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March 2023

How BaaS Can Help FIs Win More Customers

Embedded Finance Tracker® Series

Read the previous edition

DECEMBER 2022

Embedded Finance Tracker® Series

What's Inside

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Acknowledgment

The Embedded Finance Tracker® Series is produced in collaboration with Galileo, and PYMNTS is grateful for the company's support and insight. PYMNTS retains full editorial control over the following findings, methodology and data analysis.

Need to Know

Customers Crave Digital Finance at Their Fingertips

Digital banking has become the default means of financial interaction for countless consumers around the world, with the ongoing pandemic supercharging a shift that was years in the making. PYMNTS research found that almost three-quarters of consumers have used digital channels to open a new account, for example, unlocking the gateway to a digital customer lifetime.

Mobile apps are the most common banking method of choice, at 45% of consumers, with this number shooting up among younger generations, such as millennials and Generation Z. Banks that were content to offer in-person banking have received a rude awakening over the past several years, finding themselves at risk of losing large swaths of customers if they forgo enabling digital experiences.

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Digital banking has overtaken in-person visits as customers' favorite way to bank.

Share of banking customers who cite the following as their top banking choices:

45%
Mobile banking apps

27%
Online web browsers with laptops or PCs

14%
Bank branches

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Need to Know

BaaS is a key tool for providing the digital experiences customers demand.

Banking as a service (BaaS) involves banks leveraging their charters to offer nonbank companies the ability to provide banking services to their customers. BaaS benefits customers by allowing them to access financial services from a wider variety of sources. It benefits banks, meanwhile, by enabling them to expand their footprints to include even customers who are not seeking traditional financial institution (FI) relationships.

BaaS is currently a small market, with 7% of bank executives saying they provide these services, while 4% are in the process of developing a BaaS strategy and 13% are considering the possibility of launching BaaS offerings. Experts indicate, however, that the industry is expanding by 26% annually, projecting a bright future — so long as banks pick the right technology partners to enable BaaS options.

Need to Know

Choosing the right partnership can be the difference between success and failure in BaaS.

The distinction between BaaS technology partners and third-party platforms or brands is important for banks to understand: The latter are the customer-facing, nonfinancial brands through which end users leverage BaaS capabilities, while the former, often FinTechs, are the technology providers facilitating the connection between the brands and the banks themselves. Both are vital to the success of a BaaS initiative, and banks must carefully select the right partners in each.

Fees, fraud management, account verification and know your customer (KYC) requirements are vital considerations for banks when selecting a BaaS technology partner. With the multitude of banking choices that BaaS is enabling, along with customers' willingness to switch for the options they want, it is make-or-break for banks to make informed choices when embarking on BaaS partnerships.

Customers are becoming more interested in digital banking options.

36%

Share of consumers highly interested in using a digital bank in the next year

9.3%

Portion of consumers who use a FinTech as their primary bank

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News and Trends

Embedded Finance Grows as an Alternative to Traditional Banking

Embedded financial services are quickly gaining market share in the banking industry. A recent study found that these services will produce $230 billion in revenue by 2025 — up from $22.5 billion in 2020. This growth is being fueled by increased online credit card spending and the introduction of new services, ranging from Uber's provision of debit cards for its drivers to Ulta Beauty's partnership with Klarna to offer installment payments to its customers.

Eighty-eight percent of companies that have deployed embedded finance reported increased customer engagement, and 85% said these embedded finance systems helped them gain new customers. With greater demand for the convenience of banking wherever consumers are, embedded finance is becoming a viable alternative to traditional banking across many verticals.

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News and Trends

Banks face new challenges, thanks to rise of embedded finance

Embedded finance is disrupting the banking industry, forcing traditional institutions to adapt quickly to changing consumer values. One recent survey found that 54% of bank executives said they have faced more competition over the past three years due to the rise of embedded finance and other digital banking alternatives.

Thirty percent of customers said they are considering switching FIs, forcing banks to alter their business models to compete with digital finance. Experts point to BaaS as a valuable partnership for traditional FIs, allowing them to maintain clout in the financial industry by offering their services to customer segments that would not otherwise visit them.

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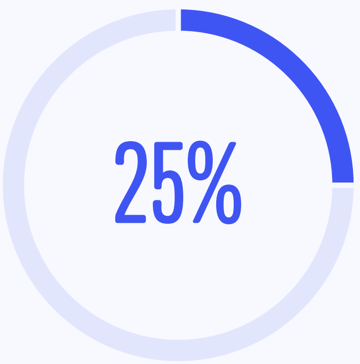
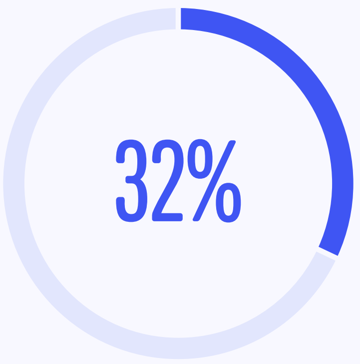
25% of bankers see BaaS as a new revenue-stream opportunity

The banking industry remains in flux following the tidal wave of digital innovation that arose during the pandemic. A recent survey found that 25% of bankers saw BaaS as an opportunity to create new revenue streams, and 32% are currently assessing how BaaS can streamline their daily operations. BaaS is one of many new technologies banks are deploying to enhance the customer experience, including digital account opening, data analytics and reporting as well as digital lending. A full 61% of bankers said that investing in new digital technologies was a top priority in the coming year.



Portion of bankers who view BaaS as an opportunity to create new revenue streams



Share of bankers who are currently workshopping ways BaaS can streamline operations

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PYMNTS Intelligence

Partnering for BaaS Success

Banks embarking on a BaaS journey may feel they have their work cut out for them, especially if they are relatively new to the digital banking scene. While traditional financial services such as loan approval, credit issuing and KYC are still vitally important to a smooth and secure BaaS experience, banks also must take on new functionalities, such as the use of application programming interfaces (APIs), payment gateways and a host of other technical capabilities.

Developing in-house BaaS solutions might work for large FIs with dedicated IT staff, but the majority of banks will need to partner with technology providers to implement BaaS. This month, PYMNTS explores how banks can partner to enable BaaS and how these partnerships can help banks unlock opportunities for greater personalization.

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PYMNTS Intelligence

The BaaS playing field

An understanding of the players is fundamental before deciding how or whether to take the plunge into BaaS. The first category of players consists of traditional banks, generally without strong technology expertise, that offer their licenses to digital banks or BaaS providers to enable nonfinancial companies to deliver banking capabilities to their customers. The second category consists of hybrid players that possess not only banking licenses but also strong technology and API expertise. The third category includes API technology players that do not possess banking licenses but have a particular focus within BaaS, such as payments or cards, that may be especially appealing to certain license providers.

Incumbent banks must first determine whether BaaS can benefit them, either as users or as in-house providers themselves. For those that choose to enter the playing field, the best option will often be partnering with a technology provider that can develop the most products, allowing the bank to optimize customer experience at maximum efficiency.

BaaS revenue is quickly growing as FIs recognize its full potential.

25%
Compound annual growth rate of BaaS through 2026

17%
Share of banking revenue in the Middle East generated by BaaS by 2031

Enabling BaaS through partnerships can pay substantial dividends to banks. Revenue from BaaS operations in the Middle East alone is expected to total $5 billion by 2026, for example — 4% of the region's total banking income. The potential for personalization can also pay in customer loyalty.

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PYMNTS Intelligence

BaaS for unlocking personalization

Working with businesses on BaaS applications provides FIs with new data streams regarding the services that customers use most, the features that result in the most engagement and a host of other actionable data points. Banks, in turn, can mine data ecosystems via platform models to gather real-time insights and improve the personalization of both their BaaS offerings and their in-house banking services.

Customers are seeking increasing levels of personalization in their banking experiences. A recent survey found that 72% of banks reported an increase in demand for personalized financial services in times of economic strain, and 61% said that customer experience expectations have risen in recent years. Delivering personalized experiences via BaaS could be vital to retaining these customers in the face of increased FinTech competition.

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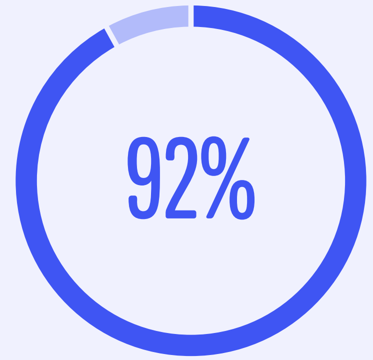
Portion of FIs currently innovating or planning to innovate embedded finance experiences



Portion of community banks that are currently innovating embedded finance solutions for payment processing or plan to do so

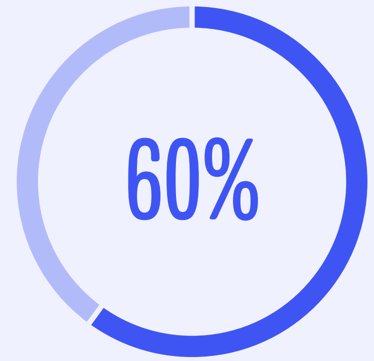


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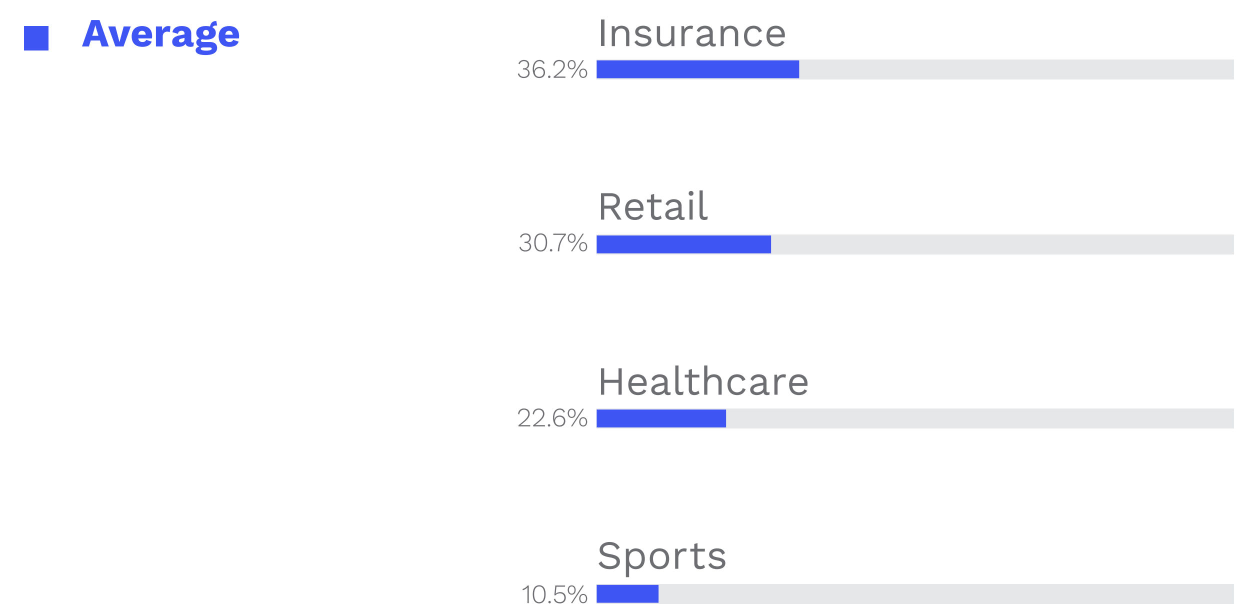
Chart of the Month

Embedded Finance's Popularity Across Industries

Businesses in a variety of fields are exploring embedded finance solutions as a means of improving the customer experience. The industry most likely to adopt embedded finance was insurance, with 36% of FIs saying they were planning to develop embedded finance solutions for this industry. Retail and healthcare took second and third place, respectively, while sports came in last at just 11%. This is likely because customers already use large sums of money when paying for insurance or healthcare, while relatively little is spent for sporting goods purchases, reducing the need for debit or credit solutions.

Industries expected to adopt embedded finance solutions

Share of industries expected to be most likely to adopt embedded finance solutions



Source: PYMNTS
Meeting the Challenge of Payments Modernization: Understanding Customer Needs, June 2022
N = 287: Complete responses, fielded Oct. 28, 2021 – Nov. 30, 2021

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Insider POV

An Insider's Take on How Banks Can Tap BaaS for Growth

VLAD LOUNEGOV
Founder and CEO

Mbanq.

"If you look at our platforms versus some of our clients from the traditional space, like credit unions and small banks, you'll see that platforms have much faster growth than all our credit union clients combined. There's a lot of need for banking, and those organizations and affinity groups command much more recognition in the community versus mainstream banks."

Vladimir Lounegov, co-founder and CEO of Mbanq, shares with PYMNTS how FIs and brands can supercharge growth by introducing new embedded finance features with the right BaaS partners.

During part of his 20 years as a banking consultant, Vlad Lounegov helped some of the largest banks in the world acquire other FIs and build their portfolios of services. When the 2007-2008 global financial crisis struck, the mergers and acquisitions pipeline dried up and the entire industry refocused on efficiency.

Lounegov pivoted to technology as a profitability driver for banks, but payments innovations and new technology such as artificial intelligence and blockchain had not yet penetrated core banking. It turns out that when Lounegov founded Mbanq in 2017, he was in the right place at the right time. Starting as a technology company before shifting to software as a service, Mbanq is now driving the next great shift in financial services — BaaS.

"At the end of the day, we're selling compliance as a service, lending as a service, everything critical to running banking operations, handling complaints and chargebacks. This is where we make most of our money," he said. "The tech is important, but our biggest margins are made through services."

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Insider POV

Mbanq has already created and operates more than 50 banks, FinTechs and credit unions through partnerships with clients, creating value with a deep and growing technology stack that delivers embedded finance at scale. While the company works with credit unions and traditional banks, Lounegov said smaller and regional banks that are landlocked with geographical constraints face issues with lagging deposits. These barriers make it harder for local banks to expand lending offerings or grow beyond core banking.

Ultimately, banks are brands, Lounegov said, but people care more about brands they engage with on social media or via mobile apps than FIs. Therefore, BaaS platforms for brands and organizations have driven the lion's share of Mbanq's growth and also represent a wider opportunity for expanding use cases, which include early access to wages or payday advances.

Other use cases, including low-loss lending models that will be key as consumers wrestle with inflation through 2023, are more reliant on data and analytics that can be automated for reliable lending decisions. For brands, the prize goes beyond winning or retaining customers — BaaS brings a mountain of usable data to drive future products and services that build sustained growth. This will be an area that Mbanq looks to amplify on the platforms the FinTech is building this year.

"Brands spend so much money on market intelligence. Imagine how much market intelligence [BaaS] will give them?" Lounegov said.

Mbanq is also working with major professional sports leagues and teams around the world that are aiming to monetize their fan bases and tap consumer data for more predictable decisioning and to complement their existing market research. In addition, Mbanq works with Ivy League institutions and other colleges and universities to help them capitalize on the trove of data they keep on each student and to maintain stronger financial ties with alumni, who are key to development goals.

As FIs and brands wrestle with the evolving embedded finance landscape, figuring out BaaS for their specific situations is a must to stay competitive, especially for those FIs whose innovation game has grown stale.

"The biggest problem we run across is the systems that incumbent banks and core banking providers use," Lounegov said. "They haven't really innovated enough over a long period of time, so what happens when we roll out BaaS is the new technology starts to cannibalize business from the legacy core, and you see the legacy business become smaller in comparison.

"If these legacy core providers don't innovate fast enough, BaaS will eat their lunch."

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Companies to Watch

Goldman Sachs Faces Rocky Embedded Finance Future

Embedded finance is not always smooth sailing, and even financial giants such as Goldman Sachs must work hard to make it a success. A recent SEC filing reported that the FI's platform solutions business, which handles embedded finance, lost $3 billion over the past three years. This does not mean that embedded finance itself is to blame, however: Banking revenues in the September quarter were $88 million, down from $91 million in June, indicating a headwind for the financial sector in general. Future months could potentially shed more light on Goldman's embedded finance direction and the shape of the industry as a whole.

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What's Next

Mastercard Explains How BaaS Will Scale in 2023 and Beyond

Mastercard executive vice president Sherri Haymond detailed to PYMNTS in a recent interview that while the seeds of BaaS success were sown amid the pandemic, the industry's future continues to look bright. Experts estimate that BaaS could represent a $7 trillion opportunity by 2030, driven by customers' demands for financial services wherever they are. Successful embedded finance use cases such as Uber and Lyft, for example, could serve as models for other industries to offer seamless payments to their workers in-app rather than requiring them to get paid through bank accounts.

$7T

Projected BaaS market capitalization by 2030

70%

Projected annual BaaS growth over the next three years

50%

Share of BaaS enablers that plan to increase their partnerships with distributors and financial services providers over the next five years

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galileo

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