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(Review Article)

BAAS: Banking as a service brings Industry disruption

Prashant Bansal *

Individual Researcher, Edison, NJ, USA.

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Abstract

Banking as a Service (BaaS) has emerged as a transformative force in the financial sector, challenging traditional banking models and offering innovative solutions. BaaS enables non-financial institutions to integrate banking services into their own products and platforms, leveraging the technology and infrastructure of licensed banks. This disruption has far-reaching implications for both established financial institutions and fintech startups.

For traditional banks, BaaS presents an opportunity to expand their reach and generate new revenue streams by partnering with non-financial businesses. By offering their banking services through BaaS platforms, banks can tap into new customer segments and diversify their income sources. However, this also poses challenges, as banks must adapt to the changing competitive landscape and ensure their technology infrastructure can support BaaS offerings.

For fintech startups, BaaS provides a cost-effective and efficient way to enter the financial market. By leveraging BaaS solutions, these startups can focus on developing innovative products and services without the need for significant upfront investments in banking infrastructure. This has led to a surge in fintech innovation, with startups offering a wide range of financial products and services, from payments and lending to wealth management. The disruption caused by BaaS is also driving a shift towards open banking, which promotes the sharing of customer data and financial information between banks and third-party providers. This increased transparency and competition is benefiting consumers by providing them with more choice and flexibility in their financial products and services.

Keywords: BAAS; Open Banking; Embedded Finance; Digital Banking; API; Customer experience

1. Introduction

BaaS (Banking as a Service) is a key component of Open Banking. It's a platform provided by financial institutions that allows other businesses, both financial and non-financial, to access and integrate banking services into their own products and services. This is achieved by leveraging the underlying technology infrastructure of the licensed bank. In essence, BaaS empowers non-bank entities to offer banking functionalities to their customers. The BaaS landscape is rapidly expanding. As both banks and non-financial companies recognize its potential, the demand for BaaS solutions is surging. In this model, non-financial entities leverage the technology of financial institutions to seamlessly integrate comprehensive financial services into their customer experiences. The widespread adoption of digital technologies, including cloud computing, open banking, and APIs, combined with evolving customer expectations, makes the growth of BaaS an inevitable trend.

The lines between fintech and traditional businesses are blurring. Thanks to the rise of BaaS, platforms can now easily incorporate financial services like corporate cards, accounts, and loans into their offerings. This transformation allows these platforms to become comprehensive business solutions, providing customers with a unified platform for managing various aspects of their operations. This literature delves into the world of BaaS for US-based software

* Corresponding author: Prashant Bansal

platforms. We'll explore the benefits of embedding financial services into other products and provide insights on evaluating BaaS solutions.

2. Baas v/s Embedded Finance v/s Open Banking

Open Banking empowers banks to offer their core banking services to other businesses. By leveraging APIs, banks can provide a range of BaaS products that enable these businesses, both financial and non-financial, to integrate banking features directly into their mobile apps. This technology empowers companies to offer their customers seamless access to financial functionalities within their existing products and services.

Open Banking creates a network of financial products, accessible through APIs, that both financial and non-financial businesses can leverage. This allows third-party providers to develop innovative financial applications and services by integrating with these products. Essentially, Open Banking enables banks to extend their reach and offer their services to a broader range of businesses, effectively expanding their market.

2.1. BaaS (Banking as a Service) is a cornerstone of Open Banking

It's a platform provided by banks that allows other businesses to integrate banking services into their own offerings. This is achieved by leveraging the bank's technology infrastructure. Essentially, BaaS empowers non-financial entities to offer banking functionalities to their customers. A prime example of BaaS is a real estate company that provides financing options directly on its website. By partnering with a bank, the company can offer these services under its own brand while adhering to banking regulations without the need to establish its own financial institution.

2.2. Embedded finance

It involves integrating BaaS solutions directly into a non-financial business's digital platforms. This allows any company to offer financial services as part of their core offerings. For instance, a luxury hotel brand could partner with a bank to issue a branded credit card. The hotel would benefit from a tailored card with unique features, rewards, and perks, attracting customers without the need to become a financial institution itself. While the hotel would still need to adhere to regulatory requirements, the bank handles the complex aspects of banking operations. Embedded finance offers a personalized financial experience for the dedicated customer base of existing businesses, enhancing the overall value proposition.

BaaS providers simplify the process of integrating traditional banking services into any business, from emerging fintech to established platforms. By partnering with banks, BaaS providers offer a range of financial products like accounts, cards, and loans that businesses can seamlessly embed into their software. Through BaaS APIs, these businesses can empower their customers to manage finances, pay bills, and access funding directly within their familiar platform. BaaS providers are essential for a diverse range of businesses, including digital only banks and marketplaces. When a software platform incorporates BaaS solutions, it's often referred to as "embedded finance," as financial services become an integral part of the platform's core offering. Many platforms already provide some form of embedded finance by offering payment processing or ACH services through third-party providers. BaaS providers empower these platforms to expand their financial services offerings even further.

2.3. Benefits of Banking as a Service

2.3.1. Banks and financial institutions can significantly expand their customer base and boost revenue by offering BaaS solutions.

This approach allows them to stay competitive in a rapidly evolving market by providing their services to a wider range of businesses. By handling the complex technical aspects of banking in the background, BaaS empowers these institutions to focus on delivering innovative financial products and services.

2.3.2. Integrating financial products can significantly enhance a company's offerings, enabling them to provide a comprehensive financial experience and develop innovative solutions that drive customer value and generate new revenue streams.

When implementing BaaS with these companies, it's essential to focus on monetization strategies that deliver value and enhance customer satisfaction.

2.3.3. Embedding financial services directly into non-financial software offers a significant convenience for their customers.

By eliminating the need to switch between multiple systems and navigate complex banking processes, it provides a streamlined experience. This fosters customer loyalty, leading to increased satisfaction and a higher likelihood of continued use and positive referrals.

2.3.4. Essential business functions, such as payment processing, account management, and access to credit or debit cards, are crucial for any company.

Incorporating these financial services directly into your product offers customers a compelling reason to continue using your software, significantly reducing the risk of customer churn.

2.4. Working of BaaS with various platforms

BaaS (Banking as a Service) empowers software platforms to offer banking functionalities that were previously exclusive to licensed banks. This enables businesses to provide tailored banking services within their own platform, enhancing the overall customer experience.

To illustrate, consider The Auto, a platform that specializes in appointment scheduling and payment processing for car dealers. One of The Auto's customers, Car central, has relied on the platform for three years to manage appointments and payments. If Car central desired additional financial services to support their business, they could either involve a bank or access these services through The Auto.

3. Involves Bank

With the expansion of their business, Car central required a dedicated bank account to manage the funds used for payroll. Opening a traditional bank account would necessitate visiting a physical financial institution and providing detailed business information. If Car central were not approved for a business account, they would have to resort to a personal account, leading to a commingling of personal and business finances. In this scenario, the account would be established at a traditional bank, but the car dealers would then need to manually transfer funds from their business income on The Auto to their new account, facing a waiting period of two to three business days for funds to settle before paying their employees. To fund marketing and renovations, Car central sought a loan from the same financial institution where they had opened their bank account. However, they discovered a loan with a lower interest rate at another local bank. The application process involved a lengthy in-person submission of business information. Due to the bank's unfamiliarity with Car central and the typical cash flow patterns of dealers, the loan application was initially declined. After applying to two more banks, Car central finally secured a loan several months later.

Below illustrates the typical journey of user and business to open business account with one bank and loan account with another.

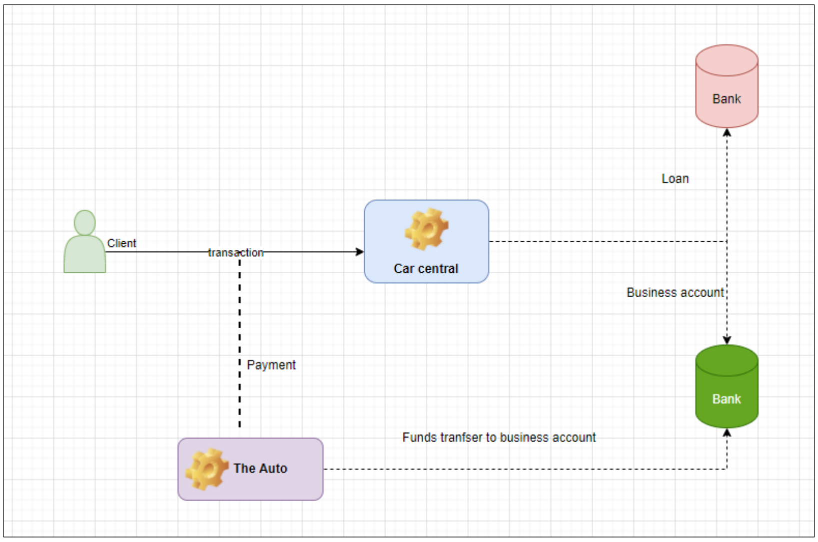

Figure 1 Journey of user and business to open business account w/o open banking

Car central goes to one bank to open their business account which might take around a week and mostly needs in person visit to the branch. Once bank account is opened then “The Auto” would take 2-3 days to settle the payment to the business account depending on the bank. Some banks might take longer as well. Now, car central can secure a lesser loan interest rate with another bank and wishes to open loan account with another bank. This again with cost them hefty amount of time as they are new to this bank and KYC and other compliances take time to process.

Managing multiple bank accounts for car central is a time-consuming process. The owners must spend significant time each week reconciling finances, tracking funds, paying bills, and preventing bounced checks. Additionally, a substantial portion of their earnings may be tied up in transfers, limiting their ability to spend the money efficiently.

3.1. Use the platform to access all.

The Auto, originally an appointment scheduling platform for car dealers, has expanded its offerings to include a comprehensive suite of financial services. Customers can now process payments, access capital, obtain business cards, and open financial accounts all within a single platform. These additional benefits complement The Auto's core features of scheduling and appointment booking.

Since Car central processes all client payments through The Auto, the platform has a comprehensive understanding of the dealer’s financial history and industry-specific needs. When Car central applied for a loan, The Auto's bank partner quickly assessed their eligibility based on their payment volume and history on the platform, approving the loan within a day. The loan funds were immediately accessible within Car central's financial account on The Auto, eliminating the need for additional paperwork.

Car central could easily use their business card, linked to their financial account, to access both earned and borrowed funds. This allowed for immediate spending, enabling them to use the card for business expenses as soon as clients made payments. The platform could also offer rewards, such as cashback on dealers-related purchases or a free month of The Auto, to further incentivize card usage.

By centralizing all financial activities, including customer payments, loans, and business expenses, on The Auto's platform, Car central's owners saved countless hours on financial reconciliation. They had access to real-time financial reports without the need to switch between multiple tools. The platform also eliminated the risk of missed transfers or missed loan payments, providing a truly all-in-one solution for managing their business.

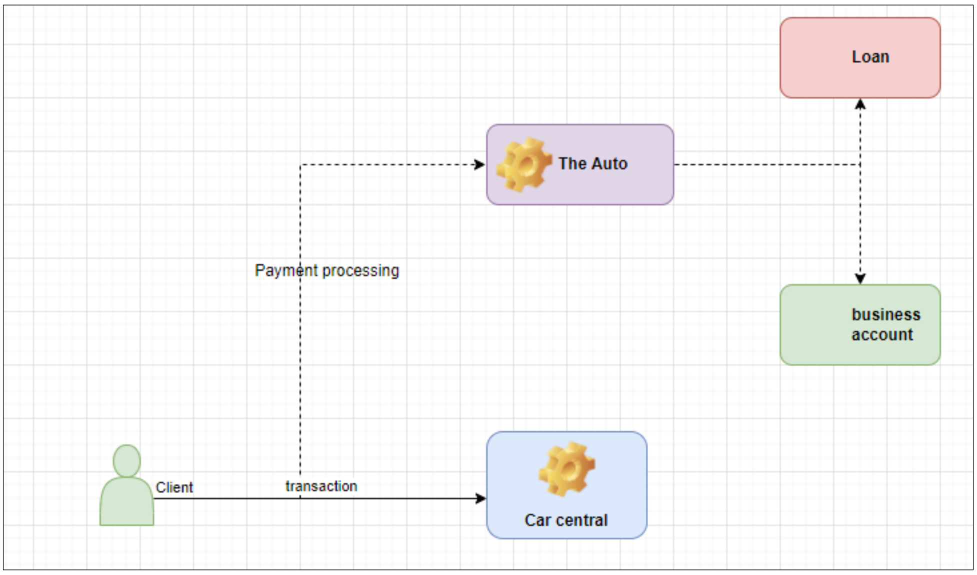

Figure 2 Journey of user and business to open business account with open banking

4. Navigating the BaaS Landscape

To thrive in the dynamic BaaS market, providers must possess the technological capabilities to meet the evolving needs of businesses seeking to embed these solutions. Here are key considerations for successful BaaS providers:

4.1. Integration and Customization

A modern, flexible infrastructure is essential for BaaS success. This infrastructure should allow for easy decomposition of banking products, akin to Lego blocks, accessible through well-defined APIs. This foundation enables seamless integration with third-party organizations and fosters the creation of innovative offerings built upon the core systems.

4.2. Scalability and Reliability

The BaaS platform must be scalable to accommodate the growth and evolving requirements of partners. Reliability is equally important to ensure a consistent and uninterrupted service.

4.3. High-Security Standards

Robust security measures are paramount to protect client data and maintain market reputation. Implementing features like strong data encryption and a secure architecture design is crucial for compliance with industry standards.

4.4. Support and Maintenance

Effective support and maintenance are vital for ensuring smooth operations and customer satisfaction. Regular updates and enhancements help fortify the platform against vulnerabilities and maintain its relevance and reliability.

5. Conclusion

Banking as a Service (BaaS) has emerged as a transformative force in the financial sector, offering innovative solutions and disrupting traditional banking models. By providing a platform for non-financial institutions to integrate banking services into their own products and platforms, BaaS has opened new opportunities for both banks and fintech startups.

For banks, BaaS presents a chance to expand their reach, diversify their revenue streams, and stay competitive in a rapidly evolving market. By partnering with non-financial businesses, banks can tap into new customer segments and offer their services through a wider range of channels. Additionally, BaaS can help banks reduce operational costs and improve efficiency by leveraging shared technology infrastructure.

For fintech startups, BaaS provides a cost-effective and efficient way to enter the financial market. By accessing banking services through BaaS platforms, startups can focus on developing innovative products and services without the need for significant upfront investments in banking infrastructure. This has led to a surge in fintech innovation, with startups offering a wide range of financial solutions tailored to specific customer needs.

The benefits of BaaS extend beyond banks and fintech startups. Consumers also stand to gain from the increased competition and innovation driven by BaaS. As more businesses offer embedded financial services, consumers can enjoy greater choice, flexibility, and convenience in their banking options. Additionally, BaaS can help to promote financial inclusion by making banking services more accessible to underserved populations.

Implementing BaaS requires careful consideration of several factors, including technology infrastructure, regulatory compliance, and partnership strategies. Banks and fintech startups must invest in the necessary technology and expertise to deliver a seamless BaaS experience. Additionally, they must ensure compliance with relevant regulations and build strong partnerships with other stakeholders.

In conclusion, Banking as a Service is a powerful force that is reshaping the financial landscape. By providing a platform for innovation, competition, and collaboration, BaaS is driving the evolution of banking and delivering significant benefits to both businesses and consumers. As the adoption of BaaS continues to grow, we can expect to see even more exciting developments and opportunities in the years to come.

Compliance with ethical standards

Disclosure of conflict of interest

No conflict of interest to be disclosed.

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