Embedded banking but not as you know it

From 'Inside Out' to 'Outside In' banking

Executive summary

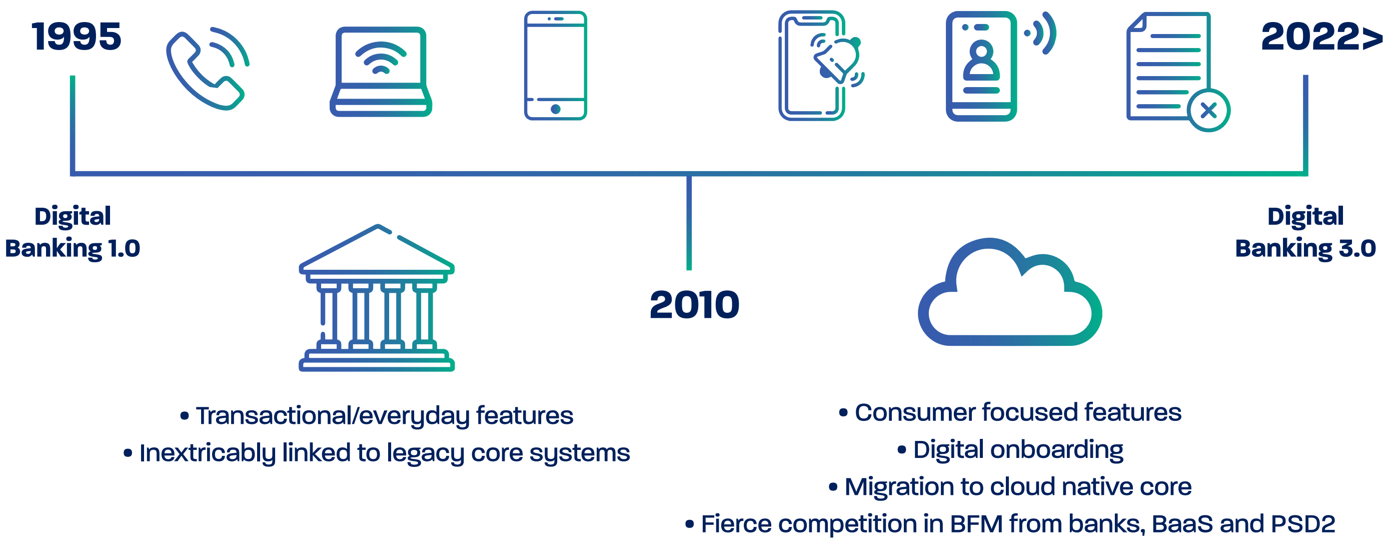
Every now and then the fintech sector finds itself impacted by a wave of technological innovation, which marks the dawning of a new era. Right now, we are seeing that through the rise of embedded banking, a concept that incorporates payment and banking services within a third-party digital experience. Like with many elements in finance, the idea is not totally new, but the pace with which it is being adopted has forced established industry players to sit up and take notice.

In fact, it could be argued that several financial institutions, particularly those in the retail and consumer banking sectors have already resigned themselves to the idea that tech-first platforms will dominate the future of digital banking. There's a growing expectation among industry commentators that social media platforms, consumer lifestyle brands, and nimble fintech upstarts will be where customers feel most comfortable doing their future digital banking.

Whether this is the case awaits to be seen, but one thing is for sure; the future of small-to-medium sized business (SMB) banking is decidedly less obvious. Right now, there's a war waging for who, or perhaps even what will be the 'front door' for the digital services required to run a business. Here at BankiFi, we want to shine a light on that battle. In doing so, we aim to highlight some of the reasons why legacy banking institutions are so well-suited to the challenge.

Let's start with the basics, SMB banking customers differ greatly from retail and corporate customers. That might sound obvious, but it hasn't always been seen as such. In the past, there's been a tendency to see all banking customers through a very similar prism, with services only marginally tailored to each. However, the companies currently winning the battle for SMB banking customers are flipping this on its head by treating SMB customers as a segment in their own right.

A history of digital business banking



So, how can banks start to win the battle for the front door? Well, the first step is to reassess their digital channel approach and evaluate experiences designed for the small and medium business (SMB) segment. Currently, many banks offer basic digital "transactional" experiences, comprising the ability to view balances and transactions, and perhaps the ability to make a few payments. By contrast, non-bank competitors offer solutions that go far beyond these capabilities, enabling users to solve real-world problems with digital tools.

As we will explain in this paper, banks need to make up some lost ground surrounding this issue and start delivering more compelling solutions, which are able to address the common pain points felt across the SMB community. To this end, 'beyond banking' services that include a suite of financial workflows, and access to multiple financial relationships need to be enabled as a purpose-built solution for SMB clients. If this happens, banks can put themselves in a great position to win the battle for the 'front door' of digital services.

Ultimately, the embedded banking trend shows no signs of slowing down, which puts banks in a position that requires immediate action. These institutions still have time to get ahead of this shift before it passes them by, however, they must act now. It is clearly in the interest of banks to embrace technologies that elevate the SMB banking offer and allow those small businesses to view and manage their finances digitally, resulting in the financial institution becoming the trusted financial advisor for the SMB.

However, to achieve this, banks must be willing to adjust some of the tenets of embedded banking to better fit the needs of themselves, and their customers. As we will outline in this paper, this shift is perhaps best understood as representing an 'Outside In' approach to banking. This modified approach differs from the waves of digital adoption within the banking and finance sectors that have preceded it but it unlocks a raft of new opportunities.

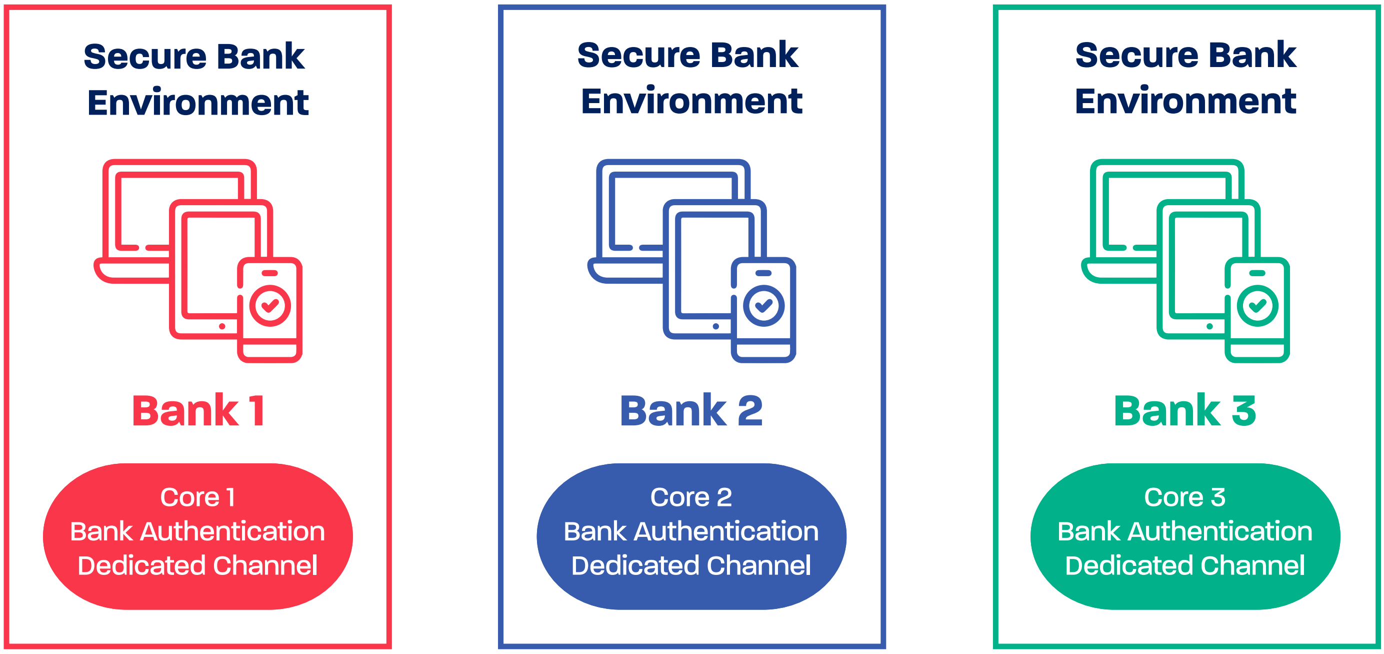
The Evolution of Digital Channels from 'Inside Out' to 'Outside In' Banking

Digital Banking 1.0 – 'Inside Out' Banking

The first wave of digital banking began back in the mid-nineties. These digital front ends have been tightly coupled with old legacy core banking platforms, some of which have been around since the 1970s. While initially fit for purpose providing purely transactional capabilities, the arrival of mobile banking exposed their limitations, with this being further amplified more recently by digital only neobanks and fintechs. Both of these groups created digital experiences from the ground up rather than digitising existing bank channels, which gave them a flexibility advantage in comparison to the traditional banks.

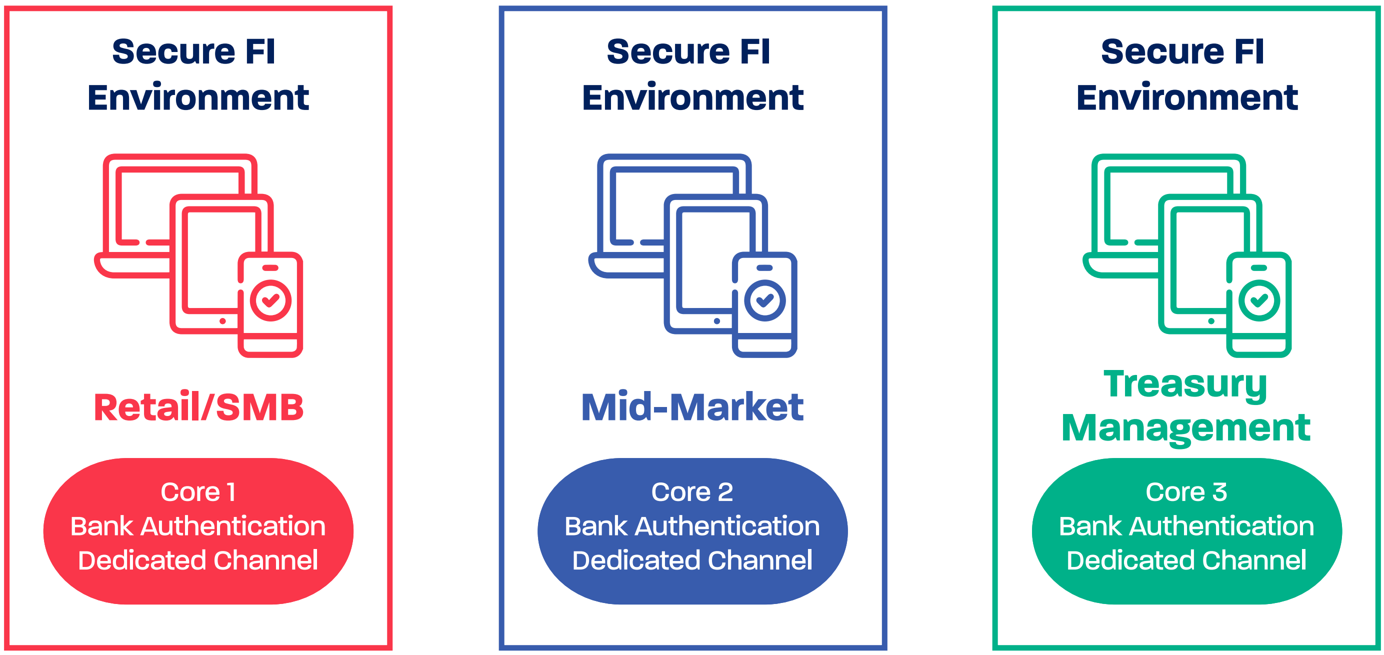
The stark contrast in approaches not only reflects the organisational silos within which a bank operates, but also illustrates the outdated thinking which ignores the fact a customer may have more than one bank relationship and several non-bank relationships. In this common scenario, they would currently require a digital product from each of their banks and relationship providers, resulting in multiple digital products, identities, user IDs and passwords - and no holistic view of a business' financial health.

Traditional ‘Inside Out’ Channel Banking

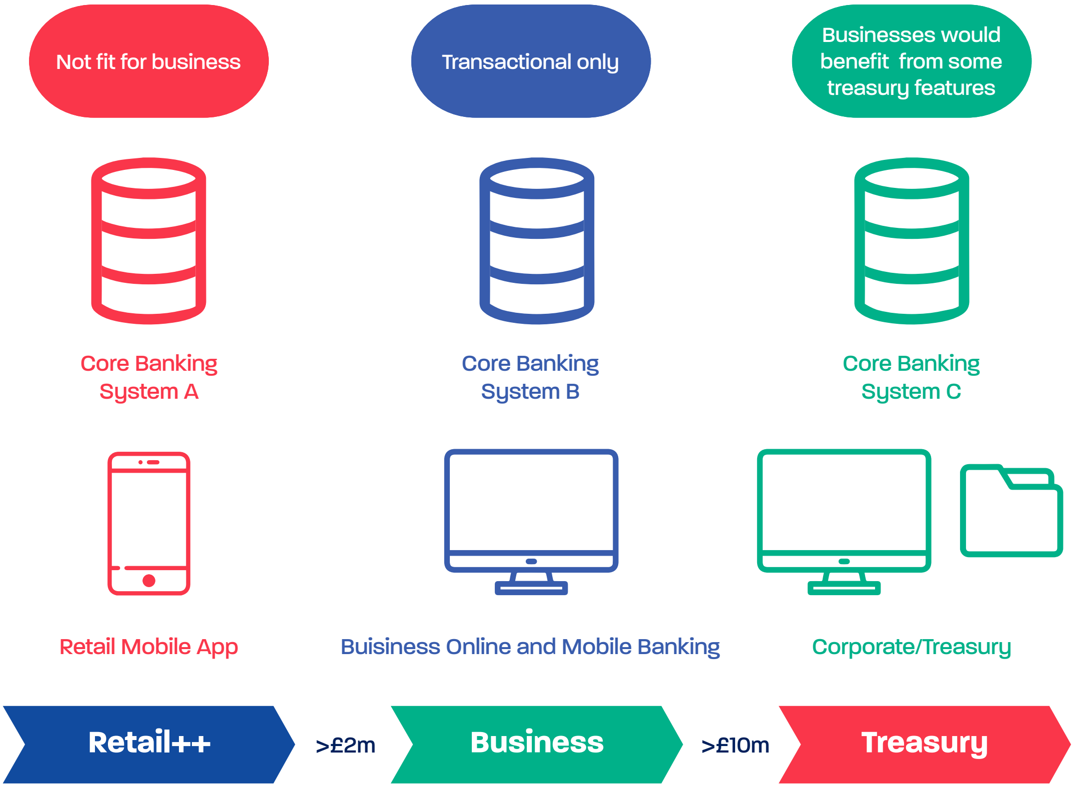


The model is also problematic within a single financial institution. Banks tend to segment their customers using measurements such as turnover, assets, and number of employees. These measures are used to define customer groups, which also dictate the product propositions available. Therefore, a sole trader may reside within the retail core and digital experience, a slightly larger business may reside in the commercial bank core with a dedicated digital product and a large corporate will reside somewhere else, again with a dedicated tightly coupled digital product. This rigid approach makes it very difficult to service customers with what they need, because each time they outgrow the bank-imposed segmentation, they have to migrate onto a new product, and therefore risk being lost to a competitor bank with a more desirable offering.

Traditional ‘Inside Out’ Channel Banking – Verticals



The 'Hidden' Business Customers



Digital Banking 2.0 – Mobile and Omni Channel 'Inside Out' Banking

The second wave of digital banking, fuelled by fintech and neobanks, saw the introduction of many simple but effective additions to the purely transactional nature of Digital Banking 1.0.

One memorable development was the introduction of notifications for payment in and outs, which provided real time, up-to-date information. However, the biggest improvement was the digital onboarding process. In business banking, this has improved significantly, evolving from a cumbersome, paper-based process to an entirely digital process that can be completed in minutes for limited companies who have single or dual directors.

While digital enablement of workflows has led to significant improvements for some businesses, it has done little for sole traders or micro business banking customers that use their personal current accounts for trade. Nor has it addressed the issues for customers who outgrow their bank-imposed segmentation and would be forced to move to a new account in line with the bank's systems for transitioning from a micro business to a business banking customer. The bank's digital strategy has been hampered by legacy cores that have not adapted to changing customer requirements.

The assessment of these shortcomings concluded that in order to support the needs of a digitally native customer, banks would need to not only refresh their digital channels, but also complete a wholesale transformation by replacing their out-dated core platforms with a new modern cloud based core system. These changes would cost inordinate amounts of capital and carry an enormous risk of failure - which created a significant digital transformation challenge for banks.

However, when APIs and catalytic regulation such as open banking and PSD2 came along, a significantly less risky option for banks became available. Following these monumental industry changes, banks could provide small business customers with the services that they needed, whether those customers had a banking relationship with the service providing bank or not. This transformational opportunity has, as is so often the case, been created by the law of unintended consequences. Regulators in certain parts of the world were acting to create a level playing field for new entrants, however, in practice they have created an opportunity for the incumbents to strengthen their position. Whether the banks take the opportunity is yet to be seen, but the most important outcome should be improving the lives of millions of small businesses by ensuring that they get the services that they need, regardless of the service provider.

If those incumbents do, however, wish to seize the opportunity, it is there, and the time is now by implementing Digital Banking 3.0.

Digital Banking 3.0 – 'Outside In' Banking

Digital Banking 3.0 is now upon us.

For decades, banks have craved to understand their wallet share with customers who have multi-bank relationships. Consensual access to data through open platforms and APIs has now made that a reality. Up until recently, multi-banked customers who wished to access all of their data in one place could only do so if they were a large multinational corporation with membership of SWIFT though MA-CUG, or if they ran an in-house payments or collections factory provided via an ERP vendor.

APIs have now made it possible for even the smallest of businesses to access all of their financial and accounting data in one place. To think that Digital Banking 3.0 is just about enabling businesses to see their bank balance across multiple banks would be to trivialise the opportunity. Payment messaging initiated through open payment schemes (domestic and global) and containing extended remittance information to achieve immediate payment receipt, settlement, and payment confirmation is quickly becoming a transformation model, as well as an expectation of consumers and businesses. The equivalent of MT940/MT942 balance reports are now available through APIs as is the ability to offer even the smallest of businesses the equivalent of a payment on behalf of, MT101, or a collection on behalf of where the primary relationship bank now has the ability to debit and credit accounts held with other financial institutions.

Digital Banking 3.0 goes far beyond sophisticated transactional functionality, into the provision of workflow processes that customers require to operate their businesses. Services such as accounts payable and receivable that used to be the privilege of large businesses with dedicated administrative departments have now become a core requirement for small businesses.

Technology can now automate the Order to Cash (receivable) and Procure to Pay (payable) cycles and integrate with accounting and ERP systems, providing end-to-end capability including sophisticated matching and reconciliation, all at the touch of a button. Similarly, the days of providing a cash position across multiple accounts and currencies through Excel have now been surpassed, with customers demanding real-time technology that provides an up-to-date position, all made available through an open platform supporting API connectivity.

As businesses become increasingly more global, their payment requirements do not stop at domestic payments, but instead go much further and require sophisticated treasury functions around liquidity management, dynamic hedging and least cost payment routing. Yet again these types of function have been the bastion of the few rather than the norm for the many.

As businesses become more sophisticated and their requirements more complicated, they need to be able to pick and choose the functions they require, rather than be segmented into a rigid digital banking product. There is no longer a one-size-fits-all product, and business customers are now demanding a subscription-based solution that allows them to consume functions as they need them.

The essence of Digital Banking 3.0 is very open, meaning that the customer has multi-banked relationships. Digital Banking 3.0 is not a product but an experience, a set of configurable services presented through the "unified UX" of the end user's provider of choice, and most importantly, the bank from which the service is offered may or may not even have a banking relationship with the user.

Another common misconception in Fintech or AltFi circles is that one of Open Banking and PSD2's primary purposes was to make account switching easier. While EY research suggests that 30% of UK SMBs are likely to switch their business current account provider, it also demonstrates that 46% will switch to a traditional bank with branches.[1]

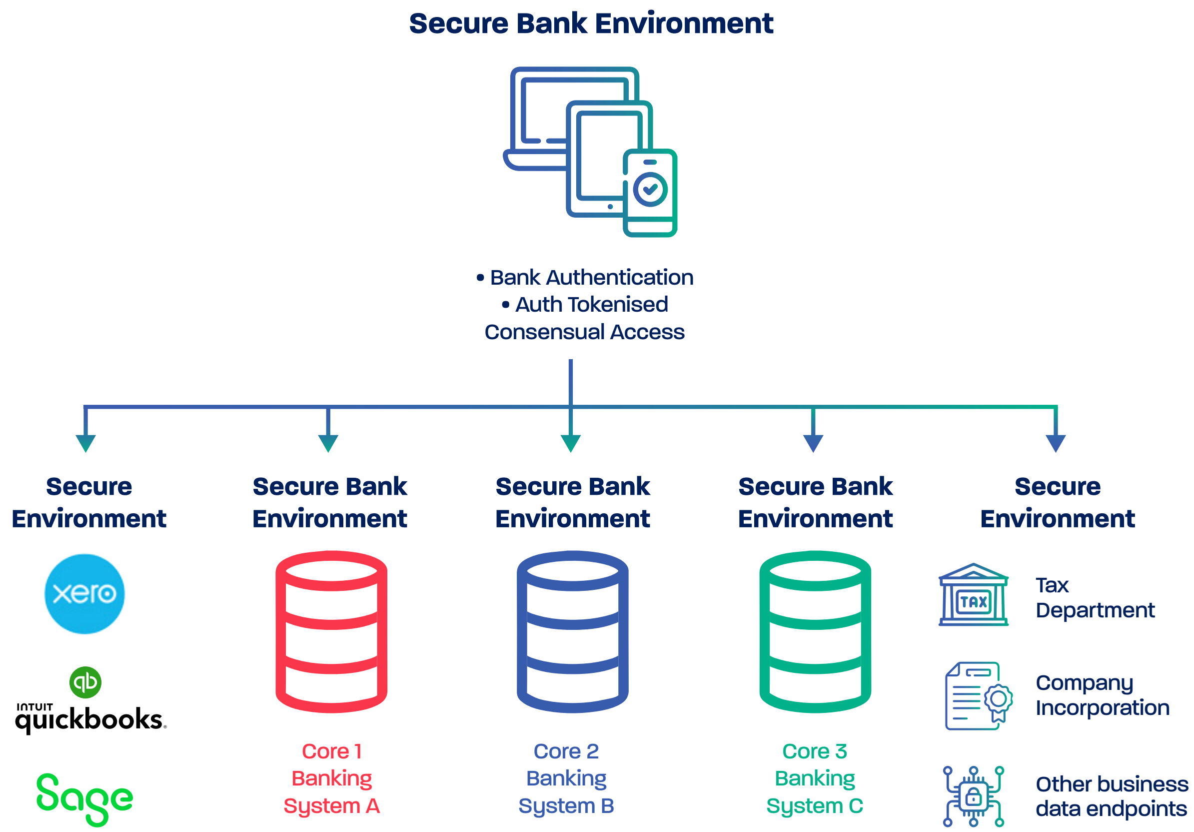
Furthermore, 44% of small businesses in the U.S. state it is very important or required that their bank offer money management tools to keep their business, reinforcing that greater bank focus on financial wellness will place banks at the centre of their customer's financial management and retain their business.

The opportunity for Digital Banking 3.0 lies in the bank's ability to offer the best possible service to the customer. Just as the bank who offers the service needs no banking relationship with the customer, nor therefore do the bank's competitors. The battle to serve as the front door for customers is being played out between banks, accounting package vendors, payments providers and the likes of Amazon and Shopify. The winners will be those who solve real world problems, helping small businesses to save their time, collect their money more quickly and access the tools they need to understand the financial health of their business in one easy-to-use experience.

That experience could be embedded banking in the traditional sense, from a third party experience, or it could even be embedded banking but not as we know it - where all of the banking, data and services to run and operate a business are served up from a bank's digital channel. Crucially, this would not necessarily be the bank with whom the customer has a banking relationship with. This is the essence of 'Outside In' banking.

This approach represents a paradigm shift for most bank's digital channel owners. To realise the potential of this opportunity, a new way of thinking needs to be introduced around:

- Who owns the customer
- Who owns the data
- Who controls Data Orchestration
- Who controls Digital Identity



1. SME Banking Survey, EY, November 2021
2. Aite Novarica, Tips and tools for capitalizing on bank advantages and growing your SMB client base, August 2022

Previously, in the 'Inside Out' approach, the answer to all of the above questions was the bank who is offering the digital banking product. Now, taking the 'Outside In' approach, the answer is the customer and the digital identity question is key.

To reflect the needs of the 21st century, digitally-native SMB, when adopting the 'Outside In' approach, the customer will use the identity they have been issued by each data custodian, the bank included, to authenticate and access their data as and when they need to.

The strategy for banks to win the battle for the front door, will be to elevate all of the rich functionality found inside the tightly coupled 'Inside Out' cash management or treasury products into a digital product that sits 'Outside In'.

One foundation of all SMB and Treasury Management products so far has been an entitlements engine. The entitlements engine dictates who within an organisation is allowed to perform a particular function on a particular piece of data, including roles such as preparing payments and who can do payroll. As with all 'Inside Out' models, they were never designed to cater for multi-bank relationships and certainly not for multi-data relationships.

Each bank has built an entitlements engine that caters for its digital banking product exclusively. So if a customer has three banking relationships, it will need three digital banking products and to configure each entitlements engine for the roles that the users within their organisations perform.

This is a huge replication and does not even consider non-bank relationships such as the accounting packages. Furthermore, this approach has really only considered roles and responsibilities for employees within the company, and not for parties outside of the company such as accountants, advisors or bank relationship managers.

They have also never considered several hugely significant roles within the new data sharing economy:

- Who within an organisation can grant access to data being shared with other parties
- Who within an organisation can get access to their companies data held by other organisations/data custodians

The 'Outside In' approach requires a new level of complexity to be built within an entitlements engine that is inherently multi-relationship as well as having a federated approach to authentication and access rights to cater for the various relationship and data providers a customer might have.

It requires all of the rich functionality that used to sit inside a bank's environment to now sit outside the bank with controlled access at a device, organisation, individual role and data level. The functionality needs to go beyond banking and cater for the workflow processes that a business needs to run and operate, but deployed leveraging the trusted bank brand to extend the trusted advisor role SMBs are seeking from their financial institution relationship

The Evolving Role of Digital Banking Channels in the SMB Relationship

The role of digital channels has traditionally been very transactional, however, in recent times the likes of Square, Paypal, Stripe and the accounting package vendors have started to provide a holistic digital experience for SMB's to operate businesses from their platforms. They have also started to encroach into the traditional areas where a bank has previously had a monopoly – deposits and lending.

In most cases these providers do not have the same regulatory shackles that a bank has, in terms of loans tied to capital ratios and deposits, and so have a distinctly unfair advantage. However, to their credit, they have assessed the value and benefit to be gained through a superior digital experience, which has elevated them from table stakes to intelligent finance.

Small business needs

1. Earn my trust

- Fair pricing
- Fair value exchange for data
- Transparency
- Reliability

2. Make the basics easy

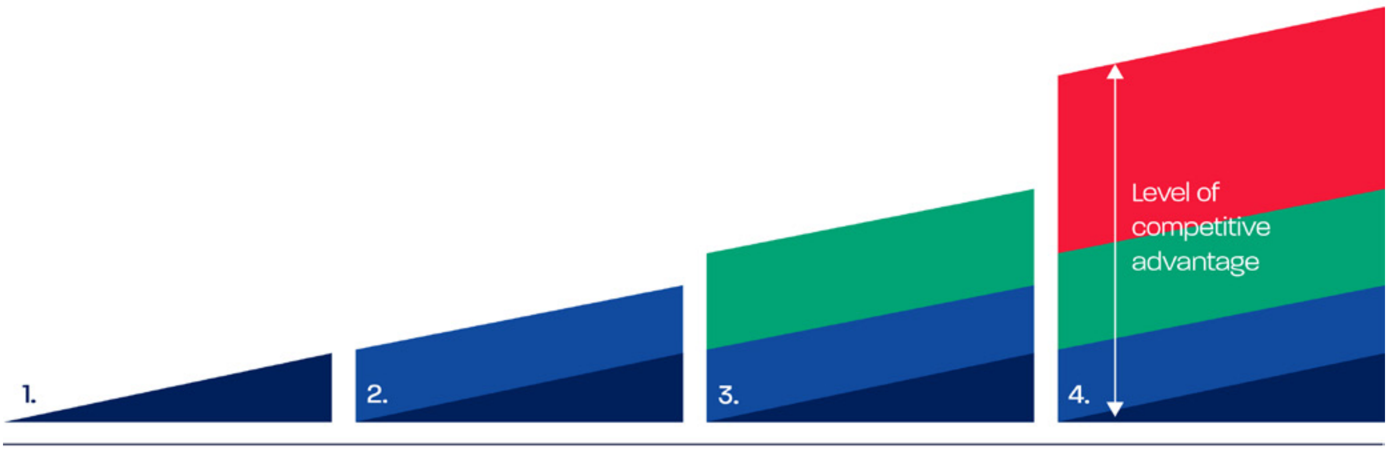
- Payments to/by me
- Access to working capital
- Basic financial management

3. Make my financial workflows easy

- Order-to-cash
- Procure-to-pay
- Advanced financial management

4. Advise me

- Actionable alerts
- Optimal choices
- Guidance by business stage and vertical



Banks response

1. Table stakes

- Achieve trust
- Excellence in online
- Call centre specialists

2. Incremental

- Product enhancements
- Excellence in mobile
- Descriptive analytics

3. Step changing
Embedded finance

- Migration from products to workflows
- Data analytics dashboard
- Predictive analytics

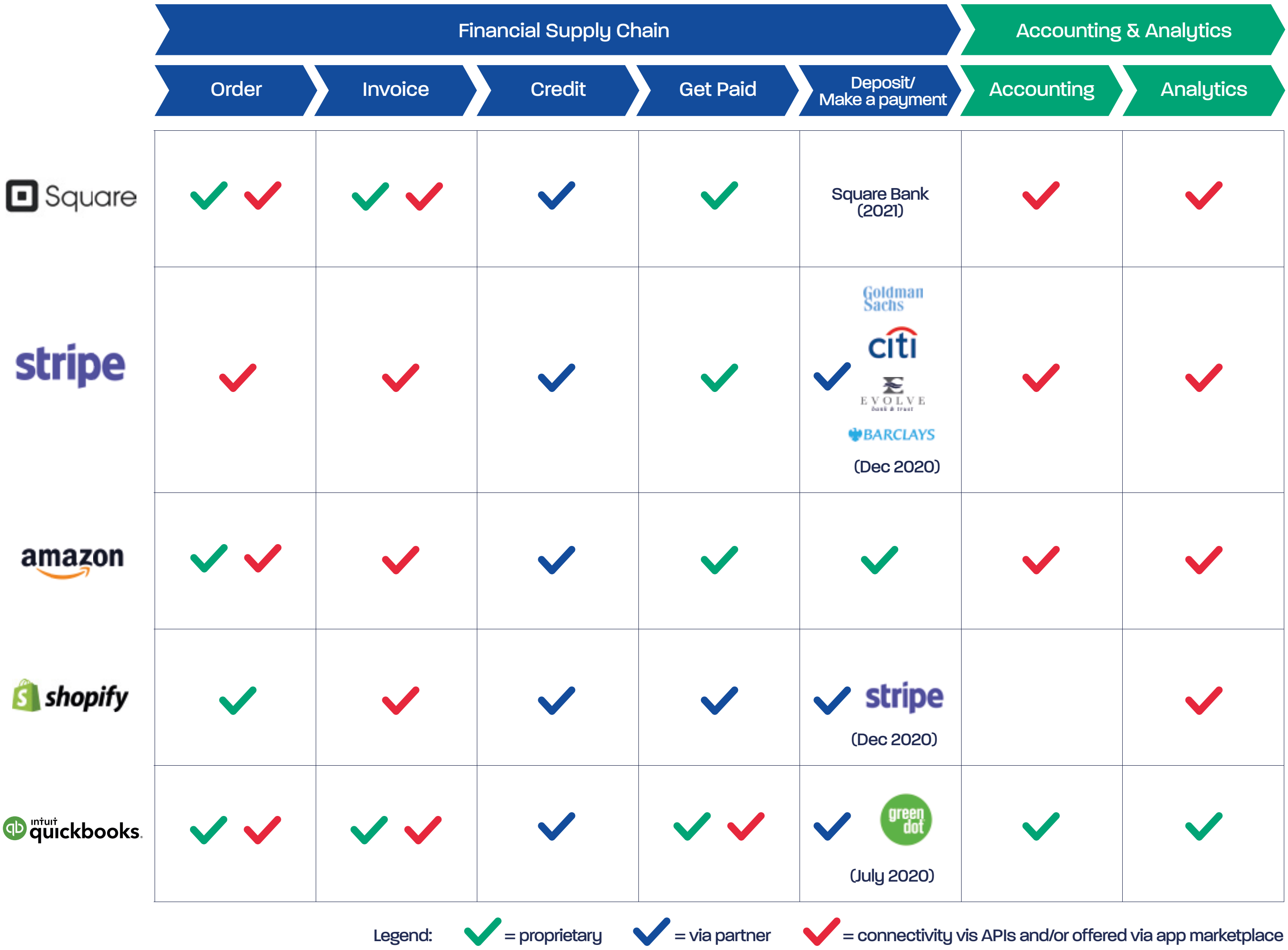
4. Game changing
Intelligent finance

- Personalised, AI-driven advice at scale
- Prescriptive analytics

To remain relevant, and to protect deposits and lending, a bank's digital channel now becomes the centrepiece of the "embedded banking" battle. The digital channel needs to be transformed from a purely transactional experience to the place from where a business runs and operates. Moreover, it can no longer be the 'Inside Out' tightly coupled channel for that bank, it has to be the 'Outside In' digital experience that manages and orchestrates services and workflows for all relationships an SMB has with its data custodians and trading partners. By being front and centre of the SMBs relationships with its banks, accounting package vendor, its debtors and creditors, the service providing bank will have access to a goldmine of real-time data that will provide an up to date picture of the SMB's financial health.

The digital channel now becomes the source of a deal flow for proactive lending, replacing the need for expensive relationship managers and/or independent brokers. If a bank truly embraces the 'Outside In' approach, and offers its digital channels to SMBs who do not have a banking relationship with them, it can additionally create a customer acquisition channel.

The digital channel becomes the cornerstone to both a defensive strategy to stave off the threat of the new entrants, as well as an offensive strategy to acquire new customers, deposits and ultimately grow its lending book.



Buy, Build or BankiFi

Regardless of whether financial institutions choose to develop proprietary solutions or partner with a tech company, one of the first decisions facing many is how to embed value-added services in existing digital channels which will result in the best chance of business adoption. This usually takes one of the following forms:

1. 'Embedding' services in existing digital channels used by businesses
2. Adding technology to a 'marketplace'

Each option presents its own challenges.

Because financial institutions have tightly integrated their digital channels to individual cores in an 'Inside Out' manner, they are effectively multiplying the integration effort, time and costs. This is before you consider the cost of the lost opportunity.

While only embedding the services in one channel may reduce cost and shorten timeframes, this approach completely alienates large segments of the target market. Taking the UK as an example, approximately 3 million sole [traders/proprietors] operate their business from a [personal/retail] [current/checking account]. With 32 million SMBs in the U.S. the potential opportunity associated with digital services and workflows for "hidden SMBs" could be staggering.

Whereas, the marketplace model is, at best, a semi-integrated solution. The benefit that all financial institutions and fintechs are trying to provide to SMBs is a reduction in the time they spend on non-core tasks, such as managing finances. By presenting a myriad of solutions to time-poor businesses in a marketplace, how can we expect them to take the time to learn about each one, let alone adopt them?

There is also a third option which very few financial institutions have considered. Building digital channels on top of pre-existing, open sources of data, which are completely agnostic of any channel, will significantly reduce integration costs whilst accelerating speed to market. Many financial institutions have spent years and millions of pounds on Open Banking and PSD2 compliance. Only now are some of them starting to realise the benefits of consuming data and services in an 'Outside In' manner.

It's option three that encapsulates the BankiFi approach. While all models are viable and working to some degree for banks worldwide, it's option three where the real opportunity lies. This is where fast acting banks and financial institutions can best increase their chances of SMB adoption and become the go-to trusted advisor.

Running digital channels at a bank is a costly business, with many banks believing it is just a compulsory cost of being in business. The direct and indirect costs associated are significant, and the costs-per-customer are likely to increase against the backdrop of those customers potentially using an alternative digital channel to run their business.

VALUING CUSTOMER ENGAGEMENT

Businesses who adopt this model ('Outside In') won't only see improvements in their ability to attract and meet the needs of new SMB customers. Taking the 'Outside In' approach will also help companies to develop stronger relationships with the customers they already have. In fact, under this model, a rise in customer engagement levels is almost inevitable, with SMB consumers far more likely to feel that their specific needs are being met by their banking partner.

The value of this can't be overstated. According to research from LifeRay, around three-quarters of all B2B banking customers expect their banking partner to have a 'deep' understanding of their needs. Making improvements in this area will also likely lead to revenue growth in the long run. In fact, a McKinsey report in 2016 found that 'focusing on the customer experience, starting from front-end sales and ongoing support can increase revenue by 5% to 10%'.

LOOKING AT COST

By being more receptive to technological change, banks are likely to see a rise in revenue levels, alongside a growth in customer engagement and satisfaction rates. For many, these two benefits alone are more than enough to make the proposition enticing. However, adopting an 'Outside In' approach to digital banking also comes with the further benefit of helping to lower operational costs, both for the user, and the banking partner.

In making more services available via digital means, banks can reduce their reliance on brick-and-mortar stores. In turn, this allows companies to minimise outlays on significant costs, such as property leases. By the same token, SMB owners can reduce travel costs associated with visiting physical banks. Similarly, SMB owners are also able to complete essential financial processes remotely and efficiently, without it affecting their availability on an upcoming job.

Conclusion

The road to embedded banking has been long, and winding, but now that it's here, it must not be ignored. As this paper has chronicled, the innovation is only the latest in the world of digital banking, following a long lineage of technological updates, which can be first traced back to the 1990's. Sadly, over that period, it seems like the trend may have done more for others than it has for the sector it was originally introduced to support.

Thankfully, embedded banking offers the sector a chance to reset its existing relationship with the adoption of advanced digital capabilities. In many ways, the innovation is something of an equaliser between legacy banking companies, and more tech-first, nimble upstarts. Particularly in the world of SMB banking, it would seem this technology finally enables banks to offer the level of service previously associated exclusively with customer centric FinTechs.

As this paper highlights, the two worlds of banking and SMB are currently changing at a rapid pace. These shifts have created something of a vacuum across both worlds, particularly as it pertains to how digital banking services will be delivered in the future. For legacy banking companies, the question is whether they're willing to rise to the challenge, and to engage SMB customers in a way that they truly respond to.

If this is managed, a world of SMB banking opportunities will reopen for legacy banks. From attracting more customers, to generating greater levels of customer engagement, the bottom-line business benefits associated with the model are manifold. However, there remains some institutional uncertainty around embracing change that might hold the sector back from claiming these advantages, and ultimately winning the battle for the SMB 'front door'.

That's where a business like BankiFi can come in and help. Unlike some other finTech companies, we believe it's our duty to protect banks, as only they have the true financial clout to effectively meet the needs of all customers. To do this, we're on hand to help companies embrace more modern, forward-thinking ideas, such as embedded banking, and to help bring these companies up to the level of their fintech peers from a technological perspective.

By taking the time to read this paper, you should understand the immense benefits that come with embedded banking, especially for banks looking to provide SMB banking services. The next few years are going to be make, or break in this field, so those who want to embrace change are advised to do so now. Hopefully, with the right guidance, companies in this sector can react positively to an uncertain moment and write a new, positive chapter in the history of digital banking.

Contact Us

Want to learn more or arrange a demo?

Email: **info@bankifi.com**

About BankiFi

BankiFi is a technology platform designed to make business banking better, enabling banks to provide a set of integrated services - accounting, invoicing and payments - designed around the processes your customers use to run their business. We equip banks to become customer centric, rather than product centric - increasing your revenues and reducing costs while allowing your business customers to thrive.

Learn more at **www.bankifi.com**