Embedded Finance and the "*Fintechification* " of Retail

ARTICLE

Sergio Albuquerque
Felipe Diniz

October 2023

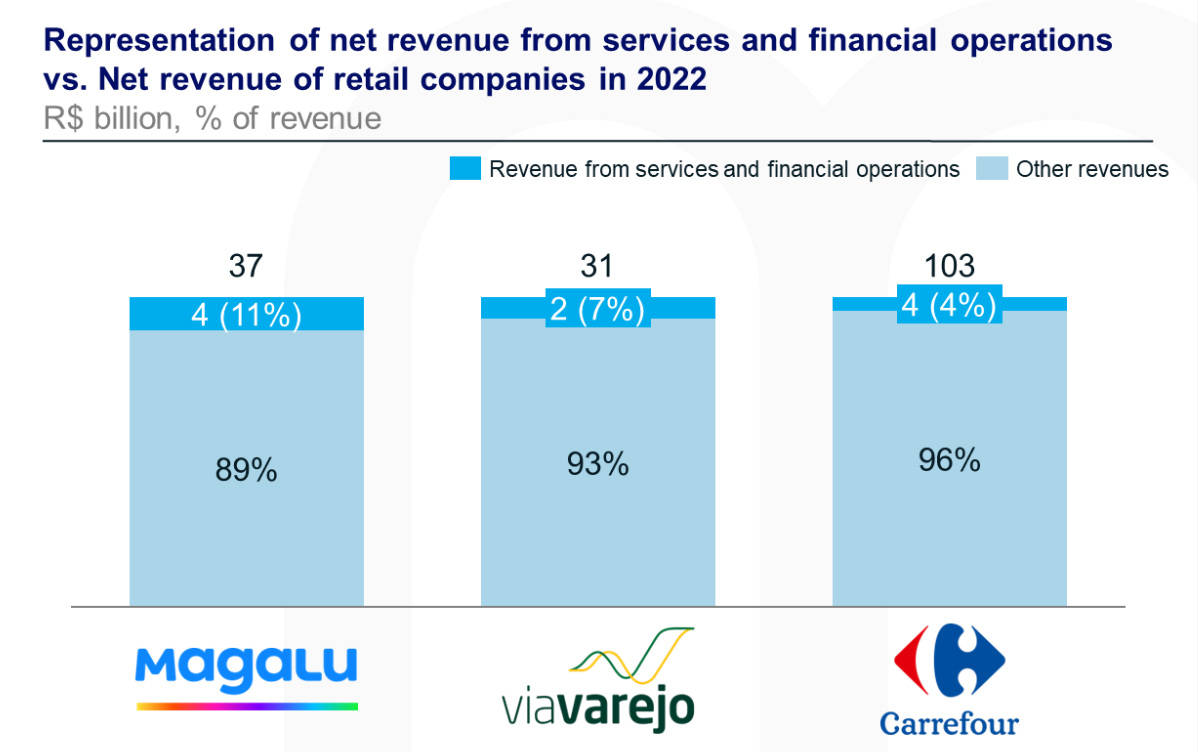
A not-so-new novelty

The offering of financial products is not something new; it has always been a central element of the value proposition of retail in Brazil. Examples of products offered in supermarkets or department stores have existed for years: Hipercard cards, “Crediário” installment plans at Casas Bahia, among others.

Although BNPL, buy now and pay later, and embedded finance may sound like new terms, the truth is that Brazilian retail has always relied very well on the advanced National Financial System to streamline its offering. Who needs BNPL with Casas Bahia's “Crediário” installment plan?

Offering products and services such as credit and insurance is part of the day-to-day operations of retail. Although the monetization strategy may vary from company to company, the financial revenue of retailers is still a significant portion of their total revenue, as shown in the chart below, where this percentage ranges from ~5% to ~10% in selected examples

Chart 1: Representation of financial revenue in total revenue of companies



Source: Income Statement of companies

What has really changed?

It is undeniable that the options of financial products and the volume of this offering have increased significantly in recent years. Three main trends help explain this phenomenon:

- Change in consumer behavior:
  - **Greater digital proficiency:** the increase in the number of people accustomed to navigating apps and using digital resources facilitates the use of digital product and service offerings
  - **Experience:** today's consumer is much more demanding; accustomed to using apps that make their life much easier "at a click", the consumer is no longer willing to have an experience that is not fluid and almost immediate;
  - **Customization**: consumers are increasingly less tolerant of generic offers - hyper-segmentation and exclusivity are marketing megatrends;

- Technologies and new business models:
  - **Technological advancement:** the natural progression of technology exponentially expands the range of potential solutions
  - **New models:** the creation of new business models that have proven successful, such as Banking as a Service, also contributes to increasing the offerings of retailers.

- Deregulation:
  - Deregulation of the Financial System has been part of the Central Bank's agenda for at least 10 years - and this has been a constant during this time, even with changes in management and political orientation of the current government, there has always been a genuine effort by the leadership of the Central Bank of Brazil to increase banking competition and in other sectors of the National Financial System.

Banking as a Service - the great transformation of the sector

Before the arrival and popularization of BaaS (banking as a service), retailers had to build, practically from scratch, platforms to offer financial products. This process was expensive and limited this offering to a select group of companies.

With the introduction of the banking as a service model, financial institutions began providing the regulatory and technological banking infrastructure to companies in various sectors. Additionally, they started offering pre-structured products (such as accounts, payments, credit, etc.), whether proprietary or third-party, suitable for different types of companies.

The BaaS provider assumes all compliance costs—expenses necessary to maintain an institution in compliance with Central Bank regulations—while the contracting company focuses on offering financial products to its customers, leveraging its sales channels. Thus, the Banking as a Service model allows for a quick and cost-effective integration of a financial product offering for any type of company.

The global BaaS market generated revenues of approximately USD 640 billion in 2022. In Brazil, the sector is estimated to have reached around USD 1.4 billion in 2021. According to a study published by Febraban, BaaS revenue in Brazil is expected to grow at a rate of 30% per year over the next 10 years.

In addition to BaaS, retailers have various models available to offer financial products and services to their customers. They can act as banking correspondents or establish joint ventures with financial institutions. BaaS stands out for its ease of implementation and low required investment. However, this solution generally offers limited customization, and a significant portion of the value generated in this chain is captured by the financial institution.

The following figure illustrates some of the different options available today for financial offerings and provides perspective on their advantages and disadvantages.

Table 1: Options for implementing financial solutions in retail

Average Value ● High ○ Low

	Model Description	Revenue Potential	Investment	Implementation Time
Banking as a Service	▪ A model that enables the provision of customized financial services for different sectors such as retail and technology.	◔	○	◔
Banking Correspondent	▪ An institution authorized by the Central Bank to provide service at financial institutions.	◔	◔	◑
Joint venture	▪ A strategic union of two or more companies aiming to gain synergies such as market share expansion, technology sharing, etc.	◕	◑	◕
Instituição Financeira	▪ A licensed company to operate in the financial sector and offer banking and financial services to customers.	●	●	●

1. Real values depend on the type of product, partner, etc.
Source: Mirow & Co.

New Industries and New Products

"Every company will become a Fintech company."

The growth of BaaS, changes in regulation and consumer behavior are transforming the financial sector. These trends have expanded the spectrum of companies offering financial products, diversified the market segments served, enriched the product portfolio, and expanded the variety of solutions offered:

- As a result of changes in consumer behavior, we observe a notable transition from offline to online environments, with financial products seamlessly integrated into digital experiences, such as during the checkout process in apps.
- At the same time, the range of financial products offered by retailers and other companies has grown exponentially in recent years. Previously limited to credit and insurance options, these companies are now able to offer virtually any financial product or service available in the market.
- Finally, the reduction of entry barriers, driven by BaaS, has allowed for growth in the number and variety of companies providing financial services. Even small businesses have started entering the market, with products like private label cards. Additionally, the offering, once concentrated in retail, now extends to a wider range of sectors, including education, consumer goods, and industrial sectors.

Below, we list a small sample of companies from different segments - food retail, consumer goods, telecommunications, transportation - that have adopted embedded finance solutions. Literally, every major company is becoming a fintech.

Who will be the potential winners?

Embedded finance is becoming popular in various segments, but some companies will extract more value from these solutions than others. Characteristics that enhance value generation include:

- **Large target audience**: Companies with a large number of customers (and/or many suppliers and partners) have greater offering opportunities and gain a significant competitive advantage by leveraging their channels.
- **Audience with limited access to financial products**: Companies whose customer base (or suppliers) is underbanked and/or has restricted access to financial services can benefit significantly from embedded finance. Typically, customers who are less attractive to banks have pent-up demand for financial services and can be served by innovative solutions.
- **Frequent interactions with the target audience**: The higher the frequency and recurrence of interactions with customers, the better the opportunities for a company to sell financial products and services. Thus, companies with high customer engagement are particularly likely to benefit from the integration of these offerings.

In this sense, companies such as retailers, e-commerce, marketplaces, social networks, telecom, and utilities have great opportunities to capture value from the offering of embedded financial services..

Generating value for companies and their customers

It is essential that the offering of financial products by non-financial companies contributes to reinforcing the core business value proposition, increasing the average ticket and customer loyalty. The rationale behind this type of offering is based on an attractive value proposition for the customer, which, consequently, provides competitive advantages to the company, reinforcing its business model.

Several advantages can be highlighted for customers of this type of solution:

- **Seamless experience:** In an increasingly automated world, the offering of financial products simplifies user interactions. Transactions are carried out in a proprietary, fast, secure environment and are aligned with the customer's journey, especially in the digital medium.
- **Access to credit and financial products**: Many customers have difficulty obtaining credit or are underbanked. This is particularly true when the offering company serves a economically more vulnerable target audience, such as some food retail networks. The offering of financial products can provide these customers with the opportunity to access services they would not normally find in banks.
- **Access to benefits:** Many of these products can be structured to function as a loyalty program, offering progressive benefits according to usage. Examples include cashback on purchases, sweepstakes or prizes, and bonuses for hiring credit services.

At the same time, non-financial companies offering embedded financial products can benefit in multiple ways:

- **New revenue sources:** The offering of financial products can be an additional source of revenue for the company. This can be especially relevant in situations where the offering company has reduced margins and any additional revenues significantly impact the bottom line.
- **Greater loyalty**: In addition to revenue growth, the offering of financial products primarily serves to leverage the core business. The greatest impact is on increased loyalty; in the case of retail, this is reflected in increased recurrence and average ticket observed. In a recent survey conducted by Accenture, 88% of companies that implemented embedded finance solutions succeeded in increasing engagement with their customers.
- **Cost reduction**: when applied to certain products, such as payments, the use of embedded finance can have a cost reduction bias. For example, a retailer that creates a digital wallet can use it to replace credit card payments from its customers to a digital wallet, for example, reducing the MDR of these transactions.

How to build a robust and coherent embedded finance offering?

Generic solutions are cheap and easy to implement. Implementing a checking account for employees, for example, can be relatively inexpensive, costing only a few thousand reais, and be completed in a few months.

However, if the offering is a central component of the company's value proposition, planning and deciding on the elements of this offering and the business model become crucial. Generic offerings can compromise the brand image and result in revenue loss and missed opportunities to retain customers.

Therefore, it is essential that companies interested in offering embedded financial products plan carefully. It all starts with defining the objectives of offering a financial product. Is the main focus of the embedded finance offering to generate additional revenue? Or does the company want to retain customers and increase their recurrence? Depending on the desired objective, different product configurations can be evaluated.

At the same time, identifying the target audience and the strategy to reach them is crucial. For example, offering a digital account/wallet for employees differs significantly from a credit product focused on suppliers. It is necessary to assess the trade-offs between opportunities and decide on the most effective market approach. What will be the most profitable strategy? These are some fundamental reflections that must be considered and that will influence the business model and the technological solutions adopted.

The figure below illustrates some of the key questions that a company needs to address to define a robust embedded finance offering.

Figure 2: Key questions for the embedded finance offering

NON EXAUSTIVE

What is my goal?	Which audience do I want to reach? Why?	Which products make sense to offer? How to monetize?	What technological and business solution can I offer?	How to negotiate with a potential partner? How to implement?
▪ Generate additional revenue ▪ Build customer loyalty ▪ Enhance experience ▪ Increase instore customer frequency ▪ Reduce transaction costs	▪ Customers ▪ Suppliers ▪ Partners ▪ Employees ▪ Others	▪ Cards and payment methods ▪ Checking accounts ▪ Credit ▪ Insurance ▪ Loyalty program	▪ Sales channel ▪ Banking as a Service (BaaS) ▪ Banking correspondent ▪ Joint Venture (JV) ▪ "Becoming a bank"	▪ Revenue share ▪ Profit share ▪ Fixed fee ▪ Transactional

Multiple combinations can be used for a financial offer (e.g., offering credit via BaaS for employees and private label card offer for customers).

The solutions space is vast, as are the potential opportunities. The main challenge lies in shaping a robust and coherent offer. What is the best embedded finance strategy for your company?