

Trade Finance

Transferring Risk in Trade Assets using Participation Agreements — is the BAFT MPA way always the best?

Presentation by Geoffrey Wynne, Partner,
Sullivan & Worcester UK LLP

Thursday 2 February 2023



What this talk will cover

- What are we talking about today?
- What are trade assets?
- Transfer of Risk
 - › What was BAFT MPA designed to do?
 - › What has happened since?
- Needs of the Parties
 - › Seller
 - › Participant
 - › Law and Accounting requirements in all this
- Different forms emerged (and emerging)
- Other options available
- Move BAFT forward – is it worthwhile?
 - › Participant focussed?
- Summary

Trade Assets

- What did BAFT MPA focus on?
- Receivables seen as an “add on”
 - › Developments are increasing to use participations for these
- Differences between funded and unfunded
- Funded
 - › Likely to be loans, receivables, payment undertakings
 - › Unfunded more challenging?
- Unfunded
 - › Letter of credit
 - › Difference between Doc LC and SBLC
 - › Other unfunded commitment e.g. performance bonds

What was BAFT MPA designed to do

- 2008 (original) v 2018 (current)
- Better reflect transfer of financial asset
 - › Now called Seller and Participant
- Designed to be between banking groups
 - › Hence Master Parties
 - › Can be any group entity as seller or participant
- Offer and acceptance mechanism
- Funded and Unfunded can be covered
- Ownership transfer (Clause 6) when funded (or becomes funded)
 - › This is key to true sale and risk transfer

Issues within the current BAFT MPA

- Assumption that Participant takes document risk
 - › Limited obligations of Seller
- Seller has certain (limited) obligations during the transaction
 - › No fraud risk specified
 - › How is the position dealt with?
- Each transaction starts with an Offer
 - › No obligation on Participant to accept
- Participant has certain rights in relation to post completion matters
 - › Seller still runs the relationship
 - › What risks does Participant accept?
- Description of Recourse Parties and Recourse Rights
- So it works!
 - › Why change it?

What has been happening?

- Sign of success of participation structure that we are discussing this
- More tailored transactions – so what to do?
- Make the offer and acceptance more detailed?
- Write a more specific Participation Agreement?
- Choice often driven by Seller who wants Participant committed
 - › Needed for its own internal reasons
- Choice sometimes driven by Participant who wants specific types of assets
 - › Participant often knows what it wants and the document may not provide it
- How much do we rewrite?
 - › BAFT structure still a sound basis?
 - › What are the common issues and could they be solved by other templates?

Law and Accounting Issues

- Before looking at why changes might be useful consider developments in legal and accounting analysis
- They are interlinked
- They have been there all the time
 - › Changes to BAFT 2018 reflected this
 - › Legal analysis for English and NY law purposes now much closer
- Accounting treatment may cause issues
 - › Position of auditors
 - › Driven by legal analysis of true sale or risk transfer

Legal Issues

- Legal isolation is subject to a legal, not accounting analysis e.g. certain bankruptcy laws; choice of law of transaction documents (RPA; assignment)
- True sale opinion – consideration of level of control post sale. Note, a right to re-acquire transferred financial assets e.g. a call option may not in itself effect true sale
- View the transaction as a whole - does the transferor maintain effective control over the transferred financial assets?
- US lawyers review the level of recourse /effective control over the transferred financial assets differently than under English law
- Consider whether you require a transaction specific true sale legal opinion

Considerations for a true sale under a BAFT MPA

- Needs to be a funded participation
- Structure of Clause 6 designed to deal with the key issues of transfer of rights
- Use of equitable assignment designed to work
- Compare this to a receivables purchase where seller collects as agent (still the legal owner)
- Accounting issues sometimes require more
 - › Position in bankruptcy of seller
 - › Use of Elevation rights before then

What about Credit Risk Mitigation (CRM)

- CRM can include (amongst others) funded or unfunded sub-participations
- If CRM meets the applicable accounting criteria for de-recognition, this will reduce the underlying exposure from a CRR-perspective
 - › So the CRR eligibility requirements for CRMs may not be relevant in a funded participation as there will have been a sale of the asset
- In an unfunded sub-participation, the participant pays only following default of the underlying obligor
 - › Prior to payment of a claim there is no transfer to the participant of the Seller's rights against the underlying obligor
 - › Following a default of the underlying obligor, the terms of a sub-participation agreement might require the seller to transfer to the participant the seller's rights against the underlying obligor (novation or assignment)
 - › As there is no transfer to the participant (at the outset) of the seller's rights against the underlying obligor, an unfunded sub-participation would not give rise to a legal true sale

CRM as credit protection

- An unfunded sub-participation is capable of being eligible as credit protection for the purposes of calculating capital requirements under the CRR - subject to meeting the relevant eligibility requirements in the CRR
 - › CRR requirements applicable to using a participation as CRM will depend on the applicable approach and the method used by the seller to calculate the risk weighted exposure amount and to recognise the effect of unfunded credit protection for the relevant exposure
 - Example requirements include: the credit protection must be “direct” and “clearly defined and incontrovertible”

Legal opinion to analyse whether the arrangement is capable of being a “guarantee” for the purposes of CRR and therefore CRM

- Structure of the Participation Agreement is key to this
- BAFT structure works for these purposes
 - › Take care in making changes

Accounting Issues

- US GAAP - transferred financial assets must be legally isolated from the transferor and its creditors to qualify as a true sale from an accounting perspective
- Accounting Standards Codification (ASC) 860 – 10 – 40 – 5 (a) states the following are required for “legal isolation”:
 - › The transferred financial assets have been put ***presumptively beyond the reach*** of the transferor and its creditors, even in bankruptcy or other receivership
 - › The transferred financial assets ***would be beyond the reach of the powers of a bankruptcy trustee or other receiver*** for the transferor or any of its consolidated affiliates included in the financial statements being presented
 - › A set-off right is not an impediment to meeting the isolation condition because courts would not consider these when looking at a true sale

Further Accounting Issues

- CRR distinguishes between “trading book” and “non-trading book” for the purpose of calculating capital requirements
- Under the CRR “trading book” means “all positions in financial instruments and commodities held by an institution either with trading intent, or in order to hedge positions held with trading intent”
 - › Subjectivity of test and “trading intent” – plans for a more objective test were due in 2020
- Banks should have clear policies, procedures and records of their determination as to which instruments are included or excluded from the “trading book” for the purpose of calculating their regulatory capital requirements
- Accounting true sale - IFRS or GAAP
 - › International Financial Reporting Standards are developed by the International Accounting Standards Board (IASB) and International Sustainability Standards Board (ISSB)
 - International application – principle based so may be more room for interpretation
 - › Generally Accepted Accounting Principles (GAAP) are prepared by the Financial Accounting Standards Board (FASB)
 - Used in US – rules based

Accounting true sale – a comparison

GAAP true sale	IFRS true sale
<p>ASC 860 (<i>Transfers and Servicing</i>) “legal isolation of the transferred assets, which places the assets beyond the reach of the transferor's creditors or a bankruptcy trustee for the transferor”.</p> <p>This is dependent on the facts.</p>	<p>IFRS 9 (<i>Financial Instruments</i>) applies a combination of risks and rewards and control tests:</p> <ol style="list-style-type: none"> 1) Risk and Reward: having transferred a financial asset, does the entity continue to be exposed to the risks of ownership of that asset and/ or the benefits that it generates – economic exposure. 2) Control: which entity controls the asset (i.e., which entity can direct how the benefits of that asset are realised).
<p>Focus is on whether a transferor has surrendered control over a financial asset</p>	<p>Control test only used when entity has not substantially transferred all the risks and rewards of the asset nor retained them</p>
<p>Control surrendered only if all three of the following conditions are met:</p> <ul style="list-style-type: none"> • the assets have been legally isolated; • the transferee has the ability to pledge or exchange the transferred assets; and • the transferor otherwise no longer maintains effective control over the assets. 	<p>IFRS 9 provides three examples of transferring substantially all the risks and rewards of ownership:</p> <ol style="list-style-type: none"> 1) Unconditionally selling a financial asset 2) Selling a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase 3) Selling a financial asset together with a put or call option that is deeply out of the money (i.e., an option that is so far out of the money it is highly unlikely to go into the money before expiring)

Key drivers to changes in approach and drafting

- Need to adapt the BAFT framework to a specific transaction
 - › Just amending offer and acceptance often too cumbersome but possible
- Drafting driven by the parties based (often) on a transaction term sheet
 - › Take the BAFT document and change it
 - › Showing changes from BAFT often helps
- Legal and Accounting issues drive this
- Business requirements need to be more closely reflected for the specific transaction

What are specific areas?

- Cover specifics of assets involved
 - › Eligibility criteria
 - › Concentration risk
- Are participations funded or unfunded or both?
 - › Application of just relevant BAFT provisions
 - › Timings and level of commitment
 - › Conversion of unfunded into funded
- Usually make one way
 - › Describe who is Seller
 - › Cover who is Participant
- What about rights and responsibilities?

Where does BAFT MPA often have changes in this area?

- Seller wants clear obligation on Participant to take risk in the asset
- Participant wants very specific statement of its risks and rights when it participates
- Amendments to Seller/Participant representations
- Amendments to each party's rights and responsibilities
- Closer consideration to Elevation rights and timings
 - › Participant perhaps more aware of risk
- Need to review definitions in particular
 - › Particularly so for non-bank participants
- Greater focus on what the participant needs?

Is it possible to standardise the changed approach?

- Simple answer is “no” BUT
- Clearly areas worth looking at to achieve a better starting point
 - › Especially where the participant is a non-bank
- Terminology
 - › Can that help achieve easier negotiation?
- Clarify rights and obligations of the parties
 - › Areas of representation quite key
 - › Spell out more closely what the Seller has to do?
- If there are clearer then rights and obligations of the Participant may be easier to define

Areas to consider in more detail

- Definitions could be improved to reflect exactly what is being participated
 - › “Trade Receivable”
 - › How is it evidenced?
 - › Payer of receivable /buyer of goods could help
- Specific seller representations
 - › Cover the underlying transaction?
 - › Cover documentation and its purpose and effect
 - › Clarify when and for what reason the Participant pays (if unfunded) or receives (if funded)

What if a BAFT MPA is not used as the base document?

- Need then to have specific form of document to reflect the asset or the responsibilities
- If a funded participation in receivables use receivable purchase agreement – ie. a purchase
- If in a loan – transfer it
- If unfunded have a guarantee or an SBLC
- Each would work but lacks the flexibility of a BAFT MPA
 - › So BAFT MPA works but may be useful to have variations/modifications

Summary

- BAFT MPA still can work
- It can satisfy legal and accounting requirements
- Works particularly well between banks
 - › Even these may need changing where one party is always the seller (or Participant)
- Time to provide other options?
 - › Always possible to tailor the drafting
- Participation is a good structure
- The BAFT way should be the way ahead in whatever route we choose

Any Questions?

Geoffrey Wynne

Partner

Geoffrey Wynne is head of Sullivan & Worcester's London office and also head of its Trade & Export Finance Group. He has extensive experience in banking and finance, specifically trade and structured trade and commodity finance. He also advises on corporate and international finance, asset and project finance, syndicated lending, equipment leasing and workouts and financing restructuring.

Geoff is one of the leading trade finance lawyers and has advised extensively many of the major trade finance banks, multilateral financiers and companies 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. He has worked on warehouse financings in many jurisdictions and advised on how to structure involving warehouse operators and collateral managers. He has also advised on ownership structures and repos for commodities and receivables financings.

Geoff sits on the editorial boards of a number of publications and is a regular contributor and speaker at conferences. He is also the editor of and contributor to *The Practitioner's Guide to Trade and Commodity Finance* published by Sweet & Maxwell and *A Guide to Receivables Finance*, a special report from TFR published by Ark.

Geoff has recently been recognized as the only UK lawyer included in the Trade Finance section of the *UK Legal 500's* all new UK **'Hall of Fame.'** *Trade & Forfeiting Review* (TFR) honoured Geoff with the TFR Fellowship Award in its 2017 TFR Excellence Awards.

Sullivan & Worcester UK LLP	T +44 (0)20 7448 1001
Tower 42	F +44 (0)20 7900 3472
25 Old Broad Street	gwynne@sullivanlaw.com
London EC2N 1HQ	

Awards & Recognition

The Legal 500 UK, 2023

Sullivan ranked in Tier 1 for Trade Finance by *The Legal 500 UK, 2023* for the ninth year running
Partner Geoffrey Wynne is included as a Leading Individual for Trade Finance in the “Hall of Fame”
Simon Cook and Mark Norris are recognised as Leading Individuals
Sam Fowler-Holmes is recognised as a Next Generation Partner and Hannah Fearn as a Rising Star

Chambers UK, 2023

Chambers UK, 2023 ranked Sullivan for Commodities: Trade Finance (UK-wide)
Geoffrey Wynne and Simon Cook are both ranked in Tier 1 and Mark Norris in Tier 3
Sam Fowler-Holmes is recognised as an “Up and Coming” lawyer

IFLR1000 Banking and Finance Guide, 2023 (32nd edition)

Sullivan recognised for Banking Lending - Lender Side, United Kingdom, in *IFLR1000's Banking and Finance Guide, 2023*
Partner Geoffrey Wynne is ranked as a Leading Lawyer – Highly Regarded in the United Kingdom

Global Trade Review (GTR) “Best Trade or Supply Chain Finance Law Firm”, 2022

GTR named Sullivan “Best Trade or Supply Chain Finance Law Firm” at the GTR Leaders in Trade Awards in 2022

Trade Finance Global “Best Trade Finance Law Firm” 2022

Sullivan named “Best Trade Finance Law Firm” 2022 by *Trade Finance Global* (in connection with BAFT) at its International Trade Awards, 2022

In 2021, 2020 and 2019, GTR named Sullivan

The firm was named “Law Firm of the Year” in the category “Leaders in Trade for Innovation” at the 2021 GTR Leaders in Trade Awards and “Best Trade Finance Law Firm” at the GTR Leaders in Trade Awards in 2020 and 2019

2021 Lexology “Client Choice” award for Banking, United Kingdom

Geoffrey Wynne named a recipient of the Lexology “Client Choice” Award 2021 for Banking, United Kingdom

Trade Finance Global “Best Trade Finance Law Firm” 2019

Sullivan named “Best Trade Finance Law Firm” 2019 by *Trade Finance Global* at its International Trade Finance Awards, 2019





**What's
Your
Next?**

Move forward with Sullivan

Boston

One Post Office Square
Boston, MA 02109
+1 (617) 338-2800

London

Tower 42
25 Old Broad Street
London EC2N 1HQ
+44 (0)20 7448 1000

New York

1633 Broadway
New York, NY 10019
+1 (212) 660-3000

Washington, DC

1666 K Street, NW
Washington, DC 20006
+1 (202) 775-1200

Tel Aviv

28 HaArba'a Street, HaArba'a Towers
North Tower, 35th Floor
Tel Aviv 6473925
+972 74 7580480

sullivanlaw.com

[@sullivanlaw](https://twitter.com/sullivanlaw)

