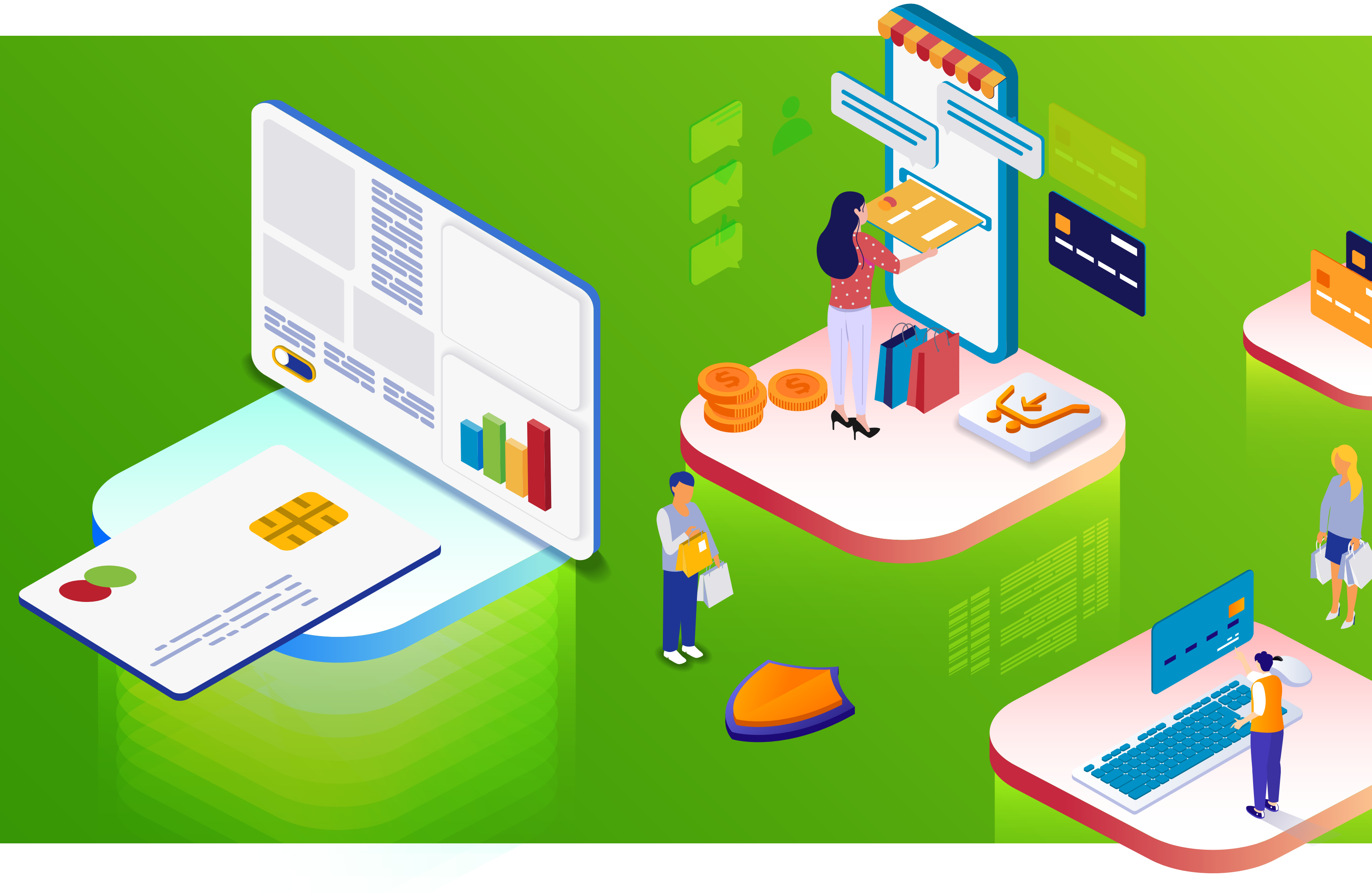
Embedded Finance

Delivering Value at the Point of Decision



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Executive Summary

Every industry goes through a cycle of disruption when new channels of engagement emerge. Amazon introduced eCommerce to the masses and upended the retail industry forever, while television, film and recorded music were each transformed by the advent of streaming services.

The financial services industry is now on the cusp of a similar cycle of disruption that is already transforming how consumers access capital to fund everything from exercise bikes to commercial equipment: embedded finance.

Trust is shifting from incumbent financial institutions to innovative players and mechanisms like marketplace lenders and embedded finance, that successfully break down traditional barriers to obtaining funding. According to one survey, more than 60% of consumers would use a financial service from an e-commerce provider[i]. Yet, there's opportunity here for banks and credit unions, as well. New regulations, advances in open banking and the arrival of Banking as a Service (BaaS) all open the door for traditional financial institutions to take leading roles in embedded finance.

Embedded finance is positioned to become the number one distribution channel for financial services within the next ten to twenty years, which means the time to start preparing for the revolution is now.

Why embedded finance, and why now?

Embedded finance has been around for decades, albeit in much different forms than today's application programming interface (API)-driven iteration.

Brick-and-mortar merchants have long offered their customers a variety of financing options to reduce the burden of paying cash upfront for pricey merchandise like furniture, appliances and automobiles. From retail financing plans and layaway, to store credit and closed-loop credit cards, retailers have been willing to take on a certain amount of risk in order to get the sale and provide customers with a positive experience at checkout.

Unfortunately, such options have often been clunky and inefficient. Consider indirect auto lending, which consists of an agreement between a community financial institution and an auto dealer to provide financing at the time of sale. Despite there being a number of specialty technology providers that have attempted to create a smooth, frictionless experience among the various players – the customer, the dealer's finance manager and the lending institution – the process is far too often encumbered by miscommunication, asymmetrical information and slow approval times – increasing risk of loss and the likelihood of a less-than-ideal experience for all involved.

Despite this, many car buyers choose the indirect option strictly for the convenience ability to finance and purchase a vehicle while in the showroom, without the hassle of getting preapproved or visiting their bank branch to obtain financing.

Adam Cohen, General Manager of Enterprise at Payoneer, defines embedded finance in its current iteration as "the use of Banking-as-a-Service and API-driven banking and payments services to integrate financial services within other environments and ecosystems[ii]."

Embedded finance is a seamless and integrated process that closes the gap between buying and lending, allowing these two actions to happen in concert at the point of purchase.

According to Nathan Snell, Co-founder and former Director of Product Management at nCino, embedded finance is both a new rail – for financing, compliance, banking and payments – and a new direct-to-consumer channel that enables financial institutions and their customers to bypass the middleman-financial marketplaces.

"With today's version of embedded finance," Snell explains, "COVID has served as an accelerant – driving consumers to pursue touchless, digital solutions while incenting retailers and businesses to adopt such processes. The digital ecosystem, through eCommerce, has matured to the point where embedding lending, payments, funding, KYC compliance and data security into the sales and purchasing process is practical, cost-effective and efficient."

BNPL is the tip of the spear

According to Snell, the remarkable success of the Buy Now Pay Later (BNPL) model during the pandemic has been well-documented. But it is just one, early success story – the "killer product" that has proven the value and viability of embedded finance. Consumers spent upwards of $20 billion using BNPL on eCommerce purchase in 2020, more than double the amount spent the prior year[iii].

Snell cites a few well-publicized examples from the last few years:

- **Affirm** originated nearly $1 billion through Peloton each year, a relationship that now accounts for 28% of the fintech's annual revenue.
- **TD** has partnered with fintech Amount to provide financing for NordicTrack exercise equipment.
- **Amazon** has made $1 billion in short-term loans to sellers on its marketplace[iv].
- **Uber** rolled out Instant Pay, which accounts for 70% of driver payouts[v].
- **Shopify** partnered with Stripe and processed $14 billion through its Shopify Payments service in Q3 2020[vi].

According to a report from Financial Technology Partners, the total market potential for BNPL is $5 trillion in the U.S. alone. Worldwide, the channel will account for over 4% of payment transaction volume by 2024, a 100% jump from 2020[viii].

The BNPL market is currently dominated by fintech upstarts like Affirm, Klarna, Afterpay and Uplift. But big banks including Citibank, JP Morgan Chase, Citizens Bank and American Express have also introduced installment pay programs in recent years. Next up is Big Tech, with Apple poised to join the parade with its launch of Apple Pay Later with Goldman Sachs as its partner lender. The convenience of financing a purchase at the point of sale right from your iPhone will undoubtedly attract many consumers.

Why is embedded finance important?

"Like the retail, music and film industries, financial services is in the midst of a disruption cycle," says Snell. "Over the past decade, marketplace lenders like Lending Club, Prosper, SoFi and Funding Circle have carved out their own niches, like small business lending, student loans and mortgages, and disrupted incumbent banks in those spaces. Now, embedded finance is having its time in the spotlight."

The Cycle of Disruption

	ECOMMERCE	MUSIC	VIDEO	BANKING
Bundled	Big box retailers	Major labels	Major studios	Banks
Digital Transformation	Yahoo store, IBM, etc	iPod makes it easier to listen	Early streamers starts, YouTube	nCino, SoFi, Lending Tree
Unbinding / Niche Upstarts	Carts, Product Catalog, Pricing	Napster, LimeWire	Netflix, Hulu, YouTube	BaaS, Niche, Embedded
Marketplace	eBay, Amazon	Spotify, Apple		Upstart, Lendio, Google Pay
Bundled	Amazon	Spotify, Apple	Netflix, Apple, Amazon	Square, Stripe
Bundled	Amazon, Shopify	Spotify, Apple, Tidal	Netflix, YouTube, Disney+	Upstart? Square? TBD

Consider that payment fintech Affirm, through its partnerships with companies like Peloton and Amazon, generated $8.3 billion in gross merchandise volume in the fiscal year ending June 30, 2021, an increase of 79% over the year prior. The firm reported an active consumer base of 7.1 million for the period, representing growth of 97% over the prior year. Active consumers had 2.3 transactions, on average, translating to roughly 15 million loan transactions in fiscal year 2021[viii] .

Let's compare that to the loan volume generated by the typical community bank. In 2018, the average community bank had just $3.2 million in loans on its books, and only 663 of the roughly 5,500 community banks had more than $1 billion in assets[ix].

How about the Big Banks? Surely they have the market leverage to fend off competition from this new wave of embedded finance providers, right?

Well, the combined market value of the top 30 global banks and insurers was $3.6 trillion in 2021.

By 2030, embedded finance (including embedded insurance, embedded lending and embedded payments) is predicted to reach $7.2 trillion[x] **– double the size of Big Banking and Big Insurance today.**

"The future is digital," Snell says. "Banks must find a way to deliver an exceptional customer experience and establish lasting, loyal relationships, without relying on their branches and face-to-face interaction. Embedded finance is one key way to do this, by delivering the experience consumers desire and need, right at the point of sale."

"People don't care about getting an auto loan, a retirement account or a mortgage," he adds. "What they desire is a cool car to get them where they want to go, a secure future filled with fun and travel and a home to raise their family in. Embedded finance represents a sure and efficient path to achieving those goals."

How do FIs get a piece of the action?

For traditional financial institutions, particularly those in the community and regional segment of the market, embedded finance represents both a threat and an opportunity.

The threat: New fintech entrants, along with existing players are disrupting traditional finance by meeting the customer at the point of sale. If community and regional banks and credit unions aren't careful, they will be left by the wayside.

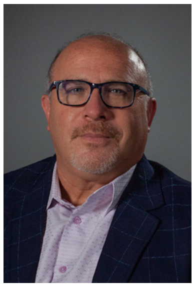
The opportunity: Whereas revenues from the embedded finance channel, currently dominated by BNPL, are relatively small at $16 billion, they are expected to grow rapidly over the next few years – to as much as $230 billion by 2025. BNPL is the right product at the right time – landing during COVID-19 smack dab in the middle of a sea change in consumer expectations around what the purchasing experience needs to be.

Where does this leave community and regional FIs? If they play their cards right, banks and credit unions are well positioned to leverage their existing, trusted relationships to capture a significant portion of this market. Here are a few suggestions from Snell:

- **Pursue open banking:** The time has come for banks to open their core technology stack. In Europe, this is already being forced through regulations like the revised Payment Services Directive (PSD2). In the U.S., such mandates have been slower to arrive, so it is incumbent on the institutions themselves to take action. Embrace the use of application program interfaces (APIs) and the evolving financial ecosystems to allow your customers and members to have access to new financial services and technologies.
- **Partner with fintech:** The key is to create a frictionless experience for your customer or member. Financial technology platforms and solutions – enabled through open banking and APIs – can help you accomplish this. Through collaborative partnerships, firms like Unit are designing solutions to help companies embed financing into their products, bringing the funding process as close to the decision point as possible.
- **Don't reinvent the wheel:** A recent survey of bank executives found that nearly half expect their business to act "as a true digital ecosystem" in the next two years[xi] . This seems strategic, but it depends on how "ecosystem" is defined. Banks that plan to develop their own ecosystem – aka a "financial super app" – are destined to fail because consumers don't care about having one app to manage their financial lives. Alternatively, success will be found with those institutions that embed their financial offerings into the retail ecosystem, bringing these valued financing options closer to the point of decision.
- **Develop and mature your digital channel:** Although the demise of the branch is taking longer than most trendwatchers predicted, as daily transaction activity migrates to the digital channel, banking institutions can no longer rely on their branches to drive the customer relationship. It is not enough to simply offer online and mobile banking—banks must take the digital channel to the next level by making it truly interactive, frictionless, efficient and convenient for the customer. Digital must go beyond delivering convenience, to delivering exceptional value and an outstanding experience.
- **Identify underserved niches:** In financial services, the path to success and ROI is through specialization. The ability to focus on a unique, underserved niche, whether through embedded finance or direct via the digital channel will take on greater importance in the next few years. We observed this with the rise of marketplace lending, which was initially introduced broadly within the consumer segment, before becoming increasingly specialized with various firms serving small business, mortgage lending, student loans and even the commercial segment.

The financial services industry is entering a cycle of disruption led by the rise of embedded finance, a seamless and integrated process that closes the gap between buying and lending at the point of purchase. For community and regional financial institutions, the embedded finance channel presents new opportunities to reach customers where and when their services are needed. With embedded finance poised to become the leading distribution channel for financial services over the next couple of decades, financial institutions would be wise to begin preparing for this revolution now.

About the Author



Anthony Morris

With more than 30 years of experience in the banking and software industries, Anthony has successfully helped financial institutions around the globe define and deliver new operating models and practical transformation visions. As the Vice President and Global Head of Banking Go-to-Market at Salesforce for the past decade, Anthony advised hundreds of bank customers on how to best leverage the cloud to deliver their digital transformation strategies across a variety of business lines, segments and programs. At nCino, Anthony engages with global bank customers and prospects to drive their adoption of the nCino Bank Operating System® and helps refine go-to-market strategies to continue expanding the nCino ecosystem.

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Endnotes

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