ALLOY

2024

State of Embedded Finance

How sponsor banks are managing compliance in fintech partnerships

Introduction

In recent years, embedded finance has grown as a new business model. It addresses customer needs by offering traditional banking products and services through financial technology (fintech) and non-financial platforms.

Research indicates a growing customer appetite for financial products from the non-financial brands they regularly interact with. However, evolving regulations and a surge in consent orders have highlighted a critical oversight in the embedded finance ecosystem: Many banks are failing to ensure their fintech partners are implementing strong risk and compliance measures, particularly in customer onboarding.

To better understand the impact that embedded finance partnerships and regulations are having on sponsor banks, Alloy surveyed 51 professionals at banks that partner with fintechs to deliver embedded finance products in the United States.

This report examines embedded finance opportunities, partnership models, and associated regulatory challenges.

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Important terms and definitions

Embedded finance

The integration of a financial product or service into a fintech or non-financial company's offerings.

Sponsor bank

A bank that partners with a fintech or non-financial company so they can provide financial products or services to their customers.

Fintech

Businesses that leverage technological innovation to extend financial products or services. These may be financial or non-financial brands.

Banking-as-a-Service (BaaS)

A business model where banks or bank intermediaries partner with fintechs and non-financial companies to make financial products and services available to consumers and businesses.

→ Learn more

About the survey

About the survey

Methodology

Alloy surveyed 51 professionals at banks that partner with fintechs to deliver embedded finance products or services in the United States.

The data includes responses from small, medium, and large organizations.

Fielded: 5/30/24 - 6/5/24

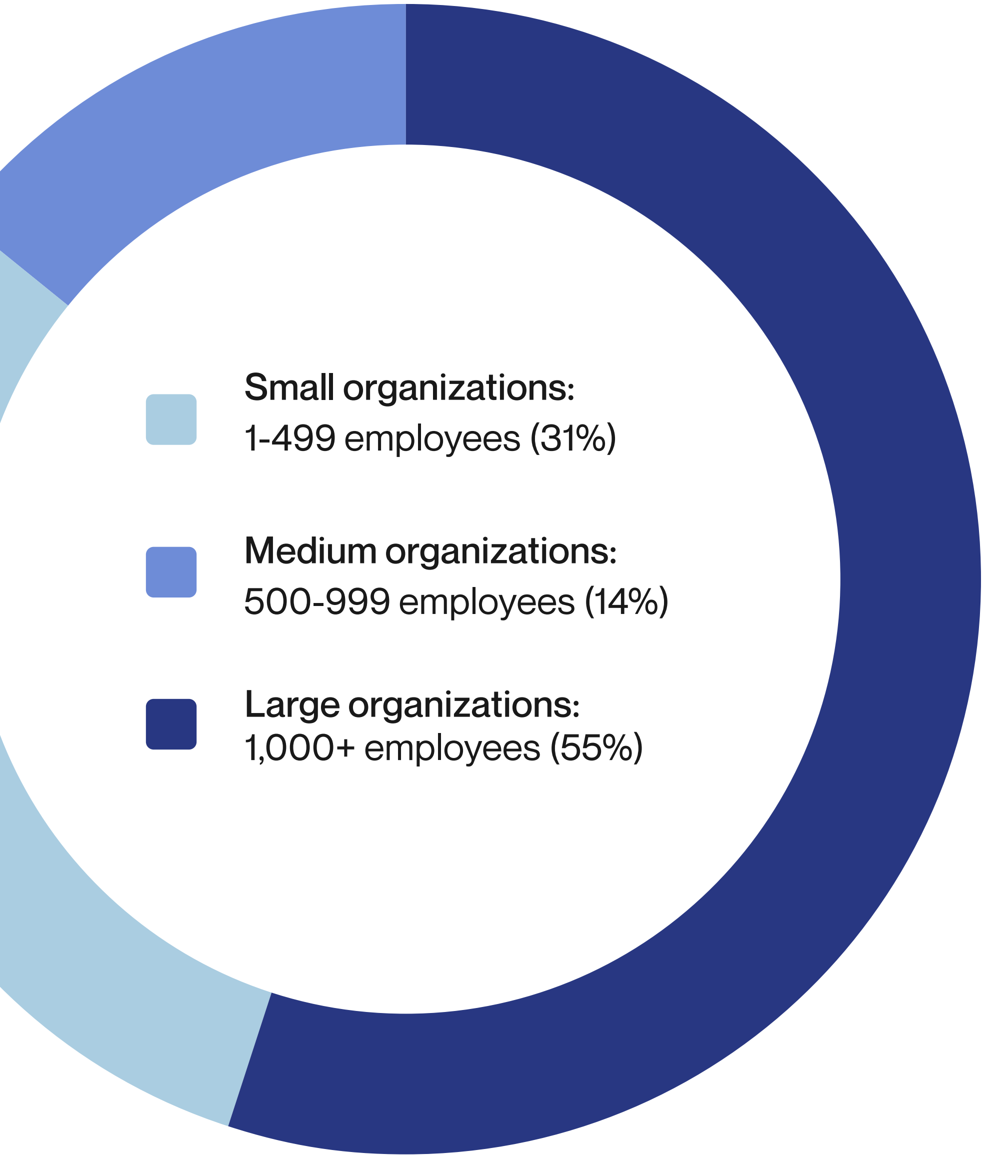
Sample size: N=51

Respondent requirements

- Employed by a bank with a sponsor bank program, at least one fintech in its embedded finance portfolio, and at least $2 billion in assets under management (AUM)
- 18 years or older
- Holds a director role or higher
- Lives in the US

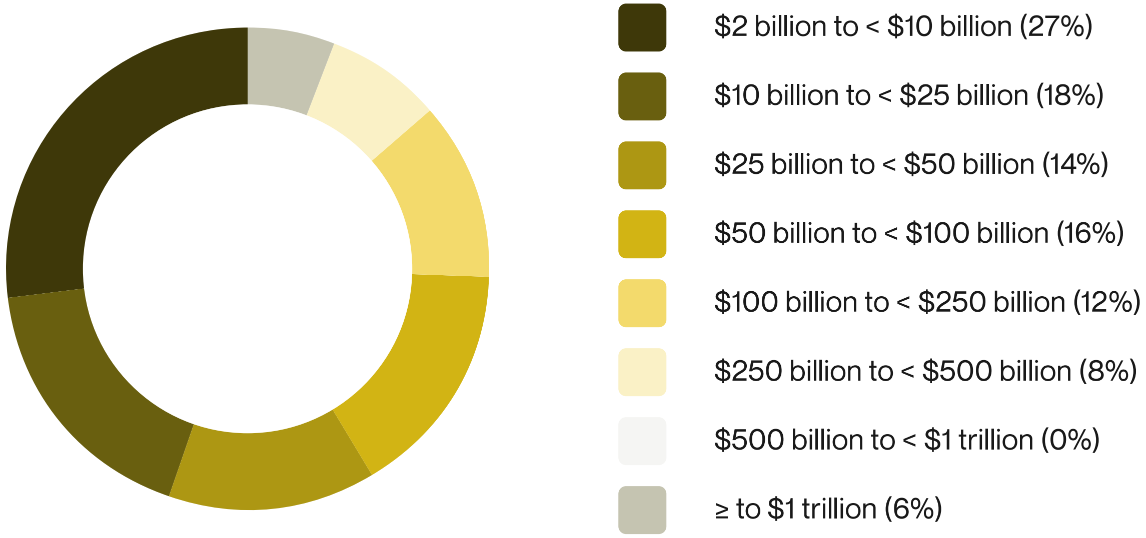
The survey was conducted by The Harris Poll, a US-based research and analytics company in operation since 1963.

Banks surveyed



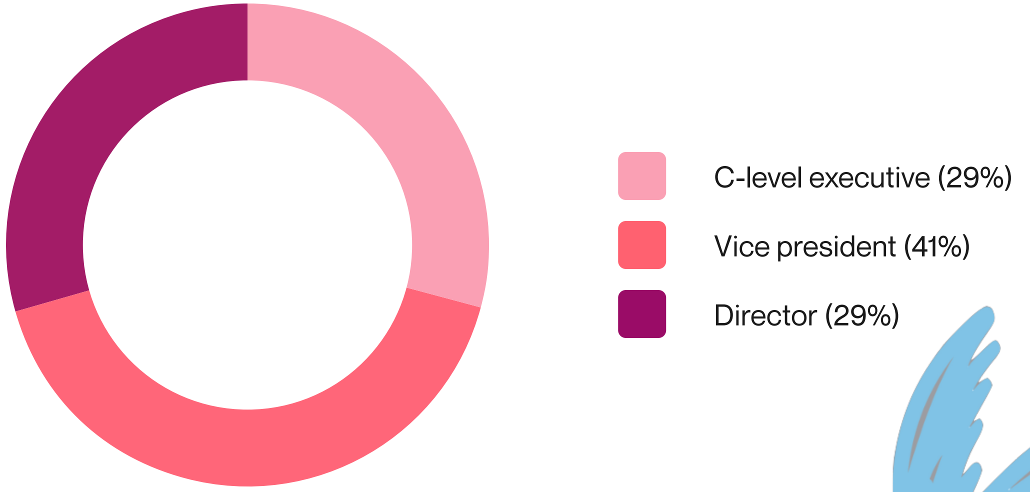
Assets under management (AUM)

While half of survey respondents worked for organizations with over 1K employees, nearly 60% worked for local and regional banks with under $50B in AUM.



Respondent job title

Respondents held a director-level position at minimum and were involved in embedded finance operations at the time of the survey.



Key findings

How are embedded finance programs impacting US sponsor banks in 2024?

94%

say that it is “very or somewhat important” for their organization to invest in new compliance technology and increase compliance training

80%

agree that meeting sponsor bank compliance requirements is challenging

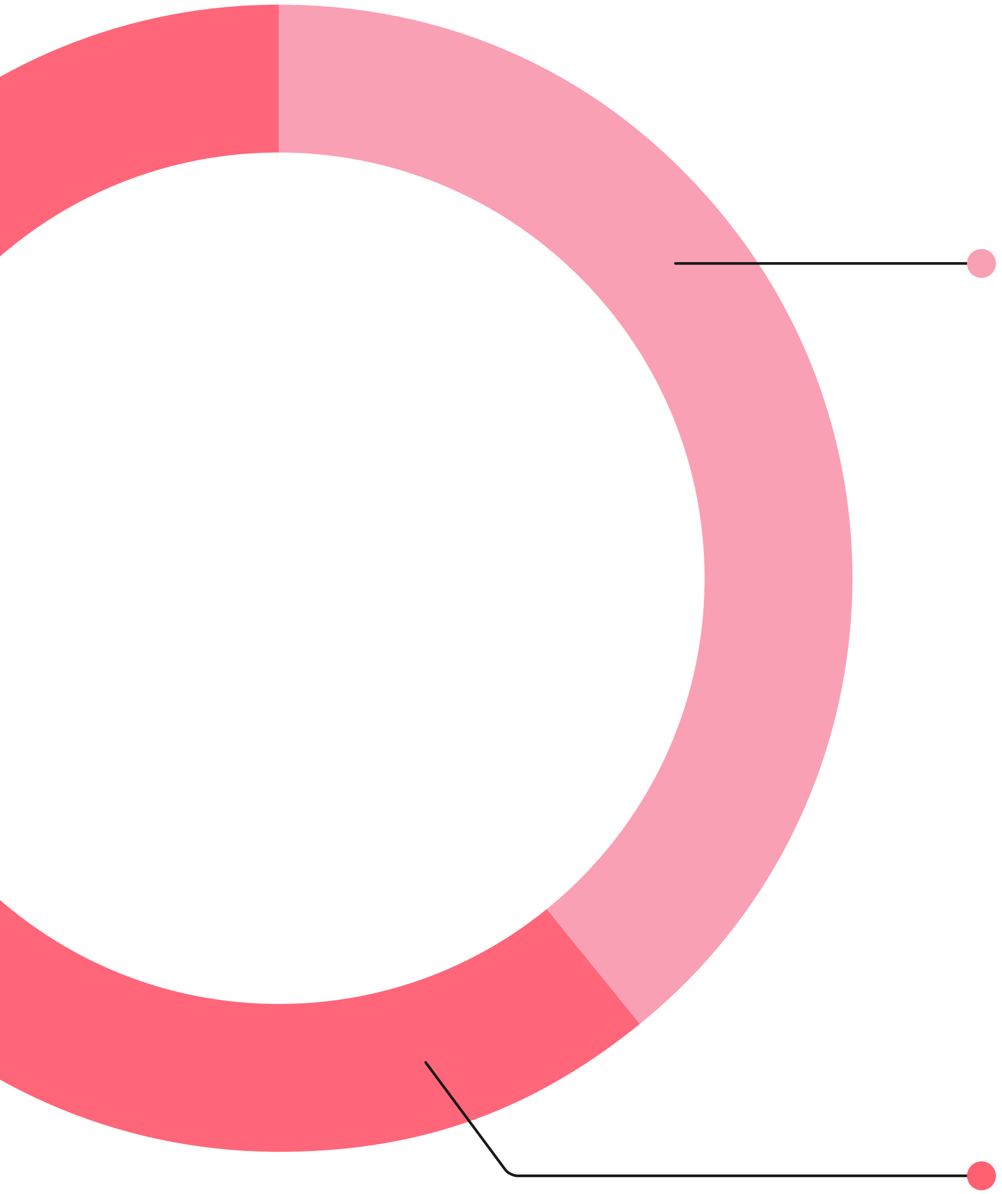
51%

of sponsor banks’ revenue and deposits, on average, are driven by embedded finance partnerships

39%

of sponsor banks lost at least $250K to compliance violations in their embedded finance partnerships

Current partnership structures



39%

contract with fintech partners **via** a BaaS platform

61%

contract **directly** with fintech partners

Banks are increasingly choosing to contract directly with fintech partners

Banks are shifting towards contracting directly with fintechs, moving away from the previously widely used model of contracting via a BaaS platform. While BaaS platforms are becoming less common at the contract layer, they are still prominently used as part of the tech layer.

Alloy insight

As API standardization facilitates integration access, we expect these direct banking relationships to become more common.

Alloy insight

Sponsor banks apply one of three compliance models to their fintech partnerships:

Low — Level of fintech autonomy — High

Compliance-as-a-service

Sponsor banks directly control their fintech partners' risk management processes, handling the frontline work of case management and compliance monitoring.

Middleware program managers

Middleware tech solutions work with fintech partners to implement embedded finance programs, owning their fintech partners' risk management.

Bank-as-regulator

Banks monitor their fintech partners' processes and end-customer volume and may allow fintechs to own design and operation of frontline risk management controls.

Source: Fintech Takes

92%

of sponsor banks believe that there is a need for more adaptable embedded finance partnerships between banks and fintechs

Alloy insight

Different compliance models offer unique advantages to sponsor banks. For instance, the compliance-as-a-service model is particularly beneficial for banks offering higher-risk products, provided they have the capacity to oversee their fintech partners' compliance processes.

The growing trend toward bank-direct relationships reflects an industry-wide desire for more flexible embedded finance partnerships. This shift is causing sponsor banks to increasingly opt for direct contracts with fintech partners. Flexibility allows sponsor banks and their fintech partners to optimize their joint success by managing the risk unique to each partnership instead of taking a one-size-fits-all approach.

As third-party risk management intermediaries continue to become less common, banks face a new challenge: They must develop alternative methods to oversee their fintech partners while still promoting autonomy.

This balance between supervision and independence will be crucial in shaping the future of bank-fintech partnerships.

Sponsor banks' top motivators for seeking embedded finance partnerships:

1. **41%** Innovation and acceleration
2. **39%** Customer acquisition
3. **37%** Cost reduction and efficiency
4. **35%** Greater customer experience and retention
5. **31%** Competitive pressure

Over half of sponsor banks' deposit income and revenue comes from embedded finance partnerships

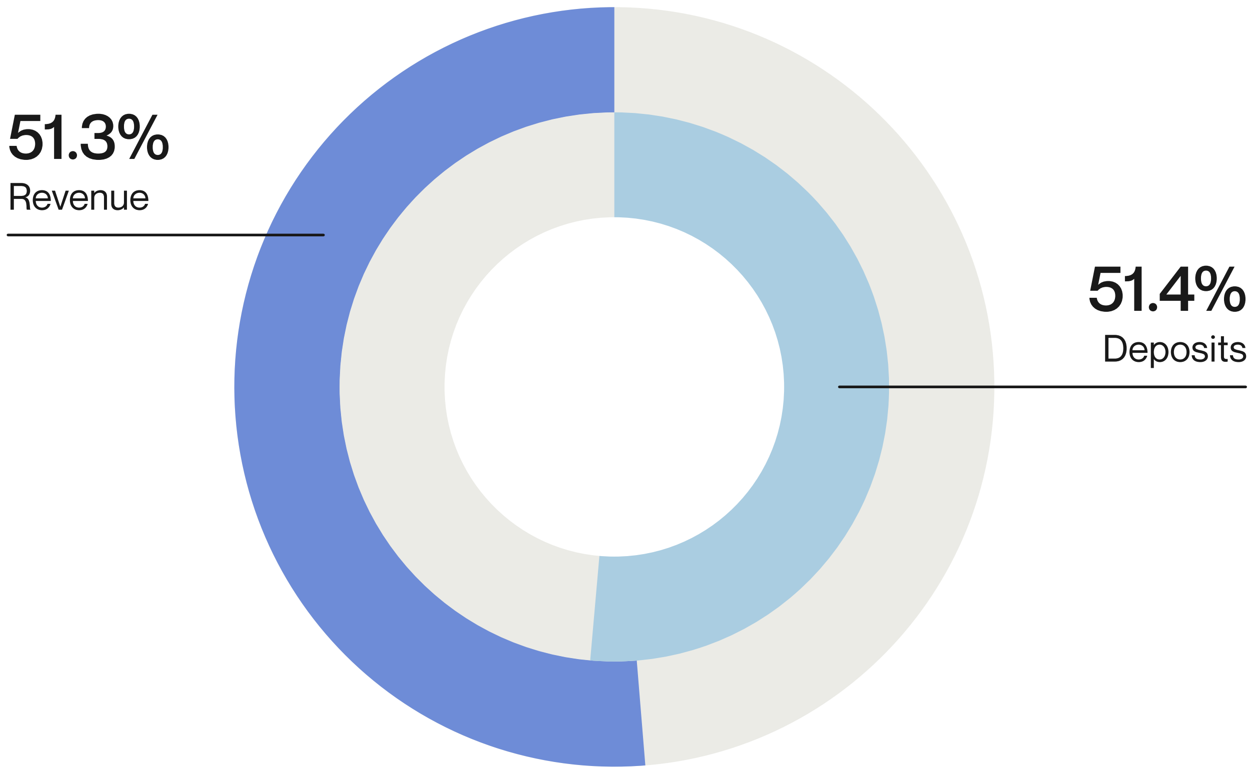
Alloy insight

Embedded finance partnerships offer sponsor banks an efficient way to increase deposits without direct customer acquisition costs. Their fintech partners effectively handle customer acquisition for them.

However, banks have multiple avenues for generating revenue from fintech partnerships — such as through fee-based partnership models — demonstrating their ability to craft multifaceted monetization strategies beyond traditional deposit growth.

This diversity in partnership strategy explains why deposit growth, despite its importance, isn't always a top priority (as evidenced on page 13).

Average percentage of deposits and revenue acquired by sponsor banks through embedded finance partnerships, compared to other means



9 in 10

sponsor banks say that embedded finance partnerships make up a significant portion of their revenue

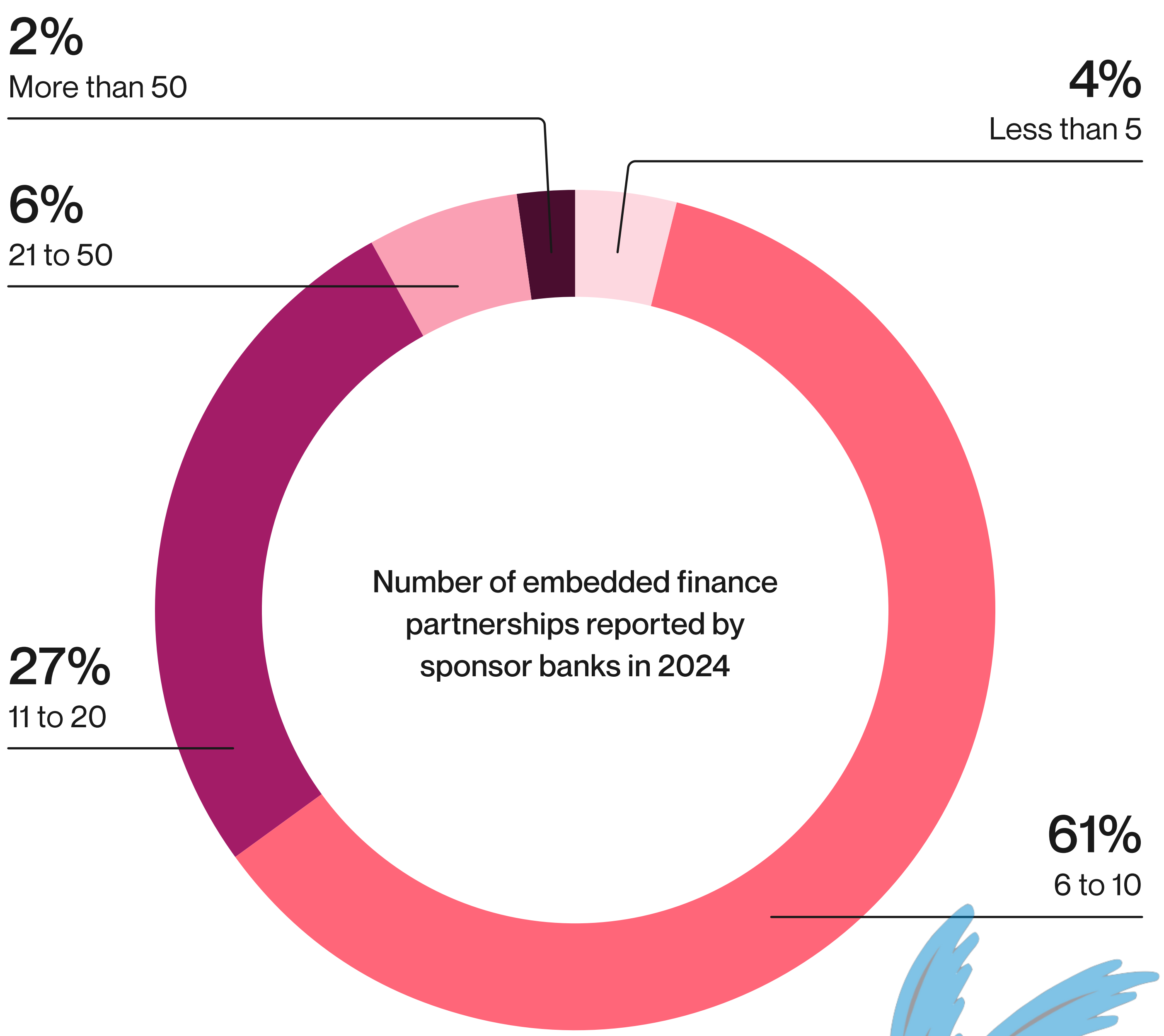
Most sponsor banks report 6 to 10 embedded finance partnerships

Alloy insight

With 96% of sponsor banks operating more than five embedded finance partnerships, banks may be diversifying their partnerships to spread risk and increase opportunities across different fintech sectors or customer segments.

This also suggests that sponsor banks need scalable processes and infrastructure to support their embedded finance initiatives across multiple partners.

The quantity of partnerships doesn't necessarily correlate to the percentage of a sponsor bank's revenue derived from embedded finance; some sponsor banks may only have a few fintech partnerships that generate a significant amount of revenue.



However, compliance is becoming a barrier to the viability of embedded finance relationships

80%

of sponsor banks say that managing and meeting compliance requirements **is challenging**

61%

of sponsor banks say maintaining an embedded finance partnership program **is becoming increasingly difficult**

29%

of sponsor banks report they are **unlikely to maintain** an embedded finance partnership program moving forward

Fintechs' focus on rapid innovation and user-friendly experiences can sometimes clash with the stringent compliance requirements banks must uphold. This divergence in priorities can create tension in embedded finance programs.

To sustain long-lasting partnerships with fintechs, sponsor banks must strike a balance between offering competitive terms and maintaining robust risk management practices that fintechs can keep up with.

Alloy insight

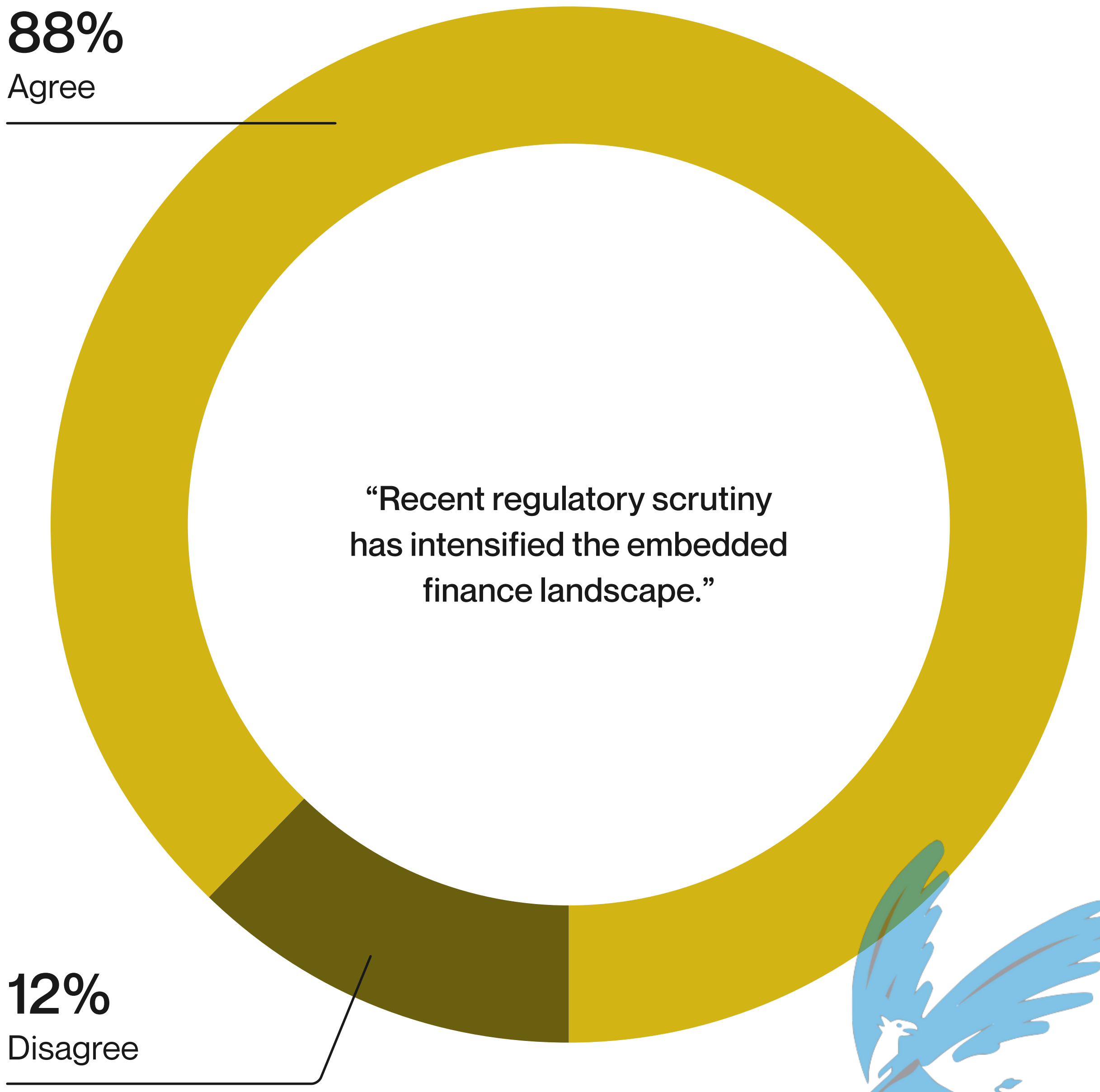
29% of sponsor banks report wanting to slim down their embedded finance program or shut it down entirely. The challenges of maintaining a multi-partner program have discouraged over a quarter of respondents from running an embedded finance partnership program.

Compliance concerns

88%

of sponsor banks agree that recent regulatory scrutiny has turned up the heat on embedded finance partnerships

Participants were asked whether they agreed or disagreed with the following statement:



9 in 10 sponsor banks find it hard to meet compliance requirements when managing embedded finance partnerships

Lack of control and auditability of fintech partners' policy controls were cited as top challenges for sponsor banks.

Ensuring compliance across multiple jurisdictions and accessing training and educational resources on evolving regulations were also top challenges.

Top challenges to meeting compliance requirements as a sponsor bank:

Primary challenges

1. Lack of control over fintech partners' policy controls
2. Not enough auditability of fintech partners' policy controls
3. Challenges in ensuring consistent compliance across multiple jurisdictions
4. Limited access to relevant training & educational resources on evolving regulations

Secondary challenges

5. Difficulty in aligning internal policies with those of fintech partners
6. Regulations and/or regulators' expectations are unclear
7. Lack of visibility into fintech partners' policy controls
8. Not enough risk management personnel

9. N/A - I don't find any challenges meeting compliance requirements

Compliance violations often lead to financial losses for sponsor banks

75%
lost $100K or more

39%
lost $250k or more

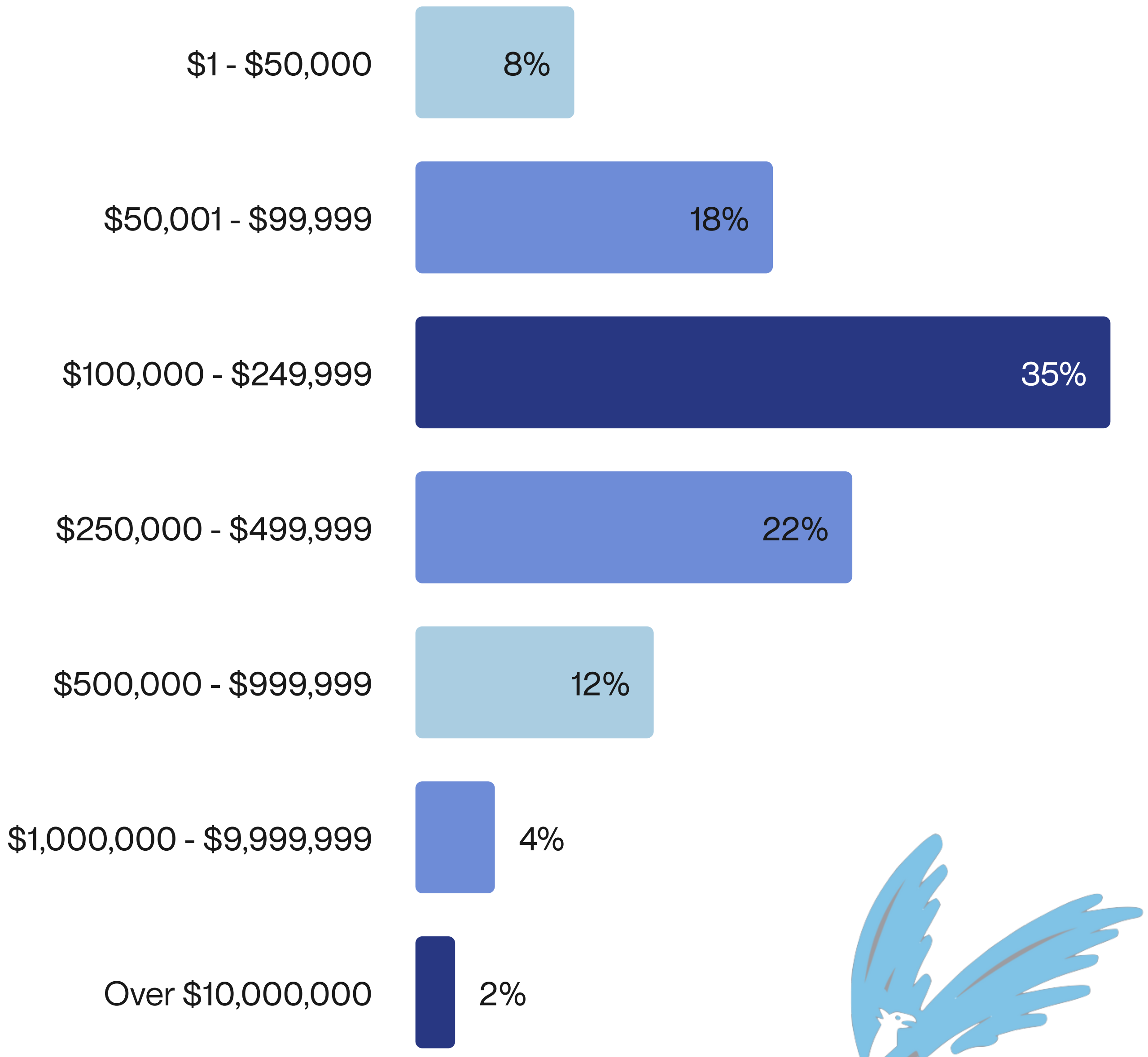
6%
lost $1M or more

Alloy insight

Often, sponsor banks build into their contracts that they can push any regulatory fines off to the fintech, which could be driving down financial impact.

Additionally, regulatory penalties are often delayed, so the true cost of compliance failures in 2024 may not be fully realized for years to come.

Money lost from compliance violations
(Includes documented financial losses and regulatory fines)



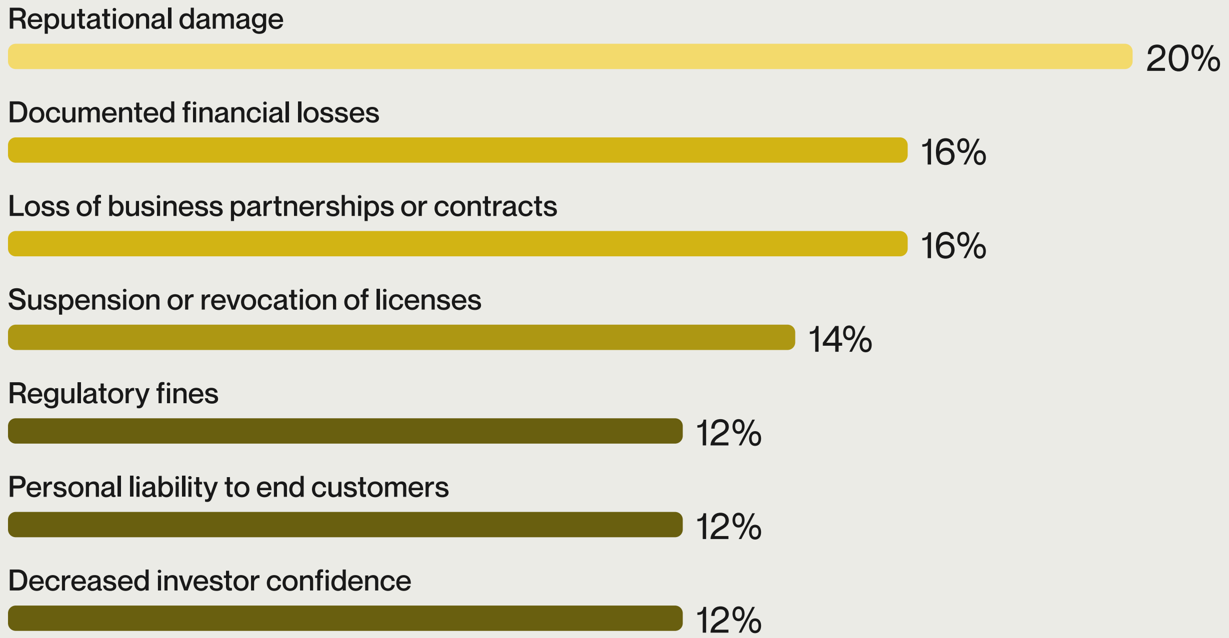
Despite steep monetary losses, banks say reputational damage is the top consequence of compliance violations

01 Reputational damage (20%)

02 Documented financial loss (16%)

03 Loss of business partnerships or contracts (16%)

Sponsor banks reported on the most detrimental consequences of compliance violations:



Alloy insight

Many of the consequences directly impact multiple areas. For example, regulators will often turn up scrutiny if they detect issues when they are examining a bank. This may result in a public enforcement action, which could then result in reputational harm. When there is reputational harm, existing clients may lose faith in the institution and seek out another sponsor bank — leading to a loss of business partnerships or contracts.

In light of these consequences, sponsor banks are increasing oversight of fintech partnerships

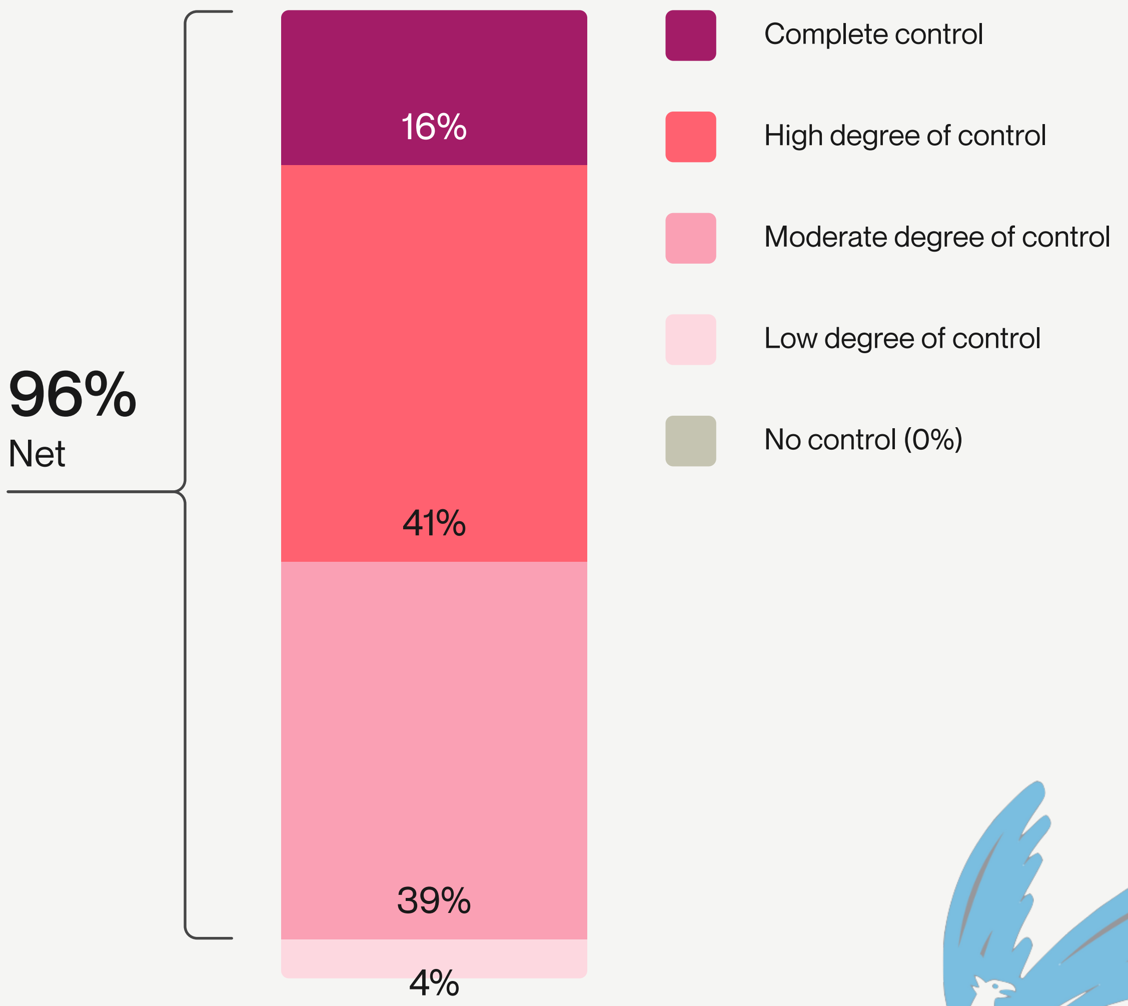
This shift suggests that banks may have lacked the technological infrastructure necessary to maintain adequate oversight in the past.

96% of banks want at least a moderate degree of control over the compliance programs of their fintech partners. While sponsor banks believe they have substantial control over their embedded finance partnerships, the operational challenges they face (page 19) tell a different story.

There is also a potential bias in self-reporting, where banks may overstate their level of control.

Participants were asked:

"How much control have you historically had over the compliance programs (e.g., CIP, AML, KYC/KYB) of your fintech partners?"



Evolving partnership needs

Despite the risks, bank-fintech partnerships remain valuable

Despite regulatory scrutiny, embedded finance collaborations between banks and fintechs continue to offer significant benefits. These partnerships result in more comprehensive coverage of financial services, ultimately benefiting customers through enhanced and diversified offerings, seamless experiences, and improved financial health.

With fintechs excelling at customer acquisition and innovation, sponsor banks can focus on core strengths like banking infrastructure and regulatory compliance. This not only leads to more resilient partnerships, but also drives growth for both parties.

Diversifying bank-fintech partnerships enhances financial resilience and allows banks to adapt to changing market conditions.

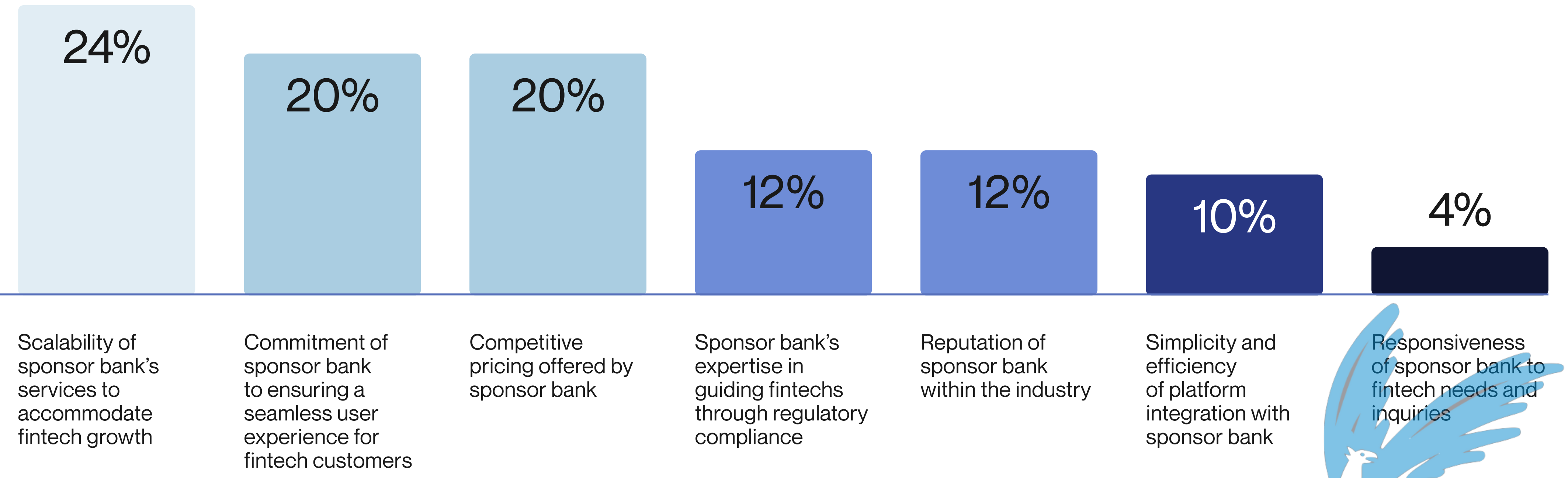
As a result, many banks view these partnerships as crucial for maintaining competitiveness and securing a larger stake in the rapidly evolving embedded finance ecosystem — even though it may be challenging to do so.

To remain competitive, sponsor banks must be aware of their fintech partners' evolving needs.

Sponsor banks report that fintechs want relationships with banks that are committed to a smooth user experience and offer scalable, competitively priced services

Participants were asked:

"What primary factor do your fintech partners emphasize when selecting you as their sponsor bank?"

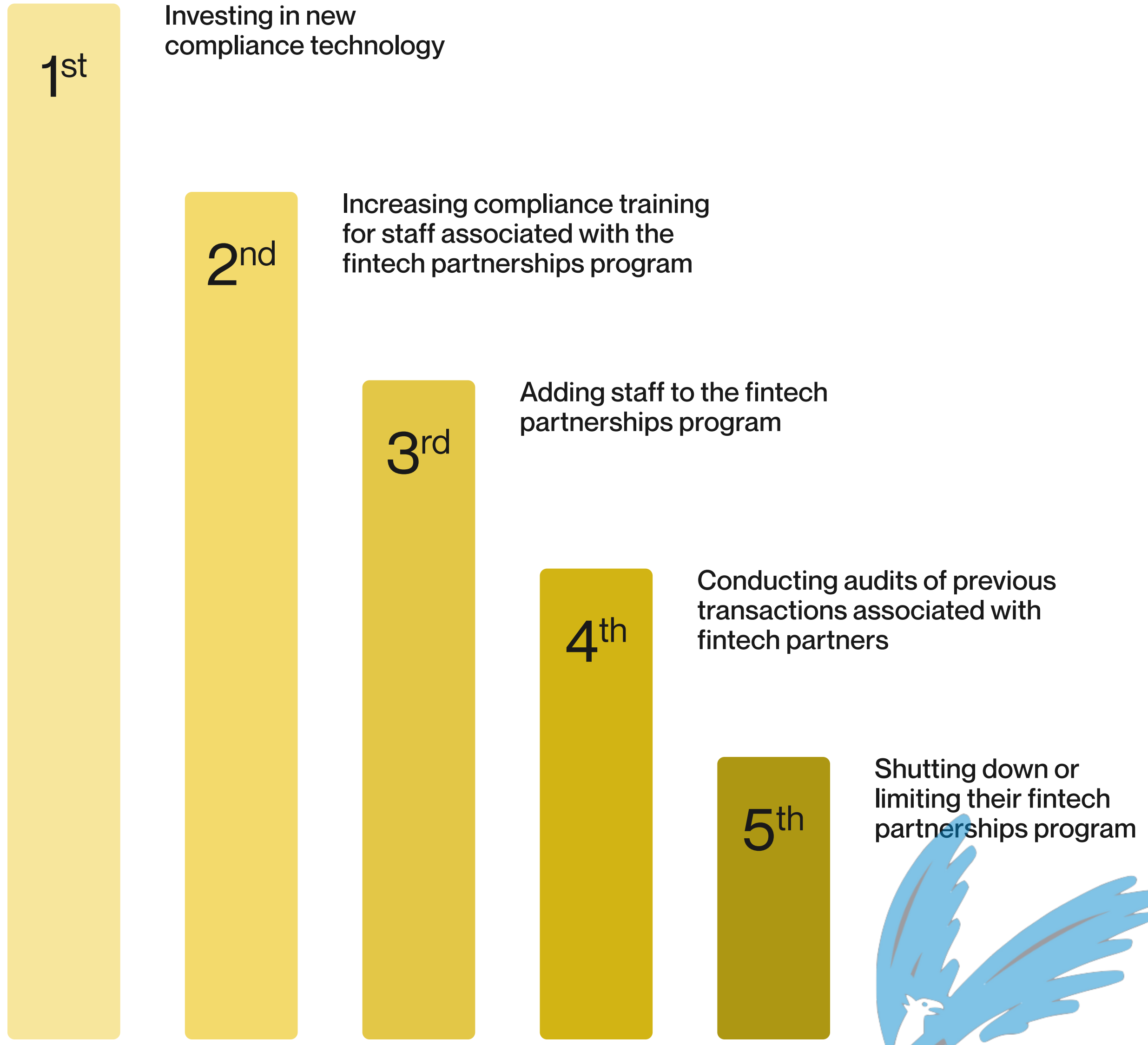


As partnership and regulatory needs evolve,

94%

of sponsor banks are investing in new compliance technology and increasing training

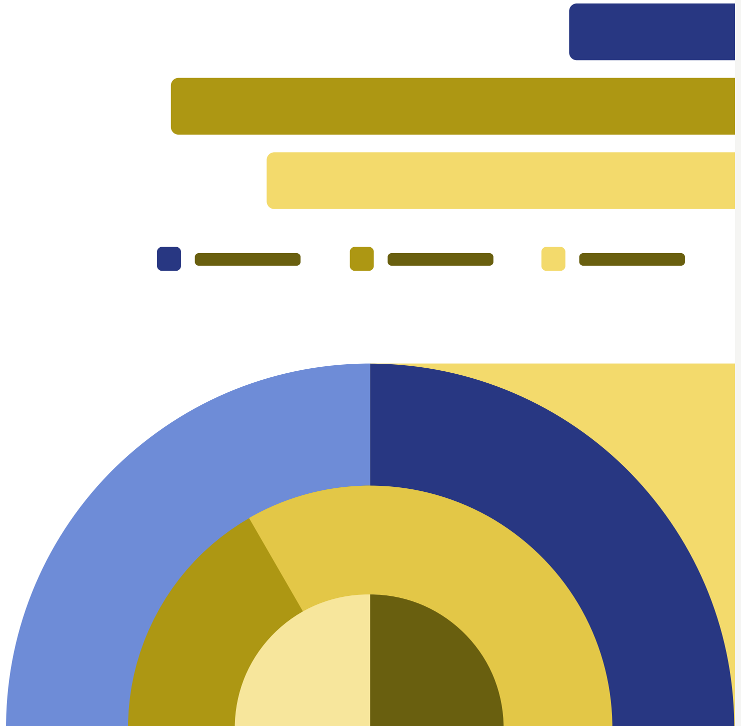
Top 5 actions sponsor banks are taking in response to heightened regulatory scrutiny of fintech partnerships, from most to least important:



Alloy trendspotting

What will change in embedded finance compliance in the next year?

Predictions from **Parilee Wang**, Alloy's Chief Product Officer



The era of treating compliance as a "check-the-box" exercise is ending. Fintechs are expected to take a more proactive stance on compliance policies, driven by evolving contractual relationships with sponsor banks and the potential for increased liability for regulatory violations.

Additionally, the frequency and intensity of regulatory scrutiny are anticipated to rise, with some banks potentially facing more frequent and prolonged audits. This heightened oversight could significantly increase operational costs, even in the absence of specific violations.

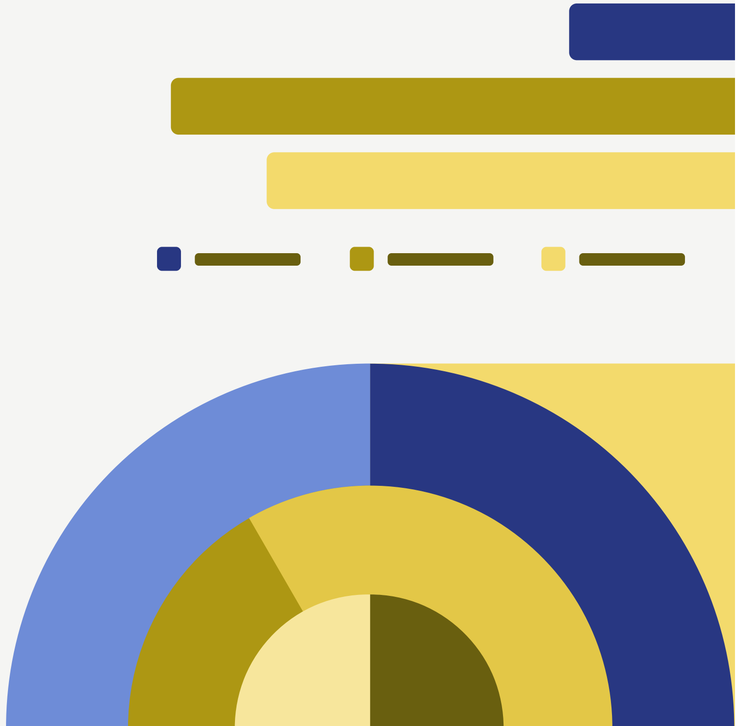
We can expect to see a marked increase in the barriers to entry for this space. This change will likely lead to a consolidation of players, with "dabblers" exiting the market and remaining participants approaching partnerships with greater seriousness and investment.

As a result, both banks and fintechs will need to invest more heavily in robust compliance programs and infrastructure that facilitate real-time collaboration to navigate these changes successfully.

Alloy trendspotting

What will change in embedded finance compliance in the next year?

Predictions from **Tommy Nicholas**, Alloy's Chief Executive Officer



With over a quarter of sponsor banks considering exiting embedded finance altogether — or decreasing their share in this market — banks need to significantly transform their operational approach to embedded finance. This shift presents an opportunity for innovative sponsor banks to distinguish themselves in the market.

Moreover, sponsor banks should anticipate a consolidation in the industry, with committed players emerging stronger and more capable of handling complex fintech partnerships.

As the ecosystem matures, we can expect to see the development of standardized best practices and more sophisticated risk management strategies. Banks that invest in these advanced systems and processes will be well positioned to capitalize on the long-term growth potential of embedded finance while also building trust with regulators and fintech partners alike.

The recent regulatory scrutiny has exposed the inadequacies of traditional oversight methods, necessitating a more proactive and integrated control system. By adopting cutting-edge technology platforms that offer real-time monitoring and shared control capabilities, banks can create a competitive advantage. These solutions not only address regulatory concerns but also enhance operational efficiency, potentially reducing the high costs associated with manual oversight processes.

Conclusion

Increased regulatory scrutiny and market changes are pushing banks to reevaluate their embedded finance programs to ensure they have the tools and oversight necessary to make them successful.

This approach is part of a broader shift away from intermediary BaaS platforms and towards direct relationships between banks and fintechs.

As more sponsor banks consider exiting the embedded finance space, we are likely to see market consolidation, with fewer but more committed players. We can also expect a more mature, stable, and compliant embedded finance ecosystem to emerge.

Despite challenges, the sector offers extensive opportunities for those willing to invest in compliance best practices. While regulations can be complex to navigate, they can also yield stable, profitable, and compliant partnerships that drive innovation and expand access to financial services.

In 2024, banks face a critical decision: invest in robust compliance solutions and fully commit to embedded finance, or risk exiting the business.

About Alloy

Alloy solves the identity risk problem for companies that offer financial products. Over 600 banks, credit unions, and fintechs turn to Alloy's end-to-end identity risk management platform to take control of fraud, credit, and compliance risks, and grow with confidence. Founded in 2015, Alloy is powering the delivery of great financial products to more customers around the world. Learn more at alloy.com.

Alloy for Embedded Finance provides flexibility in how embedded finance providers manage identity risk across their programs, enabling greater alignment with partners and ensuring compliance every step of the way. Our best-in-class compliance and risk tooling allows banks to focus on growing their business and open up new revenue streams, without compromising on risk, while enabling fintechs to customize controls and maintain their competitive edge.

Learn more about Alloy for Embedded Finance