Fintech and Securitization

By capitalizing on the fundamental notion that finance is at the heart a technology equation, the financial technology industry (“fintech”) has been disrupting banking, reshaping businesses and transforming the way consumers manage and use money.

Several factors have made the banks more vulnerable: new technologies and cheap data processing have lowered barriers to entry, and the financial crisis has left consumers more open to trying alternatives to incumbent banks they had to bail out. New entrants to the market and business models, changing customer expectations and fragmentation of traditional services are all contributing to a newly found “democratization” of banking at the hands of technology.

Since the aftermath of the 2008 financial crisis more than 4,000 fintech startups are now active, with an increasing share being valued at over $1 billion; across the fintech capitals of the world, New York, London, Silicon Valley, Hong Kong and Singapore to name a few - venture capital is pouring into financial technology attracting a whopping $12 billion in investments in 2014 alone. All told, financial-services firms in fields that fintech could potentially disrupt generate global revenues estimated at $4.7 trillion a year and profits of $470 billion, according to a recent Goldman Sachs report. With their combination of financing and technology, fintechs are able to set up and operate an electronic platform under which companies wishing to obtain a financing will be introduced to investors wishing to diversify their investments by investing their available cash in financial products.

In addition to transforming existing sectors, fintech has plunged into uncharted waters by creating entirely new types of products and services, such as crowfunding and peer-to-peer (P2P) lending, which have created new funding and financing venues for a much wider segment of the general population.

Securitization as a tool

At the cornerstone of such growth strategy lies the use of securitization as a seamless and transparent tool for investors and SMEs to obtain financing whilst securing a valid credit risk model. Based on the receivables that have a low default risk and a high turnover, securitization is a multistep process of providing a financing source by transforming illiquid assets into securities, resulting in the liquidation of the assets and the creation of new financing sources.

Through securitization, lending and borrowing do not have to be “one size fits all” anymore and technology can bring the necessary flexibility to meet needs while managing risks, providing SMEs with a critical source of financing. As part of this “securitization model”, SMEs will utilize the technology platform offered by their fintech partner to offer for sale some of their trade receivables held against their clients; the fintech may then enter into a credit insurance agreement with an insurance company under which either such fintech or the relevant investor will be the insured party, ultimately being in charge of negotiating and monitoring the insurance policy.

The Mechanism of Securitization

In essence, the mechanism of such a securitization-based financing model is the following:

- Companies post for sale some of their receivables on the platform (the "originators");
- Fintechs, acting as the operator of the platform, will ensure that such proposed receivables comply with a list of eligibility criteria similar to those developed for factorings or securitizations;
- Fintechs will ensure that the invoiced amount is due, and then "disclose" the offer of such receivables on the platform;

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- Fintechs will liaise with any investor wishing to acquire such receivables, taking all steps necessary to formalize any transfer deed purporting to transfer the property of such receivables to the relevant investor, transfer the purchase price to the originator and finally transfer the collections to such investor.

Fintechs can maximize the benefits of such a securitization model through the application of three key conditions, namely;

1) Mechanisms to ensure the security of the platform.

2) A proper risk/ return ratio that can take into account market volatility and fluctuations.

3) Reporting and information transparency.

Moreover, given some of the specific tasks that fintechs will be in charge of as part of this model - namely structuring and selecting the receivables, looking for investors and, last but not least, managing the payments in relation to the platform - there will be important legal and structuring requirements around local enforceability and taxation, some of which will be unique to the technology-based nature of this financing model.

A number of seismic changes in consumer lending provide a strong opportunity for fintechs to capitalize on further disruption in consumer lending:

- Dodd-Frank increases banks' compliance costs. Basel III requires banks to increase and improve their capital holdings. Because of these and other post-Great Recession regulations, banks have less capital to loan, increasing the need for alternative lenders;
- Maintaining retail operations increases costs for brick-and-mortar banks but not for Web-based lenders;
- Investors are hungry for higher yields over shorter periods of time;
- By creating an online marketplace structure where borrowers and lenders can connect, marketplace lending makes it possible for lenders to achieve higher rates of return on their "deposits" and for borrowers to gain access to capital at lower rates, in far less time than they would with retail banks.

Cumulatively, the above are expected to significantly boost the securitization market and institutionalize it as a major source of cheap funding across the entire financial services industry, from consumer to payments to equity, insurance and beyond. As new companies and marketplaces form, we expect that options for marketplace lending will develop for all manner of consumer and business loans, including consumer unsecured, real estate, education, purchase finance, business loans, and business working capital. By disintermediating the borrowing and investing experience through the removal of traditional players from the transaction cycle, fintech is transforming whole industries: unlocking value and creating liquidity for buyers and sellers, with more transparency, and using technology to enable scale and operating leverage.

To learn more about how Crestbridge can help you handle your corporate governance requirements for your Fintech fund structure, call **George Bashforth** on **+352 26 215 420** or email **george.bashforth@crestbridge.com** to arrange a telephone or video call.

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