Baker McKenzie.

Trade Finance Quarterly Insight

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TRANSACTIONAL POWERHOUSE

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Trade Finance Quarterly Insight

Welcome to the March edition of this quarterly publication that includes a variety of legal and market focused articles on current topics of interest in the world of trade finance.

We could of course not let the first post-Brexit edition of this publication go out without examining the implications of the EU-UK Trade and Cooperation Agreement (the "**TCA**") for businesses engaged in international trade and related financing activities. In the first of three articles we distil for readers the key implications of the TCA from a compliance perspective, focusing on a number of important and inter-related trade compliance provisions relevant for customs, VAT, product regulation, sanctions, export controls and trade remedies.

In the second article, we examine the Debt Service Suspension Initiative ("**DSSI**") that seeks to alleviate some of the financial stress, that was exacerbated by the impact of COVID-19, on the world's poorest nations by suspending their debt payments. We flagged the DSSI, in a forward thinking article on "COVID-19: Considerations for Lenders in export credit agency supported financings" that featured in our first edition of this publication, in August 2020, as being a well-intentioned initiative but with the potential to lead to some unintended consequences. This article now builds on that line of thought, including a deeper exploration of those consequences and how they can, and have been, dealt with. Specifically, we consider the scope of the DSSI and its impact on finance documentation, and finish with some thoughts on the challenges the future may hold for sovereign debt.

Finally, in the third article our Johannesburg office explore how factoring as a way of accessing finance is increasing across Africa, providing an essential alternative to traditional loan financing, particularly for SMEs who have been hit hardest by the fallout from the COVID-19 pandemic, and allowing African businesses to trade more competitively. The article also helpfully flags potential issues with this type of financing that participants should consider.

Our now regular Sanctions and Export Controls update page also features some interesting reads, including amongst others, on the imposition by the Ukraine of its first-ever sectorial sanctions; the issuance by the US government of an Executive Order to address the use of US IaaS products by foreign malicious cyber actors; and the announcement of new measures by the UK, US and Canada over alleged Xinjiang, China Human Rights concerns. There is also a link to the Baker McKenzie blog of the same title.

As always we hope that you enjoy this edition of Baker McKenzie's Trade Finance Quarterly Insight and invite you to reach out to any of the contributors or indeed anyone else in the team (please see enclosed Key Contacts) should you wish to discuss any of the issues covered in this edition or have any other trade finance related queries.

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Brexit Revisited: The New World For Trade Compliance

Editor Highlights

- The UK now represents a new compliance jurisdiction, with separate rules, powers and costs to be considered.
- Additional customs and product regulatory requirements will push up costs for exporters and importers, potentially leading to changes to supply chains and borrowing requirements.
- Lenders and borrowers will likely both also pay close attention to the changes to sanctions and export controls, where the UK now has a more independent regime.

As part of the completion of Brexit the UK has entered into a free trade agreement with the EU, referred to as the EU-UK Trade and Cooperation Agreement (the "**TCA**"). This has been heralded by many as a landmark success whilst at the same time castigated by others as an unmitigated failure. The EU has described it as a thin deal that "will by no means match the level of economic integration that existed while the UK was an EU Member State". This article distils the key implications of the agreement from a compliance perspective for businesses engaged in international trade and/or related financing activities. This shall focus on a number of important and inter-related trade compliance provisions relevant for customs, VAT, product regulation, sanctions, export controls and trade remedies. Regulation of services shall be addressed as part of a separate publication.

Key Takeaways

- The UK now represents a new compliance jurisdiction, with separate rules, powers and costs to be considered.
- Depending on the sector, this may require exporters and importers to dedicate resource to new authorisations, duties, rules of origin assessments, regulator dialogue and, in some instances, alternative supply chains and/or routes to market. This is likely to be most significant in the context of customs and product regulation, where the changes arising from Brexit are most extensive.
- This in turn may impact lenders as well. Shifts in trade patterns and trade routes may impact on exporters' borrowing requirements, together with upfront and ongoing compliance costs arising from the above in certain instances. Compliance representations and warranties may need to be amended too in order to ensure that UK aspects to some of the compliance matters above are appropriately addressed.
- Lenders and borrowers will also likely both pay close attention to the changes to sanctions and export controls, where the UK now has a more independent regime. Whilst there is a reasonable degree of similarity to EU principles, there are key nuances to the new UK approach for example to ownership / control tests, licensing, party-based lists and certain other matters. This may mean that there will still mostly be continuity from a compliance process perspective in considering "*what to look for*", but there will now be key UK differences in how to assess "*what you find*."

The above areas are just some of the key issues and challenges we have identified that you should consider as part of your Brexit strategy.

Explore our Brexit Hub to learn more or reach out to one of our specialists.

Customs

At a baseline level, the UK and EU have been successful in ensuring through the TCA that goods originating in either jurisdiction will not be subject to tariffs or tariff rate quotas when moved between Great Britain ("**GB**") and the EU.[1] However, this is subject to a number of parameters and customs formalities, all of which pose a myriad of challenges for business, as set out below.

- Firstly, goods will only benefit from the tariff exemptions where they meet the relevant rule of origin tests set out in the TCA. Goods that cannot be shown to meet the rule of origin are subject to standard most-favoured nation duties under WTO terms. The TCA contains bespoke rules of origin for each tariff line. In order to benefit from preferential tariffs, goods generally need to be wholly obtained (e.g., grown, extracted etc.) in the EU or the UK, undergo significant manufacturing in the EU or UK, or have a certain proportion (generally more than 50%) of their materials by value originate within the EU or UK. Importers must also be able to demonstrate that the goods meet the relevant rule of origin, usually via a statement on origin provided by the exporter.

- Secondly, practically speaking, these new rules also place new administrative burdens on businesses with respect to customs declarations on goods shipped from GB to the EU and vice versa, all of which can result in delays in getting goods customs cleared through the EU/GB border.[2]

- Thirdly, the UK has lost duty relief under the EU Free Trade Agreements ("**FTAs**") on trade with the rest of the world. The UK has negotiated a number of continuity agreements which will transition many (though not all) existing EU FTAs to apply in respect of the UK, though with certain amendments and (in some case) new customs formalities.

- Furthermore, from a tax perspective, movements of goods between the UK and the EU are generally subject to import VAT, which may have cash flow implications. Furthermore, businesses selling goods from the UK into the EU may be required to newly register in the EU Member State where goods are sold (and vice versa). A fiscal representative may be required depending on local rules.

- Finally, there are certain variations and exemptions to the above rules in the context trade with Northern Ireland, which falls outside of GB but is still part of the UK. These are designed to prevent the need for a "hard border" between Northern Ireland and the Republic of Ireland. As a result of this, customs declarations are now required for shipments from GB to Northern Ireland, and checks may be required on certain more sensitive goods, such as animal products that require a health certificate. In addition, any customs duties payable on such shipments (i.e., where goods do not benefit from the preferential tariffs under the TCA) must be paid at the GB-Northern Ireland border, where goods are considered to be "at risk" of onward shipment to the EU. This is designed to prevent Northern Ireland effectively becoming a "back door" for goods to be shipped from GB to the EU without any customs assessment.

Taken together the new measures place significantly increased costs and administrative burdens on business with respect to customs and VAT rules. This is currently actively impacting timing, price and trade volume for a significant proportion of UK-EU trade and this in turn may have implications for related financing of these activities.

1 "Great Britain" consists of England, Scotland and Wales, together with the outer laying islands administered by each, including the Isle of Wight, the Scilly Isles, the Hebrides, Orkney and Shetland. The "UK" includes all of these territories as well, together with Northern Ireland. There are a number of distinct rules for Northern Ireland, which do not apply for Great Britain, as set out below.

2 On the UK side, in order to mitigate this the UK has introduced phased imposition of customs controls of the border, which allow businesses to optionally postpone the submission of custom declarations and payment of duty by up to six months for imports of most goods. From 1 April 2021 full controls will apply to products such as animal, plant and fisheries products, and from 1 July 2021 onwards full customs declarations will be required for all goods at the time of import. It's important to note that this this phased approach only applies on the UK side for imports into GB from the EU. Full border controls apply in the EU.

Product Regulatory

Product regulations and conformity assessment requirements can create technical barriers to the movement of goods between different markets. Although the TCA contains a number of provisions aimed at preventing unnecessary technical barriers to trade, it does not include much in terms of the mutual recognition of the parties' respective product regulatory standards and procedures. This means that for the vast majority of products businesses now need to comply with two different sets of regulations and compliance procedures for products placed on both the EU and GB markets (note, product regulations for Northern Ireland will remain aligned to the EU).

The new UK Conformity Assessment (UKCA) mark will replace the EU CE mark for the GB market and must be applied from 1 January 2021 to a limited range of products. However, in most cases, the CE mark can still be used for products for the GB market until 31 December 2021 with the UKCA mark generally only becoming mandatory from 1 January 2022.

Another key impact is that supply chain entities will now have different roles and responsibilities under product laws. For example, companies in GB previously qualifying as EU importers for product regulatory purposes have lost that status. The related obligations, liabilities and labelling requirements will instead fall on their EU customers. In the same way, GB sellers now have GB importer status (with associated obligations) for product regulatory purposes if they are bringing products from the EU/EEA into GB for the GB market.

Furthermore, GB-based authorised representatives and responsible persons are no longer recognised by the EU. Similarly, authorised representatives and responsible persons based in the EU are no longer recognised in GB as from 1 January 2021.

Sanctions and Export Controls

The UK has now introduced its own sanctions regime post-Brexit, separate from the EU. The framework for this is set out in the Sanctions and Anti-Money Laundering Act ("**SAMLA**") in 2018, supplemented by a number of statutory instruments (the "**UK Regulations**") enacted under it which provide the key operative provisions for each sanctioned country. The UK Regulations came into force on 1 January 2021.

These measures follow a similar approach to the EU in principle, though there a number of distinctions in the UK's approach to particular definitions, licences and party-based sanctions lists, as follows.

- The UK has introduced statutory rules of interpretation of "control" to be used when assessing influence held by designated parties over non-listed subsidiaries.
- The UK has replaced the EU concept of "financial assistance" with a wider concept of "financial services", which in particular includes payment processing. This is relevant in the context of trade with countries subject to sanctions product controls and arms embargos (which is a different and more extensive list than the list of 5 US comprehensively sanctioned countries). Consequently, where the SWIFT messaging or other documentation reveals a nexus to these countries for any trade-related payments, it will likely be important in some cases for banks to undertake further review with the customer of the specific items being exported.
- The UK list of designated parties in most cases follows the EU's approach although with a few key distinctions as follows: (i) the UK has removed designations in relation to Egypt, Tunisia, Ukraine and Turkey; and (ii) the UK has introduced a unilateral sanctions regime under which parties have been designated on the grounds of human rights concerns, for example in Russia, Saudi Arabia, North Korea and Myanmar (these designations were made under the so-called "Magnitsky" sanctions introduced under SAMLA in 2018).
- The UK now has the ability to introduce general licences for transactions that would otherwise be blocked by sanctions, which was not the case under the EU regime. The UK has already introduced two general licences specific to Russia pursuant to these measures and is considering adopting a further general licence for banks specific to internal management of frozen assets.

There are also certain changes to export controls arising from Brexit. In particular, new export licensing requirements (in most cases under general licences) now apply to movements of controlled dual-use goods between GB and the EU, subject to certain exceptions for Northern Ireland.

Trade Remedies

UK trade remedies have traditionally been handled through the EU but post-Brexit the UK has now adopted its own regime. Pursuant to this, the UK may now impose its own trade remedy measures against imported products, for example on grounds of anti-dumping, anti-subsidy or safeguarding concerns. This is both an opportunity and a threat for businesses, depending on the nature of their involvement in imports to the UK, exports from the UK and domestic UK manufacture. There may increasingly now be scope for example to advocate:

a) for imposition of trade remedies, where businesses are looking to protect domestic market share;

b) for removal of trade remedies so as to expand access to UK markets from overseas; and/or

c) for the UK to undertake to WTO challenges to trade remedies imposed by third countries against UK exports.

These types of considerations (at least under (a) and (b)) have already been illustrated through the debates over the UK's continuity, and in some cases abolition, of existing EU trade remedies. There will be a careful balance for the UK government to strike going forward in seeking to protect UK manufactures but at the same time maintain goodwill with potential overseas trading partners, particularly where the UK is in search of future FTAs.

> **Many businesses are managing complex supply chain disruptions and looking to shockproof their operations through increased diversification of their supplier base: shortening their supply chain and digitalisation. These trends may dampen international trade flows. Businesses who have the liquidity and agility to pivot to changes are most likely to see recovery and some form of stability sooner, rather than later.**
>
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COVID-19 Debt Service Suspension Initiative: A Guide for Lenders

Editor Highlights

- DSSI was devised to enable the poorest countries to free up scarce money in order to mitigate the human and economic impact of the COVID-19 pandemic.
- Participation by private creditors is entirely voluntary and the IIF has highlighted the importance of international financial institutions taking the lead in monitoring the expenditure of beneficiary countries.
- The DSSI is debt postponement, not debt relief and this has led to the debate on sovereign debt shifting in favour of debt suspension.

Within the first few months of the outbreak of the COVID-19 pandemic, the Debt Service Suspension Initiative (**DSSI**) was promulgated by a joint call to the G20, from the IMF and the World Bank, to suspend debt payments from the world's poorest countries.[1] The G20 responded to and supported this appeal in April 2020,[2] and further agreed a common term sheet for implementing the DSSI with the Paris Club that same month (**Common Term Sheet**).[3]

In our August 2020 Trade Finance Quarterly Insight "*COVID-19: Considerations for Lenders in export credit agency supported financings*", we flagged that although the DSSI was a well-intentioned initiative, it did have the potential to lead to some unintended consequences. This article presents a deeper exploration of those consequences and how they can, and have been, dealt with on a legal and practical level. Specifically, we will consider the scope of the DSSI and its impact on finance documents, some key practical points learned from our experience advising lenders faced with implementing the DSSI and, lastly, our thoughts on how the DSSI has led to the G20's "Common Framework for Debt Treatments beyond the DSSI".

Scope of the DSSI

What is the DSSI and why has it been introduced?

In the IMF's words, the DSSI "*means that bilateral official creditors will, during a limited period, suspend debt service payments[4] from the poorest countries*".[5] The stated purpose of the DSSI is to enable such countries to free up scarce money in order to mitigate the human and economic impact of the COVID-19 pandemic: an end sought to be achieved through (i) a monitoring system to ensure the funds are indeed deployed by the beneficiary countries in their response to the COVID-19 pandemic, (ii) mandatory disclosure of all public sector financial commitments by the beneficiary countries and (iii) the beneficiary countries committing to incur no new non-IMF or World Bank debt during the debt suspension period.

Who can benefit from the DSSI? Which creditors does the DSSI apply to?

As set out in the Common Term Sheet, the DSSI may be taken up by countries who are either (i) an International Development Association (**IDA**) country currently up to date on any debt service to the IMF and the World Bank or (ii) a least developed country, as defined by the United Nations, currently on any debt service to the IMF and the World Bank. In total, 73 countries are eligible to benefit from the DSSI.[6] In addition, eligible countries may only benefit from the DSSI if they (i) formally request debt service suspension from creditors and (ii) are benefitting from, or have requested, IMF financing including the IMF's emergency facilities.

1 https://www.worldbank.org/en/news/statement/2020/03/25/joint-statement-from-the-world-bank-group-and-the-international-monetary-fund-regarding-a-call-to-action-on-the-debt-of-ida-countries

2 https://meetings.imf.org/~/media/AMSM/Files/SM2020/g20-communique.ashx

3 https://clubdeparis.org/en/communications/press-release/debt-suspension-initiative-for-the-poorest-countries-addendum-15-04

4 Debt service payments include both principal and interest payments falling due within the specified period.

5 https://www.imf.org/en/About/FAQ/sovereign-debt#s2q1

6 https://www.worldbank.org/en/topic/debt/brief/covid-19-debt-service-suspension-initiative

On the creditor side, all "official bilateral creditors" committed to participate in the DSSI under the Common Term Sheet. However, the varying definitions used by different G20 creditor countries as to which institutions qualify as "official bilateral creditors" has presented challenges.[7] For example, whilst China has joined the DSSI in principle, media reports suggest that the Chinese government does not consider certain loans from Chinese financial institutions as official lending for DSSI purposes. By way of illustration, the China Development Bank (**CDB**) has lent significant amounts in support of projects in DSSI-eligible countries and is widely recognised as one of China's policy financial institutions. However, to increase profits and offset official/policy lending, the CDB has also been making non-policy loans for many years and was re-designated as a development institution, instead of a policy bank, in 2008. This begs the question of whether the CDB would be considered an "official bilateral creditor" and thereby committed to participate in the DSSI.

Private creditors have, as of yet, only been called upon to participate on similar terms to those set out in the Common Term Sheet. The Institute of International Finance (**IIF**), an industry association representing the private creditor community, promptly cemented its own understanding of the DSSI and the Common Term Sheet in a May 2020 letter to the World Bank and the IMF, reiterating the voluntary basis on which private creditors may participate. In that letter, the IIF further highlighted the importance of international financial institutions taking the lead in monitoring the expenditure of beneficiary countries availing themselves of the DSSI, given that private creditors would have no obligation to do so. The concern is that any debt relief made available under the DSSI will be used not to combat the COVID-19 pandemic but instead to service private creditor debt. Ultimately, whilst the IIF's engagement in the dialogue between the public and private sectors regarding the DSSI has culminated in agreed terms of reference for private creditor participation,[8] emphasising the need for a case-by-case approach, the uptake by private creditors appears to be very limited to date.[9]

In addition, the Common Term Sheet encourages multilateral development banks (**MDBs**) to explore options similar to the DSSI but while maintaining their current rating and low cost of funds. This suggestion may prove difficult to act on as two of the three major rating agencies have emphasised that participation in debt service suspension could exert downward rating pressure on MDBs.[10] In an October 2020 joint-staff note from the IMF and World Bank, it was recognised that without very strong triple-A ratings, MDBs such as the International Bank for Reconstruction and Development (**IBRD**) and IDA could not maintain their business models. A triple-A rating is the "*central plank*" of low funding costs for MDBs.[11] This plank in turn depends on MDBs receiving preferred creditor treatment, both of which would be undermined by participating in the DSSI: S&P specifically commented that preferred creditor status could be called into question should MDBs participate in debt relief packages.[12]

According to the IMF and World Bank, MDBs not participating in the DSSI is desirable for potential beneficiary countries in the sense that the MDBs' participation in the DSSI would likely reduce net funding available to eligible countries by undermining the attractiveness of MDB debt, and increasing MDBs' funding costs significantly. On the basis that MDBs have slim margins to cover administrative costs, if their funding costs increase ultimately these costs would be passed on to debtor countries.[13]

When does the DSSI apply?

The DSSI's initial debt suspension period began on 1 May 2020 and ended on 31 December 2020. By the end of August 2020,

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7 https://www.devcommittee.org/sites/dc/files/download/Documents/2020-10/Final%20DC2020-0007%20DSSI.pdf

8 https://www.iif.com/Portals/0/Files/content/Regulatory/Voluntary%20Private%20Sector%20Terms%20of%20Reference%20for%20DSSI_vf.pdf

9 https://www.imf.org/en/About/FAQ/sovereign-debt#s2q5

10 https://www.devcommittee.org/sites/dc/files/download/Documents/2020-10/Final%20DC2020-0007%20DSSI.pdf

11 http://documents1.worldbank.org/curated/en/601251595023594564/pdf/Protecting-the-Poorest-Countries-Role-of-the-Multilateral-Development-Banks-in-Times-of-Crisis-Explanatory-Note.pdf

12 S&P Global Ratings, "How Multilateral Lending Institutions Are Responding To The COVID-19 Pandemic," (9 June 2020)

13 http://documents1.worldbank.org/curated/en/601251595023594564/pdf/Protecting- the-Poorest-Countries-Role-of-the-Multilateral-Development-Banks-in-Times-of-Crisis-Explanatory-Note.pdf

43 eligible countries had taken up the DSSI, benefitting from an estimated USD5 billion in suspended debt service payments.[14] This prompted the World Bank to recommend a one-year extension of the DSSI as it highlighted the lag of the spread of COVID-19 in DSSI-eligible countries. Consequently, the debt suspension period has now been extended until 30 June 2021. This was implemented by an addendum to the Common Term Sheet published jointly by the G20 and Paris Club in October 2020 (**Addendum**). The Addendum further contemplates that an additional extension to the DSSI may in the future be granted for a further six months, that is, until 31 December 2021.

Whilst the Common Term Sheet originally contemplated a repayment period of three years, with a one-year grace period (four years in total), the Addendum modified this timeframe. Now beneficiary countries may have a longer repayment period of up to five years, plus a one-year grace period (six years in total). To facilitate and protect new financing and sovereign debt restructuring, no financing incurred after 24 March 2020 is eligible for DSSI participation.

How is the DSSI implemented?

As highlighted previously in this article, it is a technical requirement of the DSSI that eligible countries make a formal request for debt service suspension from official bilateral creditors. Although the Paris Club has published template letters for such requests, in practice, at least with Paris Club members, this requirement may be satisfied by the representatives of the debtor and creditor countries signing a memorandum of understanding (**MoU**).

The MoUs are key documents. It is the MoU which actually describes how the broad, and somewhat abstract, parameters of the DSSI are to be implemented into revised loan agreements. For example, the MoU will specify (i) which types of debt are covered (taking care to specify how export credit guarantees are to be treated), (ii) the postponed repayment dates for the debt service payments which fall due during the debt suspension period and (iii) the payment dates for the interest which accrues on the suspended debt service payments referred to in (ii), which may align with the repayment dates in (ii) as well.

The MoU is part of the Paris Club's formalised implementation of the DSSI, but not all official bilateral creditors are Paris Club members (notably China). In a bid to increase transparency, the IMF has encouraged non-Paris Club members to adapt the Paris Club MoU or articulate their own MoU to avoid the situation (which the IMF acknowledges has arisen) whereby official bilateral creditors impose conditions on beneficiary countries which are not in line with the G20's requirements as set out in the Common Term Sheet and Addendum.

Impact on finance documents

Assuming a beneficiary country has submitted a formal request for debt service suspension from an official bilateral creditor, what are the consequences for the underlying loan agreement between the beneficiary country and that official bilateral creditor and, importantly, for the beneficiary country's other loan agreements?

Evidently, the rescheduling of debt service payments requires amendment to the underlying finance documents. One may approach the amendment task by treating the postponed debt service payments as a separate tranche or loan, repayable in accordance with the dates specified in the MoU. Further consideration may need to be given to the treatment of amounts (if any) which a beneficiary country has paid to the official bilateral creditor during the time that beneficiary country would have been entitled to forego such payment, under the terms of the DSSI, but prior to the formal/legal implementation of the DSSI via execution of an amendment agreement.

In terms of the beneficiary country's other loan agreements, in July 2020 the IIF addressed the issue of debt service suspension triggering potential events of default in private sector loan agreements by publishing a template waiver letter.[15] Although the template waiver letter does not specify

14 https://www.devcommittee.org/sites/dc/files/download/Documents/2020-10/Final%20DC2020-0007%20DSSI.pdf

15 https://www.iif.com/Publications/ID/3993/G20-DSSI-Template-Waiver-Letter-Agreement

the exact events of default which may apply, a helpfully broad definition of DSSI-related action which may trigger such events is provided, namely: "**G20/Paris Club DSSI Participation**" shall be deemed to include: (i) any discussions with the official sector leading up to participation in the G20/Paris Club DSSI, (ii) any agreement with the official sector to participate in the G20/Paris Club DSSI, (iii) any announcement of the intention to participate in the G20/Paris Club DSSI, or (iv) any actual participation in the G20/Paris Club DSSI in respect of official sector debt."

What are some of the LMA-standard events of default that could be triggered by the G20/Paris Club DSSI Participation definition? Using the Developing Markets LMA template facility agreement as a reference point,[16] G20/Paris Club DSSI Participation by a beneficiary country may trigger the "Insolvency" and "Insolvency proceedings" events of default.

A "Moratorium" event of default in respect of any indebtedness of the beneficiary country may also be triggered. The term "moratorium" is normally left undefined in loan agreements. In the restructuring context, the term is used to refer to the period during which actions by creditors are suspended, usually by operation of law. In sovereign debt restructuring specifically, a moratorium typically manifests by way of a public statement by the sovereign debtor that it is suspending payments of international debt, accompanied by domestic legislation to protect its actions from local proceedings.

Lastly, much like the COVID-19 pandemic itself, there is an inevitable contagion effect, resulting from "Cross default" clauses, which can entail the spreading of events of default from one loan agreement to the next after a single default arises. The Developing Markets LMA template facility agreement includes illustratively broad cross-default provisions. The failure to conclude an amendment agreement implementing the DSSI prior to the beneficiary's non-payment of debt service under the underlying loan agreement could trigger cross-defaults in the beneficiary country's other loan agreements. Furthermore, given that the mere commencement of negotiations with a view to rescheduling indebtedness may constitute in itself an event of default (depending on the precise wording of the event of default), a subsequent amendment agreement implementing the DSSI could be considered the "suspension" of a Financial Indebtedness commitment by a creditor "as a result of an event of default" and thus trigger a cross-default as well.

16 It should be noted that the Developing Markets LMA template facility agreement is premised on corporate, not sovereign, borrowers; nonetheless the events of default provide sound generic examples which appear frequently in broadly equivalent terms in sovereign facility agreements as well.

Key Practical Points

The potential cross-default contagion effect evidences the stark need for a timely and co-ordinated effort to implement the DSSI by beneficiary countries and official bilateral creditors. Underlying loan agreements need amending, the beneficiary's other loan agreements need waiving and documents currently under negotiation would do well to address the DSSI in drafting moratorium-related representations and events of default.

Faced with the request by a beneficiary country for debt service suspension, key practical considerations would include:

1. read the relevant MoU thoroughly - it will contain the essential commercial terms for the practical changes needed to implement the DSSI;
2. consider which events of default should be waived temporarily (e.g. cross-default due to amendment agreements being executed after non-payment) and which should be waived permanently (e.g. insolvency- or motatorium-related events of default which will always be triggered by the beneficiary country's DSSI participation); and
3. be pragmatic and recognise that DSSI implementation requires the co-ordination and organisation of multiple governmental ministries, departments or agencies from both the beneficiary country and the official bilateral creditors.

Beyond the DSSI

An essential feature of the DSSI is that it is debt postponement, not debt relief. As we have detailed and analysed elsewhere,[17] this feature has had the unexpected consequence of the debate on sovereign debt shifting in favour of debt suspension. The clear hope of debtor countries is that this process will lead to debt cancellation.

Sovereign debt restructurings are unpopular. The DSSI and its potential extension has allowed the focus to move away from confronting the scale of the heavy debt burden these countries bear. Arguably, as a reaction to this trend, the G20 has published a "Common Framework for Debt Treatments beyond the DSSI" (**Common Framework**).[18] A key statement was that debt cancellation or write-off is only an option "in the most difficult cases".

Furthermore, the sovereign debt restructuring process envisaged under the Common Framework could be protracted: any agreement would need to be signed-off by all creditors in a memorandum of understanding, to then be separately implemented through bilateral agreements between the debtor country and each participating creditor. The Common Framework also requires most favoured nation treatment in the sense that a debtor country must "*seek from all its other bilateral creditors and private creditors a treatment at least as favorable as the one agreed in the [memorandum of understanding]*". Convincing all of a debtor country's creditors to accept that approach may prove challenging.

Conclusion

In reality, official bilateral creditors and the (potentially private sector) agents administering their loan agreements are more likely to be dealing with the DSSI and its subsequent extension than the Common Framework. To assist this process, the IMF and World Bank should continue to clarify the ambit of the DSSI, and its mode of application; somewhat helpful in this respect are their respective DSSI 'frequently asked questions' pages.[19] At a practical level, close attention needs to be paid to the specific drafting of events of default in the underlying loan agreement impacted by the DSSI, as well as in the beneficiary country's other loan agreements, to ensure that any necessary waivers are obtained before the cross-default contagion spreads too far. It will be interesting to see how the implementation of the DSSI develops during 2021.

> **The DSSI is an important initiative in the COVID-19 context, and lawyers can have a key role in understanding its intricacies and consequences to ensure its successful implementation.**
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> Nick Tostivin, Partner

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17 M. Doran, J. Tanner and C. Georgaklis *Unprecedented challenges complicate the design and execution of much-needed sovereign debt restructurings in Africa*, 'Les Cahiers de Droit de l'Entreprise' (LexisNexis, Paris, France, November 2020).

18 Published at its virtual Riyadh summit, 13 November 2020: https://www.mof.go.jp/english/international_policy/convention/g20/g20_201113_1.pdf

19 https://www.imf.org/en/About/FAQ/sovereign-debt#section%202 and https://www.worldbank.org/en/topic/debt/brief/debt-service-suspension-initiative-qas

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Factoring as a Means of Accessing Finance in Africa: the Advantages and Disadvantages

Editor Highlights

- Factoring provides an essential alternative to traditional loan financing that can be utilised by businesses in order to expand and facilitate trade throughout Africa.
- Factoring will allow African business to trade more competitively, supported by the creation of a special purpose grant funded by AfDB's trust fund.
- For SMEs hit particularly hard by the COVID-19 pandemic tapping into alternative methods of funding, like factoring, will become increasingly important.

Financing by way of "Factoring"

Factoring is a financial arrangement or transaction whereby a business (Seller) who has entered into a service or sales contract with its customer(s) (Debtor) proceeds to sell its account receivables (invoices) to a third party (Purchaser) at a discounted rate, usually to gain access to immediate funding in order to meet its working capital requirements.

There are two types of factoring, namely:

Recourse factoring - the Purchaser may seek recourse against the Seller should the Debtor fail to pay the full invoice amount when this becomes due to the Purchaser.

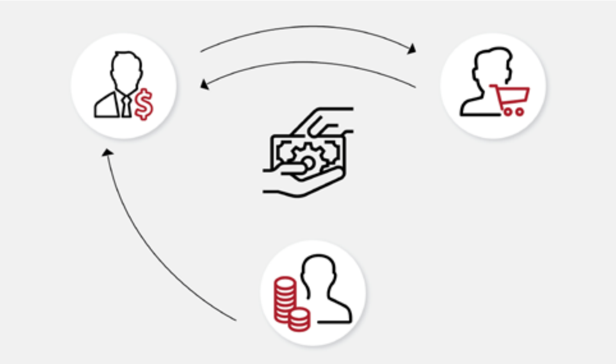
Non-recourse factoring - the Purchaser does not have recourse against the Seller should the Debtor fail to pay the full invoice amount when this becomes due to the Purchaser.

The sale of the accounts receivables to the Purchaser provides the Seller with an immediate "cash injection" into its business, enabling the Seller to better manage and predict its cash flow. This cash flow would otherwise depend on the timeous payment of its customers, which might sometimes be up to 120 days. Pursuant to a factoring transaction, the ownership of the receivable and the right to receive payment is transferred from the Seller to the Purchaser, and the Debtor will settle the receivable when it becomes due with the Purchaser and not the Seller. Typically, the Seller will sell the account receivables for 80% of its value. The Purchaser shall pay the remaining 20% to the Seller, less an agreed fee, as determined by the Purchaser once the full invoice amount has been paid by the Debtor.

A typical factoring transaction involves three parties, namely:

1. the party who sells the account receivables;
2. the party who purchases the account receivables; and
3. the party who owes a debt in terms of the account receivable and which requires payment to the Seller.

Factoring Transaction



Factoring is a particularly useful financing tool for businesses that have numerous account receivables, all with different terms, and where there is a prolonged period between the date of issuing the relevant invoice and the payment of those invoices. Further, it is especially useful for businesses who do not have the necessary collateral or credit record, which is typically associated with and/or required by traditional loan financing. As a result, factoring is especially useful for Small and Medium Enterprises (**SMEs**), particularly across Africa, where traditional loan financing may be more expensive and otherwise less accessible to these entities.

Factoring in Africa

In the context of Africa, factoring has emerged as an important tool for expanding and facilitating trade throughout the African continent, particularly in respect of SMEs. According to the African Export-Import Bank (**Afreximbank**), factoring "*will allow African business to trade more competitively*". Afreximbank reported in 2019, that factoring volumes had grown by 10% and by an amount of EUR 24 billion. Afreximbank has been a major supporter of factoring as an alternative means to financing in Africa, having provided financing to emerging factoring companies in a number of African countries, including Cameroon, Senegal, Congo, Zimbabwe, Botswana and Nigeria. In 2016, Afreximbank developed a model law on factoring, and actively pursues its adoption and implementation throughout the continent by engaging government officials, legislators, and relevant regional organisations and regulators, to bolster the legal and regulatory environment for factoring on the continent.

On 7 January 2021, Afreximbank, together with the African Development Bank (**AfDB**) and Factors Chain International (an organisation which represents companies in the international factoring market), announced the creation of a special purpose grant, which will be funded by AfDB's trust fund, to support and drive the development of factoring in Africa by supporting emerging factoring firms across the continent.

In addition to traditional factoring (as discussed above), reverse factoring or supply chain finance has become increasingly popular and an alternative means by which importers and buyers in Africa are funded. Supply chain financing is different from traditional factoring in that it is the Debtor (usually a large corporate, and in the context of Africa, a large corporate doing business in Africa) who initiates the process to factor its invoices. Accordingly, the Seller is able to leverage off the credit risk of a major corporate doing business on the African continent.

COVID-19 and SMEs

Whilst the impact of the COVID-19 pandemic and resultant lockdowns and restrictions globally has affected all businesses, SMEs have been particularly hard hit, resulting in severe liquidity shortages across different industries and sectors. SMEs are more financially fragile and typically have less of a cash buffer than the larger and more established businesses.

Further, the cost of traditional lending is likely to increase in the wake of the pandemic due to continued uncertainty and instability, making accessing such traditional funding even more difficult for SMEs. Accordingly, tapping into alternative means of financing will become increasingly important. Factoring provides an opportunity for businesses to turn balance sheet assets into cash in order to bolster growth and expansion, without adding to their debt burden, diluting equity or collateralising the businesses' assets.

Advantages of Factoring

Factoring provides a number of advantages for the parties involved in such a transaction, including (but in no way limited to):

Immediate and short-term funding - enabling businesses to gain access to immediate and short-term funding, which allows businesses to meet their operational requirements and better manage their cash flow.

Credit and collection responsibilities - the Purchaser takes on the credit and collection responsibilities of the Seller, relieving the Seller of such obligation and accordingly reducing the potential "bad debt" of the Seller. Further, as the Purchaser is usually a type of financial institution, it is typically able to credit insure against risks associated with factoring, whereas the Seller may not have the scale or means to do so.

Factoring is not a loan - the typical features of a traditional bank debt, such as collateralising assets and otherwise indebting the business to the lender on terms favourable to the lender, is not required.

Credit Rating - there are circumstances where the Debtor (i.e. the invoiced party) has a stronger credit rating than the Seller. This makes factoring attractive to a Purchaser, as the Purchaser would typically look through to the creditworthiness of the Debtor rather than the Seller.

Disadvantages of Factoring

Whilst factoring is considered an essential means to bridging the funding gap faced by SMEs, and in particular SMEs in Africa, there are a number of risks associated with factoring, including:

Counter-party credit risk - the risk that the Debtor will not be able to pay the invoice.

Fraudulent invoices - one of the biggest risks associated with factoring is the ability of the Seller to submit fraudulent or otherwise modified invoices to the Purchaser.

Legal, compliance and tax risks - the legislative framework relating to factoring differs across different African jurisdictions. For example, certain jurisdiction do not recognise the transfer of rights in respect of an intangible asset such as an account receivable. Accordingly, the underlying transaction, whereby the rights and interest in and to the account receivable would ordinarily be ceded and assigned from the Seller to the Purchaser, would not be recognised. This becomes particularly difficult in cross-border transactions. For factoring to be a viable alternative to traditional financing, it is essential that the legal and / or regulatory framework recognises the transfer or rights, which is the fundamental principle underpinning factoring.

Conclusion

Factoring provides an essential alternative to traditional loan financing that can be utilised by businesses in order to expand and facilitate trade throughout Africa, particularly with respect to SMEs, by allowing them to participate more meaningfully in the supply chain. Factoring is by no means a new phenomenon, but in recent years, there has been significant support from the likes of Afreximbank and AfDB for factoring on the African continent. However, the risks associated with factoring are noteworthy.

The adoption of the Afreximbank model law on factoring goes a long way towards creating a benchmark for African governments to enact legislation that facilities both domestic and international factoring. The adoption of such a model law would assist in mitigating the various risks associated with factoring, particularly those related to legal, compliance and tax risks in international factoring transactions. This is useful in the current economic climate, where the effects of the pandemic have made it even more difficult for SMEs to obtain or qualify for traditional loan financing. Factoring provides a viable alternative, which SMEs can take advantage of for purposes of expanding trade throughout the African continent.

> **"The importance of having legal certainty of a sale of an account receivable cannot be over stated and one should structure the sale and purchase of the rights in such a way so there can be no doubt of legal ownership in the hands of the purchaser. This could create further liquidity in the trade value chain."**
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Additional Insights

[LIBOR Transition Hub]

In July of 2017, Andrew Bailey, the chief executive of the UK Financial Conduct Authority (FCA), announced in a speech that after 2021 the FCA would no longer use its power to compel panel banks to submit rate information used to determine the London Interbank Offered Rate (LIBOR). Mr. Bailey encouraged the market to develop robust alternative reference rates to replace LIBOR. Baker McKenzie is pleased to provide expert guidance on LIBOR transition. Please click here to explore our LIBOR Hub.

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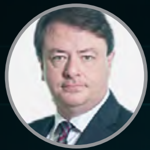

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