

In Practice

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Embedded finance: Dear CEO

In March (2023) 3 JIBFL 190, we discussed some of the challenges in providing sustainable finance products to consumers from the perspective of revenue-based finance; an embedded finance offering. Namely, there is a balance to strike between: (i) speed and automation; and (ii) positive customer outcomes. On 16 March 2023, the Financial Conduct Authority (FCA) issued a Dear CEO letter (Letter), addressed to payment firms supervised by the FCA within its payments portfolio, highlighting concerns that certain payment firms are not currently striking this balance. For embedded finance, the Letter will primarily impact providers that offer embedded banking services (if they are supervised payment firms), but it may have a wider impact across the industry.

DEAR CEO

The Letter outlines that competition and innovation has improved choice, convenience and value for customers. However, it also raises concerns that payment firms are not implementing sufficiently robust controls, resulting in an unacceptable level of risk to customers which is brought into focus by the cost-of-living crisis.

The Letter sets out three outcomes for payment firms: (i) the safety of customers' funds; (ii) non-compromise of the integrity of the financial system; and (iii) meeting customers' needs (including by the implementation of the incoming FCA's Consumer Duty).

IMPACT

In addition to the impact on embedded finance providers (EF providers) that are payment firms, we expect that the Letter will also have a wider impact on their funders; funders of EF providers (funders) will want to see evidence of their borrower's compliance with the Letter (a borrower being an EF provider).

Governance and leadership:

- the FCA is concerned that payment firms do not have appropriately knowledgeable and experienced personnel in key positions (including risk and compliance). From an employment perspective, identifying gaps in teams, training, and reviewing terms of employment contracts (such as notice periods) should be prioritised;
- more partnerships between traditional financial institutions and EF providers may provide a platform for knowledge sharing, such as training, comparing procedures, and employee secondments; and
- key person provisions in funding documents (as a funding drawstop and/or event of default trigger) will continue to be important from a funder's perspective.

Operational resilience:

- funders may increase the level and scope of due diligence undertaken on their borrower's underlying policies and procedures (particularly fraud,

anti-money laundering and know-your customer policies, processes and prevention strategies). It could also lead to more stringent due diligence requirements on EF providers that are not payment firms, with funders taking an increasingly standardised approach across the industry, as robust due diligence processes mitigate the potential for reputational damage. In the current climate, funders will be looking for partnerships with EF providers that enhance, rather than tarnish, their brand;

- the Letter highlights that the UK financial sector must "prevent, adapt, respond to, recover and learn from operational disruptions". EF providers should undertake a review of their customer terms and conditions and lending policies with a view to establishing how quickly, if required, these can be amended. However, in doing so, EF providers should be mindful of the FCA's 2022 work with B2C buy-now-pay-later providers on expected industry customer terms. In addition, EF providers that are not payment firms may also be considering the operational resilience of their own payment providers in terms of the services they provide, particularly in light of recent events in the UK and US financial sector with the collapse of certain banks; and
- as noted above, while EF providers will want to maintain a level of flexibility to change their underlying customer terms and conditions, and policies to respond to the prevailing market conditions, in practice, funders will want to control amendments. For example, by limiting the number of changes that can be made to customer terms and conditions within a set time-period (eg six months) and restricting the types of changes that can be made without prior funder consent.

Regulatory reporting:

- we anticipate that established providers will take a proactive approach; reviewing the issues identified in the Letter and their own risk management and governance controls and undertaking a gaps analysis internally and with their external advisors; and
- funders may also consider the robustness of their borrower's information undertakings and reporting requirements, in terms of ensuring visibility on their borrower's compliance with its regulatory obligations and its communications with the regulator as an early warning indicator.

SUMMARY

In the race to provide frictionless technology-led financial products, EF providers are required to provide a trusted and reliable service to their customers (for the benefit of their funders and other stakeholders too) that complies with the FCA's regulatory standards. The message and tone of the Letter and previous correspondence from the FCA on the incoming Consumer Duty is clear. The Letter requires "prompt action" to be taken by payment firms, with the FCA warning that where it identifies issues it will take "swift and assertive action".