

Banking Practice

Banking-as-a-Service— the €100 billion opportunity in Europe

As shifting consumer preferences and technological breakthroughs increase the set of BaaS offers and a growing number of “banking adjacent” players enter the market, it is time for bank CXOs to leverage their positions and boldly enter the BaaS space before they get left behind.

by Sarina Deuble, Max Flötotto, Matthias Lange, Timo Mauerhoefer, Albion Murati, Diana Pritscher, and Constantin Stürner



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The first wave of “as-a-service” propositions in banking emerged more than ten years ago. While white-label banking products have long been sold in various niches such as credit cards, consumer loans, or end-to-end (E2E) payment services, banking-as-a-service (BaaS) propositions are no longer confined to the realm of these solutions (for a working definition of BaaS, see Text box 1). As shifting consumer preferences and technology breakthroughs increase the set of BaaS offers and a growing number of “banking adjacent” players enter the scene, it is time for bank CXOs¹ to leverage their positions and boldly enter the BaaS space—lest they get left behind.

New trends, value propositions, and players are driving the massive opportunity in BaaS

Regardless of their past experiences and successes with as-a-service business models, there are substantial reasons why CXOs of incumbent banks should re-evaluate which role their organizations might play in leveraging this opportunity and how they can include it in their strategic agenda discussions.

Changing customer demands and technological advancements are shaping the growth of the BaaS market

After over a decade of moderate growth and customer adoption during the first wave of BaaS propositions (“BaaS 1.0,” like, white-label credit cards), the BaaS market is now set up for

exponential growth over the next ten years. Since customer attitudes have changed, fewer financial services are obtained exclusively from “trusted only banks;” instead, customers increasingly rely on nonbanks to provide them with banking services (such as buy now, pay later in e-commerce). The COVID-19 lockdowns further accelerated the adoption of these embedded banking services.

In addition, significant technological advancements have been fostering the increase in demand for BaaS. To make the various propositions a reality, BaaS providers focus on an API-enabled suite of banking solutions with deep integration into the partner’s value chain, including sharing data and revenues (“BaaS 2.0”).

While several fintechs have shaped the current as-a-service space, incumbent banks have recently also jumped on this opportunity and are gaining market share. One example is a leading European bank that, in 2020, entered a partnership with an international marketplace in Germany to launch two embedded lending offers for the German market that are seamlessly integrated into the marketplace platform. Based on this strategic partnership, analysts expect a 30 percent upside for the European bank. Another example is a US bank that—in collaboration with a leading technology player in 2019—issued a fully embedded credit card with no fees, daily cash backs, and seamless integration in mobile devices. Only two years later, the bank received the highest customer satisfaction designation in the Midsized Credit Card segment 2021.

¹ To a somewhat lesser degree, this also holds true for fintech and IT service provider CXOs.

Text box 1: Definition of Banking-as-a-Service (BaaS)

Banking-as-a-Service has become a buzzword. To establish a common understanding, we define BaaS as a set of E2E retail, small and medium-size enterprises (SMEs), and corporate banking solutions provided via technical interfaces such as APIs. BaaS solutions serve two purposes: 1) they enable (nonbanking-licensed) companies to embed financial

products and services—for example, current accounts, SME payments, and corporate loans—in their value propositions, and 2) they provide banks with access to new sales channels while accelerating their digital transformations.

The future of banking enables a win-win-win situation

BaaS solutions create a win-win-win situation for all participants, including customers, the customer-facing partner, and the financial service provider (namely, the bank or fintech). For customers, BaaS provides a more convenient way to access banking products when needed. This allows customers to pay, lend, save, and invest at the same (online) places where they buy groceries or cloths, sell their goods or services, or interact with friends or other SMEs.

For the customer-facing partner, BaaS allows increased conversion and boosts revenues (for example, through buy now, pay later), provides new revenue streams (like point-of-sale financing), or increases customer lock-in (for example, KYC²-as-a-service). They also benefit from new, good-margin revenue lines made available by banks, improved customer relationships, and increased customer lifetime value.

For the financial service provider, BaaS can increase access to new sales channels and new kinds of customers, thereby unlocking new revenue streams. In that context, and despite the potential risk of cannibalizing banks' existing revenues, BaaS also presents a significant growth opportunity and strategic advantages for incumbent banks along four dimensions:

- **Revenue and profitability.** For incumbent banks, BaaS can boost revenue and profitability in two ways. First, offering embedded finance solutions to, for example, big-tech companies and other nonbanking players allows banks to participate in a growing market. Second, participating in this growth market gives banks direct access to their partners' customers, leading to higher conversion rates and lower acquisition costs.

- **Customer touchpoints.** The acquisition of new customers at lower costs is far from the only benefit of accessing partners' existing customer bases. Perhaps even more importantly, BaaS creates opportunities for daily customer interactions via their partners' platforms and deep insights into customer behavior via vast amounts of customer data.
- **Product portfolio.** Insights derived from customer data can serve as the basis for improving existing financial products, developing new ones, and revamping a bank's entire product portfolio. Network effects of emerging scale can be an additional driver of product development and cost reductions.
- **Digital transformation.** Increasing and intensifying their participation in embedded financial services requires incumbent banks to accelerate their digital transformations. Thus, beyond the product, customer, and revenue benefits described above, speeding up digital is another strategic advantage for banks. For example, replacing their legacy IT infrastructures with upgraded, more efficient, and flexible infrastructures will speed up banks' paths to improving their overall cost structures via automated processes and operations.

There are two clear value pools in the emerging BaaS market in Europe

Over the next five to ten years, the total addressable market (TAM) of BaaS providers in the European Economic Area and the United Kingdom is expected to increase significantly, reaching an approximate value of between €90 billion and 105 billion by 2030 (Exhibit 1).

² Know your customer.

The BaaS market is mainly driven by dynamic developments in two areas:

Embedded finance (for unlicensed players). In this area, the increasing integration of embedded financial services (retail, SME, and corporate) into the customer journeys of nonfinancial companies with large customer bases—like retail and e-commerce—is observed, resulting in a TAM of between €75 billion and 85 billion by 2030. Retail solutions are leading the adoption and are expected to grow to between €40 billion and 45 billion, or around 50 percent of the TAM for embedded finance. This growth is composed of two main product pillars. The most significant pillar is financing or lending use cases ranging from point-of-sale financing for retailers to buy now, pay later solutions for e-commerce players to purchasing mortgages via real estate agents or brokers. The second pillar is daily banking solutions, where payment and card solutions—like private-label credit cards at retail chains or in-car payments for OEMs—offer the highest revenue potential,

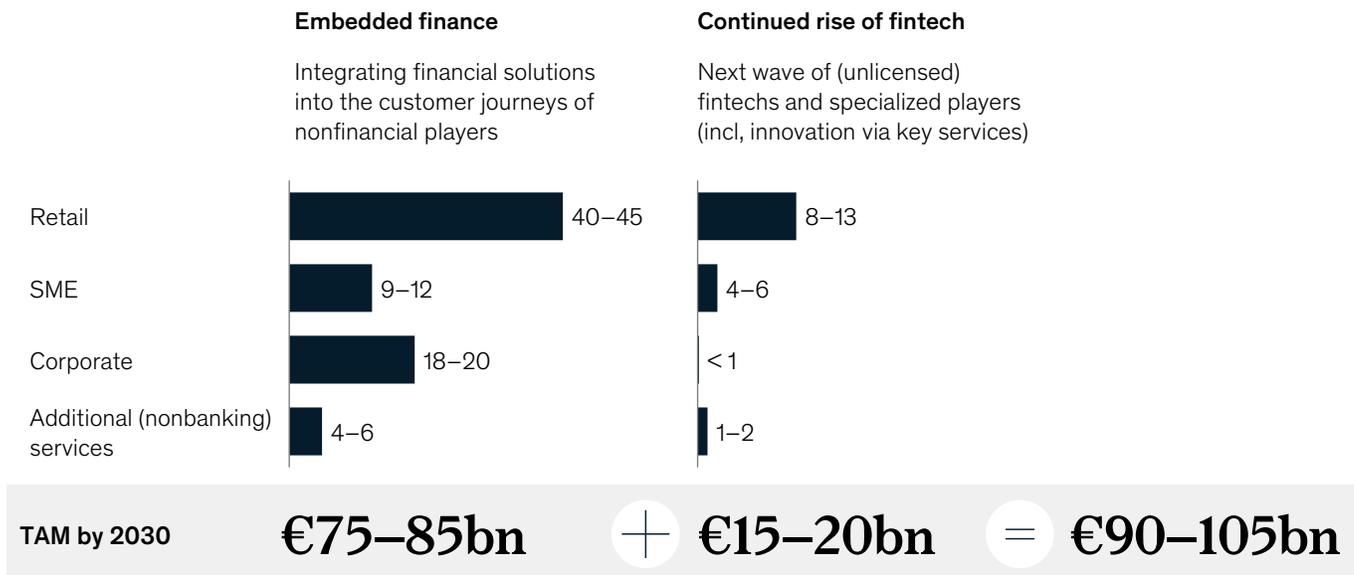
followed by embedded current accounts. The growth of the SME market to between €9 billion and 12 billion is most significantly driven by financing or lending products, such as leasing solutions and salary advancements. Daily banking products are the second largest contributor comprising use cases like giving merchants the option to use their deposit accounts for instant payments, followed by specialized trade finance solutions. Similarly, the expected €18 billion to 20 billion corporate market by 2030 can be broken down into lending and payment solutions. Additional (nonbanking) services contribute €4 billion to 6 billion in revenues from digital assets, KYC, and Bancassurance.

Fintechs. The second theme with an expected TAM of around €15 billion to 20 billion by 2030 is the continued rise of (nonbanking-licensed) fintechs and specialized players that offer, among others, customer-segment-focused banking propositions, specialized SME offers, and innovation through key services (such as KYC). In general, it can be said that, while focusing their resources on shaping their client

Exhibit 1

BaaS TAM is driven by two core themes

€ billions



propositions rather than technological backbones, fintechs are expected to primarily rely on as-a-service solutions with a banking license to increase time to market and leverage efficiencies. Furthermore, retail use cases are expected to contribute the largest share, at €8 billion to 13 billion or around 60 percent of the TAM. Similar to embedded finance, financing or lending and daily banking solutions such as cards, payments, and accounts are key drivers of the market size. For fintechs, retail investment solutions are an additional focus area, generating revenues through use cases like brokerage or trading and advisory solutions for affluent clients (tailoring exclusive services to a segment of highly digitized customers) whose numbers are expected to increase over the next years. The SME revenue potential is expected to grow to €2 billion to 4 billion by 2030, with financing and lending solutions as a key driver. Importantly, corporate solutions do not play a significant role for fintechs due to their high complexity and demanding balance sheet requirements that are usually only provided via incumbent banks' individualized solutions. Additional (nonbanking) services can

contribute €1 billion to 2 billion, covering use cases such as digital asset brokerage and trading or KYC.

What is noticeable when embedded finance and fintechs are considered jointly is that retail and SME solutions are expected to have the largest BaaS adoption in both areas, where 7 to 10 percent of all future banking revenue in a respective segment is likely to be generated by the BaaS solution provider. Corporate banking will have the smallest adoption of 2 to 5 percent due to its high complexity, where many solutions are not "BaaS-able" at all.

Besides facilitating their access to the large revenue pools outlined above, for incumbent banks this business model becomes even more attractive by adding BaaS solutions to their portfolios. This can be expected to have a significant positive impact on the banks' customer acquisition costs, conversion rate, and loan-loss ratio. Given this and the fact that BaaS propositions are still in an early stage, players should use the opportunity to further invest in shaping and optimizing their offers and overall value propositions (see Text box 2).

Text box 2: Platform-as-a-Service as a natural extension of the BaaS opportunity

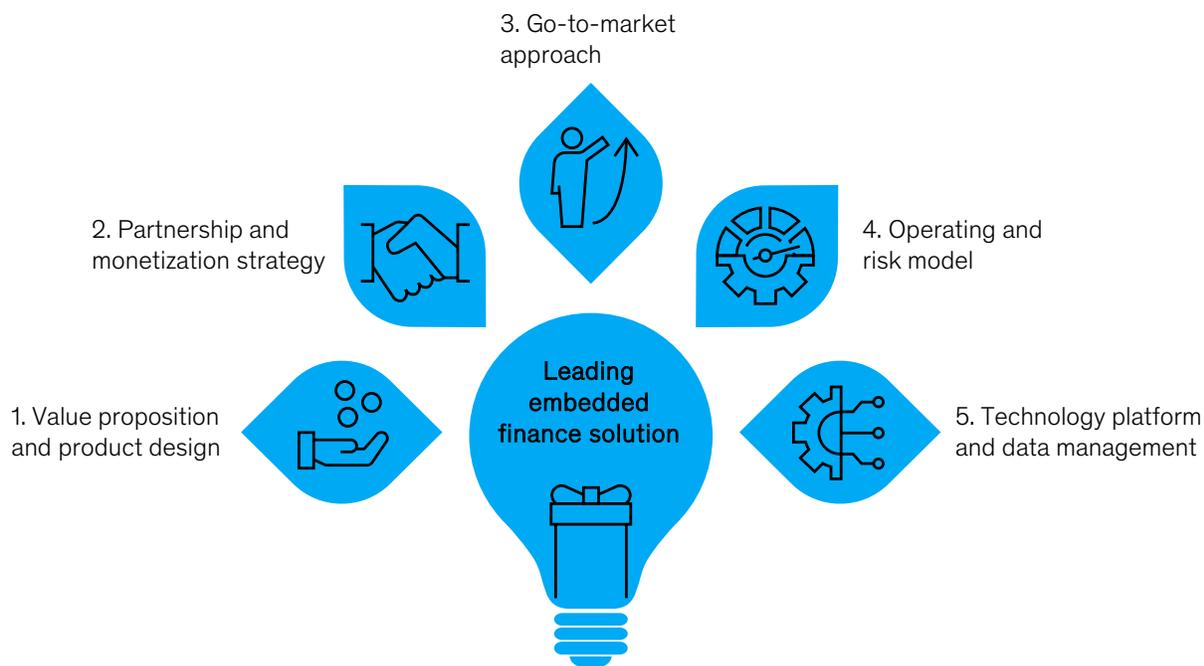
As a natural extension, the Platform-as-a-Service (PaaS) market reflects a second horizon toward capturing the full potential of BaaS. Here two additional themes are emerging due to the fact that in view of the upcoming IT modernization and the associated high costs, many smaller banks, in particular, are considering outsourcing their IT, in some cases together with operations. These new propositions offer incumbent banks opportunities to participate in and benefit from the expected strong growth of the PaaS business, either by partnering with or becoming a PaaS provider.

The first involves establishing a banking-in-a-box solution that provides core IT and banking solutions (with a TAM of €33 billion to 39 billion) to small and medium-sized banks and licensed fintechs. This gives small and medium-sized incumbent banks the opportunity to seamlessly modernize or replace their existing tech stack (including IT Ops and Business Process Outsourcing). For larger banks, the demand for PaaS solutions comes in the form of a technological enhancement or the replacement of selected banking domains (for example, payments or lending platforms or KYC)

with an as-a-service solution, with a TAM of approximately €22 billion to 26 billion.

While becoming a PaaS provider is a natural avenue for IT service providers and fintechs to expand their business model, it can also be an attractive opportunity for incumbent banks beyond the additional revenue streams. Transforming an incumbent bank into a PaaS provider with a tech-first proposition not only increases its attractiveness as an employer and fosters a more agile work environment but also generates significant cost advantages.

Five key components to address for a winning “as-a-service” proposition



As an entry ticket to this growth market, incumbent banks are required to have five components in place

Building, launching, and continuously refining successful as-a-service offers requires players—regardless of their current maturity level—to have five components in place (Exhibit 2). Since none of the components are dispensable, CXOs of incumbent banks can use the following overview of the components and key questions discussed or listed therein as both a checklist for what their organization needs to focus on and as a guideline for action:

- 1. Value proposition and product design.** The first component of a winning as-a-service product is a compelling value proposition, including a strategy for the product or features offered and a customization approach. Arriving at this strategy requires answers to central strategic questions, for example: How does the product and feature catalog look and how is it differentiated from competitors? How standardized do we want to

make the offer versus allowing large partners to customize the product? How can we achieve customer lock-in to prevent customers from abandoning the partnership or business relationship as soon as they reach scale?

- 2. Partnership and monetization strategy.** Identifying and scaling up partners is the next key component of becoming a winning as-a-service solution. The first place to look for partners is within a player’s existing relationship network. With prospective partners in mind, the action steps include defining the joint legal framework or aligning on the pricing strategy and billing logic. Key strategic questions to be discussed in this context are: How can we strike a balance between individual partner wishes and standardizable approaches to technology, contracts, and pricing? Do we want to differentiate on price (standard product and scales) or premium offer (tailored to the customer)? Who are attractive or suitable partners for scaling up and how can we win them over?

3. **Go-to-market strategy.** Players will need to decide whether the product is to hit the market under its own brand or an existing one. On the marketing side, a promotions strategy that is wholly aligned with existing products and offers is required as well as a clear vision of how to scale up the as-a-service business after its launch. Key questions in this context are: How do we scale up by activating the partners' customers? Which cross-selling opportunities can we leverage? How can we scale up across regions? How do we need to adjust our product offer to specific go-to-market verticals?
4. **Operating and risk model.** Players will need to build an operating model with clearly defined roles and responsibilities, processes (like onboarding), and service models to support end customers (for example, remote KYC and contact centers). In addition, a risk framework that covers all three strategic questions needs to be in place: How do we account for international complexity? How can risks be managed that are outside our sphere of influence? How do we collaborate with regulators?
5. **Technological platform and data management.** The final component is implementing a flexible and scalable platform that facilitates the delivery of standardized services and quick customization. To this end, players need to create streamlined data-exchange processes and a corresponding strategy that enables a fully embedded and secure delivery of the as-a-service offer. Critical questions to be discussed in this context are: What is the sourcing and partnership strategy (make versus buy)? Which existing platforms or structures can be leveraged? How can we ensure seamless data integration and transfers with a broad range of partners?

While we have previously argued that these five components are critical to success, it should not be concluded that BaaS is a good idea for all incumbent bank players that—even if only just—meet these requirements. Above all, incumbent bank players that do not have access to a flexible,

modern, scalable, multitenant tech stack, have traditionally been struggling with tech and talent issues, or are laggards on virtually all five dimensions should critically ask themselves and seriously consider whether they can muster the necessary resources and investment to build a winning as-a-service proposition greenfield.

How to jump-start incumbent banks on their BaaS journey

There is no one-size-fits-all approach for banks to participate in the growth market described in this report. Based on our experience, we have conducted an effective and proven three-step approach that banking organizations can implement to develop a BaaS strategy in line with their overall strategic aspiration and engage the management board to embark on this journey:

1. **Opportunity identification and validation.** This requires defining the initial playing field comprising potential solutions or products, partners, and opportunities via a thorough market analysis covering revenue and growth potential, competitor landscape, and the prioritization of focus areas.
2. **Feasibility assessment.** Players need to analyze the requirements to bring the opportunity to the market (including license and talent) and compare them with existing capabilities to derive implications for the current business model. Based on this thorough capability and asset assessment (technology, customers, etc.), incumbents need to develop a high-level roadmap on the buy or build potential (including resources and partner screening to deliver the solution).
3. **Mindset alignment.** Successful leaders need to ensure that all stakeholders in the journey adopt the right mindset and guiding principles to ensure competitiveness with the new wave of BaaS and PaaS players. This involves among others:
 - radically thinking from the customer's point of view to develop a product that smoothly integrates into your existing product portfolio

- designing truly embedded products with seamless customer journeys embracing the native capabilities of the bank.

To stay competitive, incumbent banks should consistently and resolutely evolve their business model and embrace new growth areas. Tapping into the massive potential of as-a-service propositions in banking is particularly suitable for this purpose

because doing so has never been as easy and promising as today. All pieces of the puzzle—like the shift in consumer behavior toward embedded finance, API-enabled solutions, and access to massive data pools—have fallen into place and BaaS applications are ready to expand. Jumping in timeously provides the benefit of producing early results and helping your company make quick progress on its journey to becoming an organization that embraces the full potential of integrated and truly embedded products. What are you waiting for?

Sarina Deuble is an engagement manager in McKinsey's Frankfurt office, **Max Flötotto** is a senior partner in the Munich office, **Matthias Lange** is a partner in the Berlin office, **Timo Mauerhoefer** is an associate partner in the Frankfurt office, **Albion Murati** is a partner in the Stockholm office, **Diana Pritscher** is an associate partner in the Munich office, and **Constantin Stürner** is an engagement manager in the Berlin office.

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