Embedded Finance Tracker® Series Report

Core Strength: FIs Must Modernize to Meet the FinTech Challenge

May 2024

As agile, digital-native FinTechs capture a larger share of the banking industry, traditional FIs are struggling to offer their own digital services due to legacy systems. Modernizing these systems will be a critical step toward leveling the digital playing field.

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02 Banks may be eager to embrace digital technologies and compete with FinTechs on their own playing field, but their core banking systems often lack the necessary infrastructure to support such endeavors. Attempts to renovate these core systems are frequently met with high costs and complexity.

03 One promising solution for improving digital services is the progressive modernization of core systems by supplementing legacy technology with application programming interfaces (APIs). Compared to rebuilding the entire core, this approach is both more cost-effective and less risky, allowing for a strategically phased technological transition.

Banks are increasingly aware of the competitive threat posed by digital-native FinTechs, which are quickly gaining market share with innovative digital offerings. Until 2024, only a minority of bankers saw this threat as significant, but that share rose to a majority this year, with 60% of bank executives now seeing big FinTechs as a significant threat to their business, up from 47% in 2023. This concern is expected to intensify as FinTechs continue to attract customers away from traditional financial institutions (FIs).

Banks recognize the necessity of competing with FinTechs by offering digital banking products of their own. However, the implementation of these products is often stymied by their incompatibility with banks' outdated core systems. Updating these systems will be imperative to meeting consumers' growing demand for digital products.

- Competition Between FIs and FinTechs Intensifies
- Legacy Systems Impede Banks' Digital Development
- APIs Make Core Upgrades More Feasible
- How Banks Can Improve Core Systems via APIs

Competition Between FIs and FinTechs Intensifies

As consumer demand for digital banking technology rises, traditional FIs are struggling to keep pace. FinTechs, however, are rushing in to fill this void, leading to a more competitive banking landscape than ever before.

Consumers have specific demands for their digital banking experiences.

Generation Z in particular wants personalized products and services that are easier to consume on their mobile devices, according to a recent PYMNTS Intelligence survey. Some of these desired functions include the ability to open accounts, pay bills, send money to family and friends, get financial advice and apply for credit. The demand for these features is so great that members of this consumer segment are willing to switch FIs to access them. Forty-two percent of Generation Z consumers who bank with credit unions have changed their banking relationships over the last 12 months, for example, as have 44% of these consumers that bank with traditional FIs. This serves as a stark warning for FIs that fail to stay up to date in digital banking.

47%

Share of **new account openings** in the first half of 2023 occurring at FinTechs and digital banks

FinTechs are securing a larger share of new accounts.

In the first half of 2023, FinTechs and digital banks accounted for 47% of new accounts, marking a significant increase from 36% in 2020. Many of these new accounts are held by consumers who also maintain traditional bank accounts, with nearly three-quarters of consumers saying they use an average of two different financial service providers in addition to their primary bank. However, there is a notable willingness among consumers to abandon traditional FIs altogether. According to a PYMNTS Intelligence survey, roughly 41% of consumers who hold their primary bank account at a digital-only bank also hold their primary credit card with the same institution — eliminating two of the primary reasons to remain with traditional banks.

Legacy Systems Impede Banks' Digital Development

Banks may be eager to embrace digital technologies and compete with FinTechs on their own playing field, but their core banking systems often lack the necessary infrastructure to support such endeavors. Attempts to renovate these core systems are frequently met with high costs and complexity.

75% of banks say they need to modernize their core systems.

75%

of banks **struggle to implement** new payment offerings on dated core systems.

According to a recent retail banking report, FIs cite a variety of motivations for modernizing their infrastructure. Eighty-five percent of respondents express a desire to improve the user experience, while 81% want to upgrade their open banking and payments gateways. However, banks' aspirations for modernization often exceed their capabilities: 75% express difficulties in implementing new payment offerings and cybersecurity upgrades due to their dated infrastructure.

Most banks see systems modernization as a formidable obstacle.

A recent survey reveals that 59% of bankers consider their legacy infrastructure a major business challenge, with outdated back- and middle-office processes and technologies being their primary roadblocks to modernization. Seventy-one percent of bankers surveyed describe their core systems as a "spaghetti of legacy systems that are difficult to untangle and update." Other challenges cited include a lack of access to real-time transaction data and the inability to leverage this data to drive new services and products.

APIs Make Core Upgrades More Feasible

One promising solution for improving digital services is the progressive modernization of core systems by supplementing legacy technology with application programming interfaces (APIs). Compared to rebuilding the entire core, this approach is both more cost-effective and less risky, allowing for a strategically phased technological transition.

Incremental core changes leveraging APIs are proving effective for legacy system overhauls.

According to a recent report, 47% of FIs were pursuing an incremental approach to updating their core systems, and 40% chose a similar, progressive modernization approach. Both strategies leverage APIs, digital wrappers and open architectures for a smoother, more scalable core overhaul. One prominent use case for API-driven updates to core banking systems is connecting enterprise resource planning (ERP) systems to payment providers, which 44% of banks reported doing in another recent survey.

44%

of banks are using APIs to connect **ERP systems** to payment providers.

By contrast, just 13% of banks surveyed chose to undergo a total core systems replacement, underscoring the difficulty and cost of such an undertaking.

Deutsche Bank recently embedded an API-accessible payments orchestration layer in its own core upgrades.

PYMNTS Intelligence spoke with Deutsche Bank's global head of embedded finance solutions, Matthaeus Sielecki, on how these innovations can benefit the entire banking industry. According to Sielecki, APIs can enable client firms and providers to have banking services at their fingertips, particularly for fast and seamless B2B payments. This capability has become especially important as small business owners now expect an eCommerce-like experience from their banks when browsing and selecting products and services.

How Banks Can Improve Core Systems via APIs

FIs face an evolving landscape where digitalization is no longer an option but a necessity. Embracing APIs and embedded finance can significantly augment their core systems, enabling them to offer superior digital services to customers. APIs provide a modular approach to system upgrades, allowing banks to enhance specific functionalities without necessitating extensive infrastructure changes. Rather than undertaking costly and disruptive overhauls, banks can incrementally improve their systems by integrating new features and services through APIs. This approach enables banks to adopt a more agile and iterative development process, reducing time to market for new innovations while minimizing the risk of system downtime or errors.

Embedded finance also offers a pathway to innovation without the need for extensive internal development efforts. By embedding financial services into existing digital platforms and ecosystems, banks can access new revenue streams and customer touch points without reinventing the wheel. For example, partnering with eCommerce platforms to offer seamless payment options or integrating banking services into mobile apps and social media platforms can extend the reach of financial products and enhance customer engagement without significant investment in infrastructure. In this way, FIs can reap the benefits of innovation while avoiding the risks and complexities associated with a complete overhaul, ultimately driving better outcomes for both the institution and its customers.

About

galileo

Galileo is a leading financial technology company whose platform, open API technology and proven expertise enable FinTechs and emerging and established brands to create differentiated financial solutions that expand the financial frontier. Galileo removes the complexity from payments and financial services innovation by providing flexible, open API building blocks and a secure, scalable, future-proof platform. Trusted by digital banking heavyweights, early stage innovators and enterprise clients alike, Galileo supports issuing physical and virtual payment cards, mobile push provisioning and more, across industries and geographies. Headquartered in Salt Lake City, Galileo has offices in Mexico City, New York City, San Francisco and Seattle. Learn more at galileo-ft.com.

PYMNTS INTELLIGENCE

PYMNTS Intelligence is a leading global data and analytics platform that uses proprietary data and methods to provide actionable insights on what's now and what's next in payments, commerce and the digital economy. Its team of data scientists include leading economists, econometricians, survey experts, financial analysts and marketing scientists with deep experience in the application of data to the issues that define the future of the digital transformation of the global economy. This multilingual team has conducted original data collection and analysis in more than three dozen global markets for some of the world's leading publicly traded and privately held firms.

The PYMNTS Intelligence team that produced this Tracker:
Managing Director: Aitor Ortiz
Senior Writer: Andrew Rathkopf
Content Editor: Joe Ehrbar

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