REPORT REPRINT

Financial fabric: The infrastructure for embedded finance

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Introduction

The past several years have seen financial services embedded into a wide variety of software and applications peddled by non-bank providers. Their mission is to form a richer, stickier and more lucrative user-value proposition. This trend is widely referred to as embedded finance. In this report, we discuss the role of financial fabric providers in helping tech companies bring new embedded finance use cases to the market.

451 TAKE

The move toward embedded finance is one of the most disruptive trends in payments, banking and technology today. It is reshaping the distribution model for financial services while creating a new role for technology companies in the financial lives of consumers and enterprises. Providers of what 451 Research calls 'financial fabric' have emerged in growing numbers over the past half-decade to help technology companies exploit and accelerate the many use cases comprising the embedded finance market opportunity. We believe this market remains in the early stages, and has only scratched the surface of its potential. Incumbent financial institutions, payment processors and core banking providers must acknowledge the acceleration of this trend, and begin to assess the longer-term customer relationship and revenue challenges it presents.

The growing intersection of financial services and tech companies

The distribution channels for financial services are multiplying. Financial services are becoming part of the stack for technology companies of all shapes and sizes, and the examples here are many:

- **POS, e-commerce and vertical software vendors** – offering integrated payment processing and lending services to their sub-merchants (e.g., Lightspeed, Shopify, Toast, Mindbody).
- **Food delivery companies** – offering couriers instant earnings payouts (e.g., Instacart, Doordash).
- **Ridesharing companies** – offering various financial products (e.g., debit cards, instant payouts, digital wallets) to both customers and drivers (e.g., Uber, Grab).
- **Consumer-focused fintechs** – expanding their functionality, for example through installment loans, debit cards and instant lending disbursement (e.g., Square, Klarna, Revolut).
- **Large consumer technology companies** – offering digital wallets, P2P payment services, lending and credit and debit cards to their end users (e.g., Apple, Google, Facebook, Amazon).
- **Telcos** – offering digital banking products, digital wallets and payment cards (e.g., Orange Money, T-Mobile MONEY).

When it comes to execution, many tech companies have realized that their talents are best spent on their core business. They are instead outsourcing to third-party specialists to provide, as a service, the complex infrastructure needed to run financial services at scale. A crop of vendors has emerged to address this burgeoning opportunity, which we refer to as financial fabric.

The rise of financial fabric providers

Financial fabric is an API-rich layer of financial infrastructure that can be embedded into a wide variety of applications, ranging from marketplaces to platforms to fintech apps. It is tightly woven into a broader business proposition, with the intent of augmenting it. Financial fabric can be deployed for various internal or customer-facing use cases, such as payment processing, payouts, lending and card issuing.

Providers of financial fabric allow technology companies to more efficiently turn on and scale financial services capabilities using fewer internal resources. There are dozens of startups currently occupying this sector. Many pitch themselves as 'payments as a service' or 'banking as a service' providers. Examples of vendors tackling various financial fabric use cases include:

- **Marqeta** provides a full-stack card-issuing service, enabling companies to issue and process card payments. It enables a variety of use cases, such as virtual cards for installment financing and cards with spending controls for on-demand services companies. In May, Marqeta raised $150m, increasing its valuation to $4.3bn.
- **Rapyd** offers what it calls a fintech-as-a-service platform, which enables companies to embed card issuance, payment collection and disbursement and wallet capabilities into their applications. Rapyd was founded in 2015, and has raised $180m in funding.
- **Moov Financial** is an early-stage startup that offers an open source banking platform for SaaS vendors, banks/credit unions and fintechs to embed financial capabilities into their products. Founded in 2017, the startup raised a $5.5m seed round in August.
- **Plaid** provides APIs that enable apps to connect to users' bank accounts. It primarily serves fintechs such as Venmo, Betterment and Acorns. Plaid was acquired by Visa in January for $5.3bn.
- **solarisBank** is a German banking platform startup that also happens to have a full German banking license. It primarily targets fintech companies, with clients in the digital banking, crypto and trading sectors. In June, it raised a $67.5m series C round at a $360m valuation.
- **Stripe** offers an ever-expanding range of financial fabric capabilities, including payment processing, payouts, card issuance and working capital. In April, Stripe raised a $600m funding round at a $36bn valuation.
- **Finix** helps SaaS companies become payment facilitators. It offers a platform consisting of modules such as processor integrations, compliance, merchant underwriting, risk management, and settlement and payout, to name a few. Founded in 2015, the startup raised a $35m series B in February, later extending its series B to $75m in August.
- **HUBUC** is an early-stage Spanish banking platform provider. It targets several fintech use cases, including card issuance, and has a white-label digital banking offering. The startup was founded in 2018, and raised €350,000 ($418,000) in July.
- **Modulr** is based in England, and provides a digital payment platform that enables companies to automate and embed payments within their software. Notably, it has direct access to Faster Payments and Bacs in the UK, and is a principal member of Visa. The startup was founded in 2015, and raised £18.9m ($25.3m) in May, bringing its total funding to over £43m.
- **Contis** is based in England, and provides a variety of account and payment offerings, including pay-ins/pay-outs, issuer processing and a white-label account and payments platform. The vendor, which was founded in 2008, is a principal member of Visa, and serves fintechs, banks and insurance companies.

From a vendor standpoint, there are differing approaches in terms of breadth of capabilities/use cases offered, and the extent to which those capabilities/use cases are outsourced. Finix, for example, provides a do-it-yourself framework targeted at businesses looking to build and operate an in-house, customer-facing payment processing service. Its customer, SMB lender Kabbage, uses Finix's technology to operate its payment facilitator offering Kabbage Payments.

Stripe, on the other hand, provides more of a full-service offering, running and operating various types of financial fabric on behalf of its customers. Jobber, a home service management software provider, uses Stripe to power the lending, payment processing and real-time payout services it offers to customers.

The revenue opportunity and competitive threat

The opportunity for tech companies to leverage embedded finance as a revenue generator are many. Square converted the Cash App into a business that produced $325m in Q2 2020 gross profit (excluding Bitcoin) in roughly three years. This was largely accomplished by issuing debit cards linked to its Cash App P2P payment service, which it began offering to users in 2017 in partnership with Marqeta. Today, nearly one in four Cash App monthly active users is a monthly active user of the Cash Card.

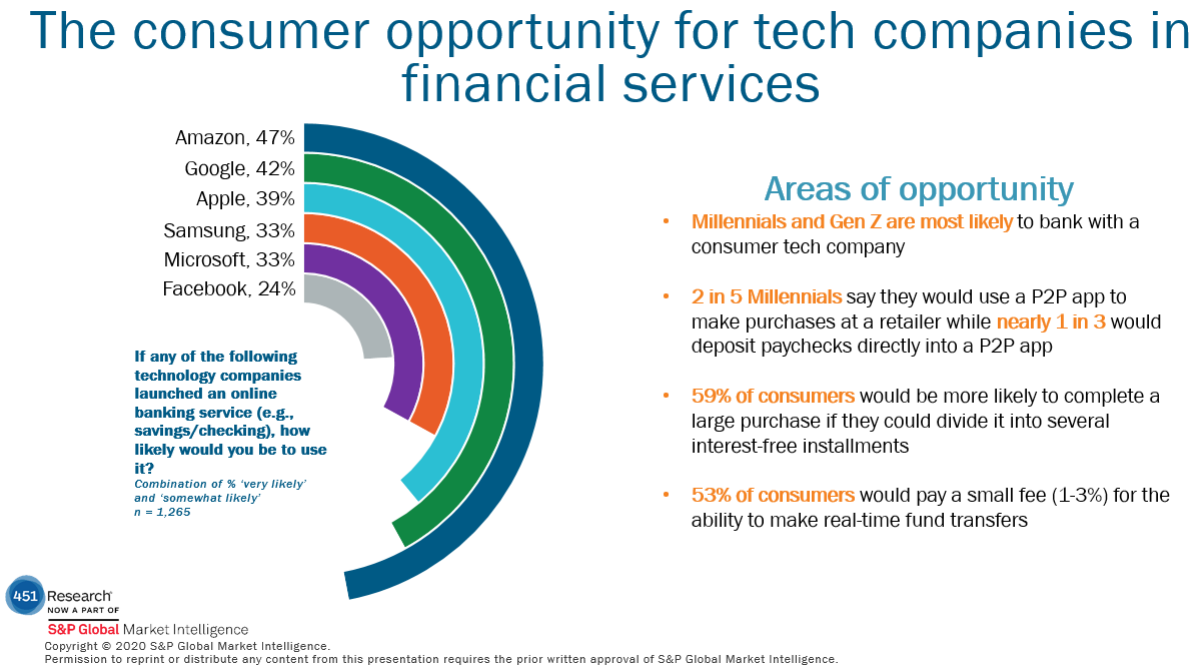
Square's Cash App is by no means an outlier success story when it comes to embedded finance. Additional evidence of traction can be seen across the spectrum of financial fabric use cases:

- In Q1 2020, Shopify processed $7.3bn in gross payments volume through its Shopify Payments service. Shopify charges between 2.9% and 2.4%, plus $0.30, for each online transaction.
- In Q4 2019, Apple facilitated three billion Apple Pay transactions. Apple is said to be charging card issuers 0.15% per credit card transaction.
- Uber now handles more than 70% of driver payouts using Instant Pay. Uber charges a fee of $0.50 per instant payout. The service is free if the driver deposits funds to the Uber Visa Debit Card (issued by GoBank).

The initial traction of embedded finance should be on the radar of incumbent financial institutions, payment processors and core banking providers. As shown in the figure below, the consumer opportunity for tech companies in financial services is quickly becoming apparent. With advantages in design/UX and distribution, technology companies are uniquely positioned to disintermediate the financial relationships that incumbents have with their customers.

The threat that tech companies pose to revenues should also not be dismissed. Deposit displacement and erosion of interest, debit interchange, processing and service fee revenue are potential challenges that payment and banking incumbents are up against as the trend toward embedded finance accelerates.

Tech Companies Show Promise in Financial Services



Source: 451 Research's VoCUL: Connected Customer, Consumer Population Representative, Q1 2020