



Banking on Software: Embedded Banking and the Future of Financial Services

Software is (still) eating the world

Marc Andreessen, co-founder of the venture capital firm Andreessen Horowitz, wrote in 2011 that software was eating the world.¹ More than 10 years later, it appears he was correct. Today, several of the world's largest companies by market cap – Apple, Microsoft, Amazon, and Alphabet (Google) – attribute a significant portion (if not the majority) of their valuations to the software sides of their businesses. But it's not just the large companies; walk into any small business and they'll likely be leveraging software-as-a-service (SaaS) companies to run their businesses.

Software isn't historically analogous to a gold rush; it's more like electricity²: another thin, enabling layer that enhanced dozens of industries rather than remaining confined to its own specific vertical. As software has “eaten” its way through industry after industry to the point of ubiquity, it has become a new distribution channel for other types of products.

Embedded banking – which is embedding traditional financial products into non-financial software platforms – is perhaps the best example of a product that has found a new distribution channel through technology. This is a massive trend that's already benefiting software companies, their business clients, and those businesses' end customers across many industry verticals.

¹ <https://a16z.com/2011/08/20/why-software-is-eating-the-world/>

² <https://www.youtube.com/watch?v=vMKNUyImaQ>

Horizontal in the aggregate, vertical as individuals

Today, business customers expect SaaS products built for the unique needs they face in their verticals. SaaS companies responded to these needs by expanding vertically to perform more high value tasks and workflows, especially those unique to their target industry. As they solved these industry-specific problems, they enjoyed meteoric appreciations in market caps. The market cap of Fractal Software's Vertical SaaS Index increased nearly 20x from 2010 to Q3 of 2021 both due an increase in the number of companies and an appreciation in the market caps of the index's composite companies.³

As SaaS companies became critical parts of their business customers' day-to-day operations, they also saw higher engagement levels. High engagement platforms are excellent distribution points for embedded banking products, so these vertically focused SaaS companies are uniquely positioned to provide them. Consider the growth anticipated in embedded payments as an example: transaction value in the US is expected to grow from \$1.7T in 2021 to \$3.5T in 2026, while penetration is expected to increase from 15% to 29% over the same time period.⁴

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As the volume of payments flowing through software platforms increases, so do the number of models these SaaS platforms can adopt for embedding payments. The most established model is payment acceptance while the most financially rewarding is payment facilitation (PayFac). Several hybrid models have popped up that sit somewhere in the middle of the spectrum, such as integrated referrals, retail and whole independent sales organizations (ISOs), PayFac-as-a-Service, and more. As the software company gets more involved in the 'behind-the-scenes' activities of payments flowing through their platform – onboarding and underwriting merchants, managing risk, and more – they receive a larger share of each payment in exchange for bearing greater operational costs and risk.

After establishing payments, these vertically focused SaaS platforms are natural fits for embedding several traditional banking products. SaaS companies' costs of acquiring customers for embedded banking products can be lower than banks for several reasons: the client is already in their platform, trusts the SaaS company with their money (in the form of payments), and can be boarded seamlessly. These inherent advantages are a major reason why 24% of software vendors without embedded banking capabilities today report that it's on their roadmap for the future.⁵

Lending is a likely fast follower behind payments for three main reasons. First, if there's money flowing through the software platforms, then the platform knows an individual customer's financial position and can use this to underwrite the loan. Second, if there's any unique data available through the platform itself, they may even have an underwriting edge over a traditional bank since they can price more accurately without the friction of information discovery. Third, if the platform is a customer's primary means of accepting payments, the SaaS platform has a collections edge over a traditional bank because the loan recipients' revenue is flowing through the SaaS platform on its way to the merchant.

³ <https://www.fractalsoftware.com/perspectives/state-of-vertical-saas-2021>

⁴ <https://www.bain.com/insights/embedded-finance/>

⁵ The Strawhecker Group (<https://thestrategygroup.com/improved-embedded-payment-solutions-in-high-demand-among-software-vendors/>)

One real world example of vertically focused embedded lending is Toast launching Toast Capital.⁶ Applications can be mostly pre-filled since all of the data is already present within the platform, and they can be offered at moments of need. It's easy to imagine something analogous in the healthcare industry. Instead of a restaurant management tool like Toast, the distribution channel would be a practice management or revenue cycle management platform; instead of restaurants, the loan recipients could be healthcare providers seeking practice lending to grow their practice. Beyond payments and lending, other highly promising products for embedding into verticalized software companies are insurance, card issuing, and even bank accounts. These products can be life-changing for business customers, and, with the right provider, SaaS platforms can offer them to customers simply by making a few API calls.

Choosing the right Embedded Banking provider

While embedded banking is an exciting new trend, it is still in its early days. The market immaturity can make it difficult to find a provider that has the right combination of developer-friendly technical capabilities, mature banking solutions, servicing, and modern risk expertise. Developer-friendly technical capabilities are shown through excellent developer portals, technical documentation, intuitive APIs, and technical teams available to support development. Mature and comprehensive banking solutions ensure that the products embedded within a SaaS platform – effectively white-labeled under its brand, in many cases – are consistent with the product quality and customer experience found throughout the rest of the platform. Servicing consists of the support model and timely information – typically driven by how close the embedded banking provider is to the core financial systems being used – available to the software company and/or the business customers

that that software company serves. Finally, modern risk expertise and management represents both avoiding blowups as well as generally ensuring that the embedded banking products are consistent with the SaaS platforms' desires: credit risk appetite, monitoring, fraud mitigation, and much more. There are several types of players to choose from, each with distinct benefits and drawbacks:



Big Banks. These providers typically have some of the largest footprints and offer comprehensive banking capabilities, yet assistance can be lackluster since they are so large.



Processors. These providers offer proven infrastructure and scalability, yet they are slow to meet modern technology demands.



FinTechs. FinTechs offer unparalleled technical accessibility, but their banking offerings tend to be fragmented or incomplete rather than a complete ecosystem offering and support can be lacking.

⁶ <https://news.crunchbase.com/venture/toast-launches-toast-capital-to-help-restaurants-secure-loans/>

Reimagining financial services with KeyBank Embedded Banking

Each of the areas listed above is important and innovators shouldn't have to choose between mission-critical components as they introduce embedded banking products onto their platforms. That's why KeyBank doesn't make SaaS platforms make the uncomfortable tradeoffs other players require. With the unique combination of modern FinTech capabilities – powered in part by XUP Payments – as well as financial expertise and comprehensive banking services, KeyBank is the right provider for embedded banking.

KeyBank can help SaaS platforms unlock trapped value. With a single embedded banking provider, software companies can...

- Simplify their tech stack
- Help lower compliance costs by leveraging bank-grade risk and servicing tooling
- Scale with a single provider, helping to reduce operational costs and complexity

KeyBank's full suite of embedded banking tools and services, built on flexible APIs, empowers platform growth through payments, treasury, and risk management.



To learn more about KeyBank's embedded banking solutions, visit key.com/embeddedbanking.

