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Briefing note

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An Evolution in Trade Receivables Financing

Trade receivables financings take advantage of a number of legal mechanisms in order to achieve particular effects. An insolvency remote sale, dominion over collections and ensuring receivables can be collected directly are some of the key features structures seek to include. The cross-border nature of trade receivables financings also often adds to the complexity, with multiple legal systems needing to be taken into consideration.

Recently, a number of these techniques historically adopted for trade receivables financings have been employed in respect of the financing of new asset classes – such as trade finance assets – as well as undergoing an evolution in some cases – for instance to finance trade receivables originated through online peer to peer platforms and refinance supply chain finance exposures.

In this briefing we look at these asset classes and new structures and how the well trodden legal approaches used in traditional trade receivables financings are being used and developed to put together transactions to fund them.

Trade Finance

Trade finance assets have a very long history and are used throughout the supply chain to ensure that cross-border trade takes place in a smooth and timely manner. It generally involves banks and financial institutions taking on certain risks associated with the supply chain. This could include the issuing of letters of credit or guarantees in respect of the payment obligations of a buyer of goods, insuring goods against the risk of loss during their delivery and pre-export finance. A number of banks with these exposures are seeking to deleverage or otherwise distribute that exposure and are doing so by putting together securitisation transactions.

International nature – conflict of laws

Trade finance obligations are very international in nature with the obligations in nearly all cases owed by a party in one country to a party in another. The contract between them might be governed by the law of a third country (English and New York law are very common in trade finance) and the goods may pass through other countries on their journey to the buyer. The matrix of laws which may be applicable is very similar to that on a trade receivables securitisation and therefore the way to document the trade finance securitisation is very similar. In Europe, for instance, the EU conflict of law regulations such as Rome I, Rome II and Brussels can be taken advantage of to achieve a level of legal certainty about the recourse

an investor in the securitisation would have. In other jurisdictions the same questions can be asked as would be asked on a trade receivables transaction – among others, would courts in your jurisdiction recognise a foreign law transfer of a receivable, would courts in your jurisdiction enforce a judgement from another jurisdiction?

Withholding Tax

With cross border transactions a tax consideration which should always be taken into account is withholding tax. The variety of trade finance assets means they have a lot of different payment profiles. Some carry interest, some do not. Some have regular payments, some are simply paid at maturity.

As with trade receivables transaction it is important to identify each cross border payment flow and consider whether withholding tax might be applicable. There is a variety of rules which might help or hinder the analysis such as the way a discount is taken (in a transaction where non-interest bearing assets are sold as a discount) and the application of double taxation treaties, which may exempt payments in certain circumstances.

Peer-to-Peer Platforms

As a product which has developed as technology and finance coalesce, peer-to-peer platforms essentially seek to connect would-be borrowers with would-be investors or lenders without the need for bank intermediation. A variety of different assets are financed through these platforms – including trade receivables, consumer loans, small business loans and even mortgage loans.

Where trade receivables are funded through such platforms, the ultimate lender or investor taking exposure needs to ask all the usual questions as they would in a traditional trade receivables transaction, but often, there is a degree of extra complication which needs to be taken into account.

Legal Due Diligence

As with any trade receivables transaction the starting point is ensuring the asset is financeable. All of the asset's key characteristics should be checked – for instance, is it assignable, are there confidentiality provisions, is there a right of set-off, what is its governing law? In most cases the platform will be acquiring the trade receivables from a (potentially large) number of suppliers and those suppliers will likely all have their own individual terms and conditions. To conduct a standard trade receivables legal diligence exercise where each set of terms and conditions is reviewed might prove administratively burdensome.

The approaches which have typically been adopted on these transactions fall into two categories:

- *small pool of obligors* – where there is a relatively small pool of obligors in the platform, it may be the case that the obligors are imposing their standard terms and conditions on the supply arrangement rather than the supplier. In such a case, despite the fact there may be a large number of suppliers, the terms applying to them (imposed by the applicable obligor) may be relatively homogeneous. Therefore the standard terms and conditions of the small pool of obligors can be reviewed.
- *sampling and representations* – where there is a large pool of obligors it may be the case that the investor or lender is comfortable for a random selection of the terms and conditions to be reviewed and to rely on representations alone in respect of the wider pool.

Responsibility and Risk

On a traditional trade receivables financing there is a fairly direct interface between the lender or investor and the supplier being financed. The negotiations as to allocation of risk are undertaken between those two sides and set out in the documents. With platforms, however, there is an additional party – the platform itself. The interposition of the platform between the lender or investor and the supplier adds an extra dimension. There is no (or at least a less clear) direct line of communication between the lender or investor and the supplier and there is also a degree of operational responsibility taken on by the platform – they process the suppliers, on-board them to the platform and manage the flow of collections.

The negotiations as to allocation of risk then have this extra layer to take into account.

Ongoing sales and eligibility testing

Hand-in-hand with those negotiations come the general operational requirements of a transaction on an ongoing basis. Who will be testing eligibility? Who will be processing ongoing sales? Who will be preparing reports? In practice, this will tend to be the platform – it will aggregate the receivables, test them against a set of eligibility criteria and prepare the reports. Functionally this makes

sense – the platform is the key intermediary in the transaction through which funds flow and data passes. The servicing arrangements for a transaction need to therefore be tailored around the operational capability of the platform.

Supply Chain Finance

Over the last few years a number of large corporates have found their suppliers (who are typically small or medium sized businesses) come under a higher degree of financial stress due to their inability to raise finance – one key driver of this is the reluctance of banks to lend to small and medium sized business due to new regulation and the general economic environment.

To help their suppliers raise finance these large corporates are, often in conjunction with banks or funds, participating in supply chain finance platforms, where the invoices that the smaller suppliers issue to the large corporate are transferred to an SPV or trust, which is in turn funded by banks, institutional investors or, in some cases, the commercial paper market.

These supply chain finance transactions are often structured very similarly to a trade receivables transaction albeit with a key extra benefit for the investor or bank providing the financing – that is a direct payment obligation from the underlying debtor. As the large corporate can be involved in the transaction they typically provide direct comfort to the SPV or trust to which the receivables are assigned that they recognise the assignment and will pay the SPV or trust directly. To some extent this can reduce the "true sale" risk towards the suppliers significantly.

The Future

As global trade and technology continue to grow and develop trade receivables will continue to be an asset against which suppliers will be able to raise finance – and the legal framework, both domestically and internationally, for raising that finance has proved adaptable and robust.

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The second Trade Receivables Securitisation Conference is a unique opportunity to gain an understanding of the new deal sizes and structures, collateral valuation and cash flow under a trade receivables securitisation, specifically designed to bring together the specifics in relation to trade receivables and the drivers behind the new opportunities opening up for securitisation in this fast moving market. **Corporate issuers and investors attend free of charge.** Click here to book your discounted place with BCR Conferences or email Sophie Milton at Sophie.Milton@bcrpub.com to apply for your free pass.

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