

How Embedded Finance is Changing the Future of Financial Services



Embedded Finance (EF) is a fast-emerging trend that is reshaping how businesses will be done across industries (e-Commerce, insurance, healthcare, automobile, tourism, etc.) and how financial services integrate with the same. In an increasingly digital-savvy world, seamless services at the point of sale across industries are becoming the norm. EF is now a top priority for financial services providers, given its US \$7 trillion+ market potential by 2030. All leading banks and big tech companies — from JP Morgan Chase and Citi to Apple and Google — are taking note and aligning their strategies around EF.

In this paper, we take a close look at what Embedded Finance (EF) is, its rapid growth, EF ecosystems and industry adoption models, how EF is reshaping downstream operations and the last mile of doing business, and lastly, what banks and financial services players must do to stay ahead, relevant, and central to this revolution.

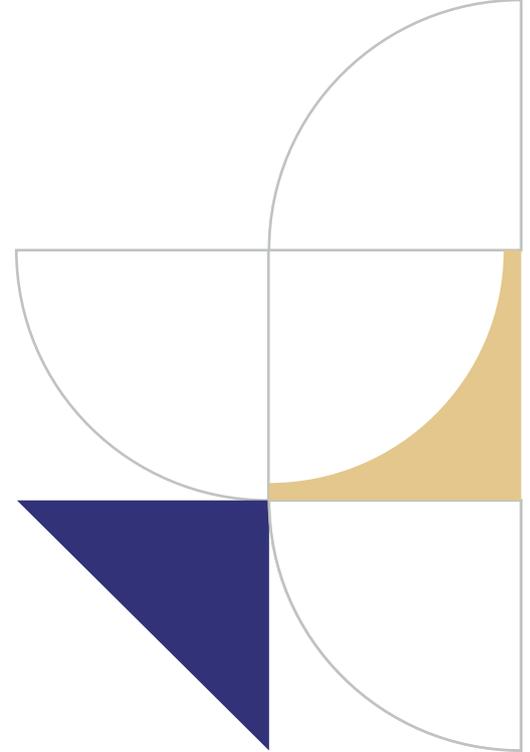
What is Embedded Finance?

Embedded Finance ensures that every company becomes a fintech company. Yet, EF means different things to different people. If you ask five executives what the term means, you will get five different answers. To put it simply, EF is the integration of financial services into point-of-sales for non-financial businesses. A key feature of EF is that consumer-facing businesses offer financial solutions in conjunction with the purchase of goods and services. In effect, EF eliminates the need for the buyer to pause a buying journey midway, go to a third-party platform to make a payment, and return to the original platform to complete the buying journey. Every industry, from automobiles to healthcare, retail, telecom, airlines, and utilities, is examining EF to erase customer pain points. EF is chiefly attributed to the success of the buy now pay later (BNPL) trend that has changed how small and medium businesses and the e-commerce world transact with their customers.

The EF trend is becoming an integral part of the lives of customers. EF is being used to:

- Make payments for rides from within ride-hailing apps
- Buy insurance for a vehicle purchase at the point of sale without leaving the auto distributor's sales system
- Pay for parking from within the Google Maps app
- Raising a loan for a property purchase without visiting a bank
- Turning the payment for the purchase of white goods at checkout into equated monthly installments (BNPL)

One of the more sophisticated examples of EF is the possibility presented by the Tesla Model 3, which can self-diagnose issues and automatically order replacement parts required for repair work. The car can, technically, complete the payment automatically using an EF platform.



Every business must examine how it can leverage EF (see Figure 1: Key sub-verticals of embedded finance with varying maturity and market potential) to make transactions more convenient.

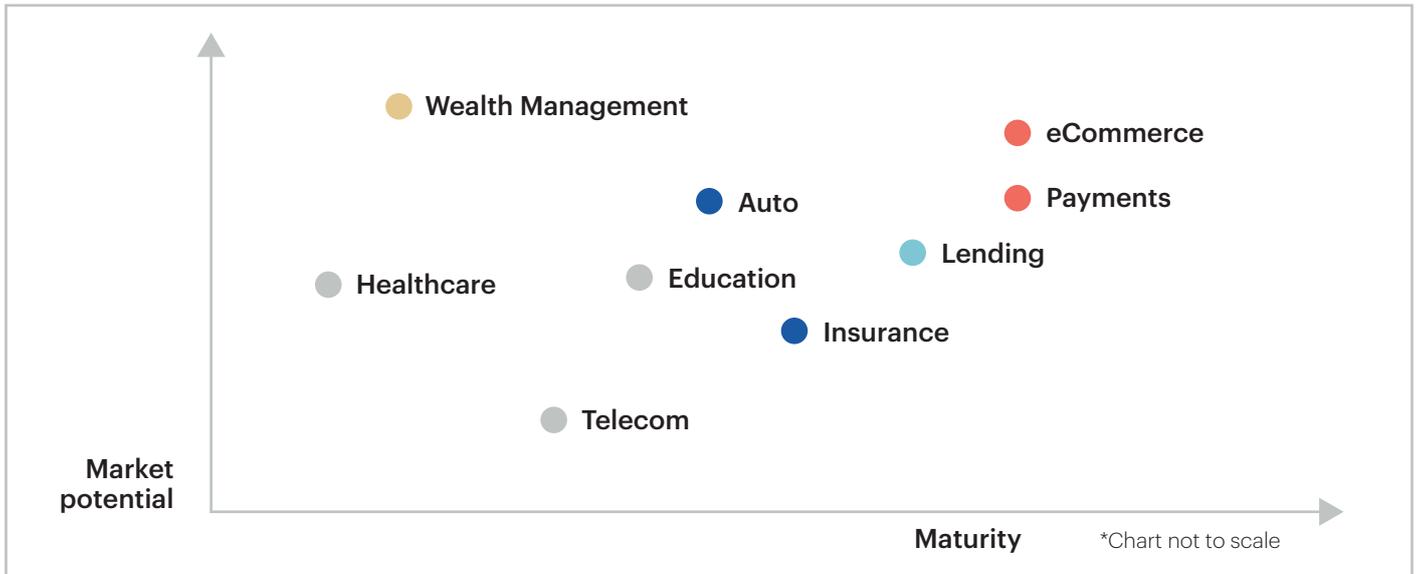


Figure 1: Key sub-verticals of Embedded Finance with varying maturity and market potential

The rapid rise of EF

In the coming years, EF is going to be a very large market opportunity, with industries such as retail and e-commerce, healthcare, education, telecom, real estate, mobility, travel, media, energy, and pharma leading the way (see Figure 2: The potential of Embedded Finance).

In 2023 and over the next seven years, nearly US \$7 trillion in market value will be available to companies that have a digital business model and that offer financial services through it.

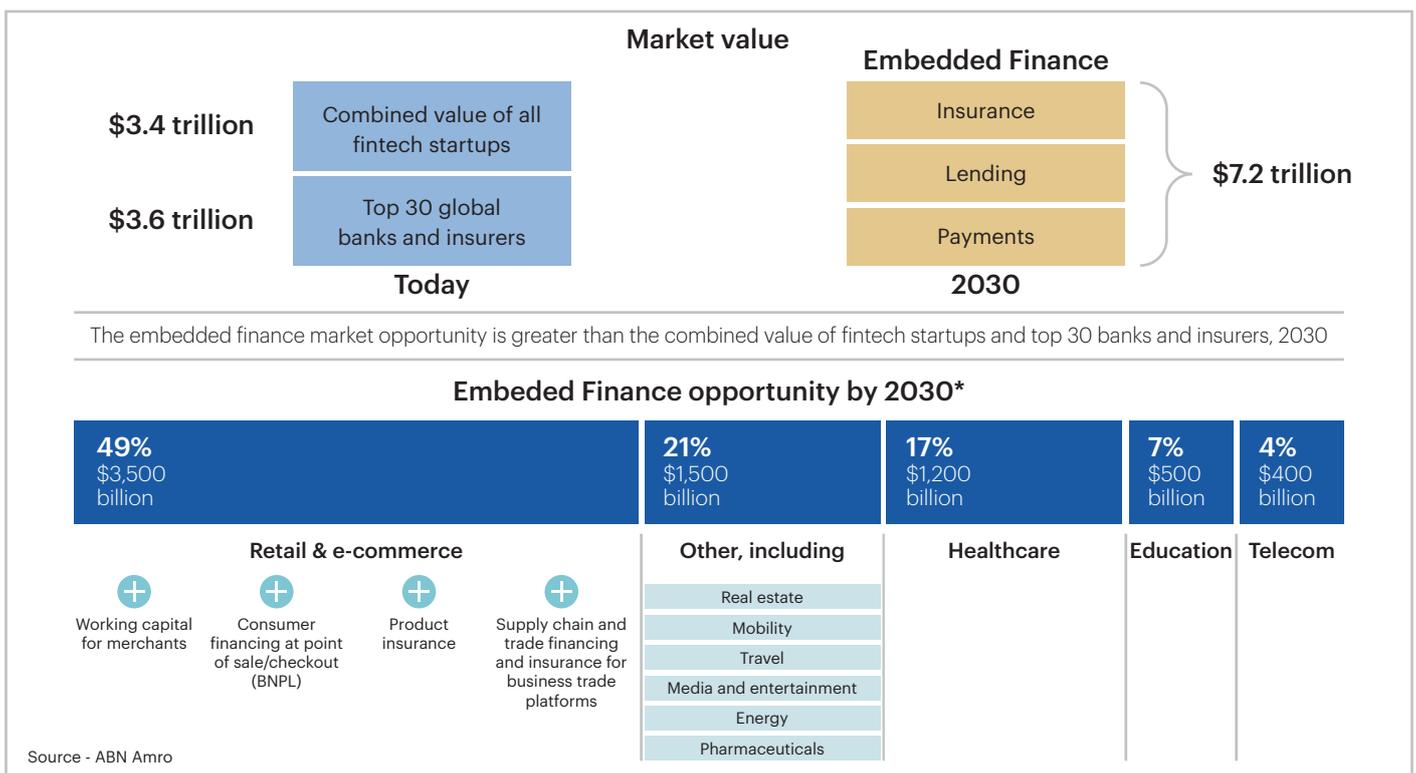


Figure 2: The potential of Embedded Finance

While the numbers for the market value of EF vary across sources, they all reflect the criticality of venturing into this market and the challenges associated with doing it right that come along.

The trend is clear: more than one in every two (55 percent) non-financial businesses plan to offer EF in the next two years. Numerous fintechs — from Affirm to Lovys — are supporting the demand by providing the platforms for EF.

The trend is not confined to fintechs. Traditional financial services (FS) companies are also offering EF services. JPMC has launched its embedded banking service, Goldman Sachs is offering embedded consumer finance services and digital credit cards

through Apple, and Citibank has launched an embedded trade service.

The proliferation of EF products, their visibility across consumer-facing websites and digital footsteps, and many banks and fintechs entering the ecosystem is largely a supply-demand phenomenon. Consumer expectations for a convenient, frictionless, and contextual experience from trusted brands and organizations are driving adoption (see Table 1: The must-haves that are driving Embedded Finance). Brands, too, have recognized the power of EF. By embedding partner/white-label EF capabilities across their consumer journeys, they are ensuring consumers can easily recall their brand and they can influence early buy decisions.

Must haves that are driving Embedded Finance

Elements	Influence/Impact
An ecosystem that delivers outstanding experience and thrives on convenience	Customers want simple, holistic, embedded, and direct experiences
Trust and innovation	Innovation in EF has higher acceptance when it is supported by fraud monitoring and financial education for consumers
Frictionless, least-effort customer journeys	Ease of signing up combined with touch-and-go processes with less than five clicks to final payment spell success

Table 1

The entities within an Embedded Finance ecosystem

The elements for EF string together an ecosystem of entities. At one end are the customers who interact with containers (aka brands offering products and services). When a container combines convenience with a memorable experience, it builds its customer base and retains existing customers. To build exceptional convenience and experiences, containers partner with trusted FS providers — typically banks — who create services under the EF umbrella. The containers, in turn, offer these services to their customers.

In this chain, providers hold the key. They bring an understanding of the financial services space, regulatory requirements, and industry licenses that makes it possible for containers to offer trusted EF options. However, while traditional providers bring value through the trust they command, they depend on fintechs, who act as enablers, to tailor financial solutions based on the needs of customers (see Figure 3: Entities within an Embedded Finance ecosystem).

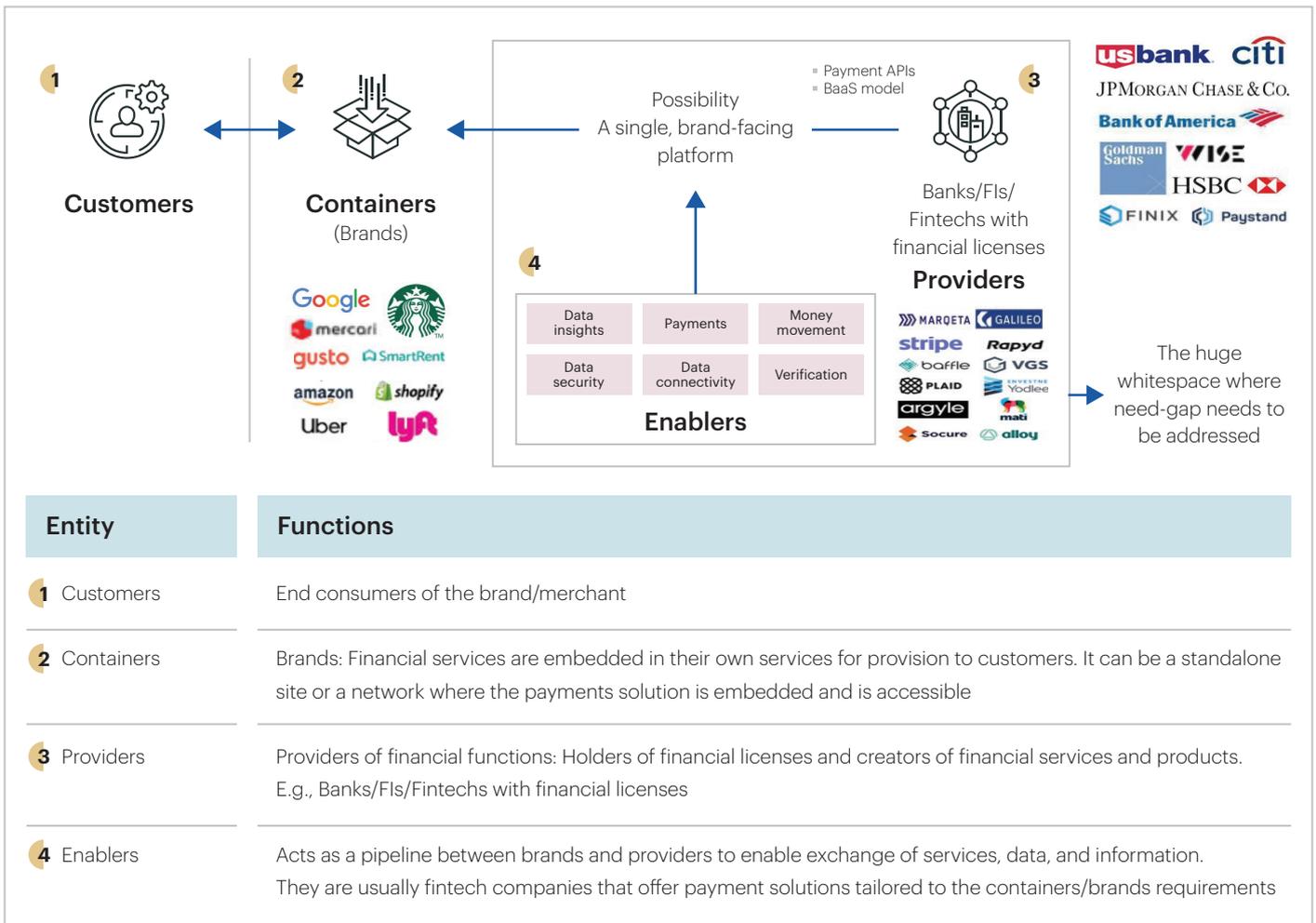


Figure 3: Entities within an Embedded Finance ecosystem

Banks are the backbone of EF (see Figure 4: Banks bridge customers and containers).

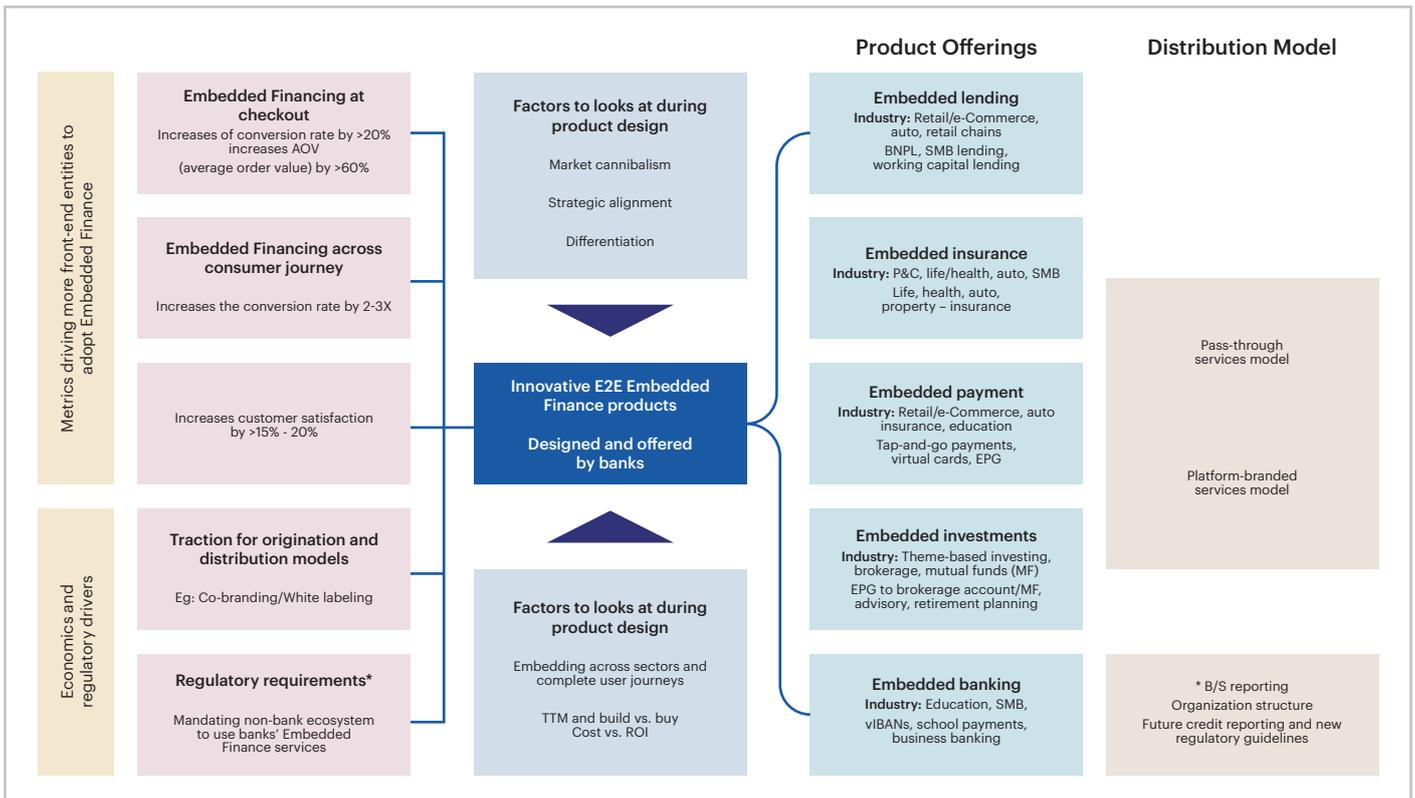


Figure 4: Banks bridge customers and containers

At the advent, cross-industry players may want to provide the service themselves. However, as seen in the case of BNPL, wherever financial transactions/customer implications are involved, central banks and regulators step in to provide guidelines for these operations. Across the globe, credit reporting and new regulatory requirements are growing, mandating brands and fintechs alike to comply with complex regulations like:

- Balance sheet reporting to understand the type of assets they are holding on their books
- Organization structure/license to do certain businesses and hold assets on their books and meet other regulatory guidelines that are extended to entities similar to banks/NBFCs

These requirements make it imperative for non-bank entities to use the banks' services — either as BaaS offerings or EF solutions — making banks irreplaceable in the EF ecosystem

EF models: pass-through and platform-branded services

Banks are ideally positioned to drive innovation in EF by working with their fintech partners to create industry-specific products and services that are closely aligned with the customer journey (see Table 2: Creating industry-specific products and services).

Their goal must be to ensure brands using their EF service, reduce their time-to-market and that the ROI is always more attractive than the build option. Banks can distribute their EF services in a pass-through model or as a platform-branded services model.

Creating industry-specific products and services

Financial service	Industry	Example
Embedded lending	Retail/e-Commerce, SMB, auto, and retail chains	Buy Now Pay Later (BNPL) models and for working capital loans
Embedded insurance	P&C, life, health, auto, and property	Service-linked policies such as auto insurance, life insurance, etc.
Embedded payments	Retail/e-Commerce, auto, insurance, and education	Tap-and-go payments, virtual cards, and electronic payment gateways
Embedded investments	Theme-based investing, brokerage, and mutual funds	Investor profiling and offering multiple investment avenues – equities, bonds, mutual funds, derivatives, and alternate investments via single counter
Embedded banking	Education and SMB	Banks offering multiple services combined with a simple account opening process – bill pay services, credit cards, line of credit, trading accounts, investment advisory, insurance services, and more

Table 2

- The pass-through model has a servicing intermediary (examples: EF provider, fintech, front end) that collects payments from customers and, after deducting a fee, remits or passes the collection through to the bank that has provided the financing. This is like renting out the balance sheet.
- Platform-branded services model has the provider bank embedding a service as white labeled or as a co-branded financial product on another platform (for example, Affirm on Amazon or Amazon co-branded credit cards).

Construct of a proposed Embedded Finance solution that containers (brands) and providers (banks) alike can leverage

Figure 5 outlines a proposed EF solution, envisioned as a marketplace (with white labeling option) that containers, providers, and enablers (fintechs such as data security providers, data and insights services, and data connectivity providers with solutions tailored to the brand's requirement) can leverage. The solution pivots around the expertise to use APIs as the building blocks for seamlessly integrating all the required services/service providers/entities and offering a platform that brings together the EF ecosystem of

customers, containers, providers, and enablers. With technologies such as hyperledger blockchain, entity exchanges can be seamlessly captured and monitored using smart contracts with real-time reconciliation and settlements while providing complete transparency. Additionally, by leveraging new-age AI/ML-driven data analytics, valuable, actionable insights can be provided to optimize and further grow these platforms/business models toward profitability.

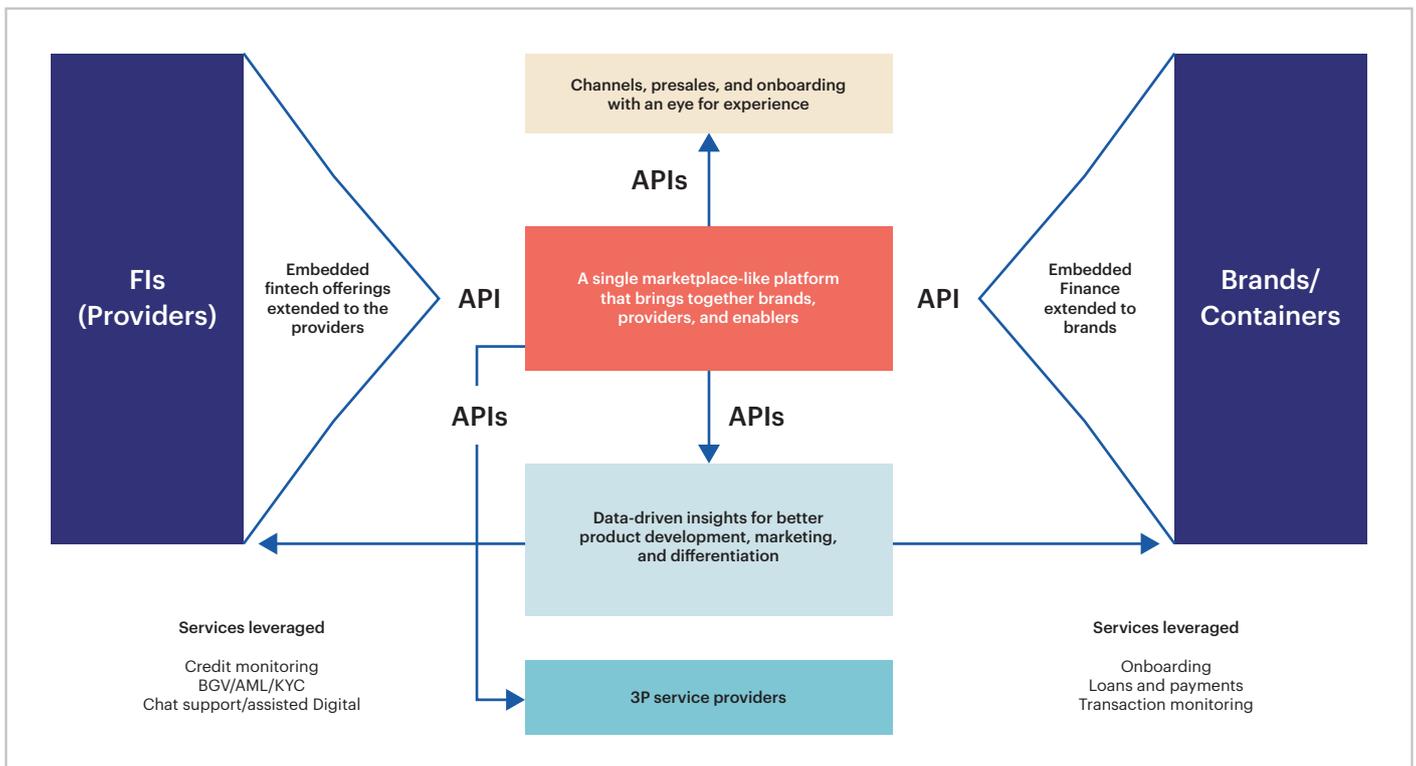


Figure 5: Proposed Embedded Finance solution that banks and brands can leverage

Why banks must innovate in the EF space

EF has upsides that today's businesses cannot afford to miss. For example, EF at checkout has the power to increase conversion rate by >20 percent and increase average order value by >60 percent. By providing EF across the customer journey, businesses can increase conversion rates by as much as 2 to 3X and customer satisfaction by over 15 percent. These upsides make it attractive for containers (brands) to partner with providers (banks), making it easy for banks to integrate with other industries.

Aside from the innovation, a successful EF play requires banks to change their IT infrastructure. This is necessary to create and maintain partnerships in the ecosystem, manage SLAs, track transactions and processes, provide governance and reporting, ensure transaction reconciliation, deliver APIs, and integrate with service providers.

The EF trend is unstoppable and is moving at a rapid pace. The adoption of advanced technologies across industries, coupled with the digitization of banking, enables integration, opens new possibilities, and creates business differentiators.

Banks and financial institutions have the unique advantage of enjoying the long-standing trust of their customers and are familiar with compliance requirements. Banks are also well-positioned to tap into existing corporate relationships with cross-industry players for natural synergies. These aspects make them game-changers in the EF space. With a technology partner, banks can turn years of building trust and creating compliance expertise into the foundation of a new revenue stream.



Authors

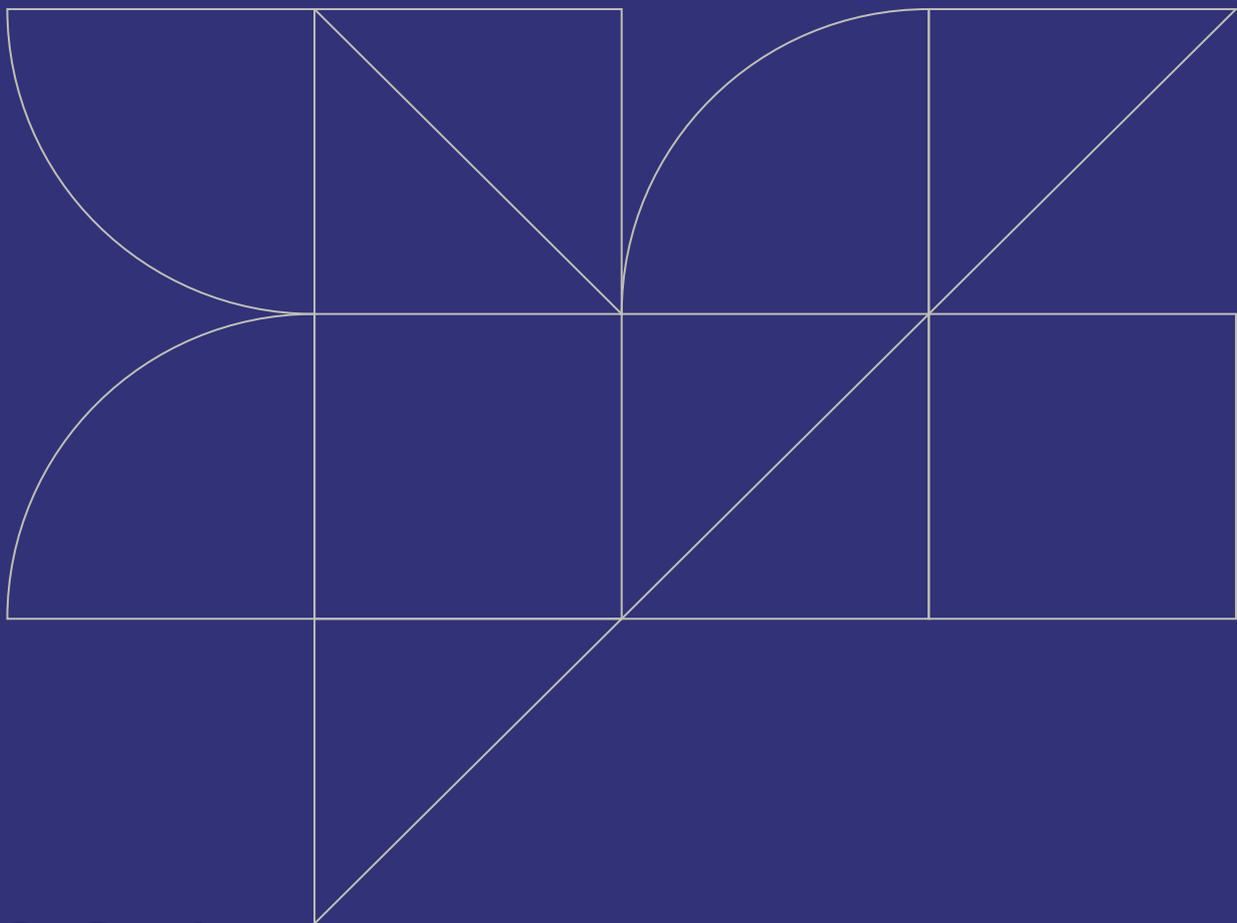
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