Osborne Clarke's 2022 Future of Financial Services week

Pushing the Perimeter – BNPL and SME Finance

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Speaking with you today

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Nikki leads Osborne Clarke's Financial Institutions Group, specialising in FinTech and the regulation of financial services offered to consumers and small businesses, including consumer credit regulation. She advises on the impact of FCA regulation across a range of clients, from disruptive new market entrants to large lenders and retail banks; and from asset finance providers to tech companies.

Nikki advises clients on whether their activities fall within the FCA regime and on authorisation applications and helps clients structure and launch new products and services aimed at consumers and small businesses. She also advises on the full range of conduct of business requirements from financial promotions and customer journeys to creditworthiness and affordability, and from forbearance and collections to persistent debt.

Nikki drafts terms and conditions and notices for a wide range of products including loans, business cash advance products, current and savings accounts, credit cards, regulated hire products and PCP products. She works closely with other FinTech specialists at Osborne Clarke to provide holistic support for fast-growing firms.

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Ben is an Associate Director in Osborne Clarke's financial institutions group and specialises in FinTech and the regulation and development of products offered to consumers and small businesses.

He regularly advises banks and other finance providers (including market disruptors) on all aspects of regulated credit and associated conduct of business rules. Ben also helps clients structure new and innovative products and helps clients through the FCA authorisation process.

He also drafts suites of regulated lending documents and associated terms for a variety of products, including loans, overdrafts, hire and the purchase of receivables.

Ben studied law at the University of Southampton and joined Osborne Clarke's financial institutions group in December 2019. Prior to joining Osborne Clarke, Ben worked in-house at a leading retail bank.

What is unregulated Buy Now Pay Later finance?

- Can mean different things to different people – we're talking about exempt products under article 60F(2) of the RAO.
- Provides consumers with the ability to spread the cost of goods and services interest and fee free.
- Key features:
  - For each purchase, the consumer enters into a single fixed sum credit agreement.
  - Repayment obligation is typically 30 days or in 3 or 4 instalments (never more than 12 or longer than 12 months)
  - No cost for the credit (no interest or fees charged to the customer)
- The lender will often have a 'shadow limit' (which the consumer doesn't see) up to which it will lend to a consumer, but this is subject to individual decisioning on each loan.
- As the lending is exempt:
  - CONC 'responsible lending' requirements do not apply
  - No requirement to provide pre-contractual information, agreements in prescribed form or post-contractual notices / statements
  - Customer journey can be quick and frictionless
- Lender remuneration: by charging fees to merchants a fee for using the service and certain fees to customers unrelated to the cost of providing the credit, such as late payment fees.
- May be offered via an 'embedded' model to merchants – e.g. by merchant acquirers, with funds flows netted via acquirer
- Lenders should be registered with the FCA for Money Laundering purposes under MLRs

The market in which unregulated BNPL providers compete

Unregulated BNPL
Max duration c.6 months
e.g. Klarna Pay in 3, Clearpay, Openpay, Flava, Laybuy
Always 0% finance and fee free

Regulated revolving line of credit products (no card) with instalment plans or regulated BNPL. Credit brokered by retailer e.g. PayPal credit, Klarna financing, Fly Now Pay Later.

Instalment plans could be 0% finance, fee-bearing or interest-bearing

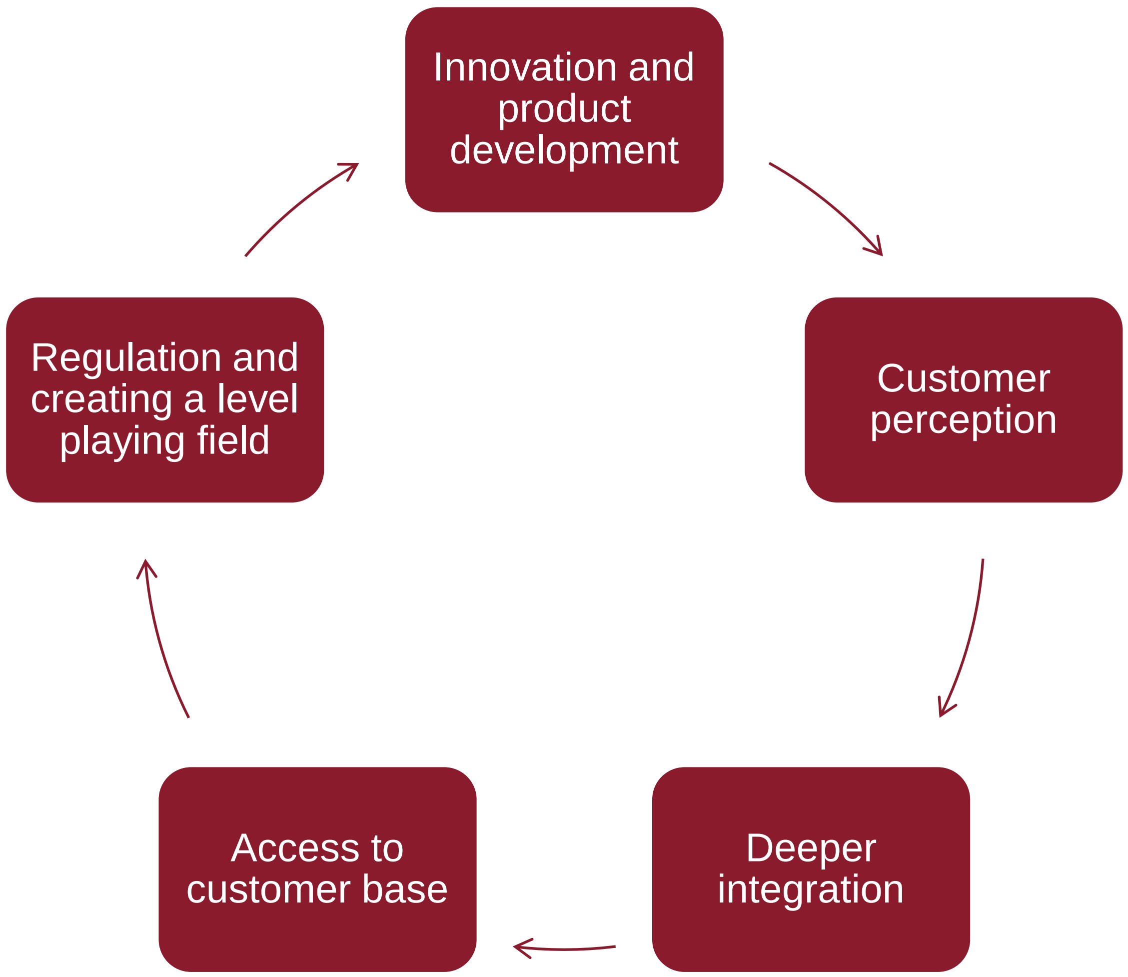
Regulated credit or storecard with instalment plans e.g. Halifax Flexicard, Barclaycard, Tymit.

Instalment plans could be 0% finance or interest-bearing

Regulated fixed sum credit, any duration, brokered by retailer e.g. Shawbrook partner finance, Creation Finance, Barclays Partner Finance (holidays, home furnishings).

Credit could be 0% finance, fee bearing or interest-bearing

Embedded finance – What is driving change?



The unregulated BNPL market and drivers of harm

- The unregulated BNPL market more than trebled in size in 2020 and growth and investment is expected to continue.
- There is a trend of younger people moving away from products such as credit cards and towards unregulated BNPL.
- Key drivers of consumer harm:
  - Consumer understanding varies widely: payment method, credit?
  - Frictionless journeys increase the risk of getting into debt quickly.
  - Affordability checks are either non-existent or inadequate.
  - Strong relationship between the lender and the retailer is a potential conflict of interest.
  - BNPL finance is often presented as the default payment method online, and there is no way for shoppers to compare like with like.
  - Viewed by customers with poor credit histories or thin files as a viable alternative to other forms of regulated lending.

"I would draw attention to an urgent need to regulate all buy now pay later (BNPL) products. While the emergence of unregulated BNPL products has provided a meaningful alternative to payday loans and other forms of credit, BNPL also represents a significant potential consumer harm." Christopher Woolard CBE, Chair, Review of Change and Innovation in the Unsecured Credit Market

What is going to change?

- HM Treasury consultation in released in October; closed 6 January 2022.
- No doubt that BNPL is going to become an FCA regulated activity - what do we think is going to change as a result?

For the regulatory perimeter

- 60F(2) exemption will likely be withdrawn, but from who?
- Will providers of 'short-term interest free' credit still able to rely on it?

For merchants

- Regulated as brokers? Perhaps not
- Requirement for all digital PoS lending to comply with a revised disclosure / financial promotion regime instead?

For product models:

- Existing product models under threat.
- An opportunity for innovation?
- A move to 60F(3) to stay completely unregulated?
- Regulating on the basis that the lender is a third party?
- Invoice financing potentially curtailed – SMEs watch out.
- Contemporaneous reforms required for refunds.

For lenders

- Some may drop out – good or bad thing?
- Information requirements and transparency
- Responsible lending and CRAs
- Section 75 protection
- FOS
- Need to appoint brokers as ARs?

SME Finance – the universe

Developments in web/app servicing

Better data

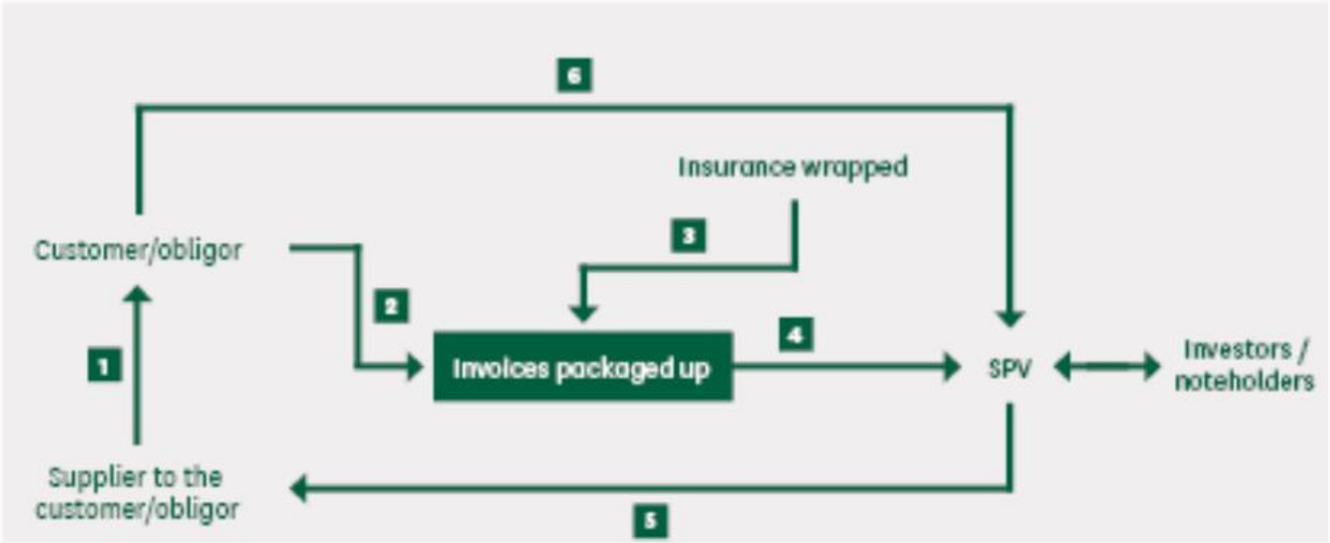
Developments in the payments ecosystem

Credit products	Non-credit products
Vanilla unsecured/secured loan	Invoice financing
Specialist business lending and working capital loans	Factoring
Hire purchase, conditional sale	Leasing/hire
Bounce Back Loan (BBILS) and Coronavirus Business Interruption Loan Scheme (CBILS)	Subscription models

Increase in non-bank finance

SME finance - Impact of Greensill Collapse

Simplified diagram of Greensill's supply chain finance business



The former fintech darling took in money from investors seeking safety and used it for risky loans. It all collapsed in a crisis of confidence.

Greensill scandal: From entitlement to outrage

Regulator to review mechanism that allowed now collapsed bank to operate in UK without a licence

FCA wants stricter rules after Greensill scandal

Greensill lobbying row: FCA mulls 'restrictions' on financial system

Findings and Recommendations

- Definition of 'FinTech' - Doubtful that Greensill was a FinTech.

- Risky new models - Purchase of future/prospective receivables resulted in a significantly riskier form of lending than traditional supply chain finance and is more akin to straightforward unsecured lending.

- Supply chain finance - No need to bring supply chain finance within the regulatory perimeter for financial services.

- Growth of non-bank sector - Raising capital requirements for banks has pushed activity into the non-bank sphere. Non-banks have to raise finance through other means.
  - Non-bank finance increasingly important to UK financial stability, so the Bank of England want more data on performance, resilience etc.
  - The FCA wants more powers to collect information, including increased reporting under money laundering rules for otherwise unregulated Annex 1 firms/review of criteria for fitness and propriety under the Money Laundering Regulations. Change in Control process tightening.

- Appointed Representatives Regime - Holding co registered in Australia, group-owned bank domiciled and regulated in Germany was not authorised in the UK. The operating entity registered in England and Wales was able to carry on the regulated activity of 'arranging deals in investments' as an Appointed Representative. Very little regulatory oversight. FCA now consulting on improving the AR regime (CP21/34)

- Securitisation Regulation - Funding structure did not fall within the Securitisation Regulation, the FCA and Treasury should look at widening the ambit of the Securitisation Regulation.

Key Take-Aways

- Tension between supporting growth and competition and protecting consumers and the market:
    - Rapid growth in market-disrupting unregulated BNPL and sudden collapse of Greensill empire have brought that tension into sharp relief.
    - Regulatory focus on consumer protection and operational resilience.
    - Pushing the perimeter.

Any questions?

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