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Speciality finance sub-sectors: commercial considerations and legal implications

This is the second of recent briefing notes we have produced in respect of the speciality finance sector, in which funders lend into financial institutions which themselves makes loans available to companies, partnerships, sole traders and individual consumers ("**Customer Loans**").

Though there are typically few substantive structural differences to the facility agreements which govern the lending relationships between funders and financial institutions across the speciality finance sector (the "**Agreements**"), the distinguishable characteristics of the asset classes (otherwise known as sub-sectors) which are the subject of the Customer Loans lend themselves to a number of documentary nuances within the Agreements – this note summarises a selection of them.

Unsecured Consumer Finance

- This sub-sector is characterised by high volume, short term, low debt quantum finance, including high cost short term ("**HCST**") loans – some institutional funders are wary lending into the HCST sector due to reputational and arrears/default performance concerns, so there will typically be increased scrutiny on performance covenants within Agreements: in particular, it is generally accepted that unsecured consumer loans have higher default rates than other sub-sectors, which means there is additional focus on consistency of performance between cohorts of such loans.
- A combination of regulatory intervention (which has driven stricter operating standards of financial institutions and limited charges which they can levy) and public perceptions of financing in this sub-sector focuses minds on APRs and customer charges – these may be addressed by portfolio concentration tests and eligibility criteria within the Agreements, which seek to limit funders' exposure and risk in this particular space to levels palatable to funders' credit teams or institutions more generally.
- Funders will give enhanced focus to finance companies' compliance with consumer credit laws and regulations via representations and eligibility criteria. Due diligence by funders on underlying Customer Loan documents focuses on regulatory aspects but will typically only cover a sample of the

underlying Customer Loans given the volume of loans outstanding at any one time.

- Funders' security packages will be scoped to include assignments of key regulatory Customer Loan documents (e.g. adequate explanations and pre-contract credit information documentation).

1st/2nd Charge Mortgage

- The secured nature of Customer Loans in this sub-sector drives a particular focus on the underlying security package granted in favour of the financial institution making available the Customer Loans. This is because the financial institution will assign the rights it has under that package, along with the rights it has in respect of the Customer Loans themselves, to the relevant funder as security for the senior financing. Defined terms relating to the Customer Loans and the underlying security package will thus be tailored to ensure that the funder's security is as comprehensive as it can be and the underlying security documents will be diligenced to ensure there is no prohibition on assignment to the relevant funder.
- Representations in relation to the underlying security package are robust – to list just a view, these address that the security granted is enforceable and secures all amounts under the relevant Customer Loan, title deeds have been retained by the financial institution as appropriate, comprehensive property valuer indemnity insurance has been obtained and the relevant report on title does not show anything which would be of concern to a prudent mortgage provider.
- Concentration tests are set against, for example, geographic location of the underlying collateral property of the Customer Loan portfolio to limit regional or other exposure.
- Eligibility criteria are set to restrict the types of property collateral securing the Customer Loans against which funders will lend.
- Advance rates are typically adjusted to reflect funder risk (for example, less (or more expensive) funding may be advanced against second charge mortgage Customer Loans).
- There will be particular scrutiny of the underwriting policies (and by extension detailed eligibility criteria) to address, for example, the professional experience of the valuer providing the valuation in respect of the property secured in favour of the financial institution as security for the relevant Customer Loan.
- Where a split-SPV financing structure is adopted (as to which, please see our previous briefing note), and Customer Loans are transferred to the SPV on completion of the senior financing, conditions precedent are included to ensure real estate formalities (e.g. Land Registry forms and searches) are completed such that the underlying security packages follow the transfer of the loans themselves.

Bridging/Development Finance

- In addition to the points referred to in the section above, which tend to apply equally to Customer Loans in the bridging/development finance sub-sector, these loans typically have a tenor of 12-24 months, though there is a trend for originators to offer longer-term products of up to 36 months – this may be reflected in an extension to the repayment profile of the senior debt facility.
- Both funders and financial institutions in this sub-sector will be keen to ensure liquidity is maintained for the latter drawdowns of staged development Customer Loans in order to preserve the value of the underlying property collateral (i.e. their respective security packages).
- Distinctions are made within the asset class itself (e.g. loans may be stratified into site purchase, development/heavy refurbishment and light

refurbishment categories) with concentration limits set to restrict exposure to the perceived 'riskier' underlying financings.

- Funders tend to offer higher advance rates in respect of Customer Loans secured on residential (as opposed to commercial) properties.
- Portfolio tests address, for example, weighted average margin, 'look through' loan to value (which in itself may be calculated on different bases – development value, open market value or vacant possession value – depending on the properties securing the Customer Loans) to maintain economic strength of the Customer Loan portfolio.
- Eligibility criteria will also restrict funding against Customer Loans with insufficient projected profitability/yield or with longer tenors and will minimise risk in other ways (e.g. ensuring appropriate planning permissions have been obtained and the underlying security package includes security assignments over construction contracts/other material agreements).

Auto/Asset Finance

- The consumer credit regime comes into particular focus in due diligence work, which will address whether the underlying Customer Loan documentation satisfies the regulatory framework in which car finance financial institutions operate.
- Eligibility criteria typically hone in on principal balance and loan to value given the relatively quick depreciation of the assets funded and portfolio tests are set in relation to financial institutions' broker arrangements to limit concentration risk.
- Representations ensure vehicles funded by the Customer Loans are not used for commercial purposes and typically that the legal title to the vehicles remains with the financier until all payments (including balloon and/or option to purchase fee) have been made.
- We expect to see further developments in Agreements relating to auto finance as a result of the recent FCA paper on the sub-sector, which had a particular emphasis on broker commissions generally and (on a loan-by-loan basis) customer affordability.
- Funders have less appetite to fund residual risk (i.e. they have a strong preference for financing arrangements in which the underlying asset price is paid off in full over the life of the Customer Loans).
- Concentration tests/eligibility criteria may test product type and/or industry classification (depending on whether assets are 'hard' or 'soft').

P2P Finance

- A number of P2P lenders in the market have "on balance sheet" funding lines in addition to their traditional funding platforms.
- These operate very similarly to traditional funding lines for the underlying asset class, however funders will be focused on ensuring there is an appropriate allocation policy between the P2P platform and institutional funders.
- Funders will also seek to ensure that P2P investors do not fund the originator's equity requirement in institutional funding SPVs.

SME Finance

- Customer Loans are more likely to be supported by company debentures and/or personal guarantees, so representations and eligibility criteria will test the enforceability of those documents.
- There is a wide range of products made available by finance companies to SMEs including revolving loans, term loans, invoice finance and merchant cash advances. Each product has different repayment and risk features, with funding controls varying accordingly.

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Akhil is a Senior Manager in the EY team and has a wide range of experience in structuring tailored financing solutions for clients operating in all of the sub-sectors referred to in this briefing.