



Embedded Finance:

This Decade's Largest Creator
Of Value

AT A GLANCE

Embedded Finance, the embedding of all types of financial products into clients' life journeys, is about to transform finance and create US\$ 7 trillion of market value by 2030.¹

The transformation is driven by the shift to e-commerce and the decomposition of the banking stack through APIs and Banking As A Service providers, and has triggered large investments by investors.

Incumbent players and even standalone end-user fintechs need to position themselves against this opportunity and develop their own Embedded Finance Strategy.

01. EMBEDDED FINANCE

Defining A Watershed Opportunity

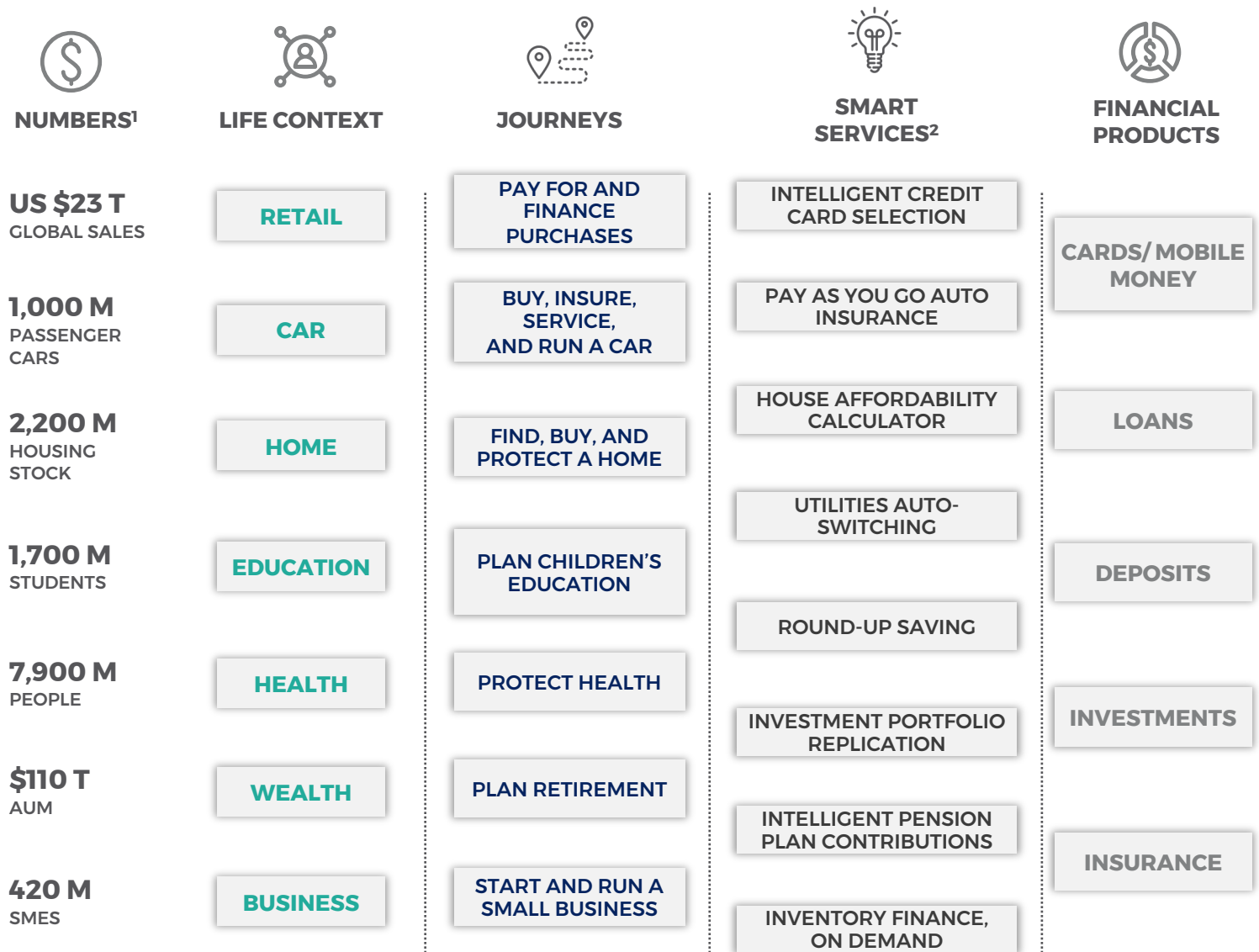


Today and over the next ten years, nearly US\$ 7 trillion dollars in market value are available to companies that have a digital business model and offer financial services through it. The estimate was recently shared by Bain Capital, and it requires putting values in a global perspective; US\$ 7 trillion is equivalent to 10% of global GDP by 2030. There is no other industry and business trend that will grow as quickly this decade. The beauty of Embedded Finance is that it enables non-financial services companies to offer banking and payment services directly to their customers.

The myriad of mundane and milestone choices humans make almost inevitably lead to the need for a financial product (see Figure 1). Historically, these products and services were sold to customers in branches, and more recently on the standalone website of a financial services provider. Financial services are now being re-imagined to be distributed at locations where consumers already engage, rather than luring them to branches, apps, and websites.

¹Bain Capital

FIGURE 1
THE EMBEDDED FINANCE JOURNEY: FROM LIFE CONTEXT TO FINANCIAL PRODUCTS



¹ Rounded figures (eMarketer, Wardsauto, Freedonia, Unesco, Worldometer, PWC, IFC)

² Illustrative examples

By connecting directly with the buyer, sellers improve their experience, better control the outcome, gather important data for analytics, and can generate extra revenue from the new service itself. Connecting financial services directly to

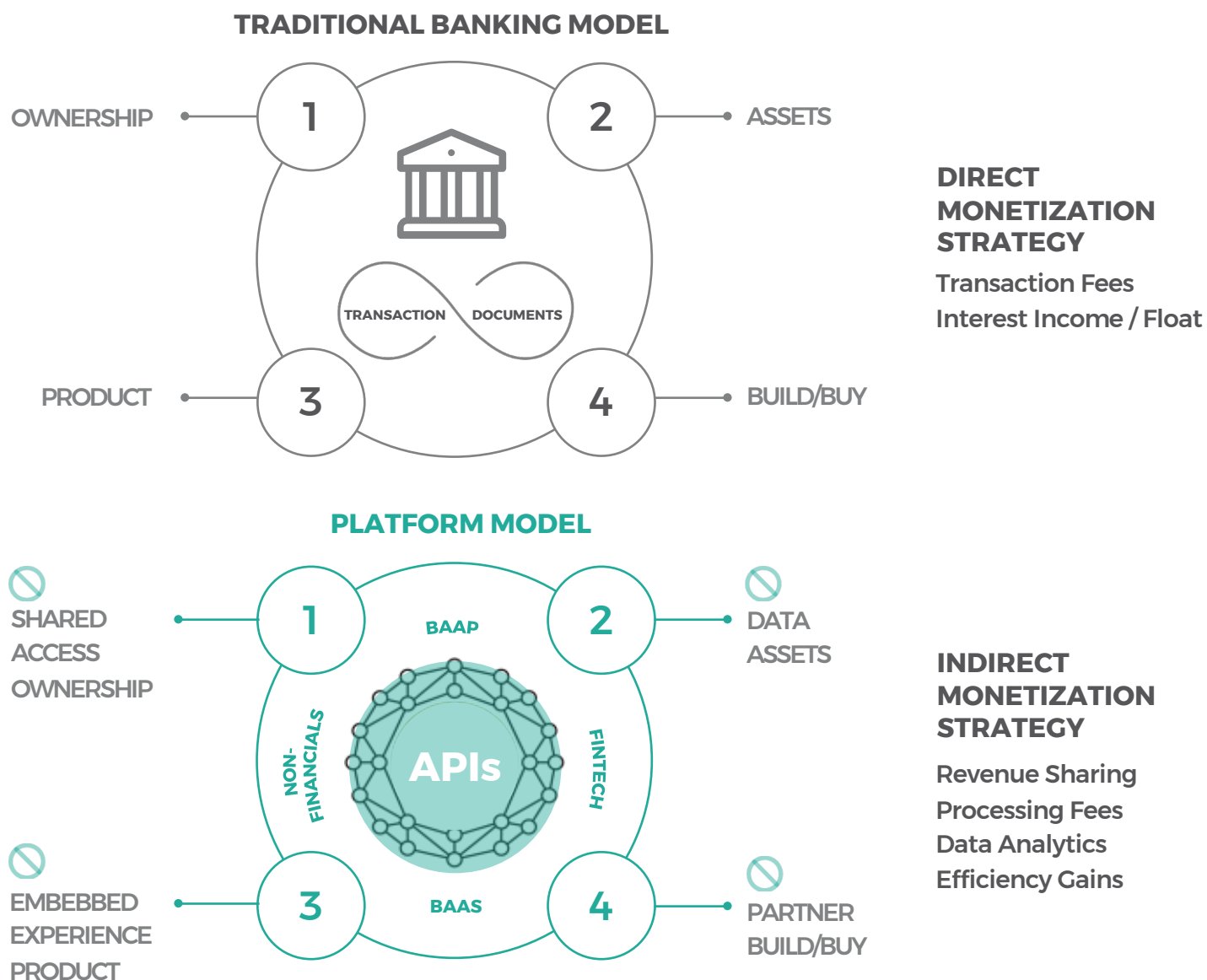
5.5 billion adults is therefore an enormous opportunity, and it requires that banks, brands, and merchants recalibrate how they abstract digital technology to capture value.

To be able to efficiently integrate financial services into customer offerings, not only does the underlying technology have to be able to scale at low cost, the business model also needs to be efficient. This disadvantages the traditional top-down and hub-and-spoke model employed by most financial institutions, and instead favors the platform business model used by digital merchants and two-thirds of fintech Unicorns.¹

At its core, this approach is built on the tenet that value is created not just by selling a company's own products and services but by connecting and

leveraging the network effect of multiple third parties. This is not about simply reselling financial services via new digital distribution channels; this is about meshing third party and proprietary elements together in such a way that the actual financial service disappears into the background of what is being offered to clients. The abstraction of financial service functionality into core technology can then be harnessed in a virtuous monetization cycle that draws more data insights from increased sales, funneling that information into innovation, which then in turn brings in more customers (see Figure 2).

FIGURE 2 **TRADITIONAL BANK VS. PLATFORM BUSINESS MODEL**



¹ MIT Sloan

02. IS EMBEDDED FINANCE HEADED TOWARDS UBIQUITY?

✓ YES

Embedded Finance is not a new concept – it has been written about under different terms for nearly 25 years – but it is only in 2018 that it became a buzzword. Now, in 2021, the buzzword is well established as a seismic trend and is set on a path to ubiquity.

The proverbial writing was already on the wall, in terms of digital trends that support Embedded Finance. E-commerce, mobile phone penetration, and financial inclusion were all on the up-and-up. Nonetheless, three important milestones will be achieved during 2021: the first two are global financial inclusion and smartphone penetration which will both break through the 50% ceiling. The third and most important trend, however, is the integration of embedded payments into e-commerce and its effect on valuations.

Payment facilitation companies such as Stripe, Square, and Paytm have grown rapidly, providing a frictionless payment experience to the users of digital services platforms. All three of these companies now have a combined value of over US\$ 100B. The bottom line and valuation benefits for merchants are also quite lucrative. Estimates for Shopify's financial services revenues are north of US\$ 500M per year and are estimated to contribute between 10% and 15% of the company's current value of over US\$ 100B.

Statistics from eMarketer released in April 2021 suggest that global e-commerce sales will increase to 16% of all sales by end of year with a sustained annual growth rate of 10% to 20% depending on the region. The pandemic has shown that consumers are willing and able to make complex or very high value purchases online (e.g. cars). At this rate, between 35% and 55% of all global retail sales will be online by 2030. Embedded Finance is therefore both a key protagonist and a beneficiary of this trend.

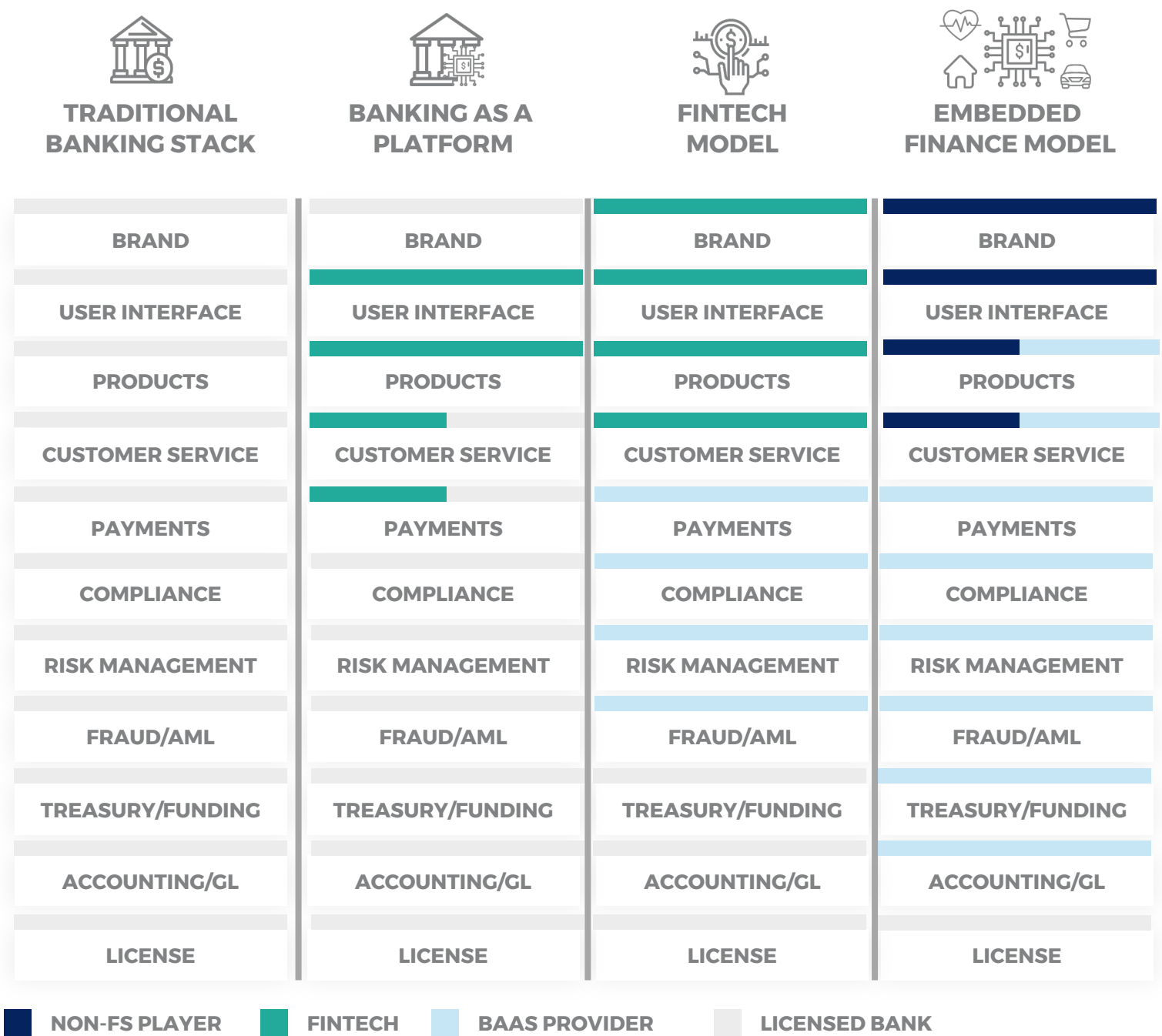
FIGURE 3
EMBEDDED FINANCE PRODUCT AREAS

PRODUCT	DESCRIPTION	EXAMPLE	FURTHER COMPANIES
EMBEDDED PAYMENTS	Substitutes the need for pulling out cash or a credit card at the end of a transaction by instead linking to a proprietary or third-party payment product	UBER Eliminates the need for cash at the end of each ride, allowing customers to use an embedded card or top-up solution	   
EMBEDDED CARDS	Cards integrated into a broader offering, often an e-wallet	PAYPAL Marketplace users can link their bank accounts to PayPal or use PayPal's cash card which gives faster access to funds than traditional current accounts	  
EMBEDDED LENDING	Allows customers to apply for and get loans at the point of purchase, either directly from the merchant or via an integrated third party	KLARNA Offers the ability to make purchases and pay in installments without the need for a credit card	   
EMBEDDED INVESTMENTS	Simplification or automation of the investing process, integrating it into daily life	ACORNS Offers customers the ability to round up daily purchases and make micro-investments	   
EMBEDDED INSURANCE	Provide insurance on demand directly to the beneficiary, embedding the insurance policy in a transaction (for the client or provider)	UBER Provides flexible cover for vehicle, personal injury, and income loss through its driver app	   
EMBEDDED BANKING	Linking up core banking offers like current accounts and deposits with a broader proposition	LYFT A debit card that allows instant payment to drivers, and offering a separate savings account through Lyft	 

However, the Embedded Finance opportunity extends well beyond embedded payments (see previous page, Figure 3). While most players focus on one or two product areas, the (Asian) Super Apps are developing offerings stretching across all areas, from payments to insurance and banking. They can do that pretty quickly, as they are not building everything inhouse, but rather relying on a set of partners

to deliver each product and the underlying components. The traditional banking stack is being decomposed and converted into a set of modular financial services. This trend is known as Banking As A Service (BaaS) and it is what is enabling Embedded Finance to both deliver niche offerings as well as to scale at low cost (see Figure 4).

FIGURE 4 — DECOMPOSITION OF THE BANK STACK THROUGH BAAS





Like Embedded Finance, the concept of BaaS has been around for over a decade. In its early incarnations, BaaS services were fully stacked applications that were bundled, allowed limited customization or modular development, and were cumbersome to plug into legacy technology cores.

However, the last five years saw BaaS solutions take full advantage of advances in cloud computing and APIs, and apply them to both core and microservice applications. BaaS is now a developed industry that can be deployed quickly in a modular fashion.

Low-cost deployment and scale are in turn getting VCs, Big Tech, and fintech entrepreneurs to pour enormous amounts of money and effort into this opportunity. KoreFusion has identified investments of over US\$ 2B across more than 30 funding rounds in the first 5 months of 2021 alone. Rounds have also become larger, with Rapyd and MX securing US\$ 300M each in January, and Zeta US\$ 250M in May. What would have been the largest deal, the US\$ 5.3B takeover of Plaid by VISA¹, was called off at the last minute over concerns from the regulator.

The spillover is strengthening funding opportunities for startups and pushing valuations for BaaS players into ever higher echelons. This creates perfect circumstances for Embedded Finance. BaaS is enabling the digitization of nearly every commercial sector and enabling financial services to be cost-effectively integrated into both the core technology stack and the platform business model.

While there is no global full-stack offering yet, the space is already populated with well-known BaaS brands such as Plaid, Synapse, Railsbank, Solarisbank, and Rapyd. Figure 5 on the next page shows the emerging market map with the different types of players. The end result of this hoopla will be an accelerated propagation of BaaS solutions and easier uptake of Embedded Finance by any brand or merchant.

¹Wall Street Journal

FIGURE 5
BAAS MARKET MAP

OFFERING	DESCRIPTION	EXAMPLES (FUNDING, US\$ M) ¹
FULL STACK	Complete stack of functionality	GALILEO (85) SYNAPSE (51) RAILSBANK (51)
PAYMENTS-FOCUSED	Players focused on payments and cards	MARQETA (528) RAPYD (470) GPS (62) YELLOWPEPPER (ACQUIRED) TUTUKA (ACQUIRED)
OTHER SPECIALISTS	Focused on specific products or elements of the banking stack	PLAID (734) CURRENCYCLOUD - FX (160) UPSTART - LENDING (144) TRADIER - BROKERAGE (6)
BANKING & SOFTWARE	Banking license plus tech platform	BBVA OPEN PLATFORM SOLARISBANK (129) GREEN DOT (33)
LICENSE-ONLY	Banking license only	STARLING BANK (922) LINCOLN SAVINGS BANK (158) ² THE BANCORP (74)
BAAS TECH	Specialized software offerings	Q2 (672) MAMBU (179) THOUGHT MACHINE (149)

¹Total funding, Crunchbase

²Total bank capital

03. IMPACT ON INCUMBENTS

Up to now, fintechs and digital platforms have been the largest employers and beneficiaries of BaaS. This is in great measure due to open banking regulations and open APIs making it possible for non-regulated providers to offer these services. This intersection of banking services, fintechs, and BaaS has served as a sandbox for Embedded Finance to develop the means to become ready to jump to non-financial sectors — precisely where the largest financial opportunity lies.

Although regulation concerning open banking is not uniformly stacked against banks, the general trend is for more financial services to be delivered by non-bank — and less regulated — third parties. These also benefit from brands with stronger everyday appeal. The danger for banks and incumbent financial services providers is that they will become relegated to regulated licensed activities and see much of their current domain commoditized. This could perpetuate sluggish returns for incumbent financial services players. A combined profit pool of over US \$1 trillion has already transferred from the world's top financial services companies to up-start challengers in the last five years, according to McKinsey.

The threat of disintermediation and diminishment is therefore not an idle one.

Despite both the threat and the opportunity to branch out into new frontiers, few incumbent banks today are strongly active in either the BaaS or Embedded Finance areas. One of the large global players, BBVA, has established a strong claim in the space — offering the first forays of Embedded Financial services to Uber, and soon Google.

Small and sundry case studies are beginning to emerge across the globe. Standard Chartered launched Nexus, its dedicated BaaS solution, in mid-2020. In the US, Marcus (part of Goldman Sachs) offers credit to Amazon merchants. Banco Itaú and Banco Bradesco, Brazil's largest private banks, invested US\$ 15M in Quanto, a local open banking platform for retailers. In Mexico, Banco Sabadell is gearing up to be a bank for fintech challengers and smaller financial institutions who could do well lightening their operations by allowing other players to provide them efficiently.

BBVA: LEADING THE PACK

BBVA is a pioneering example of a major bank using a platform to provide core functions and services to an ecosystem. The bank has operations in 35 countries and a 66 million customer database full of behavioral records and patterns from which to draw insights and develop products. In the US, BBVA is also benefiting from a complete overhaul of its core banking system, completed in the last decade.

The bank developed its BaaS offering in the US on the basis of the acquisition of digital challenger bank Simple and subsequently launched bank venture Azlo (both have closed down this year). BBVA Open Platform is offered as a white label solution to external clients since the end of 2018 and has been implemented by a handful of smaller fintechs.

Open Platform offers 5 major products: KYC for consumers and corporates, current accounts, debit cards, and payments, all offering real-time notifications about events. Support for credit cards and savings accounts is under development.

While the Open Platform's traction seems to have slowed down a little, BBVA made major announcements around new partnerships: the bank has partnered with Uber in Mexico to offer embedded bank accounts to drivers and has also emerged as one of several banks to support Google's long-awaited launch of digital bank accounts in the US.

04. HOW TO SET UP AN EMBEDDED FINANCE STRATEGY

For financial services providers, the decision on whether to develop a BaaS offering to enable Embedded Finance is the starting point. If a provider chooses not to enter BaaS, they need to think about protecting their existing business model from the threats of competing Embedded Finance offers.

Assuming a positive decision has been taken, a five-step-approach can be used to develop an Embedded Finance Strategy. This can happen either as a standalone process, or as part of a broader digitization strategy.

01.

Develop the overall vision and key choices — create a vision that captures the target clients and high-level proposition. Will it include a license or just the services? Understand what the unique selling points will be. Decide whether this will be an integral part of the rest of the business or a standalone venture. Incumbents will have to strike a balance between leveraging existing capabilities and skills and creating an environment prone to innovation and entrepreneurship.

02.

Determine revenue drivers — further develop the product offering. Is it just financial products or also additional services, such as identity, credit decision making, fraud detection, and cash handling using a branch network? Pricing is typically based on a platform fee plus the number of transactions or accounts, but revenue-sharing models also exist.

03.

Decide where to play — define regions, markets, industries, and distributors. BaaS market dynamics are driven by the licensing requirements in the target markets. Outside Europe, typically only one market can be served with one license. A strategy targeting specific verticals (e.g. e-commerce, ride-hailing) could be interesting, given the focused nature of some of the end-client propositions.

04.

Define the operating model — requires serving customers with varying service levels, cultures, and end-customer types. How does the new model coexist with existing operations? Does the approach to risk management have to evolve to capture risks from indirectly serving end clients? Third party risk must be managed.

05.

Develop the technology strategy — should a new greenfield BaaS platform be built, or existing systems be repurposed? Can customers be moved to a new platform over time? Modern modular systems provide a lot of functionality out of the box and can be integrated into an existing system landscape with the help of APIs.

All of the above decisions come together in a business case and comprehensive roadmap, stretching across business, technology, regulation, compliance, and risk. KoreFusion has developed a proprietary strategic framework for this type of digitization program.

Vendor selection should not be left too late, as the choice of partners can drive some of the strategic decisions. Other BaaS providers could become competitors and providers, a frequent occurrence in this field.

05. CONCLUSION

It is clear that a profound shift is underway in the way in which financial services products are being distributed. Every player needs to understand how he will be impacted in order to develop a proactive strategy, capitalizing on the opportunities.

The gap between players that can build or become part of a platform that includes financial products, and those that cannot, definitely stands to increase. Figure 6 summarizes some of the key considerations for different types of players.

FIGURE 6 **IMPACT AND KEY CONSIDERATIONS FOR DIFFERENT PLAYERS**

PLAYERS	EXAMPLES	KEY IMPACT	KEY CONSIDERATIONS
ECOSYSTEM BUILDERS	AMAZON GRAB SHOPIFY XERO	Easier to integrate financial products and develop propositions for specific client segments	Can I customize my proposition to a specific segment through financial products? Which part of the financial value chain do I want to build internally?
STANDALONE END-USER FINTECHS	WISE BETTERMENT LEMONADE MARKETFINANCE	Standalone offers without embedding to lose appeal	Can I find partners to embed my offer or build a platform around it? Is it attractive to develop my own BaaS strategy and proposition?
DIGITAL BANKS	NUBANK MONZO JUDO BANK TMRW		
BANKS AND OTHER INCUMBENTS	CITIBANK BARCLAYS OCBC	Erosion of market share Loss of client access	How do I develop a BaaS strategy that overcomes institutional legacy, without losing client access?

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K O R E F U S I O N

KoreFusion's Experience

Over the past 18 months, KoreFusion has led over 50 global engagements and has worked with leading corporates, payment networks, clearinghouses, regulators, and ERPs/intelligent business platforms worldwide to address their emerging challenges around payments and financial technology from both a strategy and M&A perspective.

For more insights from the KoreFusion team, and to discuss how these trends impact your business, please contact us.

KoreFusion uniquely combines strategy consulting and M&A advisory services exclusively for the international fintech, payments, and financial services industries.

With six international locations, our experts balance global best practices with local priorities and expertise.

Our Areas Of Expertise

- Faster / Real-Time Payments
- Push & Account-to-Account Payments
- B2B & Commercial Payments
- P2P & P2M Payments
- Credit, Debit, Prepaid & Commercial Cards
- Merchant Acquiring & Payment Processing
- Money Transfer & Remittances
- Supply Chain Digitization & Finance
- Consumer & Commercial Lending
- POS & Omnichannel Solutions
- Mobile & Emerging Payments
- e-Wallets & Closed Loop Ecosystems
- Cobrand & Loyalty