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Financial Services Practice

Embedded finance: How banks and customer platforms are converging

Europe’s embedded-finance market is growing at double-digit rates. It is becoming increasingly important for banks, merchants, and other customer platforms to participate.

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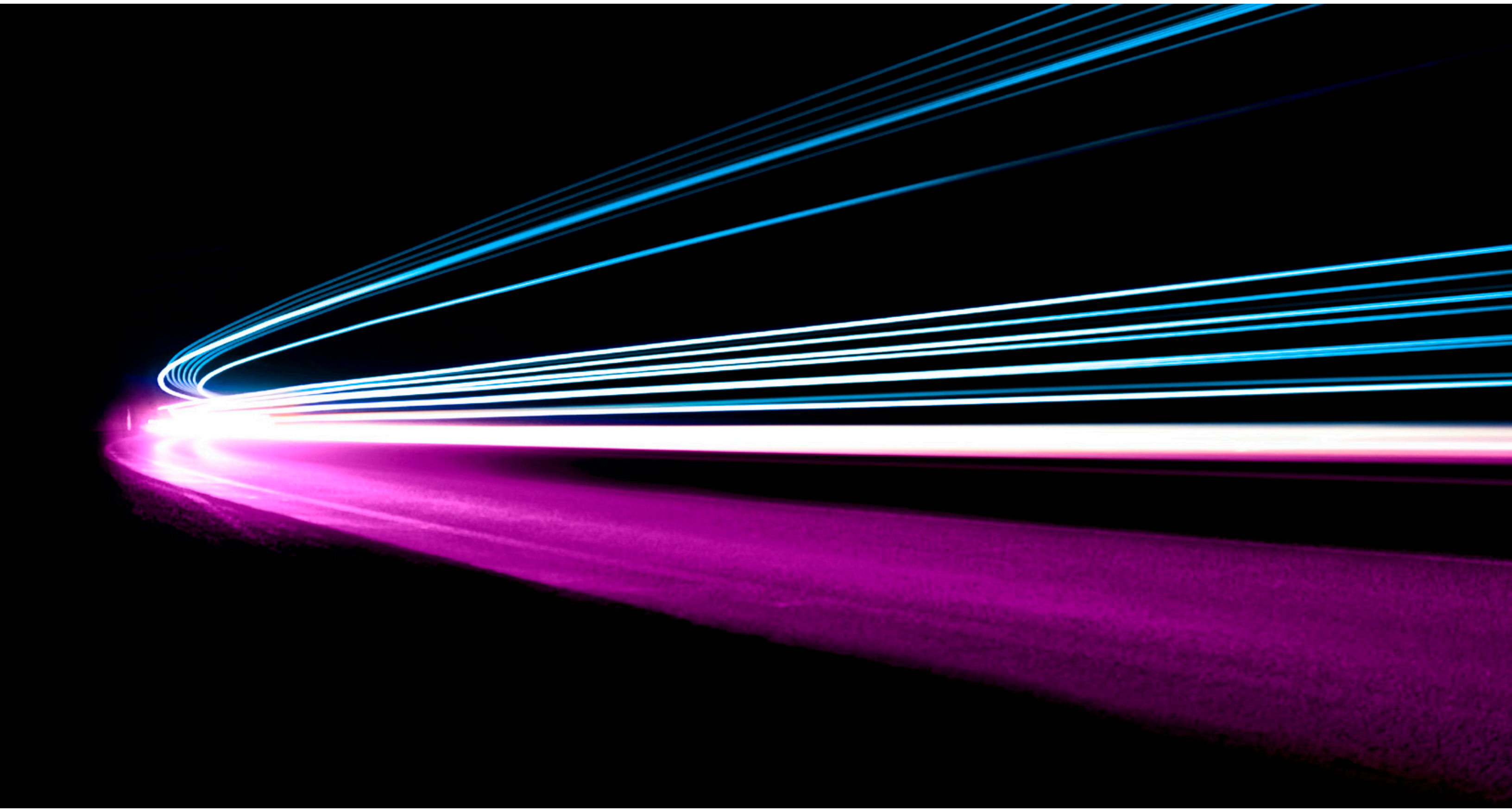

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Revenues from embedded finance (EF)—the delivery of financial products by nonfinancial entities within their broader offerings—could surpass €100 billion in Europe by the end of the decade, according to McKinsey forecasts. The distribution of financial products and services, such as loans and insurance, in third-party channels is gaining importance as technology and data allow for instant and seamless customer journeys, and customers increasingly expect to find financial services when and where they need them, such as during a large purchase.

In many sectors, customers have come to expect merchants and other consumer and small and medium-size enterprise (SME) platforms to provide EF products and services. Meantime, banks are starting to see the importance of EF as a distribution channel. This article describes how the EF industry is developing and how customer platforms can respond to the demand and win market share.

How the EF industry is growing

The EF market generated an estimated €20 billion to €30 billion in Europe in 2023, about 3 percent of total banking revenues.[1] Over the last ten years in Europe, embedded-finance volumes grew three times as fast as directly distributed loans. In 2023 and 2024, we interviewed a range of business leaders in the EF value chain. They expect consumer credit volumes to continue migrating toward embedded lending. For SMEs, leaders expect factoring and other straightforward types of financing to become embedded as enterprise resource planning vendors and SME-supplier marketplaces provide them at the point of need.

Combining the addressable-market forecasts with experts' growth predictions allowed us to estimate future EF revenues. EF channels might initiate 20 to 25 percent of retail banking sales to individuals and SMEs and account for 20 to 25 percent of retail and SME lending, up from 5 to 10 percent today (exhibit). By 2030, the EF market could surpass €100 billion and account for 10 to 15 percent of banking revenue pools.

The drivers of growth

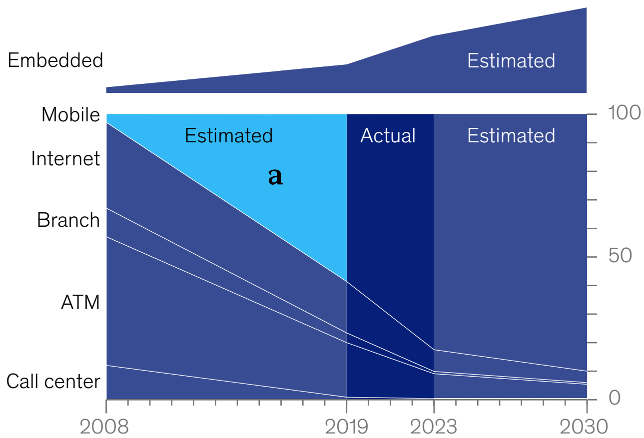
On the demand side, customers increasingly expect convenience and seamlessness in their customer journeys. A 2023 McKinsey survey of auto finance found that 40 percent of consumers already prefer online channels for financing a car purchase.[2] They want instant access to affordable financial services such as loans and insurance, when and where needed, with the fewest possible clicks. Further opportunities for finance offerings at the point of sale arise from the consumer trend away from purchasing and toward subscription and leasing models. In an unpublished June 2021 McKinsey survey of six European markets, consumers said they expect to use more integrated financing solutions in most retail categories. SMEs have similar expectations for integrated financing. Proprietary research conducted by McKinsey in 2021 in the B2B point-of-sale market found that buyers would purchase four times as much directly from suppliers' websites if the option were available.

[1] McKinsey banking data and analysis; to estimate the size of the addressable EF market as far as 2030, McKinsey has developed a market-sizing model that encompasses 23 countries, six industry verticals, and 25 financial services products in three core customer segments.
[2] "Online sales and subscriptions will shape tomorrow's car financing journey," McKinsey, March 24, 2023.

Exhibit

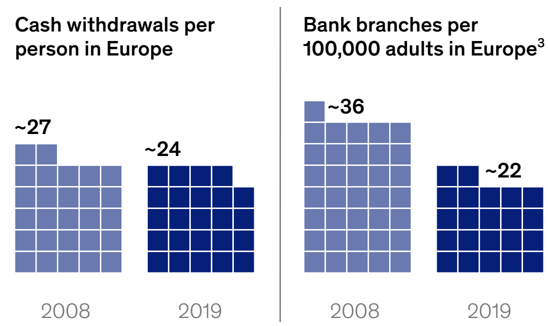
In 15 years, mobile has become the dominant retail banking channel; mobile and embedded will continue taking share.

Retail customer interactions by channel,[1] %

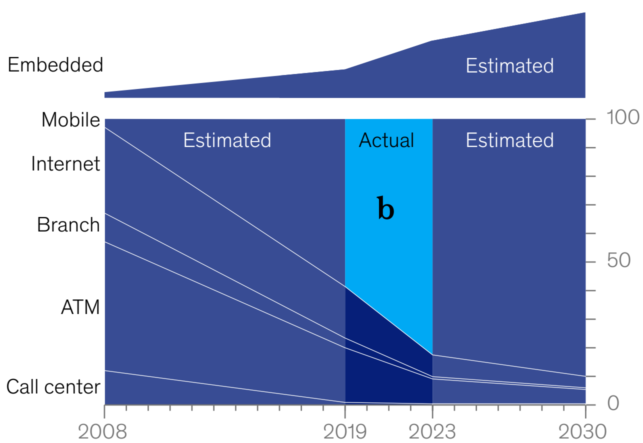


a The internet bank channel was launched by some banks in the 1980s but did not gain traction until the mid-2000s, when internet usage became widespread.[2] According to McKinsey anaysis, by 2008, the internet channel penetration was between 30 percent and 40 percent in most EU markets—for instance, 38 percent in Germany and the United Kingdom. The mobile bank channel took off around 2008 with the widespread adoption of smartphones.

From 2008 to 2019, cash withdrawals per person in Europe decreased from 27 per year to 24, and the number of branches per capita fell 40 percent.



Retail customer interactions by channel,[1] %



b Between 2019 and 2023, the mobile channel became more dominant, buoyed by pandemic-related physical distancing. Use of all other channels decreased as a share of interactions and in absolute numbers.

Interactions per customer, by channel, 2019–23, annual count

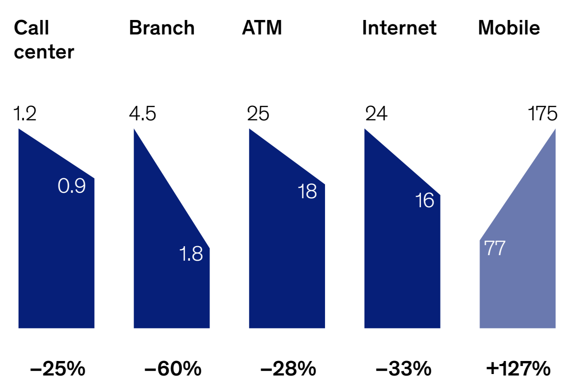
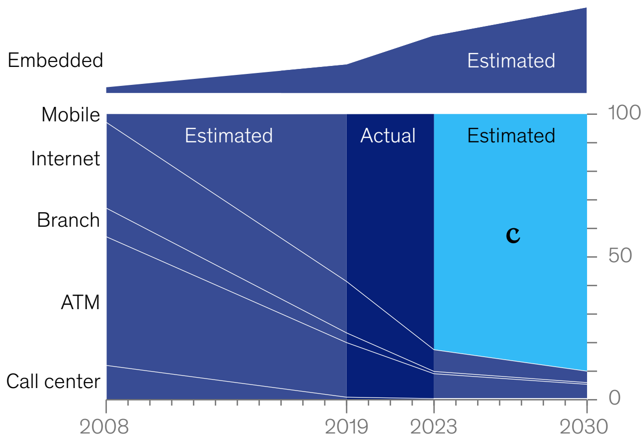


Exhibit (continued)

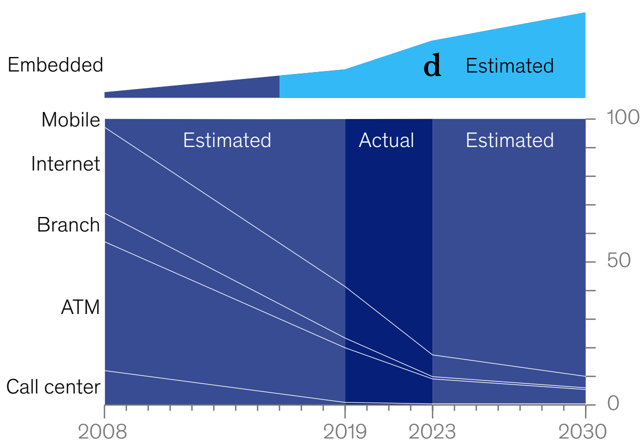
In 15 years, mobile has become the dominant retail banking channel; mobile and embedded will continue taking share.

Retail customer interactions by channel,[1] %



c As banks add functionality and remote advisory through the mobile bank between now and 2030, mobile is likely to continue gaining share at the expense of all other bank-captive channels.

Retail customer interactions by channel,[1] %



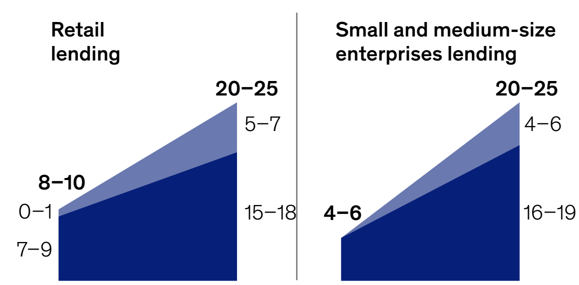
d Over a 7-year span, from 2016 to 2023, the “buy now, pay later” (BNPL) share of e-commerce sales in seven European markets surged from 2 to 10 percent. This growth was mirrored by e-commerce’s increasing share of retail sales, further solidifying BNPL’s rise in the total payments mix for retail sales.

In the Nordic countries, loan volumes from point-of-sale financing, including BNPL, grew by 8 to 10 percent per year from 2016 to 2022, while loan volumes for other retail lending products grew at 4 to 5 percent per year.

While in Europe, the embedded-finance channel accounted for 5 to 6 percent of lending revenues from retail and small and medium-size enterprises in 2023 and could reach 20 to 25 percent by 2030.[4]

Forecast embedded lending, 2023–30,
% of banking revenues from lending

Unlicensed fintech channel[5] Enterprise channel[6]



[1]McKinsey analysis across 115 banks in 15 European countries. Number of interactions defined as the sum of computer and mobile log-ons, branch transactions, ATM transactions, and inbound calls. [2]Evan Sparks, “Nine young bankers who changed America; Thomas Sudman,” *ABA Banking Journal*, June 26, 2017; “Access and income no longer barriers to online banking–Gartner,” Finextra Research, June 15, 2009. [3]World Bank data. [4]Worldpay payment processing data for France, Germany, Italy, Netherlands, Norway, Sweden, and UK. [5]Lending offered through unlicensed fintech companies, where a partner bank to the fintech company stands for the balance sheet and regulatory license for the loan product. [6]Lending offered in a nonfinancial customer experience, journey, or platform—for example, lending distributed via retail merchants or via enterprise resource planning systems.
Source: McKinsey Nordic banking model; McKinsey analysis

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For merchants, embedded finance increases sales through higher conversions, increased basket sizes, and enhanced customer lifetime value. According to an RBC Capital Markets research report, buy now, pay later solutions contribute to a 20 to 30 percent increase in checkout conversion and even greater improvements in basket size.[3] One global large-ticket retailer has identified the provision of financial services as a priority in the coming years because doing so is a critical sales enabler and competitive advantage. Customers using this retailer's embedded lending solutions in physical and online channels spend 20 percent more than other customers per visit. However, solutions must be convenient. While this retailer saw just 5 percent cart abandonment for one embedded lending solution, that figure rose to 30 percent for a similar service that was harder to use—worse than not having a lending solution at all.

On the supply side, the cost of offering embedded finance has been significantly reduced in recent years because of technological advances such as in applications programming interfaces, which make it easier for systems to interoperate, and better and more widely adopted electronic identification schemes. Underwriting decisioning for lending can now be automated at nearly zero marginal cost through instant connections to public data sources such as tax records and private sources such as account transactions and balances. Forthcoming regulatory developments, such as the proposed financial data access (FIDA) framework and the third European Payment Services Directive, will further facilitate embedded finance. For example, the FIDA proposal would cover mortgages and loans, pensions, savings and non–life insurance products, and data that could underlie a creditworthiness assessment.

For financial services providers, embedded finance will become an increasingly important means of customer acquisition in some areas. In one major European market, we found that the acquisition cost of a qualified SME lending lead is 15 to 20 times higher than an EF lead.

Bringing customers, customer platforms, and EF providers together can also help solve societal problems. Inbank, an Estonian fintech, has built a partner portal on which hundreds of solar panel installers can offer financing to their customers. Installers can configure the loan using a few customer data points and receive an automatic loan decision. Customers can sign the loan digitally, and the vendor can download the contract as well as payment and sales reports.

Many EF value chains are immature, with imbalances in how the benefits are shared among the participants, and some of their solutions, such as "0 percent interest, pay later," have become unsustainable with increased funding costs. The providers of the financial products and services in the value chain are increasingly focused on solving these tensions.

Two ways embedded finance is delivered to customers

Companies deliver EF solutions to the market by using one of two archetypes: a partnership that brings together a customer platform with a financial services provider or a system built and owned by a merchant.

Partnership archetype: Customer owner and financial services provider

Customer platforms and merchants that do not want the investment and commitment of building their own EF capability often partner with a provider. These partnerships range from plain-vanilla point-of-sale financing for electronics retailers to more specialized models. Amazon Germany offers preapproved and tailored loans to its SME sellers via a seller portal in partnership with ING. ING gets leads from Amazon through the seamless redirection of sellers and uses Amazon data on seller performance to make credit decisions and provide loans in a few clicks. Another example is eBay, which, in partnership with YouLend, offers sellers flexible funding that can be used for any business purpose and is typically repaid as a percentage of their sales.

[3] Dan Perlin, "Buy now, pay later: How an old idea got a new lease of life," RBC Capital Markets, November 9, 2021.

There are many specialists and fintechs in the provider space, and incumbent banks are waking up to the challenge. Many financial services providers are investing in embedded finance, for example, by digitizing and automating credit origination and modularizing their ability to integrate with third-party channels so they can do it quickly and inexpensively.

This approach lets the party that owns the customer focus on their core business, retain the flexibility to switch providers, and keep their brand separate from financial services. Common drawbacks are misaligned incentives, inequitable profit distribution, and a lack of harmonized and fully integrated offerings, which can hurt the customer owner's value proposition.

Merchant-alone archetype: Built and owned

If the customer owner is sizable and the EF offering significantly contributes to the core value proposition, the merchant may benefit from building and owning its EF capability. This archetype is common among auto OEMs. Volkswagen, for instance, offers loans though Volkswagen Credit. Since the company deeply understands the residual values of its cars, it can value its trade-ins more accurately than a third party, leading to better customer offers and margins. Customers also get the convenience of a financing offering at their point of need, online or at the dealership. As more customers buy online directly from the dealer, more OEMs may take ownership of financing, including leasing.

Several retail merchants have adopted this archetype. The UK-based online retailer Very evolved from a shopping catalogue business in 2009. It has offered its EF solution, Very Pay, to customers for more than a decade. The Polish online marketplace Allegro, which sells 70 million items a month, launched its fintech, Allegro Pay, in 2020.[4]

The build approach provides a foundation for shared incentives and strong alignment, including the flexibility to modify offerings in the light of transparent economics. It can also ensure the control and use of data—for example, for personalized campaigning and offerings. However, these advantages should be weighed against the risk of later deciding to switch to a third-party provider, which could require abandoning a significant investment.

We expect that both of these archetypes will endure through the decade. The first, we expect, will remain more prevalent where integration costs are low and the market is more fragmented—in fashion e-commerce, for example. The second will likely persist in some large vendors, at least in their core geographies.

Five practices for delivering lasting, value-positive EF solutions

Leading EF solutions have in common five features that companies can emulate to maximize the value of their EF initiatives for the partners and their customers:

1. *Distinctive customer journeys.* Several elements of the customer journey, such as instant decisioning and straight-through processing, are standard today. Leading vendors and platforms go beyond those. They use regular customer journey teardowns to understand customer conversion and pain points and constantly improve their solutions. They also measure customer responses to changes—for instance, with AB testing—to develop innovative customer journeys.

2. *Joint vision and delivery.* EF solutions are best supported by joint teams from the finance provider and the customer owner. Each party can take responsibility for its part of the journey, from pre- to postpurchase, with clear customer engagement rules and mutual ownership of customer satisfaction.

[4] "Serwis Allegro to nasz sposób na Wasze szybkie i wygodne zakupy przez Internet" ("Allegro is our way to make quick and convenient online purchases"), Allegro, September 26, 2015.

3. *Data sharing and collaboration.* When the parties share their data, the EF provider can make better decisions, such as when granting a loan, and the customer owner can improve conversion rates and marketing with postpurchase payments data.

4. *Win–win partnership economics.* An open-book, profit-sharing philosophy enables mutual value creation and leads to solutions that can evolve and endure.

5. *Enhanced unit economics.* EF partners can continuously improve their combined economics by, for instance, considering originate-to-distribute models that can lower their capital needs, and by leveraging data from the customer owner to reduce costs for data in credit decision-making.

With increasing customer pull and better delivery tools, EF likely will continue to grow and affect virtually every sector through the rest of the decade. By 2030, 10 to 15 percent of banks' revenues and 20 to 25 percent of retail and SME lending revenues may originate in EF, and total European EF revenues could reach €100 billion. Given this potential, companies and banks can gain from examining how they might deploy embedded finance.

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