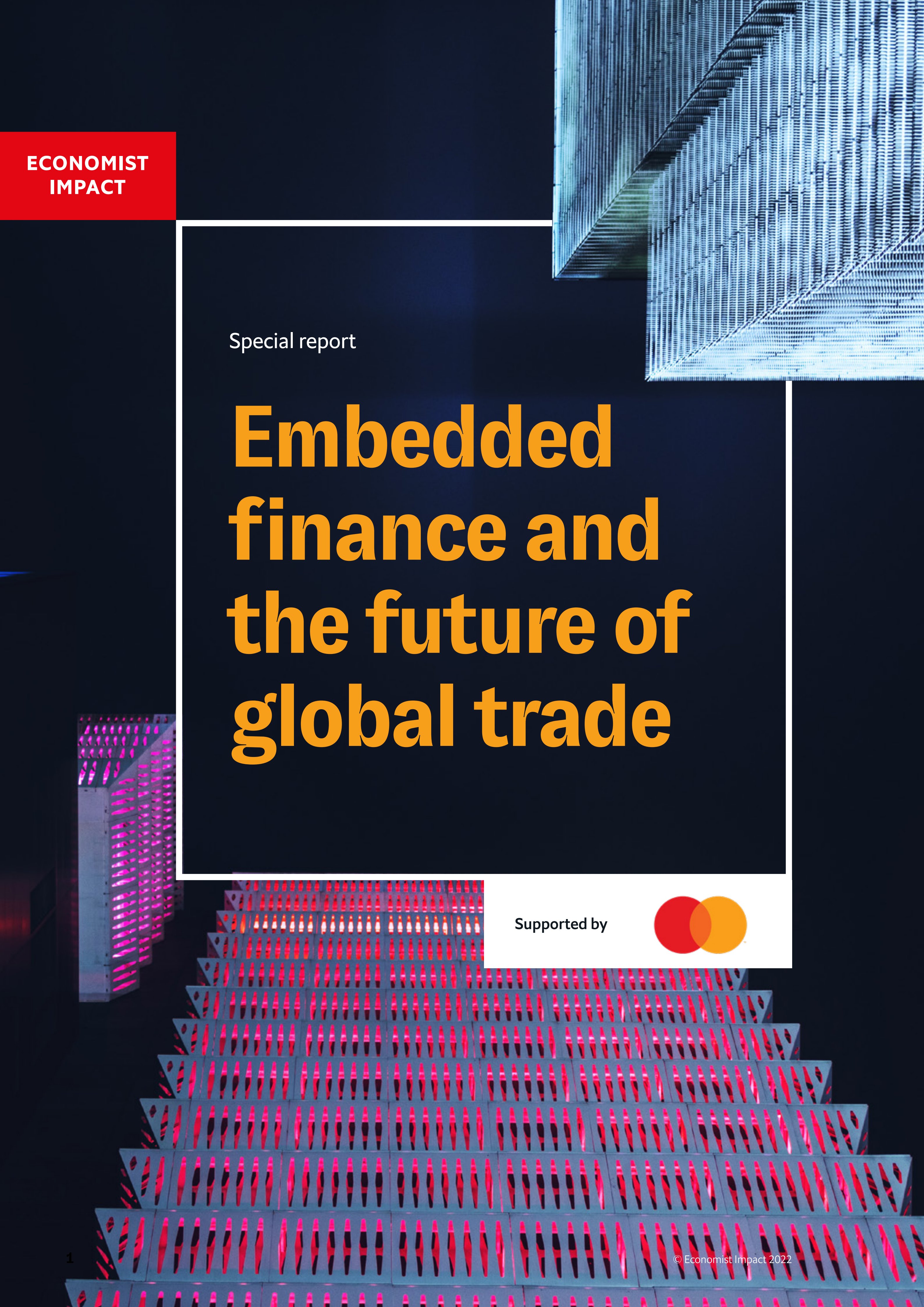

ECONOMIST IMPACT

Special report

Embedded finance and the future of global trade

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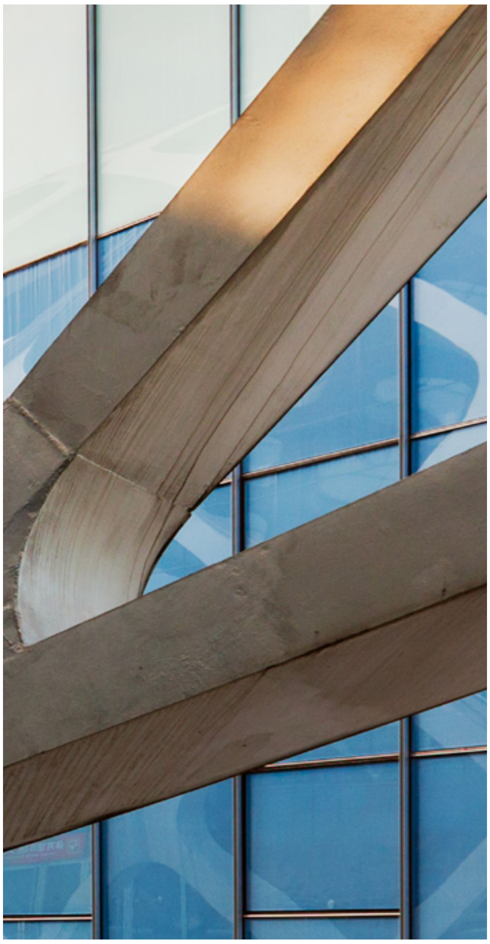


Executive summary

Today's landscape for global trade and digital commerce is one that is fraught with challenges. Alongside longstanding process inefficiencies, companies are grappling with a whole new set of concerns, from geopolitical uncertainty to high inflation. Fortunately, developments in technology have the potential to help companies navigate these issues – so how could the rise of embedded finance innovations benefit different players in the trade ecosystem? And what does it mean for commercial payments and the treasury function?

Introduction

The environment for global trade and digital commerce is at an important inflection point. Macroeconomic challenges, geopolitical tensions and the ongoing energy crisis are contributing to a raft of uncertainties for companies. Meanwhile paper-heavy processes, siloed systems and limited visibility continue to stand in the way of quick and seamless trade transactions.

The good news is that developments in technology and digitisation are bringing new opportunities to drive efficiency and economies of scale, and answer increasing demand for improved commercial payment and finance experiences. Embedded finance, in particular, promises significant potential when it comes to speeding up processes and facilitating new opportunities for trade and digital commerce.

So what does embedded finance have to offer, what are the possible use cases – and why should corporate treasurers and organisations across the international trade ecosystem be paying attention?

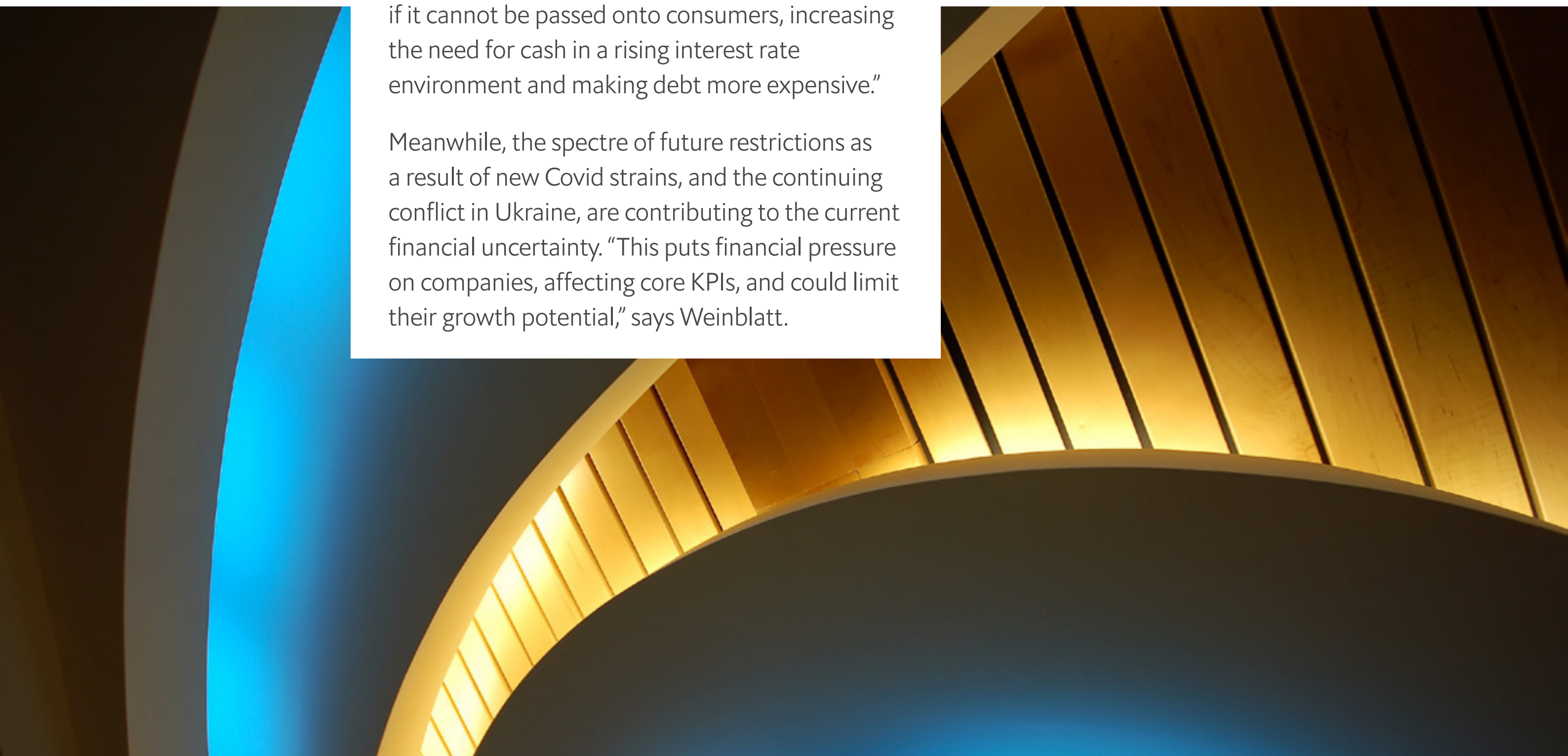
Current state of play

Today's international trading environment includes numerous obstacles that continue to hinder frictionless commerce and create barriers for small and medium-sized businesses looking to leverage the global marketplace. The last two to three years have brought disruption of many kinds – not only as a result of the pandemic, but more recently due to geopolitical instability and surging inflation. According to Claire Thompson, Executive Vice President, Global Trade, Mastercard, such disruption is "advancing impactful digitisation, but much work can and must still be done."

Danielle Weinblatt, Chief Product Officer at working capital solutions provider Taulia, notes that "there is an imbalance in global supply chains which has been most acutely felt in the US," citing shortages in shipping containers and a focus on routes that favour those which have the shortest turnaround times. And of course, high inflation in the West is another pressing issue: "Increased cost of production will inevitably reduce profitability if it cannot be passed onto consumers, increasing the need for cash in a rising interest rate environment and making debt more expensive."

Meanwhile, the spectre of future restrictions as a result of new Covid strains, and the continuing conflict in Ukraine, are contributing to the current financial uncertainty. "This puts financial pressure on companies, affecting core KPIs, and could limit their growth potential," says Weinblatt.

Looking forward, she predicts that the "18-month challenge" will centre around how these issues play out, and on how Chief Financial Officers (CFOs) manage uncertainty. On the one hand, bivalent vaccines could halt lockdowns; supply disruptions could stabilise; peace could be brokered between Russia and Ukraine, and energy supplies could return to normal levels. Alternatively, however, the global economy could find itself in a similar situation, with stagnant growth and inflation reaching Asia. "All of this means that CFOs of companies that trade globally will have to walk a tight line between survival and failure," Weinblatt points out.



Legacy barriers to growth

But while today's environment is particularly challenging, not all the obstacles in the way of smooth trading and commercial relationships are new ones. International trade has long struggled with the challenges brought by outdated processes and siloed systems. "As businesses across the supply chain prioritise resilience, visibility and choice more than ever before, a lack of digitisation, and the fragmentation that causes, stands in the way of progress," notes Thompson.

Valeria Sica, Global Head of Trade Data, Partnerships and Innovation at Citi, highlights two particular challenges. "International commerce is very fragmented by nature," she comments. "It is a business that involves several parties for a transaction to occur, including banks, customs, buyers, sellers, shippers, freight forwarders, insurers etc." In fact, she says, a typical transaction may involve anything from four to over 20 stakeholders.

Dean M. Leavitt, Founder and CEO Boost Payment Solutions, notes that the data exchange between trading partners presents a particular challenge. "In verticals like freight and logistics, the way that data is exchanged remains a challenge," he says. "When you add in the cost of cross-border transactions, this does represent a challenge in terms of the payment infrastructure's ability to keep up with the needs of international commerce."

At the same time, says Sica, commerce continues to be heavily paper driven – Citi's trade business, for example, digitises almost 25 million pages per year. "Moving the entire ecosystem into the digital space will create efficiencies and economies of scale for all players, enabling growth for international commerce," she adds.

Enter embedded finance

Given the scale of these challenges, what role could innovations such as embedded finance play in smoothing trade and digital commerce and driving growth opportunity?

In recent years, the arrival of the second Payment Services Directive (PSD2) in Europe, and the rise of open banking more broadly, has created new opportunities for financial institutions to share payment data with third parties via APIs. This, in turn, has provided a foundation for technology-driven embedded finance solutions. Development is set to continue apace in the coming years, with the transaction value of embedded finance forecast to exceed $7 trillion in the US by 2026.[1]

"The transaction value of embedded finance is forecast to exceed $7 trillion in the US by 2026"

Broadly speaking, embedded finance describes the seamless integration of financial and payment tools and services into a non-financial service provider, creating opportunities to build digital platforms that offer superior customer service. In the retail world, use cases include the adoption of embedded payments by ride-sharing apps, which mean customers have a better experience and complete transactions for services inside an app. Businesses, meanwhile, have the opportunity to compete effectively, create new business models, and drive additional revenue streams.

But while embedded finance and its application for commercial or business-to-business payments may be attracting attention today, the concept itself is not new, argues Leavitt. "Anybody who's acquired a car in the last 40 years at a car dealer, either via a car loan or lease, has experienced embedded finance," he says. "We might now be calling it Buy Now Pay Later (BNPL), but it's been in place forever. The difference is that in the past, it wasn't facilitated by financial technology companies."

Embedded finance and commercial payments

Embedded finance may not be a new concept in the consumer payments context. However, it is still nascent in the B2B world – and moving forward, it could have the potential to revolutionise corporate banking, payments and services.

According to Mastercard's Thompson, "embedded innovations accessed through one digital platform" are much more than an answer to back-office problems, and will enable businesses to operate more efficiently while realising new revenue opportunities. Thompson believes that by integrating operations into an intuitive one-stop digital platform, businesses will be able to make and receive payments, access financing and deliver value-added services more easily. This, in turn, will enhance operations, while increasing loyalty and relevance with customers. As Thompson remarks, "If your customers are offered exactly what they want, at the precise moment they need it, why would they look elsewhere?"

[1] Source: Bain & Company and Bain Capital

The next generation of embedded finance, says Chad Wallace, Executive Vice President, Commercial Solutions, Mastercard, will see financial institutions building banking-as-a-service platforms and working with technology companies to embed payments and financing options into their platforms. A key driver, he says, is the fact that individuals are used to smooth payment and finance experiences in their personal lives – "and they're now looking for that consumer grade experience when they're working, whether running a small business, or leading the treasury department within a corporation." According to Wallace, this demand for improved experience, coupled with an advancement in technologies that will enable it to happen, and is driving a "reboot of commercial payment experiences and an evolution of trading practices."

Banks are already focusing their attention on these opportunities. A survey published by PYMNTS and FIS in May 2022, *Meeting the Challenge of Payments Modernization*, found that 92% of financial institutions are currently innovating, or planning to innovate, embedded finance experiences for corporate payments. Specific areas of focus include payment processing (52%), credit cards (40%) and loans (39%).

"Embedded financing in B2B can have a variety of definitions, but essentially it means that financing can be deployed between trading partners transactionally to improve the process or reduce a need for capital as a barrier to trade," says Taulia's Weinblatt. "Blurring these worlds will be essential to how businesses think about transacting in the future."

"Buying and selling should be easy, but for far too long a lack of integration and lack of automation has held businesses back." Embedded payment and finance propositions, he says, "will give rise to intuitive experiences," whereby everything from invoicing, approvals, payment and financing will be available via a digital platform offering all the tools a business needs to thrive.

Jonas Edlund, Co-Founder and Vice President Corporate Development, Pagero

Potential use cases

How, then, can advancements in embedded finance address the existing challenges in international trade and global commerce? Mastercard's Thompson sees embedded finance as the destination point for how businesses will deliver and consume services in the future, adding that "businesses cannot afford to dawdle when it comes to figuring out their digital strategy."

Of the potential for embedded financial services for commercial payments, Wallace says "advancements will remove barriers to international commerce and create significant opportunity to differentiate." He adds that this will be achieved by "improving the flow of payments and goods across the supply chain through enhanced and personalised experiences and offerings."

The possible use cases for international trade are significant, from improving process efficiency and unlocking new revenue potential to advancing supply chain resilience:

- **Embedding financial services into business processes.** Dirk Kruse, CEO of SAP Fioneer, says the digitisation of trade is unlocking new opportunities to embed financial services into business processes, both for source-to-pay (supply side) and lead-to-cash (demand side). The most prominent examples, says Kruse, are embedded financial services at point-of-sale and point-of-purchase in B2B transactions.
- **Tracking trade and data flows.** Opportunities for improvement can also be found in the ability to track trade flows and related data flows, which Kruse says can "unlock new ways of distributing capital to businesses that need them."
- **Building resilience and stability.** Kruse argues that the disconnect between the flow of physical and digital goods, related money flows, and information flows, exposes some companies to business and financial risks – and that embedded financial services "will act as a catalyst in delivering supply chain resilience and stability for companies."
- **Freeing up trapped cash.** Increased visibility, choice and control will enable companies to release trapped cash and increase liquidity, says Thompson.
- **Providing access to capital.** Citi's Sica says embedded finance will provide access to capital to smaller entities, while potentially strengthening the entire supply chain for the big players. "I also think having the right tools for fast access to working capital could create efficiencies that could eventually translate into benefits for the entire chain," she says.

At the same time, different types of business stand to benefit from these developments in different ways:

- **Fintechs** have an opportunity to drive scale and drive additional value.
- **Banks** may be able to acquire new clients and drive new revenue streams, as well as serving existing clients more efficiently.
- **Small businesses** may be better placed to access the capital they need to drive growth and manage their cash flows more effectively.

For corporate treasury teams, the prospect of a more integrated commercial/B2B payment and finance experience has much to offer. For one thing, says Citi's Sica, it will create efficiencies that could impact the bottom line for treasurers, and help facilitate international commerce. "Creating spaces where any eligible company can participate, independently of its size, will likely enable more activity in the space," she adds.

"For example, companies can evolve from the 'manufacture and sell' model to a 'deliver and operate' model that can open new, under-penetrated market segments and develop new revenue streams."

Dirk Kruse, CEO, SAP Fioneer

Over time, Kruse predicts that embedded financial services will evolve from simply delivering an integrated payment option at the point of sale or purchase, and will enable true business model transformation. "For example, companies can evolve from the 'manufacture and sell' model to a 'deliver and operate' model that can open new, under-penetrated market segments and develop new revenue streams," he says.

Technology as an enabler

API innovation has a role to play in helping companies unlock opportunities to improve efficiency, inspire innovation and drive a better experience, notes Taulia's Weinblatt. She explains that embedded finance will enable the treasury function to act on insights immediately, and respond to liquidity needs inside a single platform.

"The objective of embedded financial services is accessibility by leveraging real-time data that enables efficiency and speed," she adds. "In the future, organisations will be able to streamline arduous processes to gain access to financing solutions and tap into these solutions in any B2B platform."

Also significant is the potential offered by algorithmic financing to help financial institutions and fintechs assess risk more effectively, which can translate into lower financing rates for customers and their suppliers – a development that Weinblatt says is "the beginning of an opportunity to offer deep-tier financing."

Regulation: help and hindrance

Regulation is another important enabler, particularly when it comes to the adoption of new technology and the development of real-time payments. As Sica explains, "Having new regulations driving the adoption of digital tools like digital identity and fraud protection brings transparency to the entire ecosystem, which translates into efficiencies and a positive impact to all stakeholders."

Wallace also flags the vital importance of understanding regulatory changes when developing new products and services, and that organisations must "think local in order to act global".

Multinational companies face challenges when it comes to navigating the regulatory environment and an organisation cannot not lose sight of local regulatory changes, such as data privacy regulation which varies by region. Wallace says that companies must prioritise staying ahead of regulatory changes or they will struggle to operate in certain markets. He adds, "Unless you have a clear understanding of how different markets are developing – for example, by having compliance and regulatory teams that are close to government bodies – you will lose touch and lose relevance with customers who rely on activity in those countries."

As Leavitt points out, regulation can be both help and hindrance. "Over-regulation can potentially stymie growth, whereas in other areas it can help growth," he comments. One area that could facilitate growth is the deployment of government-backed cryptocurrencies, which Leavitt says could be a "potent value proposition" for cross-border transactions, particularly for B2B commerce.

Cross sector relevance

Social media marketplaces are already creating tools that enable people around the world to buy and sell products. Wallace of Mastercard argues that there will be a rise of software players, tech companies and social media networks that will quickly take up the ability to embed financial services into their products and services.

From there, says Wallace, use cases will develop across a range of different industries. "In construction, embedding financial services into the way that contractors pay some of their subcontractors could be an easier way to pay and get paid for the teams that are creating large commercial real estate projects," he says. "We're seeing the same thing in healthcare – are there opportunities for a doctor's office to leverage the way the insurance company is paying them on a regular basis in order to afford some of the payables they need to make?"

Increasingly, he says, software platforms are looking in more detail about how they can serve specific industries, and embed financial services in a way that helps specific customers optimise their working capital on a regular basis.

No time like the present

So why should treasurers be thinking about the topic of embedded finance today? Why not wait and see how the market develops? For one thing, while some companies may have struggled with inertia in the past when weighing up whether or not to digitise commerce, the experience of the last couple of years may have led to a shift in perspective.

"You have to be focusing on this now. You have to make sure your platform is as efficient as it can be if you're going to compete with your peers."

Dean M. Leavitt, Founder and CEO, Boost Payment Solutions

Leavitt argues that the pandemic sparked a realisation that companies that do not prioritise the use and acceptance of digital payments "do so at their own peril." He adds, "If you're a treasurer, or doing international business – or even domestic business – you have to be focusing on this now. You have to make sure your platform is as efficient as it can be if you're going to compete with your peers."

Thompson believes that a "mindset change" is encouraging greater collaboration across the trade ecosystem that will ensure that embedded finance propositions are accelerated over the next one-to-three years. In particular, she predicts that more intelligent trade flows will be realised through partnerships that go "beyond the transactional".

Overcoming barriers to adoption

That's not to overlook the obstacles that need to be addressed before the full potential of embedded finance can be realised. As Thompson observes, "While the demand is real, the challenge is getting the right infrastructure in place and making sure the myriad international organisations across the trade ecosystem work together to realise the benefits that truly embedded innovation offers."

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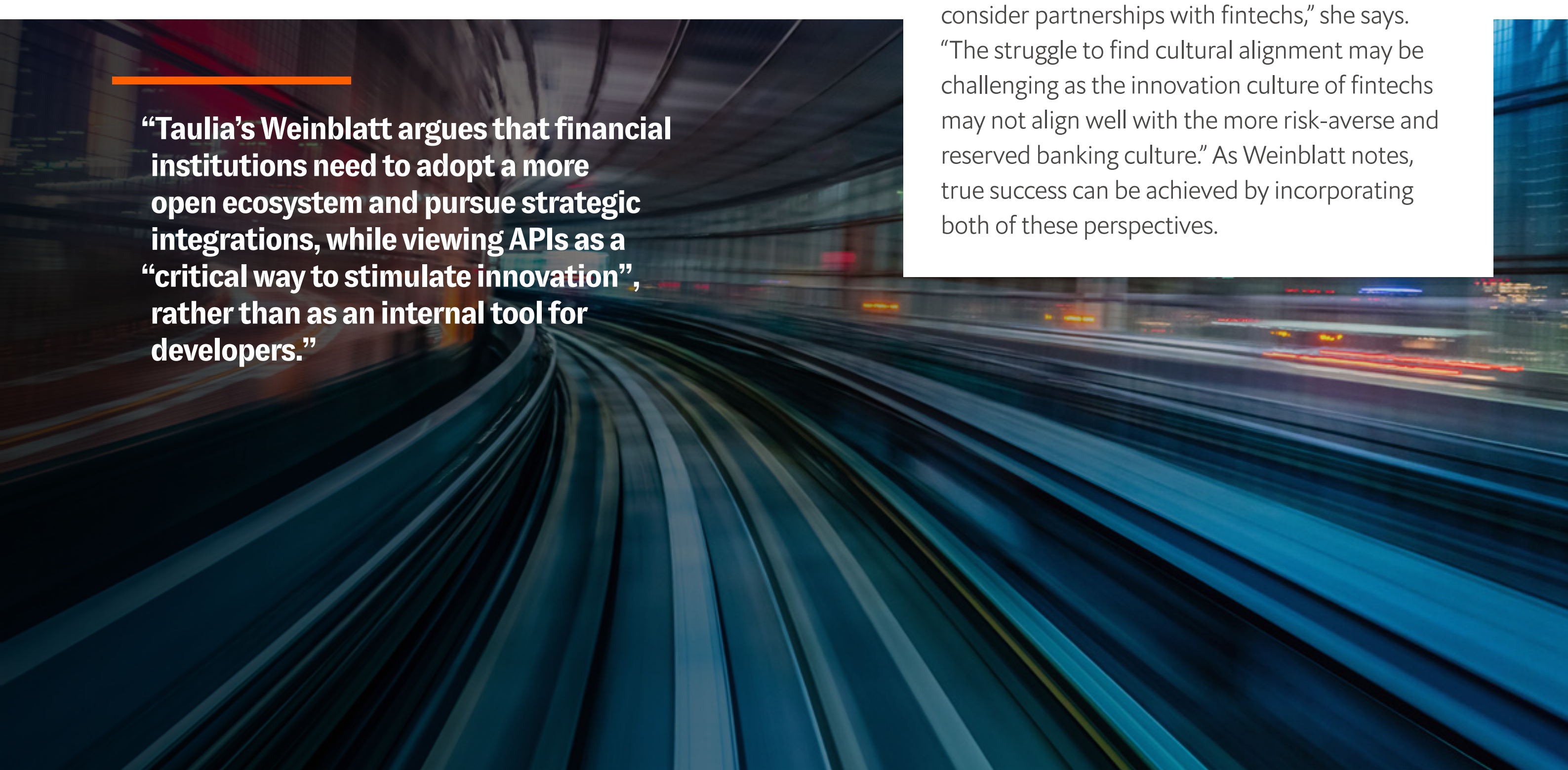
Claire Thompson, Executive Vice President, Global Trade, Mastercard

Specific barriers to adoption can include lack of investment budget and inadequate infrastructure, as well as a lack of understanding of how embedded finance differs from existing financial service models. Kruse argues that "self-disruption" is the only way to overcome some of these barriers – but at the same time, it's important to understand that the route to innovation can be disruptive to incumbents, while the scale of opportunity may be unclear to the new entrants themselves.

When it comes to driving the adoption of embedded finance, Taulia's Weinblatt argues that financial institutions need to adopt a more open ecosystem and pursue strategic integrations, while viewing APIs as a "critical way to stimulate innovation", rather than as an internal tool for developers.

At the same time, accessing the right talent is an ongoing challenge, "which also creates collaboration challenges as financial institutions consider partnerships with fintechs," she says. "The struggle to find cultural alignment may be challenging as the innovation culture of fintechs may not align well with the more risk-averse and reserved banking culture." As Weinblatt notes, true success can be achieved by incorporating both of these perspectives.



"Taulia's Weinblatt argues that financial institutions need to adopt a more open ecosystem and pursue strategic integrations, while viewing APIs as a "critical way to stimulate innovation", rather than as an internal tool for developers."

Advancing a sustainable future

Alongside the challenges of the current environment, other factors are also set to shape the future of digital commerce and global trade. In particular, these include the growing emphasis on diversity and inclusion, as well as on sustainability and environmental, social and governance (ESG) considerations.

Diversity & Inclusion

Citi's Sica highlights that diversity and inclusion should be "central to our collective mission of enabling growth and economic progress" – a view that is supported by Wallace, who believes that a more diverse mindset is needed if organisations are to bring more inclusive offerings and propositions to market.

As such, fintechs and payment providers are paying more attention to the importance of diversity and inclusion when it comes to building teams and understanding customers' needs, he says.

"In order to participate on a global scale – especially in trade, commerce and ecommerce flows – you have to think about what's going to resonate with different groups of people."

Chad Wallace, Executive Vice President, Commercial Solutions, Mastercard

"In order to participate on a global scale – especially in trade, commerce and ecommerce flows – you have to think about what's going to resonate with different groups of people," comments Wallace. "And it's difficult to create a product that's going to resonate with those groups unless you have a diverse team yourself."

Sustainability

Where ESG considerations are concerned, embedded finance has a role to play in helping to drive greater inclusion for SMEs by offering better and faster access to working capital. Embedded innovations have the potential to transform credit decisioning processes through greater insight across the supply chain, ultimately evening the playing field when it comes to access to products and solutions that can help small and medium sized businesses thrive.

At the same time, customers are paying closer attention to companies' social responsibilities in the global marketplace. "Increasingly, consumers and investors are interested in organisations that pursue ESG initiatives," says Weinblatt. "At Taulia, we believe this is a critical component of what we can offer to organisations that want to build sustainable supply chains by providing them with transparency, metrics, and ways to support a diverse supplier base."

Taulia's approach involves offering transparency to organisations that want to see the ESG rating of their supply chains. "In collaboration with third-party ESG data providers, we can uncover opportunities for improvement and help classify different suppliers across the supply chain," she says. "Additionally, we can offer these suppliers favourable rates for early payment if our customers choose."

SAP Fioneer, meanwhile, is developing a standardised ESG software solution that provides a data foundation, with a clear audit trail integrated into all existing banking processes. "By building a reliable, regulation-compliant single source of ESG truth within the bank, banks can work with external ESG providers, as well as collect and verify ESG data from clients in a structured and efficient manner," says Kruse.

Conclusion

While the principles behind embedded finance may not be new, it's clear that technology is enabling the development of a next generation of products and services that could revolutionise international trade and digital commerce. As development in the consumer context continues apace, the potential benefits for corporate banking and commercial payments are becoming clearer. CFOs, members of the treasury function and enablers across the commercial payment ecosystem are prioritising their digital strategy and reconsidering how a combination of technologies, brought to life through a partnership approach, will help them compete effectively and drive sustainable growth for themselves, their customers and suppliers through 2023 and beyond.

Offering customers new payment options is just the start: as well as tackling age-old process inefficiencies, embedded finance could also give companies the tools they need to transform their business models, stabilise supply chains, free up trapped cash and accelerate access to capital. As such, treasurers should be looking closely at their digital strategy, and ensuring they have access to the tools needed to compete in the new landscape.

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