

# THE RISE OF BANKING AS A SERVICE

New opportunities and growing  
urgency for financial institutions

  
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Back in 1950, each Formula 1 team was a car manufacturer that made the car engines itself. The Alfa Romeo team car had an Alfa Romeo engine and so on. In 2021, F1 is far more open to partnerships and third parties. Ferrari's cars use its own engines — but Alfa Romeo cars also use Ferrari engines. Honda simply supplies engines to teams such as Red Bull.

We think that financial services are going through a similar change, with the rise of banking-as-a-service, or BaaS. This is a great opportunity for existing banks, insurers, and wealth managers, which could find more customers by teaming up with non-financial businesses. But if they do not react in a rapid, strategic manner, BaaS could also pose a threat, as it opens up the financial services market to new challengers. Incumbent banks and other financial institutions need to make strategic decisions about how to enter this growing business — what products to offer and which partners to work with.

## **THE RISE OF BAAS**

Banking as a service is enabled by the seamless integration of financial services and products into other kinds of customer activities, typically on non-financial digital platforms. Consumers increasingly use these platforms to access services such as e-commerce, travel, retail, health, and telcom. The financial service could be someone taking out a small loan when they pay for a holiday on a travel site; the instant calculation and sale of micro-insurance for newly purchased jewelry; or a small enterprise mitigating its cashflow challenges through an instant working capital loan from an e-commerce site.

A non-financial business can thus distribute financial products under its own brand, so that the customer experience is of buying a product from that brand — but the financial product is actually provided by a financial institution. A financial institution that wants to offer BaaS via a distributor can set up a platform for this purpose based on the latest low-cost, cloud-native, scalable technology, which will reduce its cost to serve customers.

## **THE BENEFITS OF BAAS**

For a financial institution, BaaS is an opportunity to reach a greater number of customers at a lower cost. The traditional banking model is based on expensive legacy technology and operations. The cost of acquiring a customer is typically in the range of \$100 to \$200, according to Oliver Wyman analysis. With a new, greenfield BaaS technology stack, the cost can range between \$5 and \$35.

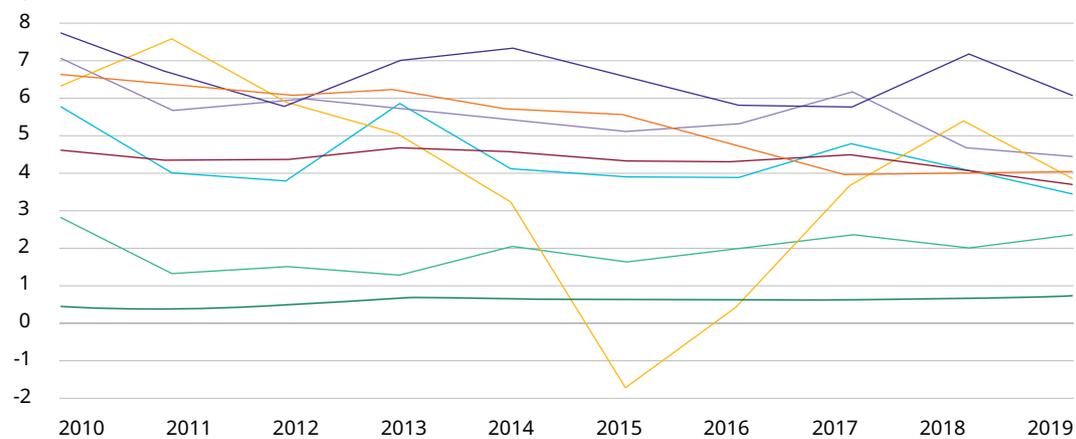
For the distributor, offering financial products opens up new revenue lines at attractive margins and can deepen its relationships with customers, both retail and SME and can then capitalize on cross-selling opportunities. One global e-commerce platform generates 57 percent of its revenue from financial services provided to customers under its platform brand but fulfilled by a variety of financial institutions.

## THE THREAT TO INCUMBENT FINANCIAL INSTITUTIONS

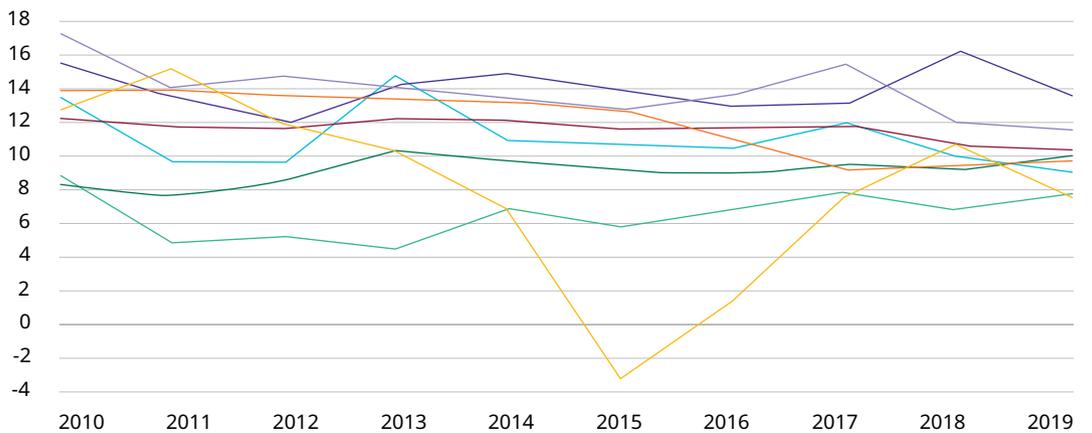
This opportunity comes as financial services incumbents struggle with low performance. Together, banking and insurance have been generating lower returns on assets than other industries over the past decade: just 0.8 percent in 2019, compared to 5.7 percent for communication services. One reason is that incumbent financial institutions are not using their technological assets as efficiently as they could and find it difficult to reduce the cost of technology (See Exhibit 1).

**Exhibit 1: Return on Assets (ROA) and Return of Equity (ROE) by industry**

**Return on Assets (ROA) by Industry**  
%, 2010 — 2019



**Return on Equity (ROE) by Industry**  
%, 2010 — 2019



- Communication Services (Media, Entertainment and Telecom services)
- Energy (Oil, Gas and Consumable fuels)
- Utilities (Electricity, Gas, Water etc.)
- Consumer Discretionary (Automobiles, Apparel, Hotels etc.)
- Financials (Banking and Insurance)
- Technology (Software, Hardware, Semiconductors)
- Consumer Staples (Food/Beverage, Household products)
- Health Care (Healthcare services, Pharmaceuticals)

N = 35,847, includes all public companies with over USD 10MN total assets at the end of FY 2019. Industry mapping based on North American Industry Classification System (NAICS)

Source: S&P Capital IQ

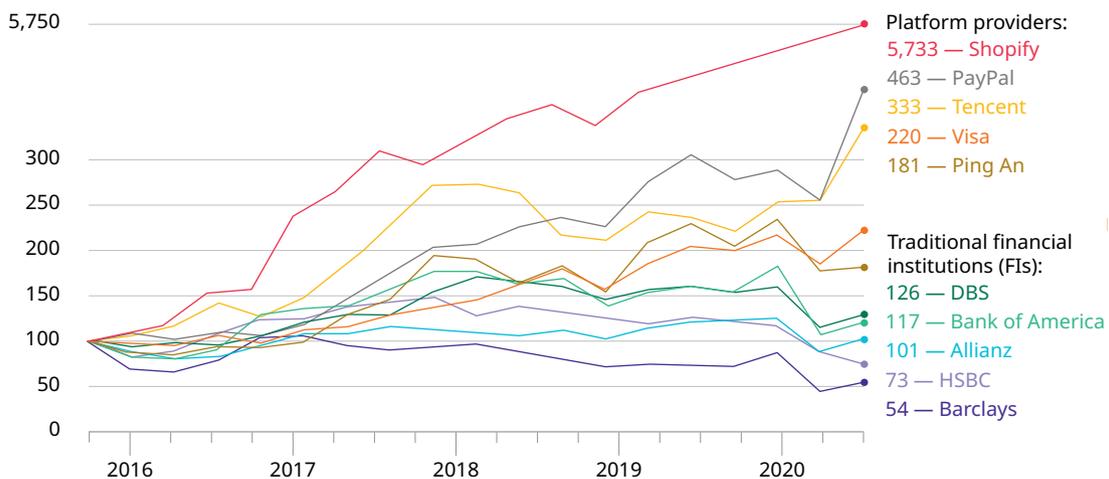
Many non-financial services industries have digitized their business models and distribution channels to serve customers at a very low cost. They can easily embed financial products as part of their digital platforms e.g. taking out a loan when you are checking out of an e-commerce store. If incumbent financial institutions do not offer financial services in this new way, they could lose business to rivals who are opting to move into a BaaS model to further distribute their products and capitalize on these large existing pools of customers using digital platforms such as online retailers, healthcare and telcom providers.

Moreover, a wave of digital challenger banks are now running at a fraction of the cost of incumbents. Some technology companies have obtained banking licenses, enabling them to offer their BaaS platforms to distributors that want to provide financial products to their customers. The leaders in this model come from China, where one leading digital bank has an annual cost per customer of just \$0.6 — compared with a typical cost of more than \$20 for an incumbent bank. These giant tech firms are now offering their advanced, low-cost technology platforms as a service to distributors to provide financial products outside China as well.

Costs are also being reduced by the rise of business-to-business fintech providers, which provide modular financial services to digital challenger banks and nonbanks alike. One leading provider of identity verification technology can process electronic know-your-customer (KYC) applications at a fraction of the cost to most in-house solutions.

Together, these moves threaten to leave incumbents with just a few competitive advantages: the regulatory license, the handling of cash through branches, and a recognized, trusted finance brand. The new competitive challenges to financial institutions are illustrated by market capitalization trends over the past half-decade, which show platform providers significantly outgrowing incumbent financial institutions (See Exhibit 2).

**Exhibit 2: Market capitalization of selected traditional financial institutions versus platform providers, indexed at 100 in Q4 2015 — Q2 2020**



Source: Oliver Wyman Analysis

To fight back, some incumbent financial institutions are spending billions of dollars to digitize their existing business models. But it might be more effective for them to start up new models — that is, BaaS — by embedding their products in other platforms. This implies building BaaS platforms from scratch, unless they can upgrade their existing technology to achieve similar, attractive unit economics. Some incumbent institutions have already launched their own BaaS platforms and signed partnerships with tech firms to provide financial services, such as lines of credit for customers buying certain goods.

## THE SIZE OF THE OPPORTUNITY

Financial institutions and distributors could achieve major revenue growth by launching BaaS business models and sharing the fees, according to Oliver Wyman research. In one study we sponsored in the Asia-Pacific region in late 2020, we examined the BaaS opportunities in selected markets for a range of financial products: retail lending — such as virtual credit cards and buy-now-pay-later services; SME lending — for example working capital loans and trade finance; deposit services — such as current and multi-currency accounts; wealth management services; and insurance products. We generated viable business scenarios with potential distributors including e-commerce platforms, retailers, conglomerates, lifestyle services, and healthcare providers.

Each customer that buys a financial product on the digital platform has the potential to generate between \$100 and \$250 of financial services revenue, we calculated. If between 4 and 5 percent of the digital platform's customers buy a financial product through it (a conservative estimate), the arrangement would generate between \$5 million and \$13 million in revenue for every million customers. Under an 80-20 revenue sharing agreement, the financial institution would gain \$4 million to \$10 million in revenue and the distributor (digital platform) \$1 million to \$3 million.

Take one established, medium-large global bank with between \$300 billion and \$400 billion in assets in Asia.<sup>1</sup> If it entered a fee-sharing arrangement with five major non-financial partners or distributors, with around 50 million active customers between them, we estimate the bank could gain \$200 million to \$500 million of BaaS revenues over three to five years. That would increase its Asian revenues by between 2 and 5 percent.

## NEW RISKS

New partnerships can mean new risks, and financial institutions will need to manage these carefully. A partnership governance model will be essential to define clearly the roles and responsibilities of the financial institution and the distributor. The model should include clear agreement on revenue split, well-laid out processes, and performance monitoring.

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<sup>1</sup> Excluding Hong Kong and Japan; based on latest reported financial statements available at time of publication (FY 2019).

Compliance controls will be needed to prepare the distributor to run a financial services offering that complies with regulations. The financial institution will have to ensure the compliance of all operations, communications, products, and marketing, so as not to put its license at risk or run into regulatory problems.

The financial institution will also have to make a detailed risk assessment for each BaaS offering and partnership. It will need to follow this up with clear risk-management governance in a way agreed with the distributor.

## **STRATEGIC DECISIONS FOR FINANCIAL INSTITUTIONS**

We think it is crucial for each financial institution to start making decisions over BaaS. First comes overall strategy. Will it in future be a distributor of financial products, a producer of them, or both? Is it willing to give up its customer-facing relationships and allow distributors to put their brands on financial products it provides, licenses, and services? What will be the differentiated proposition to distributors and end-customers? If it chooses not to enter BaaS, how will it protect its existing business model and revenue lines from the threats of competing BaaS offers?

Another consideration is future revenue lines from BaaS. Will these just be financial products? Or will they include additional subscription services, such as identity, credit decisioning, and cash handling using a branch network? And can the financial institution generate revenue by leveraging the more granular customer data it can gain through a BaaS offering?

Thirdly, where will the institution first launch BaaS, and which markets will generate the most opportunity? Which industries and types of distributor should it target? How should it set up its operating model to service multiple distributors with varying service levels, cultures, and customer types? How will the new models co-exist with the financial institution's existing operations?

A fourth set of decisions will be over technology: Should the institution use its legacy technology stack or build a new greenfield BaaS platform? Should it move customers over time to the new greenfield BaaS platform? Would it be better to build a customized platform or use plug-in third-party components and software — in which case, how will it manage the accompanying third-party risk?

## **BAAS FOR THE FUTURE**

We believe that BaaS will bring together digital technology platforms and finance to change the shape of economies and most sectors for years to come. BaaS is a clear opportunity for financial institutions to capture new revenue growth at a low cost. Also, a BaaS business is scalable and agile, making it particularly suitable for entering new markets and then expanding. For distributors, it is an opportunity to open new revenue lines at attractive margins and gain a much deeper understanding of consumer behavior through financial data.

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