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FORWARD FLOW SECURITISATION: THE RIGHT TOOL FOR THE RIGHT JOB?

Developments in forward flow securitisation have made it a popular financing tool for originators looking for funding certainty while the public markets remain turbulent. Removing assets from the balance sheet or leveraging them at origination can be a significant benefit. In this article, we look at the benefits as well as a number of issues that can make transactions of this type complex and commercially sensitive.

What is Forward Flow Securitisation?

The traditional securitisation funding model for originators is to originate a portfolio of assets, funded by a combination of equity and corporate debt, and then to securitise those assets. They might be securitised through a private 'warehouse' transaction – where they will be held by a special purpose vehicle ("**SPV**") financed by a combination of senior (and sometimes mezzanine) debt provided by external funders and junior debt provided by the originator. Alternatively (or later on) they might be securitised through a public bond issuance, funded by public market investors (and, more recently, direct investors through pre-placement or loan note tranches).

As an alternative, some originators engage in forward flow securitisation, where assets are originated and sold to external funders on origination. The asset is removed from the originator's balance sheet, putting the funder entirely on risk for the asset's performance. The economic benefit of the transaction for the originator derives from fees for origination and servicing of the assets, while the funder gets the benefit of excess returns over funding costs. This leads to the possibility of higher profits for the funder than can be achieved by taking a senior or mezzanine position in a private or public securitisation. Funders may further leverage these types of transactions by adding senior (and sometimes mezzanine) finance.

More recently, a popular tool for originators looking to secure funding has been the forward flow or 'wet-funded' warehouse securitisation, combining the private warehouse transaction with forward flow techniques. In this type of transaction, external funders provide the originator with 'wet funding': money transferred to the originator to fund the origination of assets which are

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Key Issues

- Forward flow securitisation and wet funded warehouse securitisation can be useful tools in turbulent markets.
- Advantages include long term funding certainty, balance sheet optimisation, and increased returns.
- But forward flow transactions require participants to deal with complex issues around control, future credit risk and regulatory compliance.
- A well-constructed forward flow securitisation based on 'relationship lending' can bridge the gap between unsecured debt and a full asset backed financing.

securitised through an SPV on origination.[1] In legal terms, this is often characterised as an advance payment of purchase price for the sale of the assets originated by the originator and immediately transferred to the SPV. However, some origination platforms are instead structured such that the assets are originated within the SPV itself. Again, these types of transactions may be leveraged by adding senior and mezzanine finance.

Why Use Forward Flow Securitisation?

Forward flow and wet-funded warehouse securitisation can be a very useful tool for originators and funders in certain circumstances.

Benefits for originators

For originators, the traditional securitisation funding route of establishing a private warehouse transaction to hold assets until an appropriate time to carry out a public bond issuance has been disrupted by recent turbulence in the public markets, driven largely by increases to – and uncertainty around – interest rates, and the lack of appetite from public investors for asset-backed securities. Many originators need a consistent stream of external funding to pursue their business objectives. Holding assets on balance sheet without finance in these circumstances is not an option. In this environment, forward flow and wet-funded warehouse securitisations, or a combination of these tools, can offer originators long-term certainty of funding to continue to develop business lines, usefully filling the gap between unsecured debt and fully securitised asset-backed debt.

True forward flow securitisation, in particular,can also be a very useful tool for managing the originator's balance sheet. As assets are sold on origination in whole to the funder, they can be immediately derecognised from the originator's balance sheet, allowing capacity for ongoing origination. Similarly, wet-funded securitisation can allow originators to leverage assets on creation, making funding costs significantly leaner by reducing the need to fund origination initially through equity or other corporate debt.

As we explain further below, forward flow securitisation can, in some circumstances, also allow originators to avoid onerous securitisation regulatory requirements by avoiding the creation of a "securitisation" for regulatory purposes.

Benefits for funders

For funders, forward flow securitisation can be a way of gaining exposure to certain asset classes without the need to develop their own origination and underwriting capacity or to meet consumer lending requirements. This has been particularly evident in the fintech sector, where online lending platforms have become a popular way of delivering finance to end-consumers matched by investment from non-bank lenders, with significant returns available both to the platform (through origination and servicing fees) and to the funders (through excess spread). In this respect, see the article entitled "*Speciality Financing Platforms: connecting borrowers and lenders globally*" later in this volume.

[1] As opposed to 'dry funding', funding to purchase assets that have already been originated, used in the traditional private/public securitisation.

Certain kinds of financial institutions, particularly cash-rich deposit taking institutions, might also achieve regulatory capital benefits by holding an investment in assets rather than, for example, an exposure to a securitisation. Forward flow and wet-funded warehouse securitisations can also be a way for funders to develop and cement relationships with their clients by ensuring long-term involvement in product and business development.

Key Issues in Forward Flow Securitisation

However, forward flow and wet-funded warehouse securitisations present a number of unique issues and concerns in addition to the usual commercial focuses of asset-backed finance. In both the typical forward flow and the wet-funded warehouse securitisation, the key differentiator for the funder from the traditional warehouse or public securitisation model is that the funder is taking more risk on the origination business itself. This means there needs to be much more focus on the originator's business plan and historic performance than on the assets underlying the securitisation.

In turn, this means that transactions of this type tend to feature stricter controls over the originator, the origination process and the assets to be funded (through eligibility criteria and concentration limits). Parties also need to be aware of the implications of funding a future portfolio of assets, by taking steps to mitigate future interest rate risk, including through hedging strategies, and ensuring an appropriate exit route. Finally, funders and originators need to take care to ensure that the transaction fits within applicable regulatory parameters, notably consumer regulation and the securitisation regulatory regime.

Control over the originator

For the reasons just outlined, these transactions typically feature increased focus on the controls over the originator and the origination process. Common areas of concern are the origination documentation and credit and collection policies and ongoing business performance.

Origination documentation and credit and collection policies

Forward flow and wet-funded warehouse securitisations typically include extensively negotiated covenants around amendments to the origination documentation and credit and collection policies. Originators will be looking to retain freedom to operate their business flexibly and without onerous approval processes (particularly where requirements to make changes might come suddenly and result from regulatory or legal pressures). On the other hand, funders want to know what they are getting as assets are originated, so they will seek approval rights for changes that could affect the credit quality of the assets. They will also want to ensure that they are not being exposed to regulatory risk, for example by monitoring, and ensuring they have approval rights in relation to the originators' proposals to change origination documentation and credit and collection policies to comply with applicable law. Covenants like these continue to be put under increasing stress as national and international crises like the COVID-19 pandemic, and regulatory responses to those crises, require originators to act quickly to make changes for consumers.

Credit policies are also a key area for diligence and negotiation, with funders looking for control over pricing strategy to

ensure coverage for funding costs or to improve returns. There is frequently tension here, with some funders (typically bank lenders) being institutionally sensitive towards products with high costs or interest rates for consumers, while financial investors are more comfortable supporting the origination of nonconforming and subprime assets.

Business performance

Funders will also be looking to monitor the ongoing business performance of the originators, and this is commonly in the form of audit covenants. The usual topics of negotiation are frequency and scope. Funders may want to involve external auditors, which can cause significant operational pressure on originators complying with requests for information and access, while originators will want to limit audits to predictable and, ideally, infrequent occasions. Funders may also want to ensure they have a secure exit route, by performing audits on the assets to verify that they are of a good enough quality to be suitable for public securitisations. There is also likely to be negotiation around who bears the cost for audits, with originators arguing that funders, or the transaction itself, should meet these costs, while funders might look for cost coverage from the originator. Some transactions might see the responsibility for meeting costs change depending on whether someone is at fault.

Borrowing bases, eligibility criteria and concentration limits

In forward flow and wet-funded warehouse securitisations, control over asset quality and credit exposure is controlled primarily via a combination of:

- **eligibility criteria**: which determine which assets are eligible to be purchased and funded; and
- **concentration limits**: which determine how much of the portfolio can consist of assets in certain categories or with certain common features.

Together, these typically define what is referred to as the borrowing base – the portfolio of assets that are eligible for funding. The funder will then apply an advance rate (essentially a percentage discount) to the borrowing base to determine the limits of its credit exposure.

Credit given to collections

A key topic of negotiation on the borrowing base is the ability to fund future asset generation and, in connection with that, what credit is given to collections received on existing assets. Originators and funders often have a keen focus on whether collections received form part of the borrowing base, such that it can be borrowed against and used to generate more assets. Failing that, originators would need to wait until that cash is used to repay debt before it can be reborrowed. Originators are often successful here; it is a fairly straight forward argument to convince a funder that cash in the bank is suitable security. More sophisticated originators may even push for netting arrangements, where they only need to sweep collections to the funder on a periodic basis, and they can do so net of cash used for new origination. This can be a more difficult fight because it requires funders to take commingling risk on intra-period collections.

Concerns for funders

Different types of funders are likely to have different risk appetites. In a leveraged forward flow or wet-funded warehouse securitisation, the equity investor is likely to have a different perspective on eligibility criteria and concentration limits to the senior funder. The equity investor may be comfortable to take more risk on less credit-worthy assets to generate higher returns, but less happy to take risk on tax issues which would affect the equity investor before the senior funder. A senior funder may have very specific limits on its credit approval, or be looking for exposure to very specific assets, and therefore have limited scope for negotiation. This could mean wanting to limit assets to certain geographic regions or credit qualities, or certain asset types (for example, in the context of residential mortgage securitisation, only one of owner-occupied or buy-to-let). As discussed above, there are can also be tension over pricing strategy, with funders having varying levels of appetite for exposure to nonconforming or high interest rate assets.

Mitigating interest rate risk

As interbank rates continue to fluctuate and increase, one of the key concerns and pressures on asset-backed financing is the need to mitigate interest rate risk. This can be particularly complex for forward flow securitisation, where the ultimate composition of the portfolio (including the weighted average interest rate of the fixed rate assets) might not be known at the start of the transaction or indeed ever. Many originators are having difficulties here, as portfolios of assets generated during low interest periods might be incapable of supporting market pricing for securitisation debt when those assets later come to be securitised.

Forward flow securitisations therefore typically use a range of different tools to control interest rate exposure. These include:

- eligibility criteria and concentration limits intended to keep the weighted average interest rate of the fixed rate assets above an agreed percentage;
- excess spread triggers, where the returns are required to be maintained at a certain threshold over funding costs;
- hedging triggers, where originators are required to put hedging in place if there is a risk that the asset portfolio will not be able to support an increasing interest rate on the liabilities or where interbank rates exceed an agreed rate; and
- ‘pre-hedging’, where originators agree mechanics to put in place interest rate swaps at the point of asset origination, rather than using a retrospective test to ensure compliance with hedging requirements.

Pre-hedging

Pre-hedging has become increasingly popular and can lead to significant complexity. Typically, this involves interest rate swaps being entered into when assets are offered to consumers for origination, either on an asset-by-asset basis, or based on small pools of assets, to mitigate interest rate risks on those assets or pools. This enables originators to get certainty over their funding costs at the point the offer is made to the consumer. When the assets are originated and sold into the securitisation, they are transferred with the economic benefit of the related interest rate swap (e.g. by novation). This offers both the originators and the funders certainty over the debt service that

the portfolio can support (because fixed rate assets are essentially turned into floating rate assets on origination).

However, mechanisms like this can be particularly difficult to model, as they are impacted by, among other things, customer trends, origination patterns, and expected prepayments. Originators wanting to use these mechanisms will therefore need sophisticated approaches to continually monitor the shape of the securitised portfolio, their expected asset generation and completion success rate, and the funders' hedging requirements, to avoid costly risks. For example, because the interest rate swap is traded at the point of offer rather than origination, a high rate of failure to convert offers into assets could lead to significant hedging costs with no assets to meet them.

For swap counterparties, who have traditionally provided either vanilla interest rate swaps or balance guaranteed swaps for securitisation transactions, meeting the operational demands of increasingly frequent and granular swap transactions can be difficult.

Exit strategy

In a traditional private warehouse securitisation, the typical exit strategy is a refinancing by way of public securitisation, often referred to as a "public take-out". Warehouses will contain a call option to enable this by allowing the originator to repurchase all the assets or arrange for their disposal to an SPV. The warehouse therefore allows the originator to accumulate assets until they have sufficient assets available to support a public transaction, while retaining ultimate control over the assets.

In the forward flow securitisation model, where the entire beneficial ownership of the assets is transferred to the funder, a public take-out may still be a viable route for the funder to refinance its exposure to the assets, but the originator's only involvement is likely to be as servicer of the assets. This means that the originator has far less control over the shape of the resulting public securitisation, will not be able to benefit from the cheaper funding costs available from the public market, and is therefore less incentivised to participate in the public take-out. For originators with multiple forward flow securitisations, they will need to take care to avoid reputational issues involved in having multiple public take-outs occur within a short time period. To this end, they might be able to negotiate clear markets provisions with funders. Options for managing other reputational risks are limited. For example, they may be unable to ensure public pricing consistency given their lack of control over the assets.

Wet-funded warehouse securitisation can offer originators the best of both worlds, by allowing them to retain control over their assets (through funding the junior debt in the securitisation and holding a call option) while they accumulate. Originators should note, however, that senior funders of these types of transactions typically insist on measures to ensure their involvement in the resulting public takeout. This is often a combination of:

- a prepayment fee payable to the senior funder for terminating the private securitisation early;
- an agreement by the originator to give the senior funder a right of first refusal for any arranger/lead manager role in the public take-out; and

- an agreement by the senior funder that the prepayment fee will be reduced by the amount of any arrangement/management fees paid to it as part of the public take-out.

Consumer duty

Forward flow securitisation has often been used as a route for non-bank and unregulated financial investors to gain exposure to regulated products. By leaving the origination process in the hands of a regulated lender, the unregulated financial investor can acquire the credit risk of the assets without the need itself to be regulated.

However, the UK Financial Conduct Authority's new consumer duty (the "**Duty**"), which comes into force on 31 July 2023 in relation to new and existing products or services that are then open to sale or renewal, risks disrupting that approach. Broadly, the Duty will introduce a new consumer principle, requiring firms to "act to deliver good outcomes for retail customers". This applies to both manufacturers and distributors of products marketed or distributed to retail customers. The FCA has explained that the concepts of manufacturer and distributor are "*deliberately broad to capture all aspects of the manufacture and distribution of products and services*".[2] There is therefore a real risk that a non-bank lender transacting with a regulated lender in creating a product for the purposes of forward flow securitisation is within the scope of the Duty (even if they are not regulated for other activities).

This has seen funders take steps in transaction documentation to limit the perceived control they are exercising over the products and the relationship with customers. Naturally, this is a source of tension, particular in light of the concerns over control over the origination process and documentation that we outlined above. Alternatively, some funders are accepting that, in certain scenarios, being within scope of the Duty is unavoidable, in which case a co-manufacturing agreement might be required. For more information on the FCA consumer duty, see the article entitled "*The FCA Consumer Duty: practical implications for market participants*" earlier in this volume.

Risk retention

The traditional model of forward flow securitisation offered originators the opportunity to bypass regulation that applies to securitisation transactions. In a whole-loan sale forward flow securitisation, where the entire economic benefit of the originated assets is sold to the funders and the originator has no ongoing exposure to the credit performance of the assets, it is likely that there is no securitisation for the purposes of the EU and UK securitisation rules. Accordingly, originators can avoid the onerous risk retention, transparency and credit granting requirements that apply under those regimes.

Common issues for wet-funded warehouse securitisation

For the hybrid, wet-funded warehouse securitisation model, where originators are retaining a junior credit risk in the transaction and therefore there is likely to be a securitisation for regulatory purposes, originators and funders will need to take care that regulatory requirements are met. While these kinds of transactions do not inherently present difficulties, the fact patterns that make

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[2] FCA, *A new Consumer Duty: Feedback to CP21/36 and final rules* (PS22/9, July 2022), 20: https://www.fca.org.uk/publication/policy/ps22-9.pdf

them a viable source of funding can coincidentally present regulatory issues. For example, originators developing assets solely for the purposes of securitising those assets through a forward flow or wet-funded warehouse securitisation might have to consider carefully the requirements around credit granting, and applying the same criteria to securitised and non-securitised assets.

Similarly, originators creating new origination platforms might need to consider in advance whether their proposed risk retaining entity is an entity of substance capable of passing the "sole purpose" test. Regulatory developments over the last year, in particular the consultation regarding the final draft risk retention regulatory technical standards ("**RTS**") under the Securitisation Regulation (EU) 2017/2402 ("**EU Securitisation Regulation**") and the changes made to the those draft RTS from the previous drafts make clear that the sole purpose test, and the use of thinly capitalised vehicles as risk retainers, is still a focus for regulators.

Equity investor risk retention

More recently, a popular alternative model has been for the equity investor in a leveraged forward flow or wet-funded warehouse securitisation to be the risk retainer. This might be because the originator has no appetite to retain risk. Here, the regulatory issues typically centre around finding the correct characterisation for the equity investor as an eligible risk retainer. Broadly, the EU Securitisation Regulation (and its UK equivalent) have two routes for equity investors in this scenario: be an eligible risk retainer either by being involved in originating the assets, or by purchasing a third party's assets on its own account and securitising them.

For transactions involving the purchase of assets by an SPV from the originator (including wet-funded warehouse securitisation's involving an advance payment of purchase price as wet funding), the latter route can be the obvious choice. Concerns around whether the assets were truly purchased by the equity investor "on its own account" and then securitised can be allayed by the equity investor giving a commitment to fund the SPV and the SPV giving a commitment to purchase assets from the originator.

Where the transaction does not involve the purchase of assets, for example where the assets are originated in the SPV, typically the equity investor must find a way of being comfortable that it was involved in the origination process. This might be a combination of being related to the SPV (as a shareholder, for example), negotiating the terms of the transaction and the underlying assets (including eligibility criteria and concentration limits), and performing due diligence on the origination documentation and the originator's credit and collection policies.

The Right Tool for the Right Job?

In the right circumstances, forward flow and wet-funded warehouse securitisation can be an incredibly useful tool for achieving originators objectives in challenging market environments and allowing funders access to otherwise unavailable exposures. A well-constructed forward flow securitisation is a true relationship lending transaction, where the relationship between the originator and its trusted financial institution is at the heart of the commercial negotiation. But originators and funders should take care to work through the number of complex commercial and legal issues at the heart of these transactions to make sure they are meeting their goals.

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