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In Practice

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Embedded finance: key considerations for funders of platform borrowers

Embedded finance is, broadly, the availability of financial products, integrated into a company's infrastructure, provided by non-financial institutions and capitalised by "traditional" financial institutions. Companies are providing these products directly to their own customers, cutting out financial institutions as intermediaries. The benefits of these technology driven products for end-users are efficiency of transactions and bundling complementary services to enhance customer experience (eg point of sale buy-now-pay-later (BNPL) credit).

FUNDING THE FUNDING

Companies offering embedded finance need finance partners for their own debt requirements. For example, financial institutions are financing the loan portfolios of platform companies. They are also operating as "partners" (eg in June 2022, Barclays partnered with Liberis on the Barclaycard Business Cash Advance product) or as fronting banks if the services offered require banking licences – if you can't beat them, partner with them.

KEY CONSIDERATIONS

- **Structure**: in a traditional English law structure, either a special purpose vehicle (SPV) or an orphaned entity purchases the beneficial interest in the credit made available to customers. The legal interest and servicing obligations typically remain with the originator, with the purchase price being funded by the funder's debt. A back-up servicer is also appointed; a third party who services the loan portfolio upon the occurrence of a trigger event. Funders need to understand the originating–purchasing–servicing process and payment flows. Such transactions often use an asset backed securitisation (ABS) structure although, given the nature of platform borrowers, such approach may not always be appropriate. Additionally, where an ABS structure is used, the standard ABS documentation suite may require tailoring. This raises the question, can there be a stock form of funding documents for embedded finance transactions?
- **Security**: there is a combination of options used by funders: issuer security only, full group security and guarantees, or parent guarantees only to support the structure. Currently, personal guarantees are relatively uncommon. Security over e-money requires bespoke provisions in the security agreement. Consideration should be given as to whether the funding structure falls inside the scope of any securitisation regulations (which seek to provide transparency where there is an SPV structure, tranching of debt and no recourse to an originator). As such, securitisation regulations have a broader reach than only "traditional" securitisations in the capital markets sphere.
- **Regulation, data protection and tax**: fundamental errors on regulation, data protection and tax matters will affect companies' ability to scale and secure funding; they can also be costly to fix. While BNPL is currently largely unregulated, change is coming. Earlier this year, the UK government published its plans to regulate BNPL, which is anticipated to take effect mid-2023. Companies offering such products should, as encouraged by the Financial Conduct Authority, engage with the proposed regulations in advance to assess required actions and the impact on their products and business plans, and be ready to explain this to funders. However, funders may consider that regulation creates certainty and confidence in the sector as it seeks to increase consumer protection.
- **Who are the platform borrowers?**: from fintech start-ups to tech giants, there are a range of platform borrowers, business models and products within the embedded finance market. This impacts the level of funder due diligence required from a product, tax and regulatory perspective. Due diligence requirements also vary at different stages of funding. For example, on a funding transaction to a platform borrower with a revenue-based financing product, a tax report (on the funding and product terms) is typically required by institutional funders, but not by venture debt funders.
- **Geographical reach**: as technology-led companies inherently facilitate a larger geographical reach, platform borrowers are more likely to be multi-jurisdictional businesses. This requires platform borrowers and funders to engage with a variety of legal and regulatory regimes, with funding documentation being drafted to support anticipated expansion.
- **Product**: while BNPL is now established and revenue-based financing models are increasing, products and their terms are not standardised. In part this reflects the nature of these business models: providing technology-driven customer-led solutions. Therefore, lawyers need to be product lawyers, not only in the preparation of platform companies' underlying customer terms but for a funder's due diligence requirements too.

The COVID-19 pandemic saw a surge in embedded finance and a move to an increasingly cashless society. Embedded finance relies on and facilitates advances in technology, while also responding to dynamic shifts in consumer habits. As Alex Johnson (in his newsletter titled 'Embedded Finance Misses the Point' on 14 July 2022) has explored, more fintech companies will mean more embedded finance products. Technological infrastructure will develop to enable such an increase and could lead to the establishment of new financial products. Despite this potential for rapid expansion, many platform borrowers have not weathered a recession or significant inflationary fluctuations before. Hence, funders will likely be scrutinising these borrowers' strategies with respect to their own investment risk and opportunities. Will this challenging economic climate impact growth, or provide an opportunity to demonstrate industry resilience? ■