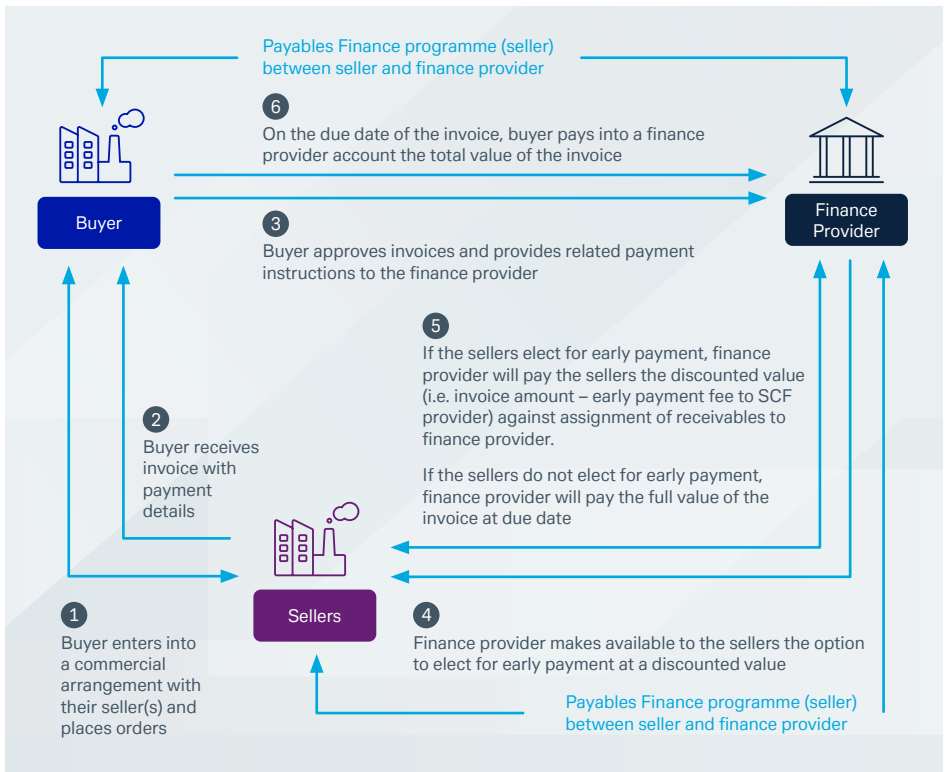
This service is usually rendered electronically, establishing the methodology through which the buyer will send payment instructions to the service provider, requiring that specific payments be made as directed. The data feed from the buyer to the service provider would normally include the specifics of the required payment, including the name of the beneficiary (seller), the account data, the amount, the currency, the due date, and the invoice reference number to tie the payment to a specific commercial transaction. There may be additional fields required depending on the circumstances, but these are generally the minimum required data points.

In the Payment Services Agreement, there is no mention of financing, lending, or the provision of credit, though the agreement would normally stipulate that by sending the specific payment instruction to service provider, the buyer represents that the underlying commercial transaction is legitimate, and that the funds are owed to the seller without protest. In the case where the service provider is a bank, the agreement will likely also contain a provision that allows the bank to directly debit the buyer's account on the due date and remit the funds to the seller on their behalf. This provision is key to the process, because it is this confirmation that allows the service provider to approach the seller, who is the beneficiary of the payment, and offer to purchase the receivable at a discount, without recourse, because they already know the obligation is valid.

The act of purchasing the receivable from the seller is governed by the second discrete relationship that takes place between the service provider and the seller. In this separate and discrete relationship, the governing document is a receivables purchase agreement that establishes the roles, responsibilities, and rights of the two contract parties. Specifically, this agreement spells out the specific terms under which the seller agrees to sell a receivable and the service provider agrees to purchase the receivable. It should be noted that in certain cases, the service provider acts as both the service provider and the financing party, although in others the respective roles can be performed by two separate and unrelated entities.

The purchase is normally concluded on a without recourse basis, and for a specific individual receivable or pool of receivables that have been 'confirmed' by the buyer. In this context, the transaction has many of the same attributes as a forfaiting transaction (see *Chapter 9: Forfaiting*) in that the one party sells to an investor a future dated claim with a specific future value in exchange for an immediate payment of the discounted or net present value, without recourse. While an obvious difference is that in one case there is the discounting of a future dated account receivable, and in a forfaiting transaction there is normally some form of negotiable instrument, the discounting methodology and maths are remarkably similar. The transaction flow of payables finance is illustrated in Figure 5.

Figure 5: The transaction flow of payables finance (GSCFF Standard Definitions for SCF)



8.4 How the mathematics works

8.4.1 Margin and cost of funds

The receivable being discounted will have a specific amount due on a specific future date, and the service provider will look to calculate the net present value of the receivable on the day it is purchased from the seller. There are three main components to determining the net present value or the discount value: they are the margin, the cost of funds (which when added together make up the discount rate), and the duration, which is the number of days from the discount date to the maturity date, the date the buyer has instructed the service provider to debit the buyer's account.

The margin is the premium the service provider needs to charge to cover the risk, opportunity cost, etc., associated with taking the credit exposure onto its portfolio. The important thing to remember in the payables finance transaction is that the margin is paid by the seller who is monetising the receivable, not the buyer who owes the money. Accordingly, establishing the right margin is of paramount importance to the service provider to ensure that the margin is attractive to the targeted sellers. If the margin is too high, fewer sellers will want to participate, making it harder for the buyer to use the structure as a way to facilitate terms extension. If the margin is too low, programme demand could outstrip available credit capacity, and might render the programme unprofitable for the service provider, which would not be sustainable. And while there are many programmes that have a single margin for all participating sellers, it should be noted that the more sophisticated service providers can establish tiered pricing to more accurately target specific sets of strategic sellers based on their alternative cost of borrowing. This maximises value for the service provider, while optimising the penetration of targeted, strategic sellers.

“Interest rates can be quite dynamic, so changes in rates on a daily basis can be quite common, and have a material impact on the discount rate”

Christian Hausherr, Chair of the Global Supply Chain Finance Forum and Product Manager Supply Chain Finance EMEA at Deutsche Bank



The cost of funds, as the name implies, is the base rate for access to funding. Interbank Offered Rates (IBOR) are the most commonly used cost of funds base rate as they are quoted daily for short tenors in all main currencies, and can easily be agreed (although IBOR is transitioning from 2022 to risk-free rates²¹). The receivables purchase agreement will specify the specific reference base rate to be used for all transactions, so while there can be some significant variance on the specifics, the principle remains valid and constant.

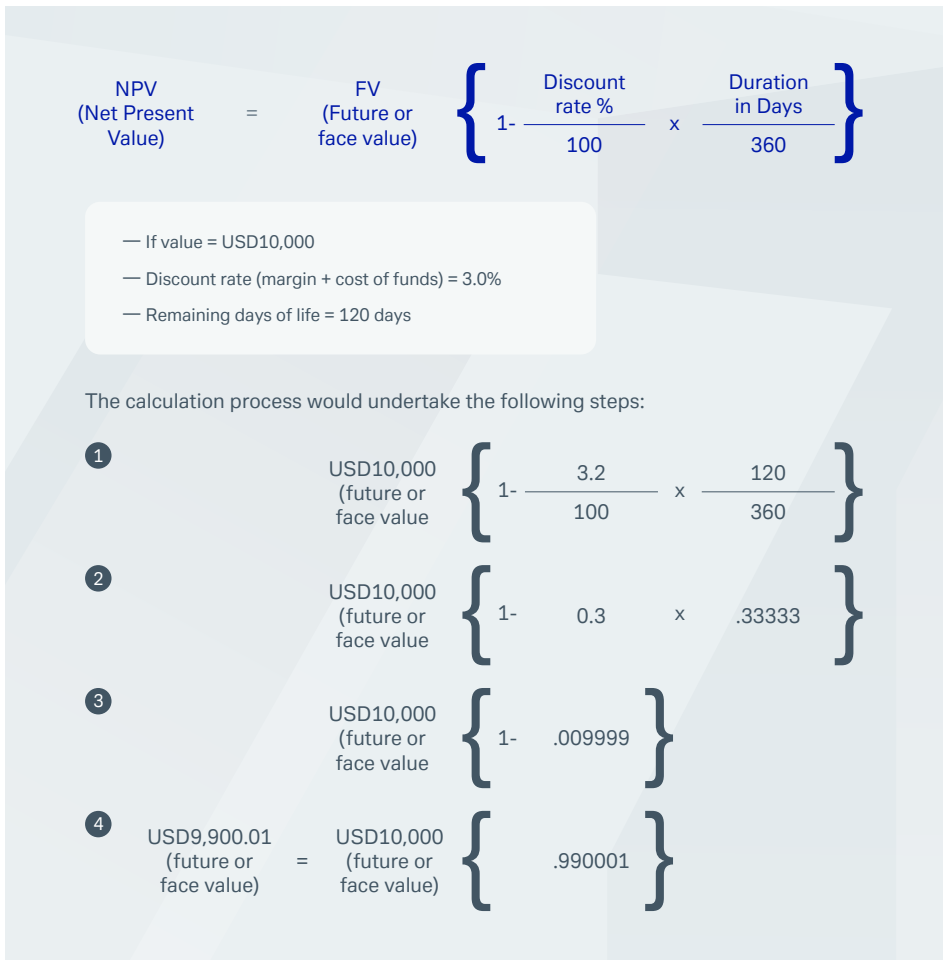
The discount rate is then an aggregation of the agreed margin and the cost of funds, so if the margin was theoretically to be 100 basis points (bps), and the benchmarked cost of funds rate was 50bps the discount rate would be 150bps.

While the service provider normally establishes a right to adjust the margin at their discretion, unless there is a material change in the risk parameters of the buyer or their country risk, for example, the margin will likely remain somewhat stable. Conversely, interest rates can be quite dynamic, so changes in rates on a daily basis can be commonplace, and have a material impact on the discount rate. Looking at the above example, if the margin remained at 100bps, but the benchmark cost of funds rate increased to 100bps, the new discount rate would be 200bps points – a 33% increase. Interest rates have been near historic lows and reasonably stable over recent years, but there have been periods where rates were quite volatile and had a significant impact on discount rates even when there was no perceptible change in the underlying credit or country risk.

The duration is the remaining days from the date that the service provider purchases the receivable to the date the receivable matures.

A sample discount calculation formula is set out in Figure 6.

Figure 6: Sample discount calculation



Once the net present value has been established, it is simply a matter of subtracting the net present value from the face value to determine the discount amount as follows:

$$\begin{array}{rcl} \text{USD10,000} & & \text{USD9,900.01} & & \text{USD99.99} \\ \text{(future or face value)} & - & \text{(net present value)} & = & \text{(Discount amount)} \end{array}$$

8.4.2 Discounting methodologies

It should be noted here that there are a wide range of combinations and permutations of discounting methodologies, including different base rates, base rate interpolation, different calculation methodologies, etc., so it is important that the seller really understands and agrees the methodology with the service provider so that there are no unexpected surprises.

In a payables finance structure, it is important to understand that while the service provider will only have one services agreement with the buyer, for a seller to be able to discount or sell the receivable(s) to the service provider, there will need to be a separate and discreet receivables purchase agreement executed with each seller who wishes to participate in the discounting aspect of the programme.

8.5 Onboarding

The process of engaging the seller to secure their participation in the payables finance programme is commonly referred to as the seller 'on-boarding' process. Through the on-boarding process, the service provider not only needs to help the seller understand the value of participating in the programme, but must enter into a contractual relationship with that seller, which requires a certain amount of due diligence, including validation that those who sign the agreement are authorised to do so. Seller on-boarding is a specific skill or competence, and those who are responsible for on-boarding the sellers should have the necessary sales skills and technical knowledge to ensure that communications to targeted sellers are effective at getting those sellers on board. If the on-boarding services are not adequately capable of on-boarding the targeted sellers, programme adoption will suffer and the buyer will have difficulty using the programme effectively to improve their working capital position. This is particularly important in structures where the buyer has an interest in targeting sellers outside of their home country and legal jurisdiction.

Accordingly, it is important to evaluate the global reach, the footprint, language, customer support capabilities of a potential service provider, and if one's programme will include cross-border transactions. In these cases, it is equally important to be certain that the chosen service provider is familiar with the local laws and regulatory requirements, and has an appropriately disciplined due diligence process to minimise the reputational and financial risks associated with inadvertently deploying a solution that does not comply with local rules.

In addition to selecting a service provider with the right resources, skill sets, and footprint to support the programme's success, it is equally important to understand that a successful seller 'on-boarding' campaign requires a solid collaboration or partnership between the buyer and the service provider. There are few things more important to the success of a payables finance programme than to have a clear and well thought out strategy for targeting the most appropriate sellers for participation. It is for this reason that really understanding which sellers to target for participation in a programme and establishing a clear computational finance programme is so essential for success. In this context, the service provider should be able to articulate their capabilities, and propose the best practice approach most suitable to helping the buyer achieve their programme objectives. It is also important the buyer be actively engaged in supporting and promoting the payables finance programme, as most sellers will not be receptive to a cold call placed by a service provider or financier seeking to purchase their receivables from the buyer.



The programmes that have the greatest success in terms of seller adoption are those where the buyer has partnered to implement a specific strategy that includes a great deal of positioning in advance of the programme launch. In these cases, each seller that has been targeted and given the required messaging and supporting information will better understand the programme, appreciate its value proposition, and the mechanics of how the programme works. Proper pre-positioning of the time to adoption will have a larger more immediate impact on meeting the working capital objectives of the buyer implementing the programme.

8.6 Service provider strength

The extraordinary growth of payables finance over the last few years as a core trade finance solution speaks volumes about the programme's value proposition to the buyer, the sellers, and the service providers. More and more large corporate entities operating as the buyer are implementing these programmes globally as a way to bridge the working capital needs of their strategic sellers with their own objectives.

Service providers, which are mainly banks, have seen great potential in these programmes because they represent a high value added service to key clients that generates an attractive rate of return for the risk. These programmes also tend to run for extended periods of time, creating ample opportunity to deepen the relationship between the service providers and their buyer clients, creating greater opportunity for cross selling other solutions such as cash management, foreign exchange, and liquidity management, which can all be integrated into a comprehensive working capital management strategy.

A successfully implemented payables finance programme will furthermore offer the opportunity to establish new relationships between the service provider and selected sellers of a buyer, as these sellers also act as buyers and may seek to implement a payables finance programme on their own. As with any initiative that can impact DSO, DPO, and working capital metrics, it is imperative to select a service provider with a strong reputation and the right mix of skills and resources as well as making sure that the structure, the documentation, and the process flows are all vetted by tax and legal advisors to minimise any exposure to financial or reputational risk.

8.7 Industry developments

The Global Supply Chain Finance Forum has been established to advocate SCF techniques in the market and foster the growth of supply chain finance. Since its foundation in 2014 and the publication of the *Standard Definitions for Techniques of Supply Chain Finance* in 2016, more than 70 practitioners from over 20 countries joined the GSCFF, and further contributions were made or are being worked on the following industry toolkits:

- The ICC BAFT Wolfsberg Trade Finance Principles are a common reference basis for good industry practice in questions related to KYC. The Open Account Appendix of the ICC BAFT Wolfsberg Trade Finance Principles clarifies the difference between clients and counterparties (i.e. buyers and their sellers in a payables finance context) and explains how both groups should be treated during the on-boarding phase from a KYC perspective.²²
- In 2019, the GSCFF published its industry guidance *Receivables Discounting Technique*,²³ going into more detail of good industry practice for this SCF technique. In 2020, a similar paper was published for Payables finance, also seeking to provide an insight into the matter of corporate accounting treatment – a topic that is increasingly relevant for all involved stakeholders over the past few years.
- In 2021, the GSCFF announced an update to its Standard Definitions to include three new techniques in a separate category called ‘Advanced Payable’, consisting of the corporate payment undertaking (CPU), the bank payment undertaking (BPU) and dynamic discounting (DD). This update highlights and confirms the quality of the original content – first published four years ago – and the need to be agile in a dynamic field such as supply chain finance.²⁴

The broad background of the GSCFF and its unique position under its sponsoring organisations ICC, BAFT, FCI, ITFA and EBA has made the GSCFF a reference point for any interested party who wants to engage into supply chain finance – whether it be a corporate, a financial provider, an auditor, a regulator or an investor. The GSCFF will continue fostering the growth of supply chain finance in the market by advocating its benefits and helping the industry to implement its standards.

9

Forfaiting

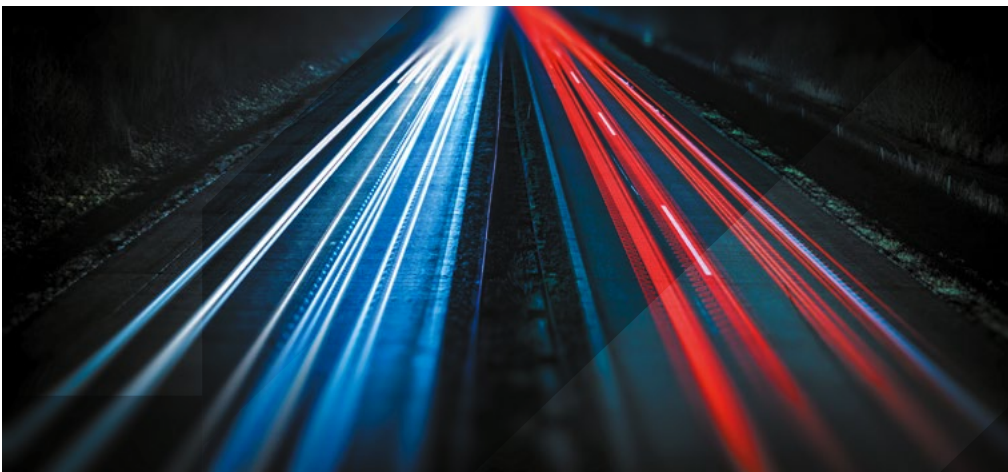
By Sean Edwards, Chairman, International Trade & Forfaiting Association and Head of Legal, SMBC Bank International plc

9.1 Introduction

Since the second edition of this book was published in August 2019, forfaiting has experienced its own “back to the future” moment as trade finance becomes increasingly digitised and the search for the optimal digital trade obligation continues at pace. Legal change, actual and anticipated, is acting as a catalyst for rethinking how digital platforms might perform and realising the potential they offer. This an area where the law has lagged behind technology, but one benefit is that the technical solutions exist already.

The developments in this area are discussed at the end of this chapter.

So, what are the essential characteristics that make forfaiting such an attractive solution for the transformed marketplace?



9.2 Definitions

The “Standard Definitions for techniques of Supply Chain Finance” published in 2016 by ITFA, ICC, BAFT, FCI and the EBA (referred to as the “Standard Definitions” in this chapter) deals with forfaiting in some detail.²⁵ The following explanation of forfaiting from the Standard Definitions shows why this technique offers solutions and opportunities for practitioners of trade finance:

“Forfaiting is a form of Receivables Purchase, consisting of the without recourse purchase of future payment obligations represented by financial instruments or payment obligations (normally in negotiable or transferable form), at a discount or at face value in return for a financing charge.”

In an age which seeks standardisation and uniformity, it should not be forgotten that forfaiting is the only technique for purchasing receivables that benefits from international rules in the form of the Uniform Rules for Forfaiting (URF800) published by the International Chamber of Commerce in partnership with the ITFA. These rules have, for the first time, provided standardised global rules in the same way as documentary credits. Many institutions offer forfaiting as a product without necessarily using that label or in some cases being aware that they are, in fact, acting as forfaiters. This can, over time, lead to a dilution of expertise and a lack of awareness of solutions to issues which have been developed and tested. Furthermore, possible new users or potential entrants to the industry may simply be unaware of how forfaiting can be used to their and their customers’ benefit. By focusing on concepts and concrete problems faced by exporters, importers, and financiers alike rather than labels, this chapter tries to show the value of employing forfaiting techniques.

“Payment instruments, or payment claims are the hook on which forfaiting transactions are hung.”

Sean Edwards, Chairman, International Trade & Forfaiting Association (ITFA)

For exporters the advantages of forfaiting their receivables are as follows:

- Eliminates a number of risks;
- Provides financing for 100% of contract value;
- Protects against risks of interest rate increase and exchange rate fluctuation;
- Enhances competitive advantage;
- Enables sellers to offer credit to their customers, making their products more attractive;
- Helps sellers to do business in countries where the risk of non-payment would otherwise be too high;
- Improves cash flow;
- Enables sellers to receive cash payment while offering credit terms to their customers;
- Removes accounts receivable, bank loans, or contingent liabilities from the balance sheet;
- Increases speed and simplicity of transactions;
- Fast, tailor-made financing solutions;
- Financing commitments can be issued quickly;
- Documentation is typically concise and straightforward; and
- Relieves seller of the administration and collection burden.

9.3 What makes a payment instrument forfeitable?

Payment instruments, or payment claims as they are also referred to in this chapter, are the hook on which forfaiting transactions are hung. This does not imply, however, a narrow range of options. There is no longer any slavish adherence to any particular type of instrument and it is best to think of a payment instrument as serving a means to an end rather than being an end in itself.

While not all forfaiters will agree that the following list is exhaustive, most practitioners would concur that a payment instrument should attempt to satisfy at least some if not all of the following criteria:

- Be independent from the transactions they finance, i.e. be “autonomous and abstract”;
- Benefit from legal certainty;
- Be as legally straightforward as possible but capable of some flexibility;
- Be tradable;
- Enjoy best possible capital treatment; and
- Enjoy favourable trade status in sovereign and private debt restructurings.

Instruments traditionally associated with forfaiting such as bills of exchange and promissory notes display a number but not all of these characteristics as some features have little to do with the legal nature of the instrument itself. For example, negotiable instruments are not, *per se*, trade debt for the purposes of sovereign restructurings; their status will be derived from the underlying purpose for which they have been issued which could, of course, be for raising working capital. Such instruments can also, in some circumstances, give inadequate rights to their holders e.g. the lack of an ability to accelerate payment, as in a loan, although this can sometimes be overcome by the use of side-letters or other collateral agreements. Legal certainty and tradability are, however, close to the ideal.

Invoices or book receivables are forfaitable. Here the principal issues tend to have a dependence on, and vulnerability to, the underlying transaction and legal certainty. Contractual wording can, to some extent, overcome this.

In short, 'traditional' forfaiting has always accepted some commercial and legal limitations to the instruments it deals in and there is, consequently, no reason in principle why more recent instruments cannot be forfaited. The Bank Payment Obligation²⁶ has many of the characteristics referred to above as do the irrevocable payment undertakings (IPUs) issued by large corporate buyers in the context of supply chain structures as explained in *Chapter 8: Supply chain finance*. What this points to, again, is the need to perceive forfaiting as a set of techniques, principles, and expertise capable of very wide beneficial application.

9.4 Forfaiting and factoring

There is often much confusion between these two techniques. As the Standard Definitions show, there are areas of overlap: both techniques involve a purchase of receivables and, where without recourse factoring is used, the differences can appear commercially insignificant. There are, however, a number of significant differences:

- Forfaiting is executed without recourse, or limited recourse, to the seller; factoring typically involves full recourse.
- Factors will often deduct a reserve from the nominal value of the receivables which they will not finance whereas forfaiters will finance the full-face value of the receivable.
- Tenors in forfaiting can be longer than in factoring although there has been much convergence in recent years with both markets favouring shorter tenors; however, long-term supplier credits are only possible with forfaiting and could not be factored easily in the current market.
- Values tend to be low.

- Most forfaiting is cross-border whereas the bulk of factoring business is domestic; cross-border factoring is a relatively prescribed business requiring adherence to a specific set of rules and single platform.
- Factoring receivables are almost universally in the form of invoices or book debts; forfaiting paper is more diverse as explained above.

As with all trade finance techniques, it is important to employ the right tool in the right circumstances. Both forfaiting and factoring have their place in financing receivables. Factoring (at least domestic) has benefitted from its relative ease of use; forfaiting has greater potential for cross-border business and, with less reliance on paper and greater digitalisation (see below), find new uses in emerging markets and digital platforms.

9.5 URF800

The Uniform Rules for Forfaiting (ICC Publication No 800) are published by the International Chamber of Commerce and are the fruits of a four-year collaboration with the ITFA.²⁷ The drafting group consisted of experienced professionals from the forfaiting, documentary credit, and wider trade finance community, as well as leading trade finance lawyers.

The URF was implemented on 1 January 2013 but must be incorporated into relevant contracts to have effect and govern the transaction in question. Its vocation is to serve the same purpose in the forfaiting industry as the Uniform Customs and Practice for Documentary Credits serves in the documentary credit industry.

The URF contains 14 clauses or articles and deals with important issues such as the determination of what is satisfactory documentation and the degree of recourse to sellers. The position taken by the URF in these critical areas is discussed later in this chapter.

A new version of the URF to deal with the digital environment, an “eURF”, is under consideration.



9.6 The meaning of 'without recourse'

It is considered to be a fundamental characteristic of forfaiting that the buyer will not have any recourse to the seller. Indeed, this is the origin of the word 'forfaiting'. Given the liability of endorsers of negotiable instruments, this principle resulted in the practice of qualifying endorsement with the words 'without recourse' or 'sans recourse'.

It is not, however, literally true that there is never any recourse to a seller. There would always be recourse for fraud, for example, and it has long been believed in the market that forfaiters originating a transaction (so called "Primary Forfaiters") have a duty to ensure that the paper they introduce is legally valid, binding, and enforceable. The precise limits and constituents of this duty have never been legally tested, which is a testament to the integrity of the market, but lack of clarity on this fundamental point is not desirable.

The URF has therefore introduced a “liability cascade” in its Article 13 which sets out the grounds for recourse to different parties. Some grounds e.g. that the party has authority to enter into the transaction, are common to all parties but thereafter Article 13 sets out specific grounds of recourse against each party. The party selling the transaction to the Primary Forfeiter (called the “initial seller” in the URF) has the greatest liability since it is typically the closest to the obligor e.g. the exporter. The URF makes initial sellers liable in the following circumstances:

- It has not passed on information which it knew or **ought to have known** would affect the existence of the payment claim or any credit support documents;
- It is not the sole legal and beneficial owner of the claim being sold free of any third party rights;
- It has not irrevocably and unconditionally transferred the claim;
- It has breached any of the terms of the payment claim or **the underlying transaction**; and
- Fraud in the underlying transaction, for example.

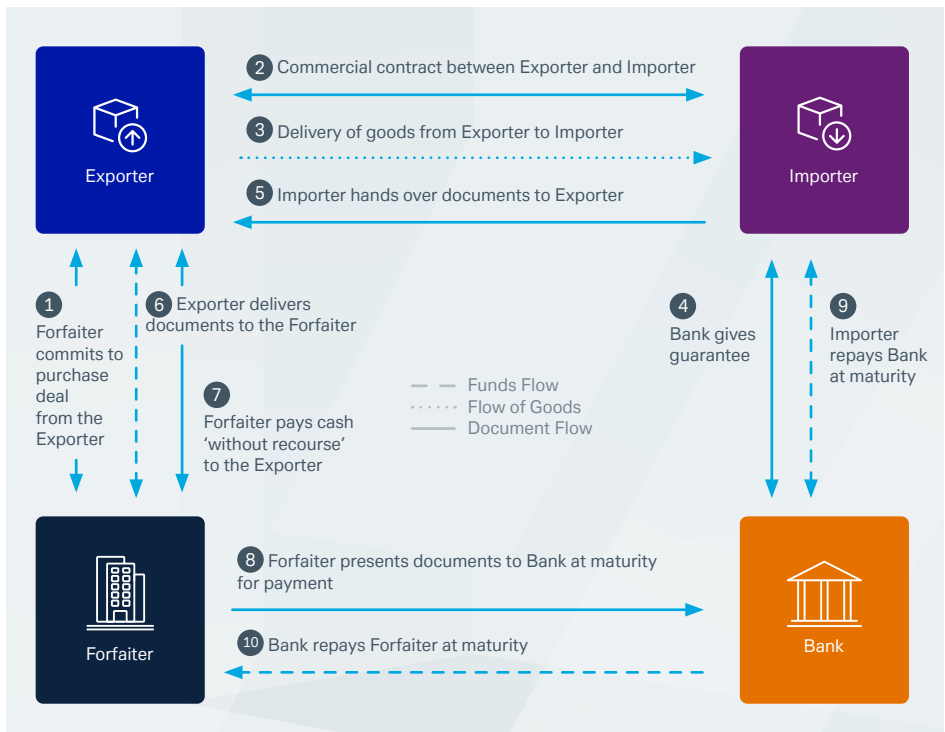
Primary Forfeitters have a duty generally to take appropriate steps ‘in accordance with market practice’ to ensure a transaction is valid. Thereafter, subsequent sellers only have a duty to pass on such information as they have available to them.

Recourse is not, of course, simply a legal issue, but will have important implications for determining whether or not a ‘true sale’ has been achieved under applicable accounting standards. In the US these are set out in FAS 125 while the applicable standards for IFRS are set out in IFRS9.²⁸

The US standard is stricter and requires legal transfer to have been achieved while IFRS looks to the transfer of risks and rewards in the underlying instrument. Generally speaking, recourse is possible for matters which are within the control of the relevant seller and Article 13 has been drafted in order to achieve this. Figure 7 (which is extracted from the Standard Definitions) shows the essential steps in any primary market forfeiting transaction:

- The agreement between the forfaiter and the seller of the payment claim;
- The delivery of documents relating to the payment claim and the underlying trade transaction and the forfaiter’s examination of those documents;
- Calculation of the purchase price and payment ‘without recourse’ to the seller; and
- Collection by the forfaiter from the underlying obligor who may be the availing bank as above or the importer directly.

Figure 7: Structure of a typical forfaiting transaction – Primary market



Source: International Trade & Forfaiting Association (ITFA)

This diagram assumes that a guarantee or aval has been given by the importer’s bank: this is not always necessary

Each of these steps, and the issues which can arise at each stage, are examined in more detail below.

9.7 The agreement between the seller of the claim and the primary forfaiter

The commercial agreement between the initial seller of the claim – often an exporter – may be documented under a master agreement (normally uncommitted) or be negotiated specifically for the transaction. In the former case, an addendum or supplement will be issued once the specific transaction is offered for sale.

At one time, commitment and option fees were common but this has become much rarer as transactions tend to be offered for sale rather later by exporters, and financiers are less willing to tie up lines where utilisation is uncertain. Consequently, the forfaiter will tend to make his profit from the discount on the purchase.

The URF contains templates for both master and single transaction agreements. The following points are common to both and are the issues that all forfaiting agreements, whether or not governed by the URF, must deal with:

- A commitment to buy and sell or, in the case of an uncommitted master agreement, ability to offer for sale and purchase proposed transactions;
- The method by which transfer of the payment claim will take place e.g. endorsement, assignment, etc;
- The documentation to be presented by the seller relating to the underlying transaction (see further below) including the date by which they must be presented in satisfactory form, usually known as the “availability date”;
- Pricing and fees;
- The liability of the parties; and
- Governing law and jurisdiction.

This list is not exhaustive, but it does illustrate the relatively straightforward nature of most forfaiting agreements, another attractive feature of this market.

9.8 Documents relating to the payment claim and the underlying transaction

The issues here generally revolve around:

- Which documents the purchaser should ask for; and
- What the standard for examining the documents delivered is, and how long the process should take.

The payment claim must be examined in very close detail as it is the bedrock of the whole transaction. At this early stage, the original document is often not available and drafts therefore need to be examined and ideally approved by the Primary Forfeiter. In addition, the Primary Forfeiter should see:

- All accompanying documents e.g. side-letters;
- Any documents required to transfer the claim e.g. assignments where the payment instrument cannot be endorsed or which must accompany the claim when demanding payment e.g. registration as a creditor with the local central bank; and
- Evidence of authority of the actual or intended signatories.

A similar exercise will need to be gone through in relation to any credit support documentation e.g. an aval or a guarantee. The URF refers to these documents as the 'required documents.'

The underlying commercial documents to be presented will, of course, depend on the exact nature of the underlying transaction but in the case of a purchase from an exporter on or before shipment, these will not be very different from those which would normally be presented under a letter of credit. Where the purchase is directly from the importer, i.e. a 'buyer credit', there may be very little documentation apart from an invoice or acceptance advice. There is nothing 'wrong' about this and simply reflects the stage that the commercial transaction has reached.

The examination of documentation, especially the payment claim and the basis on which it can be rejected, is a very sensitive and critical matter in the forfaiting market. The first thing to note is that any examination of documents will be more intensive and searching than any examination of documents under a letter of credit where the UCP simply requires that documents comply 'on their face' with the requirements of the credit. This, of course, is because the forfaiter will be purchasing documents and therefore needs to treat them as they would any investment since, if they are ineffective, they will lose their ability to demand repayment from the obligor. The traditional standard is that documents have to be satisfactory in the absolute discretion of the purchaser. This has on occasion led to some abuses, but in the primary market the range of issues on which the buyer must be satisfied can be very broad, especially with the new burdens of KYC, AML, and anti-terrorist checks. In the secondary market, as between financiers, there is less justification for this but similar standards have prevailed.

The URF tries to find a middle ground on this issue by leaving a wide discretion to the Primary Forfaiter in the primary market while directing them to give main weight to the following issues: authenticity of documentation, enforceability and legal validity, the obligation to pay without set-off, and transferability. The forfaiter should consider each issue in accordance with market practice. This could mean, for example, that they need not have definite proof that a promissory note is legally invalid but it could be rejected on the basis that enough uncertainty has been raised to cause them to have doubt.

Documentation must be delivered, in satisfactory form, by the agreed availability date for each transaction. Sometimes a transaction is described as immediately available. The URF defines this as ten business days from the date of signature of the agreement to purchase.

“The examination of documentation, especially the payment claim and the basis on which it can be rejected, is a very sensitive and critical matter”

Sean Edwards, Chairman, International Trade & Forfaiting Association (ITFA)

9.9 Calculation of the purchase price and payment without recourse

A forfaiter can take their profit on a transaction in a number of different ways. Increasingly with the growth of 'forfaitable' loans, fees and interest have been a much bigger component of this income. By far the biggest share of income still comes from the discount to the face value of the payment claims or instruments purchased.

Discount may either be on a straight or discount to yield basis. Discount to yield is more common and may be compounded by whatever period is desired e.g. annually, semi-annually, or monthly. The differences between the two methods are best illustrated with worked examples. In practice of course, all these calculations will be done using a spreadsheet or other software.

9.9.1 Straight discount

This is a discount calculated on a simple and non-compounding basis. The net value of a debt discounted on a straight discount basis is calculated as follows:

$$NV = N \times (1 - R/100 \times D/360)$$

NV = Net value

N = Nominal value of the payment claim

R = Straight discount rate

D = Total number of days between settlement date and maturity date of the payment claim

For example, the net value of a USD1,000,000 payment claim maturing in 850 days and discounted at 10% straight discount:

$$= \text{USD}1,000,000 \times (1 - 10/100 \times 850/360) = \text{USD}763,888.89$$

9.9.2 Simple discount to yield

The net value of a debt discounted on a simple discount-to-yield basis i.e. without any compounding is calculated as follows:

$$NV = N/[1 + R/100 \times D/360]$$

For example, the net value of a USD1,000,000 payment claim maturing in 850 days and discounted at 10% simple discount to yield

$$= \text{USD}1,000,000 / (1 + 10/100 \times 850/360) = \text{USD}808,988.76$$

9.9.3 Discount to yield compounded annually

First, the remaining life needs to be divided into a series of X yearly periods of 365 days plus a last 'broken' period corresponding to the number of days to the maturity date. Then the net value is obtained by the following formula:

$$NV = N / [(1 + R/100 \times 365/360)^X \times (1 + R/100 \times D/360)]$$

D = Total number of days between the last entire period of 365 days and maturity date of the Payment Claim.

For example, the net value of a USD1,000,000 payment claim maturing in 850 days and discounted at 10% discount to yield compounded annually

$$= \text{USD}1,000,000 / [(1 + 10/100 \times 365/360)^2 \times (1 + 10/100 \times 120/360)]$$

$$= \text{USD}797,770.88$$

Once the purchase price has been calculated it will be paid on the settlement date. The settlement date is defined in the URF as the date which falls three business days after the purchaser has accepted the documents as satisfactory. This may, of course, be any other date agreed by the parties.



Payment may be made 'under reserve'. This will happen when some aspect of the transaction – usually documentation – is not completely satisfactory but the purchaser is nevertheless prepared to pay for the transaction on the understanding that the matter reserved will be rectified by an agreed date. If the problem is not rectified by that time, then the purchase price must be repaid to the purchaser by the seller. Article 12 of the URF sets out a methodology for dealing with such payments. They are less common than previously as the purchaser will need to open a credit line on his seller which may not always be forthcoming.

9.9.4 Collection

The point has already been made that a purchaser should collect, as part of the documentation from the seller, all the documents that they need to make demand for payment on the obligor. Some countries, for example, may require that the demanding creditor be registered with the local authorities or show that all relevant local stamp duties have been paid.

9.10 Secondary market

The secondary market in forfaiting is largely an inter-bank market in which transactions originated by Primary Forfaiters are sold into the market and then on-sold. Such on-sale chains can be very long. Some institutions will participate in both markets while others will only be active in one.

Transactional documentation in the secondary market is much simpler than in the primary market. In many, but not all, countries it is normal to deal by telephone. The terms of the transaction are then embodied in a written confirmation which, in practice, will contain more information than that discussed on the phone call, but which cannot alter the economic terms of the transaction or relate to a claim other than the one agreed by the parties. In some countries, such as Germany, dealers cannot trade by telephone but must do so solely through written agreements. Article 8 of the URF provides for both possibilities and sets out a method and timeline for agreeing confirmations. The URF also contains a model confirmation form. As is to be expected, this is much shorter than the forms provided for the primary market but still covers the same essential areas (though much more briefly).

The biggest issue, at least conceptually, in the secondary market is the degree of liability or recourse which parties have to each other. The circumstances in which the Primary Forfeiter may be liable to its purchaser have been discussed above. The liability of each other seller in the secondary market to its purchaser has traditionally not been very clear and it is presumed that, except for fraud, the usual presumption of 'buyer beware' will apply. The URF provides that sellers in the secondary market are liable only where they do not disclose information they possess about events or circumstances that affect the existence of the payment claim (which would *not* include, for example, suspicions that the obligor may be in financial difficulties as in such cases the claim would still exist as a legal matter) or fails to transfer full and unencumbered title to the asset sold.

The other issue of importance, which has already been touched on above, is documentation and the standard for examination.

By the time a transaction comes to be introduced into the secondary market, documentation is largely fixed and can no longer be changed, although a good Primary Forfeiter, who may sometimes have the ability to influence documentation if involved early enough in the deal, should have an eye to the requirements of the secondary market when putting together the documentary package.

The tendency for secondary purchasers to only accept documentation that is satisfactory in their own largely unfettered opinion, has already been referred to. Under the URF, grounds for rejection of documents in the secondary market is limited to authenticity, enforceability, and legal validity; the obligation to pay without set-off; transferability; and those matter or conditions specifically referred to in the confirmation. These are the same grounds as for the primary market but in that market, as mentioned above, these grounds are not exhaustive. In the case of the secondary market, they are. It is the belief of the drafters of the URF that these grounds are sufficiently broad to encompass all legitimate bases for rejection while at the same time providing some sort of market discipline.

The URF also makes provision for parties to consider if and how sellers may pass on rights of recourse that they may enjoy against the party that sold the asset to them. This can be done, for example, by assignment, but requires the agreement of the party against whom recourse is sought. If done, this can avoid the spectacle of a chain-of-mirror claim, which is an expensive and risky process.

9.11 Digitalisation and forfeiting

It is often assumed that new and sophisticated technology, such as that offered by Blockchain and fintechs in general, requires the invention of new finance techniques. Nothing could be further from the truth; fintechs are, in fact, eager to embrace tried and trusted approaches and improve them with their technology (see *Chapter 10: The involvement of fintech in receivables financing*). Here, traditional forfeiting instruments such as promissory notes and bills of exchange have enormous potential and a true 21st century vocation. As simple unconditional payment obligations they are easy to digitise from a technical point of view (the author has seen this done in an afternoon) whilst possessing widespread international acceptability after many decades of use. Their inherent transferability makes Blockchain particularly suitable as an enabling technology.

The legal obstacles to digitising negotiable instruments have been or are rapidly being overcome. One of the principal drivers of this change has been the increasing adoption of the UNCITRAL Model Law on Electronic Transferable Obligations (MLETR) which first appeared in 2017 accelerated, in part, by the intense focus on digitalisation as a result of the Covid-19 Pandemic.²⁹ MLETR applies to all documents that allow rights to be transferred by mere transfer of the document.

It therefore covers negotiable instruments such as bills of exchange, promissory notes and bills of lading. Transfer is achieved through change of “control”.

A “reliable method” must be used to achieve and maintain the existence of a unique instrument which is a precondition to an effective negotiable instrument i.e. copies will be ineffective.

MLETR does not apply automatically and must be incorporated into national law. So far, MLETR has been adopted in Singapore, Bahrain and by Abu Dhabi Global Markets (effectively the legislator for the ADGM commercial zone). In the United Kingdom, the Law Commission has recommended a change to the law which will have the same effect, achieved by validating a new concept of “control” in relation to certain trade documents (including negotiable instruments). It is anticipated the necessary legislation will be passed in 2022.

ITFA has published a guide to these instruments, including wording which can be used even before a change in the law to create the functional equivalent of promissory notes and bills of exchange.³⁰ The guide, entitled *The ITFA Digital Negotiable Instruments Initiative: Bringing negotiable instruments into the digital world* is now in its second edition, and also sets out the dDOCS technical standards for electronic original documents. A number of the rapidly expanding digital platforms have shown intense interest in these instruments as they are debt obligations which can be created natively on platform, and will be transferable in the same way yet retain the same legal characteristics as traditional instruments which have been in use for centuries.

9.12 Not just a single product or technique

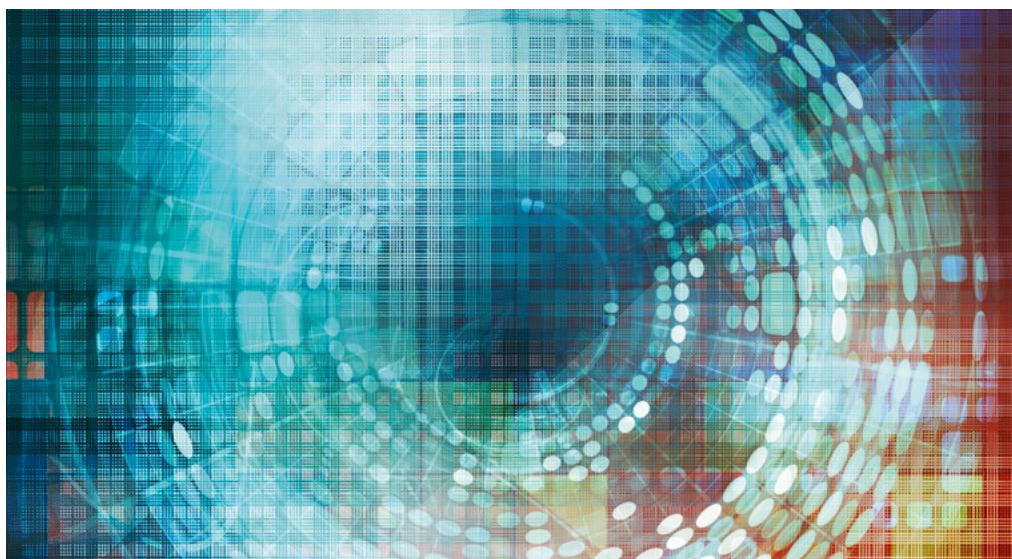
It is best to think of forfaiting not as a single product but instead as a set of principles and techniques that can be applied to sell a wide variety of financial receivables. While this also means that it can be difficult to precisely define forfaiting, it draws attention not just to the accumulated wisdom that the industry possess, but to an ability to grasp, integrate, and render tradable receivables that could not otherwise be monetised safely and securely.

10

The involvement of fintech in receivables financing

By André Casterman, Board Member and Chair Fintech Committee, ITFA and Board Member, Tradeteq

New capital requirements have encouraged financial institutions to keep their balance sheet as light as possible. Meanwhile, institutional investors have grown more and more interested in trade finance assets. In the continued low-yield environment, they are placing more emphasis on safety, prioritising diversification and stable returns. Because trade finance is based on tangible trade flows, it has a low correlation to stocks or bonds, making it a safe addition to any investor's portfolio. Fintech developments are introducing new automated processes to bring trade finance assets such as receivables to institutional investors, thereby further bridging both trade and capital markets, and helping incumbent financial institutions and funding platforms finance SMEs.



10.1 Prudential regulatory drivers

Trade finance is one of the oldest asset classes. The buying and selling of goods by corporates has traditionally been financed by bank balance sheets. Over the past few years, however, this has come at an increasing cost to banks. Prudential regulation such as Basel III is placing pressure on banks to reduce their capital requirements, causing leading institutions to explore new ways to reduce or share the risks involved. Since the global financial crisis and the subsequent implementation of stringent financial regulations, banks have been consistently moving towards the so-called “originate-and-distribute” model, keeping as much of their lending portfolio off balance sheet to retain working capital flexibility. Today, technology developments are making it possible to implement such a model on a much broader, automated scale. Banks can increasingly bring non-bank investors into the process to increase their own funding capacity in both traditional trade and open account spaces.

Trade finance distribution offers a unique opportunity to institutional investors seeking stable, long-term yields, but it is not readily available for institutional investors to access. This is not for a lack of desire; banks feel the need to distribute trade finance, and institutions have a tremendous interest in accessing it. One of the primary problems is that there is not much standardisation. With the industry at a tipping point, regulators should encourage financial institutions to expand their distribution activities and to see the originate-and-distribute model for what it is: a brilliant solution to handle capital constraints without restricting trade finance availability for clients the world over. To solve this, the TFD Initiative aims to bring the industry together in order to create that standardisation.³¹

10.2 The technology-based originate-and-distribute model

Involving non-bank financial service providers is key to the expansion of global trade finance capacity. According to the Boston Consulting Group, “the asset management industry has emerged from the global pandemic in a position of strength, with assets growing by 11% in 2020 to end the year at USD103trn”.³²

Bringing just a fraction of that into the trade finance space would be more than enough to plug the funding gap,³³ and it shouldn't be too difficult to do so, given trade finance's low-risk profile, demonstrated yearly by the International Chamber of Commerce's Trade Register.³⁴ Yet to this day, distribution to non-bank financial institutions remains a rare practice.

Because of post-crisis regulation, banks have gradually attempted to keep their balance sheets as light as possible to achieve more favourable leverage ratio calculations. One of the ways they have accomplished this is through increased supply chain finance (SCF) activity: here corporations themselves use their own cash balances to finance their supply-chain operations, and the bank simply provides the framework and infrastructure for such financing, earning a fee in the process without committing their own funds.

10.3 TFD Initiative delivers automated distribution practices

The Trade Finance Distribution Initiative (TFD Initiative) is an industry-backed drive to create the blueprint for global trade finance distribution. TFD Initiative has established the largest business community of trade originators, funding platforms, credit insurers, institutional funders and their service providers committed to increase the level of automation and transparency in trade asset and risk distribution on the basis of technology-based market practices. This industry effort seeks to develop standardised best practices for the wider distribution of trade finance assets. It includes common data standards and definitions to address operational inefficiencies, transparency issues, and risks and addresses the following key objectives:

1. **Investment automation:** The specific skillset needed to source and originate trade finance deals and understand complex legal documentation has been identified as one of the biggest barriers to entry for non-bank investors. Technology hubs are key to improving market access as they can create a rules-based workflow to ensure eligibility criteria and portfolio guidelines are met, so investors can make sound credit, diversification, and pooling decisions in the trade finance space. TFD Initiative offers the required standardisation and efficiency through its securitisation- and tokenisation-as-a-service.

2. **Credit risk transparency:** Given stringent KYC regulations, investors require a high degree of transparency on the counterparts they are exposed to. This includes credit risk transparency, which also has the advantage of allowing them to make efficient return projections. The continued progress of artificial intelligence (AI) technology plays a part in this process around compliance and credit risks.
3. **Collaboration:** The collaboration between banks and institutional investors is well underway, with the former capitalising on its existing infrastructure, network and lending capacity, and the latter making more funding capacity available. The more stakeholders get involved, the more relevant the solution will be, and the more information is shared between them, the more transparency will be created in the market.

10.4 Wider reach

Regulatory constraints surrounding the trade finance sector are here to stay. Banks are already practising distribution of assets on the secondary market. All they need to do now is expand their reach beyond the banking sector – and luckily, technological platforms are now available to do just that. As all the conditions are met for the originate-and-distribute model to grow in size and variety of investors, it should become the go-to solution for the market. The days of balance sheets dependency may well be over.

In the meantime, non-bank investors are engaging in trade finance and recognising its potential as a yield enhancer and ESG enabler. Trade finance is an attractive asset class for institutional investors as it promises higher than risk-commensurate returns. However, the market is fragmented, inefficient, illiquid and generally hard to access. Technology and artificial intelligence should be leveraged to make trade finance accessible and reduce the operational burden and costs for both originators and investors. The result of various on-going technology developments such as TFD Initiative will be improved access to credit for many SMEs.

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