In Practice

Authors Fiona Henderson, Laura Collins and Alexis Alexander

Embedded finance: revenue-based financing and responsible lending

The unique selling point of embedded finance is customer convenience; described by consultancy firm 11:FS as financial products offered to customers "at the point of customer need". For small and medium-sized enterprises (SMEs), embedded lending such as revenue-based financing (RBF) provides an alternative means for funding with many benefits, including, ease of application, greater speed to funding and automated credit decisions produced using data sources and analytics. However, against the current economic outlook there is a tension between speed and robust lending practices that protect vulnerable customers, including those in financial difficulty. With the spotlight on business to consumer buy-now-pay-later (B2C BNPL) in terms of UK regulatory oversight, what steps do RBF providers need to take to deliver a responsible lending solution?

REVENUE BASED FINANCINGS (RBF) TERMS

Generally: (i) RBF products are offered to early stage or growing SMEs; (ii) there is no equity dilution (typically required by venture debt funders, eg warrants); (iii) an initial cash amount is advanced; (iv) the advance is repaid from a share of the revenue generated by the SME's business activities; (v) if the revenue reduces, then the share of the revenue to be repaid also reduces (and vice versa if the revenue increases); and (vi) no interest is charged; the distinguishing feature being "you only pay as you get paid" (albeit, some RBF providers charge a weekly fixed fee). Therefore, the SME benefits from the certainty in the cost of its RBF product, with the repayments flexing with its cashflow fluctuations.

RESPONSIBLE LENDING SOLUTION

We consider four key areas:

- **Regulation**: RBF products offered to SMEs will *generally* not fall within the ambit of the anticipated changes in the regulation of B2C BNPL (expected mid-2023) or the FCA's new Consumer Duty for regulated financial services (which will apply from July 2023 for new and existing products and services). The Consumer Duty will comprise new rules that require firms to "consider the needs, characteristics and objectives of their customers – including those with characteristics of vulnerability – and how they behave, at every stage of the customer journey". Given the principles-based nature of the new rules, we expect established RBF providers have taken or will take proactive steps, including undertaking a consumer duty analysis vis-à-vis their policies and products. Even if not directly regulated by the FCA or subject to the Consumer Duty, we anticipate established players will consider the new rules, as potential investors, funders, and strategic partners may themselves be subject to the Consumer Duty and expect to see certain standards in place.
- **Lending policies**: we anticipate some RBF providers will incorporate responsible financing goals and values into their lending policies; for example, policies on the circumstances in which additional due diligence and financial information is required, the calculations used to determine anticipated revenue (including a minimum period of trading, and a minimum amount of revenue generated in a specified time period prior to application), frequency of repayment dates (in terms of data on collections), early renewals, product governance, and the actions required if a borrower defaults or is in financial difficulty.
- **Underwriting**: RBF relies on technology and data in its underwriting and credit scoring processes. The availability of data and data sharing will also be important from a credit assessment perspective. The rise of open banking has led most RBF providers to re-evaluate how their credit assessment operates. Credit bureau data is no longer king: the ability for established RBF platforms to integrate with ever expanding open banking providers and utilise internal automated decisioning technology enables a far wider spectrum of SMEs to be approved for finance.
- **Customer terms**: proactive regulatory analysis and the implementation of responsible lending policies will likely result in changes to customer terms. Last year, the FCA published changes made to customer terms by B2C BNPL providers following their co-operation with the FCA; setting the expected standards for customer terms in the industry. The changes focused on: (i) customers' rights to terminate early; (ii) explicit references to reasonable notice periods where a customer's account is to be terminated or frozen; (iii) clarification of set-off rights; and (iv) clarification of customer's rights to cancel continuous payment authorities. We expect the wider embedded finance industry will take note of the FCA guidance and RBF providers should regularly review their customer terms.

SUMMARY

"Frictionless finance" is often mentioned in the same sentence as embedded lending, but how much friction is required to deliver a sustainable product? Speed and automation should not come at the cost of providing positive customer outcomes. However, with a significant SME funding gap, estimated at £22bn in the UK in 2019 (Bank of England), alternative finance products such as RBF that use innovative tech and provide data-driven products have an important role to play. ■

Biog box

Fiona Henderson is a senior associate and Laura Collins is an associate at CMS. Alexis Alexander is general counsel at Liberis.
Email: fiona.henderson@cms-cmno.com; laura.collins@cms-cmno.com and alexis.alexander@liberis.co.uk