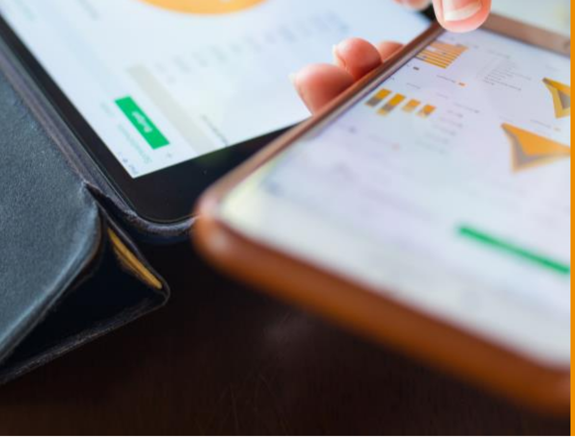

Uncovering value in embedded finance for BCM

Challenging assumptions to chart new growth

June 2023

The emergence of super apps like Alipay and WeChat Pay that seamlessly combine daily necessities with financial services has given rise to the concept of embedded finance. Re-examining prevailing attitudes within the Banking and capital markets (BCM) industry presents new opportunities for creating value.

As the world of financial services continues to evolve, embedded finance has emerged as a transformative trend that is changing the way businesses and consumers interact with financial products and services. Financial and banking services are being integrated into the user journey, becoming an integral part of the fabric of the experience. This means traditional banks will no longer be building and pushing out products, but with a new operating model focused on embedding core financial functions at the optimal point of acquisition. This approach delivers a higher conversion rate at a lower cost, without the need to build a one-to-one relationship.

According to a recent industry report, embedded finance presents an exciting and rapidly growing opportunity in mainland China, with a forecasted CAGR of 26.5% from 2023 to 2029. This growth is expected to result in revenue increasing from US$79,111.0 million to US$236,619.8 million. The speed and scale of innovation in embedded finance creates both an opportunity and challenges for incumbents to reconfigure their business models to achieve new growth. Embedded finance presents arguably the greatest opportunity for big-tech platforms with the reach and financial liquidity to make bold integration plays.

Expanding the business model: introducing a new way of banking

The rise of non-banking platforms has created a new reality for the BCM industry, where customers are increasingly looking for seamless, personalised experiences. This has led to the emergence of embedded finance, which allows for greater collaboration between different players in the ecosystem. Unlike the traditional banking model, where a single institution operates the entire process, embedded finance relies on distinct roles and players working together to deliver financial services. Platforms serve as the primary touchpoint for customers, while enablers provide the technology infrastructure and license holders hold the necessary regulatory approvals. By embracing this new business model, banks can expand their reach and tap into new revenue streams, while offering customers the convenience and flexibility they crave.

Key roles involved in traditional banking vs embedded finance

Traditional banking	**Integrated license holder (e.g. Banks):** Manages the whole process from financial, regulatory and technical back end to direct interaction with the customer
Embedded finance	**Platforms:** Aggregate services across providers to offer a network of interconnected solutions i.e. Payment solution providers (Alipay, WeChat Pay); Payment facilitators (Stripe, Square); Platform (Shopify, Planto)
	Enablers: Provide technology infrastructure and connectivity capabilities via Application Programming Interfaces (APIs) and banking as a service i.e. Cloud (AWS, AliCloud), API provider (MuleSoft), Identity and Access Management (‘IAM’ e.g. CyberArk)
	License holders: Plug offerings into platforms to increase distribution and improve customer retention i.e. Store Value Facilities (‘SVF’, e.g. BOC Pay, Tap & Go); Money Services Operator (‘MSO’, e.g. Octopus)

Our Point of View

While traditional financial services firms continue to provide banking and financial services, they now find themselves at a crossroads where they must either face the competition or join force with the fintech community and become part of the larger ecosystem.

For banks that choose to compete, success will require a well-prepared strategy on multiple fronts, including user experience across all touchpoints, life journey embeddedness, and driving innovation in product offerings.

Alternatively, banks that choose to collaborate with fintech companies and join the ecosystem must also be able to navigate a complex landscape of data quality, core competence readiness, and cyber security measures. They must be prepared for significant organisational transformation as they move away from traditional hierarchical structures towards more agile, cross-functional teams.

There are 8 Virtual Banks established in Hong Kong, built on future proof technologies and could easily be connected, and with majority of them, if not all, integrated with other services providers in the eco-system. This could be a concrete example of the strategic move highlighted above.

New business model is challenging assumptions to chart new growth

Embedded finance is attempting to defy four common assumptions that were prevalent across the BCM industry for more than a decade. What follows is an analysis of the four common assumptions about embedded finance.

‘Banks will always own the payments infrastructure.’

Despite the emergence of new players and trends in the payments industry, banks are preforming better than expected to maintain ownership of the payments infrastructure due to their reputation as trusted financial intermediaries. According to The People’s Bank of China (PBOC)’s annual payment system report, banks in mainland China handled a total of 462.65 billion in non-cash payment transactions in 2022 with an amount of RMB4,805.77 trillion. Of these transactions, 278.97 billion were electronic payment transactions.

However, the rise of decacorn payment service providers (PSPs) could accelerate a shift away from incumbent banks in the payments space. PSPs offer better solutions for both merchants and payers, embedding transactions, reconciliations, data analysis, and return flows into merchants' accounting and enterprise resource planning (ERP) systems, adding significant value. PSPs that offer comprehensive services can charge higher prices per transaction than banks, gain market share, and obtain immense volumes of customer data. As a result, incumbent banks may miss out on revenue opportunities and data streams, despite payments estimated to make up a third of banking revenue and roughly 90% of useful customer data.

‘Non-financial players won’t apply for banking licences.’

Banks have long believed that they have inherent advantages in terms of scale, customer trust, and regulatory savvy—and are therefore uniquely qualified for full regulatory licensing. But this assumption is clearly coming under pressure, the number of fintechs with a banking license playing in the embedded finance space is growing. As for now, many big-tech players already hold a lesser form of banking license in Asian regions, such as payment license in Chinese mainland; AI license, SVF license and MSO license in Hong Kong; Capital Markets Services (CMS) license, Standard Payment Institution (SPI) license and Major Payment Institution (MPI) license in Singapore. The number of fintechs with a banking license playing in the embedded finance space is growing, which has the potential to disintermediate incumbent banks. Banking executives should consider how their institutions can stay relevant and profitable if more fintechs, and especially big-techs, secure banking licenses. As data-driven compliance solutions become more commonplace, fintech and big-tech players who excel in making the most of data may find some of the hurdles to achieving compliance with regulatory requirements easier to master.

‘Banks will continue to own the primary banking account - and thus the customer relationship.’

The assumption that banks will retain their current role with their core customer base due to their ownership of the primary bank account is being challenged by the rise of embedded financial services. New entrants strive to use customer data to improve their products and services, which has the potential to disrupt the traditional banking landscape. As customers become more accustomed to payments linked to a mobile phone number, the stage is set for further disruptions in the future. Banks may need to occupy a different role in the financial system. Radical market intervention by legislators and regulators is unlikely to stop this trend. Banks should take a close look at the true cost of doing nothing versus getting their business ready to meet the challenges posed by embedded finance.

'New entrants won't enter into lending like they did with payments.'

New entrants are expanding into embedded lending, partnering with banks and credit card issuers, acquiring fintechs, or even acquiring entire banks. At the same time, Buy Now Pay Later (BNPL) offerings are predicted to reach US$437 billion globally by 2027. These high-profile examples can be seen in big-techs such as Alipay and JD.com in mainland China as well. Large retail banks and credit card networks are poised to take advantage of anticipated changes in the regulation of BNPL schemes. Incumbent banks risk losing market share in the credit space to new entrants, particularly as lending becomes more embedded into consumer sales journeys or small and midsized business operations. New entrants are upending conventions about how to determine who gets credit by drawing on data rather than credit reports and offering clear value to customers. To remain competitive, incumbent banks must do more than just copy BNPL products and remain vigilant about pressure on interest margins.

Looking ahead

Excitement around embedded finance is growing — and overpowering the conventional wisdom surrounding banks. In other articles in this series, we'll explore some of the concrete actions banks and other financial institutions should consider as they transform their businesses to deliver on the promise of embedded finance, diving deep into a new framework for risk management within embedded finance ecosystems.

We would welcome the opportunity to discuss the content of the above regulatory standards that might be applicable to your business.

Please reach out to us if you have any questions or queries.

Brian Yiu
Partner
brian.ky.yiu@hk.pwc.com

James Tam
Banking and Capital Markets Leader
james.tam@hk.pwc.com

Philip Chan
Partner
philip.mk.chan@hk.pwc.com

Rondy Wong
Associate Director
rondy.lh.wong@hk.pwc.com

We would also like to acknowledge the following team members who have contributed significantly to this paper: Eriko Yik, Michelle Wang