

Global Banking & Securities

Embedded finance: Who will lead the next payments revolution?

Winners are already emerging in the race to provide banking and payments infrastructure for embedded finance, but incumbents and new entrants still have time to claim a share of this dynamic market.

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Small businesses starting up today may never interact with a conventional bank. By logging into their e-commerce or accounting platform, they can open a deposit account, order a debit card, and meet most of their financing needs. The operators of these platforms are not usually banks. Rather, they are software companies that partner with banks and technology providers to embed financial products into a single seamless, convenient, and easy-to-use customer experience. This new form of partnership between banks, technology providers, and distributors of financial products via nonfinancial platforms underpins what has been hailed as the embedded-finance revolution. Sitting at the intersection of commerce, banking, and business services, payments has been one of the first use cases of embedded finance, and a large number of the aspiring embedded-finance providers originate from the payments industry.

The value of this integrated experience for customers helps explain why embedded finance reached \$20 billion in revenues in the United States alone in 2021, according to McKinsey's market-sizing model.¹ According to our estimates, the market could double in size within the next three to five years. Despite the scale of this opportunity, many banks, payments providers, fintechs, investors, software firms, and potential distributors are unsure what embedded finance involves, how they can participate, and what it takes to win—questions we address in this article.

What is embedded finance?

Put simply, embedded finance is the placing of a financial product in a nonfinancial customer experience, journey, or platform. In itself, that is nothing new. For decades, nonbanks have offered financial services via private-label credit cards at retail chains, supermarkets, and airlines. Other common forms of embedded finance include sales financing at appliance retailers and auto loans at dealerships. Arrangements like these operate as

a channel for the banks behind them to reach end customers.

What makes the next generation of embedded finance so powerful is the integration of financial products into digital interfaces that users interact with daily. Possibilities are varied: customer loyalty apps, digital wallets, accounting software, and shopping-cart platforms, among others. For consumers and businesses using these interfaces, acquiring financial services becomes a natural extension of a nonfinancial experience such as shopping online, scheduling employees to work shifts, or managing inventory. This more deeply embedded form of embedded finance is what has grown so significantly in the US in recent years.

The evolution of embedded finance has been enabled by fundamental changes in commerce, merchant and consumer behavior, and technology. The digitization of commerce and business management has massively expanded opportunities to embed finance in nonfinancial customer experiences. As much as 33 percent of global card spending—50 percent in the US—now takes place online, with a large portion of small and midsize companies in the US relying on software solutions for managing their business.³ In addition, as digital natives came of age, they expanded the pool of consumers and businesses open to receiving all their financial services via digital platforms. Finally, open-banking innovation, supported by mandates in the European Union and market-led adoption in the US, has helped unlock latent demand by enabling third-party fintech players to access consumers' banking data and even conduct transactions on their behalf.

Who distributes embedded finance, and what products do they offer?

Embedded finance is likely to emerge in any environment in which a critical mass of end customers (consumers or businesses) have frequent

¹The model is based on McKinsey's Global Banking Revenue Pools, 2022; McKinsey's Global Payments Map, 2022; consumer and merchant research surveys; and data from the reports of embedded-finance firms.

² McKinsey Global Payments Map, 2022.

³ McKinsey Merchant Acquiring Survey, 2022.

(often daily) digital interactions with the operator of the digital platform, which we refer to as the “distributor” of embedded finance. For a nonbank company acting as a distributor, embedded finance offers a way to enhance the customer experience and create a new source of revenue without incurring the overhead associated with operating a bank. The types of businesses well placed to offer embedded finance include retailers, business-software firms, online marketplaces, platforms, telecom companies, and original equipment manufacturers (OEMs). All these categories have seen high levels of activity and innovation in embedded finance during the past year or two.

Among embedded-finance distributors and their end customers, demand is already maturing for a range of deposit, payment, issuing, and lending products (Exhibit 1). In addition to these traditional

financial products, novel use cases are emerging. For example, embedded-finance distributors are offering prepaid cards to employees as part of earned-wage access programs; giving merchants the option to use their deposit accounts for instant-payments settlement. Some are providing just-in-time funded debit cards for gig economy workers to use when making purchases for members of delivery-service platforms.

The embedded-finance product portfolio is likely to expand further as customer-onboarding and product-servicing processes are gradually digitized and real-time risk analytics and services grow more sophisticated. Risk is likely to remain a constraint on growth, however, as products that require case-by-case assessment, in-person touchpoints, or regulatory waiting periods, such as commercial real estate financing, are less susceptible to end-to-end

Exhibit 1

Demand for embedded finance is already growing in deposits, payments, issuing, and lending.

Embedded-finance distributors

Traditional retailers	Offer attractive financial products to enrich the customer checkout experience and incentivize brand loyalty and spending
Software firms	Strengthen the platform value proposition to drive merchant adoption, retention, and revenues
Marketplaces and platforms	Offer tailored financial products to improve the customer experience and increase merchant adoption, retention, and revenues
Telecom companies	Increase customer engagement and enhance the value of smartphone software and hardware with money-movement capabilities
OEMs	Simplify ownership and financing through subscription and other financing services

Embedded-finance products

Deposits	Transaction and deposit accounts that merchants and consumers can open and use from within an app or software platform
Payments	Money movement from within nonbank apps or software
Issuing	Prepaid, debit, and credit cards for customers and employees, issued from within business management software or apps
Lending	Unsecured lending embedded in business management software (eg, merchant cash advance) Secured lending for large purchases with underwriting and origination at point of sale

Source: McKinsey analysis

digitization. Despite these constraints, we estimate that products suitable for offering via embedded finance could account for as much as 50 percent of banking revenue pools.⁴

Who are the enablers of embedded finance?

The distributors of embedded finance rely on two sets of providers to manufacture the embedded-finance offering and grant access to it (Exhibit 2):

- *Technology providers* (fintechs) provide the platform through which distributors can access, customize, and offer embedded-finance products. Some, including Marqeta, provide point solutions for specific categories of financial products, such as card issuing. Others, including Unit, Bond, and Alviere, operate platforms that offer distributors multiple financial products, such as deposits, money movement, and lending.
- *Balance sheet providers* (licensed or chartered financial institutions) are responsible for manufacturing embedded-finance products, providing risk and compliance services, and offering access to funds for lending and deposit

products. Balance sheet providers sometimes partner directly with technology providers to create an integrated embedded-finance offering for distributors. For instance, Stripe is partnering with Goldman Sachs and other banks to offer embedded finance to platforms and third-party marketplaces.

A few banks and fintechs, including Cross River Bank and Banking Circle, fulfill both of these functions. Having built their own technology layer on top of their own balance sheet, they provide embedded finance to distributors such as retailers, business-software providers, marketplaces, and OEMs by themselves, with no need for additional partnerships.

Who is capturing the value?

Not all players benefit equally from the rise of embedded finance. As in banking in general, revenue primarily accrues to risk takers and to the distributors that own the customer relationship. For example, according to McKinsey research, the majority of revenues from embedded-finance lending products (55 percent of \$14 billion in the United States in 2021) accrued to the balance sheet provider—the firm bearing the risk of credit

Exhibit 2

To embed financial products into their customer journeys, distributors work with technology and balance sheet providers.

	Distributor	Technology provider	Balance sheet provider
Role in embedded finance	Works with technology and balance sheet providers to embed financial products in its customer, employee, and partner journeys	Maintains and configures technology for delivering financial products to distributors via APIs	Provides distributors with access to regulated license, risk framework, funds, and a place to hold deposits
Types of firms involved	Traditional retailers, software firms, marketplaces and platforms, telecom companies, OEMs	Fintechs and banks	Banks

Source: McKinsey analysis

⁴ Calculated as revenue pools of lower-risk, highly automatable products that have proven demand and can realistically be embedded, based on McKinsey's Global Banking Revenue Pools, 2022.

default. However, where payments and deposit products were concerned, the distributors who owned the end-customer relationship benefited most. In lending, for instance, they earned \$4 billion of the remaining \$6 billion revenue pool, equal to 30 percent of total revenues.

These revenue dynamics explain two market trends we have observed. First, many embedded-finance distributors began by offering deposit and payment products before extending their product range to lending products such as credit cards and merchant financing. Deposit and payment products are attractive to distributors not only because they represent substantial revenue pools and promote stickiness, but also because they are a powerful tool for building customer relationships and capturing customer data that can be used to inform underwriting decisions for future higher-margin lending products.

Second, many technology providers are seeking to capture a larger share of embedded-finance revenues by expanding across the value chain. In lending, for instance, they are looking to increase their share of revenues by finding ways to share in the risk, such as offering repurchase agreements for loans originated by balance sheet providers.

What does it take to win in embedded finance?

For embedded-finance providers, success demands clear differentiation in the form of product breadth or depth, or the provision of ancillary program management services.

Options for differentiation

We see three main sources of differentiation for embedded-finance distributors, balance sheet providers, and technology providers:

1. *Product breadth.* Many distributors are adopting a “land and expand” approach to embedded finance. They start by offering payment acceptance or deposits and then extend their product portfolio to lending products or more

complex offerings to address customers’ broader financial needs. Some distributors prefer to shape their strategy around a one-stop shop developed with a single trusted technology partner that offers a wide array of products, while others opt to work with several technology providers to avoid overreliance on one partner.

2. *Product depth.* A few technology and balance sheet providers are building deep expertise in specific embedded-finance categories such as issuing, in order to claim outside market share in these niches. They develop innovative use cases—such as just-in-time fund deposits into cards or crypto-linked payment authorization—as a basis for creating novel financial products for end customers. Over time, however, the demand for integrated financial solutions and the synergies that can be captured across product categories are likely to prompt these providers to protect their flanks with product breadth as well.
3. *Program management support.* Many distributors that are new to embedded finance are understandably concerned about how to build, sell, and service a financial product for end customers. Some of them may see the regulatory and reputational risk attached to financial products, especially lending, as an insurmountable hurdle. To help them overcome the risk, many embedded-finance technology providers are offering sales, servicing, and risk management expertise or are orchestrating other partners providing them. The ability to provide distributors with this kind of program management is likely to be a key source of differentiation in the long run.

Key decisions for embedded-finance market entrants

Although leaders are already emerging, the embedded-finance market still has ample white space for new entrants; we expect it to double in size over the next three to five years. The long-term winners are likely to be those that are already

building the table stakes technology, expertise, and relationships needed for a future leadership position. Financial services firms and fintechs looking to stake their claims in the embedded-finance business would be well advised to commit themselves to implementing four initiatives: choosing a strategy, establishing a developer experience, building capabilities to support distributors, and developing support and risk services.

Choose where to compete. For most banks with proprietary distribution, embedded finance represents a significant cannibalization risk. However, banks with limited footprints or localized relationships, such as community banks and regional banks, may see it as an attractive way to expand their revenue base. Some may be comfortable with growing deposits and earning revenues relatively passively, at least early on, but many will look for opportunities to differentiate themselves and boost revenues through more advanced products and support. At the moment, payments-focused technology providers are leading the charge on embedded finance, using their money movement capabilities to attract distributors and then expanding into products that have been the strongholds of banks, such as lending.

Build and enable a modern developer experience. Many banks and legacy financial services infrastructure firms are not yet equipped to externalize their processes and workflows to allow distributors to seamlessly integrate embedded-finance products into their journeys or distribution platforms. Distributors wanting to scale up quickly will need to build a modern developer experience,

including the necessary technology to enable it. To do this, they should provide third-party developers with self-service access and well-documented APIs.

Adapt to B2B2C and B2B2B sales motions.

Although some financial institutions operate with channel partners, many are accustomed to serving end customers directly. Those using direct channels will need to build a new set of capabilities to support distributors in selling embedded-finance products to their consumer or business customers.

Develop support and risk services. Retailers, manufacturers, telecoms, and other distributors of embedded finance may not have the capabilities to build, sell, and service financial products in a risk-controlled, regulatory-compliant, effective manner, nor will they have the time or appetite to build such capabilities. They will look to balance sheet and technology providers for advice on how best to deploy embedded finance and orchestrate the expertise and tools needed to deliver it in a compliant way. As well as providing advice, the balance sheet and technology providers will need to build a risk management framework that gives them confidence that the distributors they work with are acting within their risk appetite and in a compliant manner.

Winners are already emerging among the financial institutions that manufacture embedded finance. However, tech-savvy banks, fintechs, and payments companies that are willing to invest and partner still have time to claim their share of this fast-growing market.

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The authors wish to thank Robert Byrne and Jill Wilder for their contributions to this article.

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