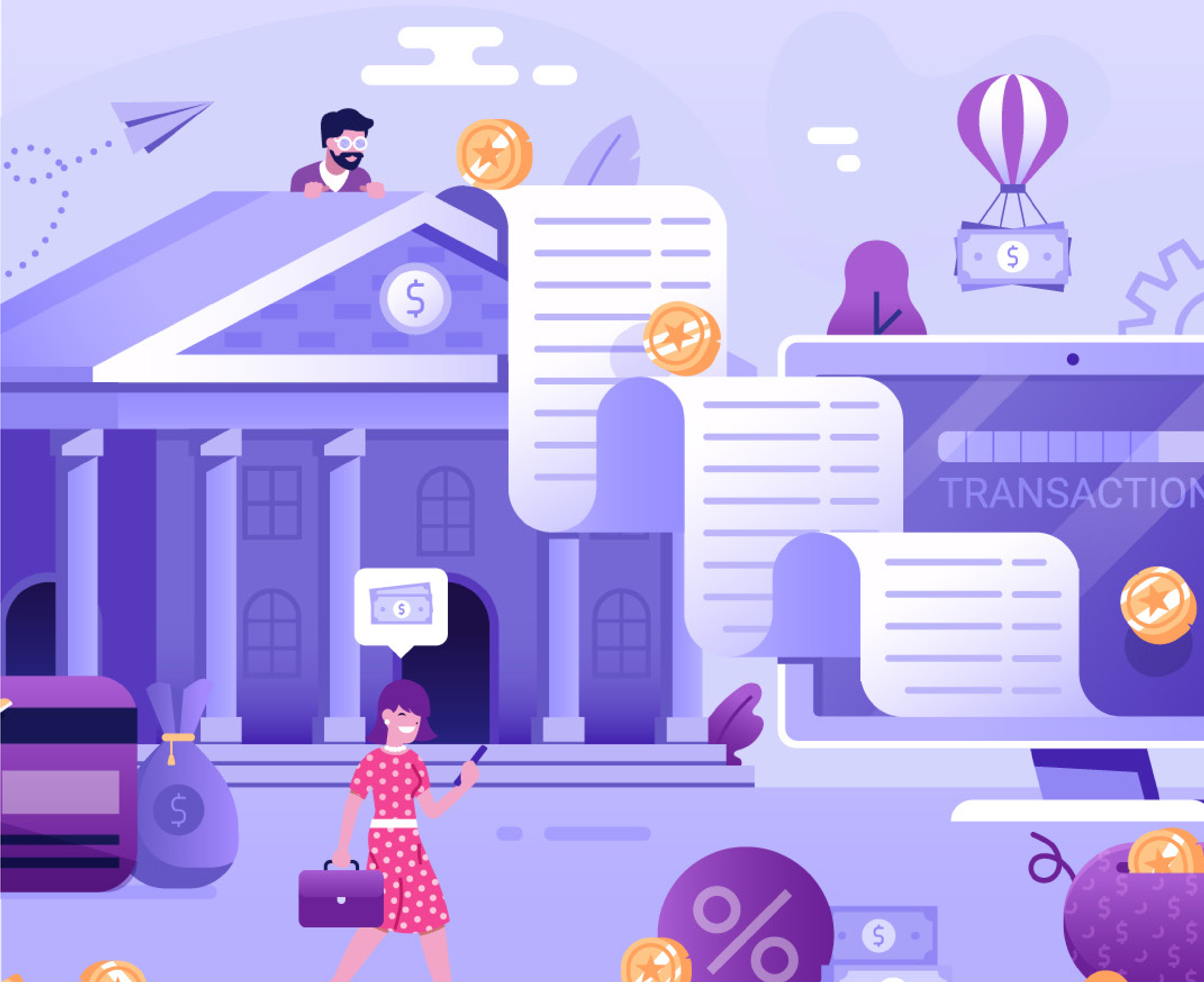
Demystifying the Buzz around BaaS



Introduction

For decades, banks have provided their corporate and retail customers with several services. So why is there so much buzz now around Banking-as-a-Service ("BaaS")? This e-book aims to answer questions such as what BaaS is, why it is important, why some banks find it hard to embrace BaaS and what banks can do to move forward on their BaaS journeys. We hope you find it useful.

The Backstory

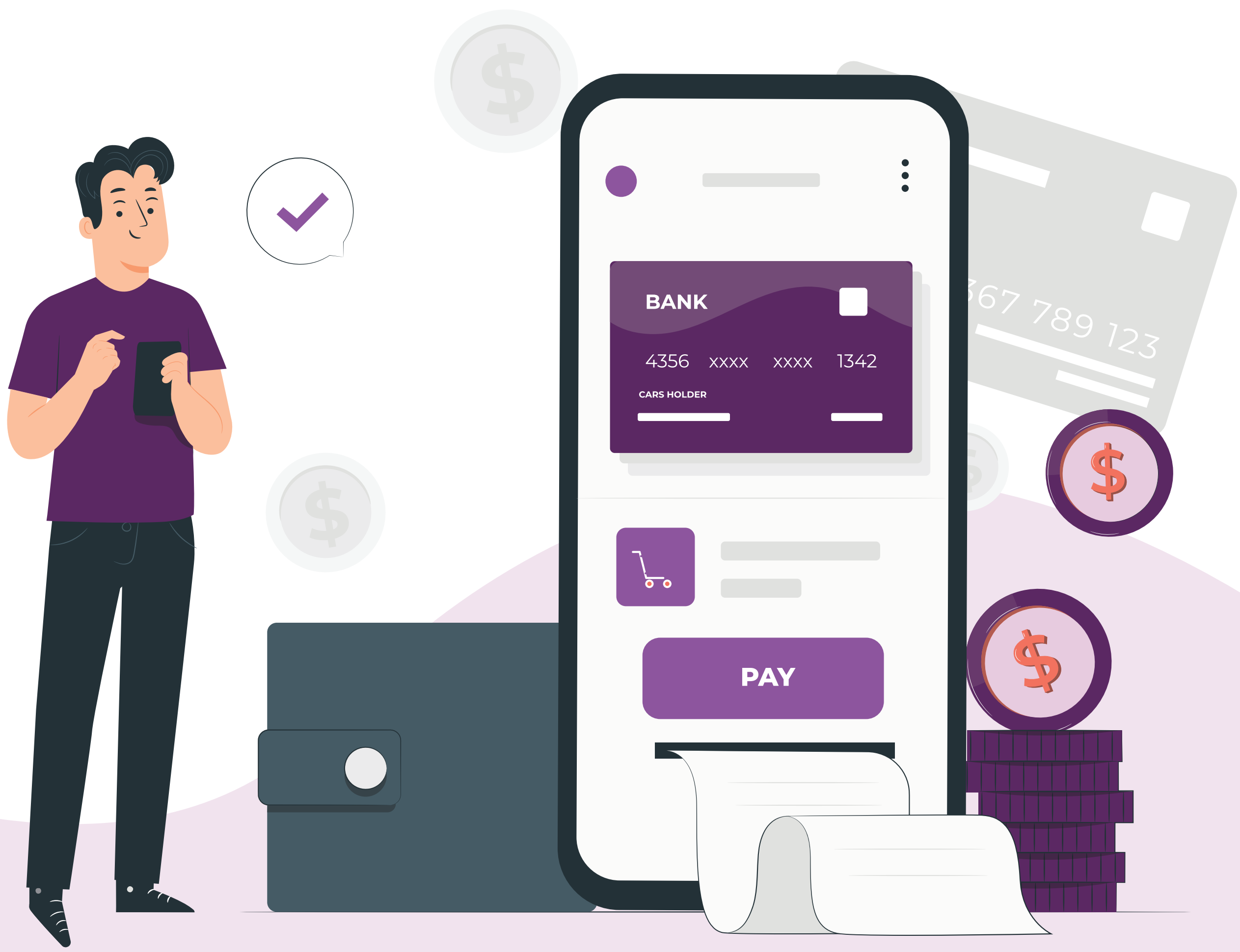
With several non-banking players (e.g., fintechs) providing smartphone-based digital payment and lending solutions, banks find themselves increasingly marginalized from their role of handling money between buyers and sellers. These platforms which are not licensed as banks, continue to significantly shape customer behavior across B2B, B2C, and P2P segments while piggybacking on global banking networks. However, banks continue to carry the costs, risks and other burdens associated with staff, real-estate, technology, and regulatory compliance.

The convenience of these digital platforms, together with the disruptions caused by the Covid-19 pandemic, has forced more customers to adopt digital offerings provided by non-banks. This has steadily caused banks to lose some of their traditional revenue streams. US and European banks in particular have also had to contend with a prolonged period of low interest rates. All this has squeezed banks' margins; indeed, the evolving environment remains a threat to the survival of many banks worldwide.

Another global trend has contributed to the growing pressure for banking to change. Thanks to e-commerce, customers can order goods and services almost from anywhere, and they would be delivered to the specified address; payments could be made digitally. This trend has now transcended the retail space, with healthcare, wealth management and many other industry sectors embracing digital commerce in a big way.
Banks have needed to reinvent themselves to adapt to the rapidly evolving environment. It was in this context that banks, along with other business enterprises, began to explore options to create symbiotic

relationships that would enable them to monetize their existing assets more effectively. This gave rise to “business ecosystems”, whose members share business objectives and pool their resources towards achieving these goals. Typically, these ecosystems comprise several complementary businesses that resolve to jointly target customers and collectively address their myriad needs. The coming together of Goldman Sachs and Stripe to address Small and Medium Enterprises (SMEs) in North America is one example. Another is the partnership between Aion Bank, a Belgium-based neobank, and Talenthouse, a platform for artists, to provide the latter’s members a range of financial solutions, including payments.

The term “BaaS” is often used alongside terms such as “open banking”, “embedded finance” and “embedded fintech.” Although there are nuanced differences, all of them at a high level refer to creating connectors between licensed banks at the back end and front-end players such as fintechs, retailers, service providers, or banks themselves as front-end players.



BaaS is a Strategic Response to The Urgent Need to Reinvent the Banking Value Chain

What is BaaS?

The term BaaS typically refers to the enablement of third-party non-banking players to provide banking products and services to customers. It facilitates disintermediation while allowing banks to monetize their under-utilized assets. The BaaS paradigm is a strategic response by banks (along with players from financial services and other sectors) to co-create a reengineered global banking value chain. BaaS enables banks to offer an expanded bouquet of relevant services, attract new customers and strengthen customer loyalty largely by letting banks monetize assets that are otherwise under-leveraged or at best, used sub-optimally.

In an environment where non-banking players are fast reducing the need for many traditional bank offerings (e.g., due to digital payments, POS-based Buy Now Pay Later schemes, etc.), the BaaS paradigm benefits each of the three principal categories of players.

1. For banks, it represents an opportunity to monetize existing assets such as their banking licenses, operational infrastructure, customer relationships and access to customer data.

2. Non-banking players across industries can run their apps on top of the banking infrastructure. Besides, they gain regulated access to certain demographic and transaction-specific data available with banks. This data can be mined for insights that help better prediction of customer needs and therefore, more relevant offers.

3. Customers get more attractive, timely offers that fulfil their needs; they are also more assured that their personal/financial data are suitably protected even when they use non-banking platforms.

BaaS relies on opening, in a secure, controlled manner, a bank's systems and certain types of customer data to authorized third parties such as digital (and traditional) banks and non-banks to co-create and provide a range of new products, services and lifestyle solutions to customers. This is in stark contrast to the closed systems that banks have historically relied on. BaaS embodies coopetition- i.e., cooperation amongst traditional competitors, with the intention of expanding the size of the addressable market and helping all parties achieve their respective goals equitably. BaaS combines the power of modern technologies with innovative ways of data-driven collaboration and governance structures to create new avenues for profitable growth for ecosystem members.

While BaaS is enabled through technology, it should, in fact, be viewed as an amalgam of corporate strategy, business model, as well as a carefully orchestrated digital sales channel that is designed to help all members of the partaking ecosystem to identify and address customer needs more proactively, efficiently, and profitably than before. It is also a tool that allows brick-and-mortar players to get a leg up in an increasingly digital-only business environment.

At the heart of the BaaS paradigm are business ecosystems whose members share data and insights about customers amongst themselves and act on them with agility. This allows ecosystems to target prospects and customers more effectively by ensuring that the right offers (products, brands, bundles, deals etc.) are presented to customers and prospects at the right time via the right channel (digital, physical or hybrid). BaaS ecosystems are equipped to address larger chunks of customer needs, besides providing customers with superior experience. For example, customers need not access multiple apps for placing orders for different products/services and thereafter, to pay for the goods and services purchased. The order engine, payment system, delivery tracker, loyalty manager and feedback/ advocacy mechanisms are all available in an integrated platform.

Four distinct categories of players are needed to form BaaS ecosystems. As summarized below, each category plays a unique role in the ecosystem.

1

Banking service providers, who are licensed to carry out banking operations; they also bring to the BaaS table their operational capabilities, technology backbones and customer data that can be leveraged by others for mutual benefit.

2

Provider-aggregators who enrich the ecosystem by bringing their own capabilities and relationships with other vendors to the table.

3

Distributors who craft new financial (and other) solutions by leveraging customer relationships (e.g., a mobile services company that has its own app for managing customer relationships, including making bill payments).

4

Distributor-aggregators who come up with enhanced value propositions based on technologies or bundled offers to give the other players access to a larger customer base

But Many Banks Are Not Equipped to Monetize Customer Data - A Key Element of BaaS

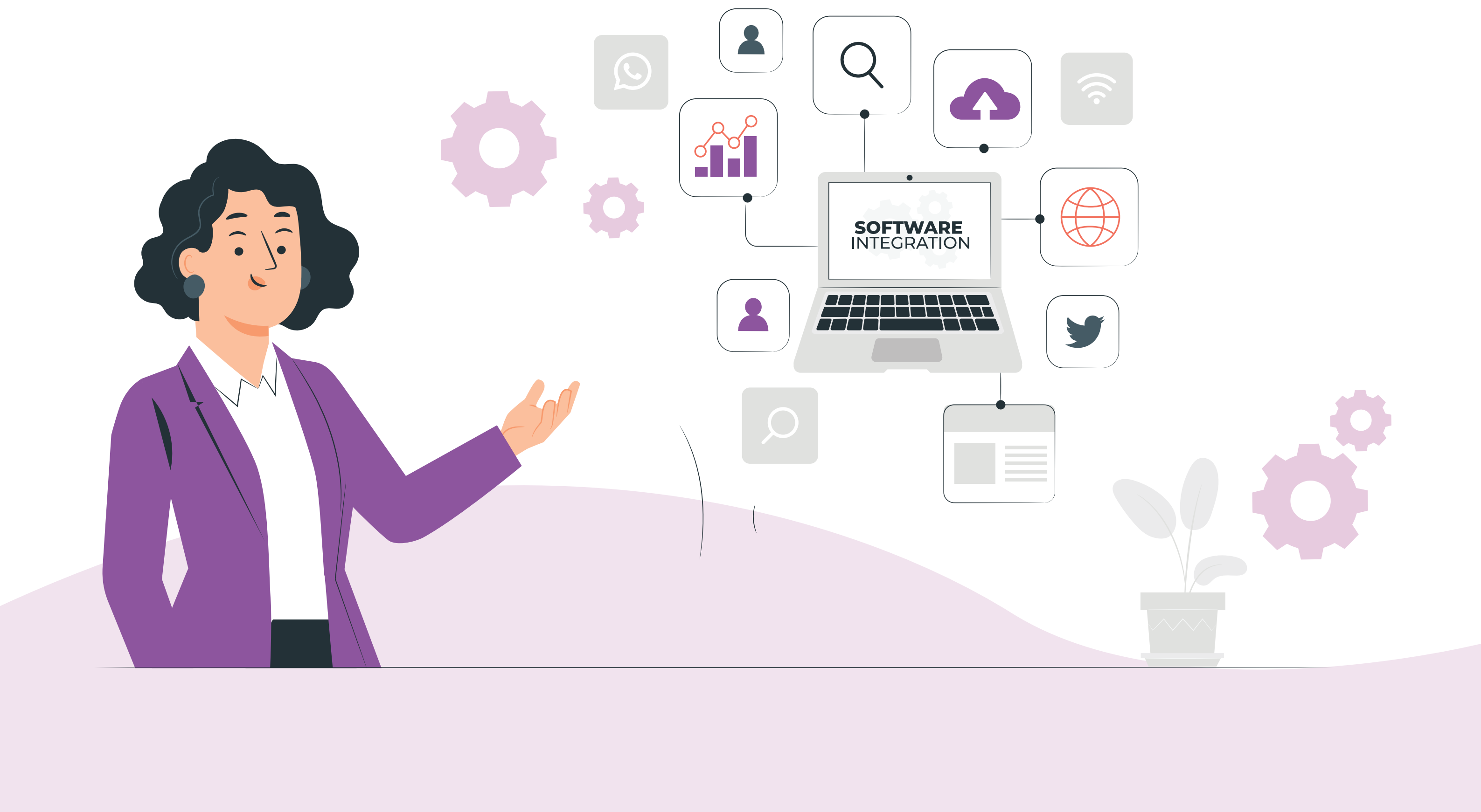
Banks have access to a lot of information about customers (e.g., KYC and transaction related). Digitalization has enabled banks to gather even more data in different formats from diverse sources. Although digital payment apps and wallets are replacing cash and credit/debit cards, banks still have access to transaction data because at the back end, financial transactions are still tied to the customers' bank accounts. They know who purchased what (brand, quantity, size/model) and from where (outlet, whether online or offline), etc.

In theory, these datasets can be used to extract customer insights that can then be shared with other ecosystem members to enable personalization, drive loyalty, and hence generate higher revenues/profits per customer. For example, spend analysis of a certain retail banking customer might reveal medical expenses incurred on delivery of a baby, followed by expenditure on baby formula, clothes, toys etc. Armed with this information, the bank's relationship manager can pitch a new family insurance plan or an education plan to the customer. The bank can also team up with baby product manufacturers or retailers and offer special deals to this customer. The chances of success are inherently higher because there is a high probability that the customer needs those solutions at that time. In other words, timely, personalized anticipation of customer needs, combined with easy, convenient payment and fulfilment. Not surprisingly, spend analysis is seeing high growth.

But many banks are unable to use even available data productively. For some, this is because of the "technical debt" of their legacy systems. For others, the lack of systems to generate actionable insights in a timely manner remains a roadblock. The product-centric way in which banks have traditionally worked means that each line of business within a bank (e.g., credit cards, deposits, loans, wealth management, treasury etc.) functioned as a silo. Systems were geared to provide a product-centric view (and not a customer-centric view). Architectural rigidities associated with legacy core banking platforms make it cumbersome to combine data quickly and meaningfully.

These impediments also manifest in the bank's inability to price products and services based on customer relationships; they are forced to instead rely on product-based pricing. This increases the risk of revenue leakage, customer churn and loss of market share, especially because price becomes increasingly critical in a tight economy. In the context of a BaaS ecosystem, other partners (and customers) will view the bank as a single, whole entity and expect the best pricing based on total revenue and not on the revenue accruing to a specific product or line of business. The inability to offer such pricing will particularly impact corporate banking relationships.

The SME segment represents a huge opportunity for BaaS, given their sensitivity to pricing of banking services on the one hand and the nature of customers they serve on the other. The BaaS model will enable banks to offer the best pricing to their SME customers, based on parameters such as the size of the relationship as well as services consumed by the ecosystem and customers. Not only will this enhance stickiness to the ecosystem (and the underlying bank) but it will also provide the ecosystem with richer datasets with which they can do a better job of predicting customer needs and presenting the best offers.



A recent study of banks commissioned by SunTec and conducted by the American Banker revealed some interesting insights into banks' digital priorities and what holds them back. Listed below are eight key findings from the study:

- 97% are building a partner ecosystem for digital banking, with the main objective of offering innovative products/services
- 67% of the respondents believe that their legacy systems stall innovation
- 20% rely on legacy systems; only 18% have migrated to a modernized core
- Meeting customer's demands for personalization (42%) and monetizing existing platforms and infrastructure (41%) are important priorities
- Personalization is limited to segment-targeted offers and preferential rates
- Bundling offers and monetizing customer spending data are on the rise
- Concerns about regulatory compliance and inflexible technology stacks are the biggest challenges around monetizing digital ecosystems
- Delivering personalized segment-targeted offers is the top priority for 2022

Write to us on **marketing@suntecgroup.com** to get a copy of the above report. Alternatively, you may download it from here. [1]

It is clear from the above findings that several banks are hamstrung by their existing technology stacks, which impede their capacity to monetize customer data and digital ecosystems beyond the more obvious low-hanging fruit. But driving future growth needs much higher levels of innovative agility so that opportunities are identified and monetized before someone else does. And this is what BaaS can help in achieving.

BaaS Will Grow Rapidly Because It Creates Innovative Monetization Options for Banks and Their Ecosystem Partners

A South African bank created a curated platform on which its customers who were qualified plumbers, electricians, carpenters, etc. were able to offer their services to those customers of the bank who needed them. This not only provided a value-added service to the bank's customers, but also allowed the creation of a new revenue stream. Since both service providers and consumers were the bank's customers, the bank also benefited from the "float." The bank also saw a decrease in customer churn.

The above example illustrates the potential for BaaS to rejuvenate banks and give them a second wind. Therefore, more and more players are committing to adopting BaaS-based models. BaaS offers a clear pathway for banks and other businesses that are members of an ecosystem to monetize customer data that is readily available (or can be easily obtained). Such innovations power both new revenue streams as well as new ways of personalization and value delivery to customers.

Given the value that BaaS can create for its stakeholders, it is not surprising that analysts project a period of high growth for the BaaS market. Growth will be driven by banks and other stakeholders embracing BaaS. Business enterprises from various sectors will inevitably embrace BaaS and be active participants in one or more ecosystems. POS financing and Buy Now Pay Later models give retail banks and other non-banking intermediaries greater opportunities for personalization and better risk management. BaaS is not limited to retail banking; corporate banking too will see wider BaaS adoption in the years ahead, with the SME segment being a clear engine of growth. The overall market will be propelled by both API-based BaaS as well as Cloud-based BaaS. The global market for BaaS is estimated to grow at a CAGR of 15.2% during the period 2021-2030. [2]

The Keys to Smooth Orchestration of BaaS Ecosystems

BaaS ecosystems will attract a steady flow of customers only when they have an adequate complement of the following three types of players:

1. Providers (of goods and services):

Manufacturers and service providers (top brands, unique brands etc.).

2. Distributors:

Fintechs and Bigtechs/E-Commerce players who associate with the ecosystem (whether exclusively or not) and provide the “connectors” with banks.

3. Banks:

Banks that are licensed to provide the core services/ infrastructure necessary to drive end-to-end financial transactions (e.g., bank accounts and credit cards linked to apps or the ability to offer loans).

Naturally, every successful BaaS ecosystem will also need to have a large, vibrant, and growing body of customers who are willing to consume what the ecosystem offers and remain loyal to it for a long period of time. This requires each player in the ecosystem to diligently play their role in ensuring that the entire ecosystem remains robust and consistently delivers its promise to customers. Some ecosystems may have one anchor bank, while others may include multiple banks; various fintechs too will associate with these ecosystems to provide seamless interfaces between the banks, the other ecosystem players, and customers.

The smooth functioning of BaaS ecosystems depends on several factors such as the following:

- Secure, efficient, real-time collection and sharing of data between various members of the ecosystem (this means that every individual member must have the requisite technological capabilities to securely capture, store, extract, transfer and retrieve data while ensuring full regulatory compliance at every stage).

- Generation of real-time, data-driven, actionable insights about customer needs and preferences that allow for agile bundling and on-the-fly offers to be presented (considering the retail/corporate customer's profile and "tier status").

- The right pricing capabilities for every product/service in the context of the individual customer. This is an important point because propensity to buy and willingness to pay are both related to the situation of the purchaser at that point in time. The more the information that is available about the buyer's situation, the greater the likelihood of making an offer they can't refuse.

- Accurate billing ensures that every member of the ecosystem is fairly compensated for what they bring, without fears of exploitation or unfair benefits to one or more members.

- Multiple stakeholders provide goods and services to a set of customers/consumers. Often, what is offered is a bundle of complementary goods/services; individual providers will have different unit economics, so it is important that stakeholders work harmoniously and transparently to ensure efficient and effective value management - both amongst themselves and for customers. This may include the need to define rules for how discounts are shared so that the probability of deal closure is maximized, and customer loyalty strengthened.

- Transparent rules that are consistently applied (e.g., around how deals will be structured, which suppliers are prioritized, how soon payments are made, cost sharing etc.).

Most of the above factors are subsumed into well-designed software systems that are secure, scalable, and flexible to be implemented alongside the in-house systems of every ecosystem member.

How Banks Can Increase Their Odds of Success in Embracing BaaS

Here are some broad pointers that we hope will help you move forward with your BaaS journey. But do keep in mind that every bank's journey will be unique because its starting point will be different, and professional advice is recommended so that your context is considered while formulating your BaaS strategy and adoption roadmap.

- Like any other transformation journey, begin with those use cases and monetization models that deliver value to customers. For some banks, BaaS may be about streamlining operations and reducing costs, while for others, it may be about giving faster loan access to customers. Reportedly, Apple has recently launched BNPL programs on its own, something that has been enabled by BaaS.

- Understand how the identified use cases will add value to ecosystem members. Value may come from attracting new customers, expanding the average value of each purchase, increasing frequency of transactions based on the ecosystem's ability to fulfil more needs (products and brands as well as pack sizes, flavors etc.). This is critical in arriving at pricing models and offers, which are also important determinants of value to the end customer.

- Ensure that current systems capture and share the necessary data across the ecosystem in pre-defined formats. Invest in building a platform that can support all players and scale up to accommodate new additions over time. It may be useful to get key ecosystem partners to co-invest in this, both to reduce the capex burden as well as to create ownership and buy-in and manage risk.

- Speed and accuracy of pricing and billing might seem like a relatively small part of the overall BaaS picture; however, these are crucial to build trust both with customers and ecosystem partners. It is important that banks have a dedicated pricing and billing engine that can be easily integrated with the legacy core banking software. This engine must be flexible enough at the level of individual parameters (based on tiers, segments, individual customers, applicability of VAT/GST, the relevant rates, exemptions etc.), allowing for real-time, rule-based, system-driven changes based on updated information and customer insights. This capability also helps in driving superior transparency across the value chain, in turn enabling rules-based revenue share and customer value management. These are important building blocks of trust amongst ecosystem members as well as between the ecosystem and customers/consumers.

- While getting the internal IT stack in order is essential, just as important is to select the right fintech partners to provide the "connectors" between the bank and others in the ecosystem. The pricing of transactions handled by the fintech platform is important, as are the rules to decide how pricing varies based on where the transaction originated.

- Pay attention to the customer experience, because increasingly, there is a power shift in their favor. Do not compromise CX for in-house technical convenience or just to accommodate a partner.

- Different industries will be governed by different regulations; these may well vary across jurisdictions. Individual countries (or blocs such as the EU) will have their own data protection and privacy rules and regulations. It is important that your platform be flexible enough to allow for these differences, so that your bank, other members of the ecosystem and the ecosystem, always remain in compliance with all applicable regulations.

- Finally, while it may be tempting to develop your BaaS platform in-house, you will almost certainly save time and money by working with external experts who have the demonstrated expertise and track record in different areas that are key to building your BaaS capabilities. This is important to keep in mind simply because BaaS is not a monolithic solution; it is made up of several moving parts requiring broad and deep expertise to design, build, implement, integrate, and maintain. Also, if there are delays, you might lose the early-mover gains.

We hope you found this e-book relevant, informative, and useful.
If you have any questions about BaaS or SunTec or any suggestions, please write to us at marketing@suntecgroup.com.

Sources:

1. *https://www.suntecgroup.com/reports/building-customer-engagement-on-top-of-the-core/*

2. *https://dataintelo.com/report/banking-as-a-service-global-market/*

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