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In Practice

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Embedded finance: market challenges and market changes

In September ((2022) 8 JIBFL 560) we outlined that embedded finance is the availability of financial products, integrated into a company's infrastructure, provided by non-financial institutions (platform lenders) and capitalised by "traditional" financial institutions. One of the benefits of embedded finance is an enhanced customer experience. This customer-led approach will become more important in the current and forecast economic environment. COVID-19 drove a change in consumer habits and demands and saw record valuations for fintechs. However, as the world economy faces an increasingly challenging outlook, there has been a so-called "rebalancing" of these high valuations. In July 2022 credit card transactions by UK cardholders were up by nearly 10% on last year (UK Finance) and global e-commerce revenues are forecast to shrink for 2022. Does this signal trouble ahead for embedded finance?

THE BAIN REPORT AND RESPONSIBLE LENDING

In research published in September 2022 (the Bain Report), management consulting firm Bain & Co projects that by 2026, "embedded finance will exceed US$7 trillion of total US financial transactions" (an increase from US$2.6trn in 2021). It also expects that its projections will hold true despite the current market volatility and recession risk. In particular, the Bain Report: (i) anticipates that payments and lending will remain the largest services provided by platform lenders, but the key to continued growth will be the combination of these services with additional products (including insurance, tax and accounting); and (ii) calls for traditional funders to partner with fintechs in order to enhance offerings to customers, reduce costs and increase access to embedded finance products (the "better together" approach).

Technology and digitalisation reduce friction in accessing capital, but platform lenders are now increasingly required to balance this with consumer protection considerations and consider if some friction in the customer journey is responsible. Further, against the backdrop of high inflation and economic uncertainty, responsible lending and the recently coined term "fintech for good" are coming to the fore; particularly as regulation of buy-now-pay-later (BNPL) products in the UK is anticipated next year, and the Financial Conduct Authority (FCA) have introduced their new Consumer Duty for regulated financial services (which will apply from July 2023) with the aim to set higher and clearer standards of consumer protection. For example: (i) fintechs are educating: Revolut recently partnered with UNiDAYS, aiming to help university students take control of their own finances and promote financial wellbeing. This demonstrates the power of partnership for fintechs and the "better together" approach; and (ii) fintechs are considering ESG (environmental, social and governance): business to consumer (B2C) platform lender Plend recently partnered with Switchd on its "MakeMyHouseGreen" platform, offering finance to fund the cost of purchasing green energy installations such as solar panels.

MARKET PRACTICE

Taking into account the above, we anticipate the following changes:

- **Consolidation and partnering**: we may see established platform lenders become more acquisitive; seizing opportunities to amalgamate their client base, data and product offerings with competitors. We also expect partnering between fintech and traditional funders to continue to grow.
- **An increase in business to business (B2B) BNPL**: overall this market is considered less saturated than B2C, with a move to digital distribution and online sales by businesses galvanised by the effects of the COVID-19 pandemic.
- **Growth in untapped markets**: multi-jurisdictional platform lenders may look for opportunities in nascent markets. For example, the Canadian market has historically high credit card transactions, and recent legislative changes now enable merchants to pass on all credit card fees to customers in most Canadian provinces.
- **Sustainable growth**: we anticipate that platform lenders will be assessing whether or not they take on institutional investment and considering the terms of institutional investment available more closely; bearing in mind their own growth and profit targets, and the rising cost of debt.
- **Amendments to customer terms:** (i) platform lenders will examine their variation clauses, considering how much flexibility they have to make amendments to customer terms in response to an uncertain economic environment. Transparency and treating customers fairly should be at the forefront of these considerations; and (ii) we expect there will be a trend towards longer payment terms to address customers' budgeting requirements and platform lenders' credit collection costs.
- **Proactive regulatory compliance**: established platform lenders will take proactive steps to comply with anticipated changes in the regulation of B2C BNPL products by: (i) analysing distribution and customer journeys to assess their impact on the fair treatment of customers; (ii) reviewing their disclosures on the nature of their products; identifying their products as credit and asking customers to consider if they can afford the repayments; (iii) implementing more detailed affordability assessments, which are becoming more aligned to those of regulated lending products; and (iv) generally, taking into account the FCA's focus on transparency at checkout and how credit checks are undertaken.

In summary, there will certainly be challenges in the market for platform lenders but there will also be opportunities for partnership, positive change and to deliver solutions and innovation for customers. ■