The Neobank Revolution

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Introduction

The banking industry has long been known as an impenetrable oligopoly, with some of the frontrunners dating their origins back centuries [1] and handling eyewatering daily cashflows often surpassing the trillion-dollar mark [2]. Entrepreneurs would struggle to find a harder market to disrupt. Yet that is exactly what neobanks, such as Revolut, Monzo or Chime, are attempting with clever, customer-centric digital innovation at the heart of their progressive platforms. Their David-and-Goliath-esque battle has so far proved successful, but are they destined to fail?

The term neobank, or challenger bank, was first coined in 2017, stemming from the Greek work ‘neos’, meaning ‘new’ [3]. It is an innovative way of banking beyond the confines of brick-and-mortar establishments, garnering a compelling digital presence both in developed and developing markets. It has grown exponentially year-on-year to a current userbase of 250 million who’s transactions sum over $3 trillion a year [4]. A remarkable feat in any other industry yet merely a rounding error to the retail and investment banking titans.

Whilst digital banking has been around for the best part of the 21st century and there are myriad offerings in the space from established players, neobanking brings to market untapped innovation in the form of agility, user-centricity and accessibility. It hammers home the advantages apps offered by high street banks failed to capitalise on.

What Neobanks Bring to Market

Neobanks are fintech firms that offer apps, software and other technologies to streamline mobile and online banking [5]. They possess no physical branches which directly reduces expenditure; thus they can offer lower prices and rates to customers. Similarly to traditional banks, their revenue comes mainly from transaction fees charged to the merchant, subscription/lending services and investing deposits held from customers. They mostly offer simple to use, cheap, online-only current and savings accounts aimed at financially shrewd people of all ages. Organic growth and customer satisfaction are more highly valued than turning profits, at least in the nascent stages.

Each neobank is unique in their offering, perhaps because they can be fundamentally different. Some may hold a full-fledge banking license (e.g. Monzo and Starling [6]), some hold partial licences for limited sets of products (e.g. N26 can offer debit cards but must partner with other banks to offer savings accounts [7]). Others may operate without a license altogether, opting to partner with a traditional bank (e.g. Chime who essentially present a well-packaged app whilst the underlying financial products are offered by their partners [8]).

Neobanking has similarities to Decentralized Finance (DeFi) although they are built on different concepts. Whilst both are entirely digital platforms that can benefit from the latest technology trends such as blockchain and decentralization, Neobanking still involves a third-party medium to effect the transactions, whilst DeFi promotes an entirely independent, end-to-end architecture.

The industry’s explosive growth has numerous catalysts, notably: a lack of trust in traditional banks, the rise of digital technology and the support of government and regulatory bodies. This scepticism can be partially attributed to the resentment felt towards banks from the aftermath of the financial crisis in 2009 and was further compounded by the inaccessibility of physical branches during the pandemic. Subsequent data breaches and unrewarded customer loyalty have further dampened confidence [9].

Another factor for growth is the ever-increasing demand for convenience, driven by this millennia’s tech-savvy, and arguably lazier, generation […]. Instant access to one’s finances or transferring money in a matter of milliseconds can easily be taken for granted. Although these are not novel, they are examples of everyday tasks which have been streamlined and optimized by neobanks. Big banks simply fall short in their offering.

License-dependant, some neobanks can be categorized as financial institutions instead of banks, meaning they adhere to favourable regulations which often shortens legislative waits. Further, the EU’s progressive approach to financial institutions through the Payment Services Direct (PSD) and follow-up PSD2 laws have increased industry transparency and facilitated market entry. Combined with the EU common financial standards which facilitate rapid international expansion, it is clear governments and regulatory bodies aren’t opposed to the dismantling of the banking oligopoly [9].

This more open landscape allows innovative fintech firms to securely access customer account data that was previously locked away by traditional banks. To unsettle the leading players, capitalising on the negative perception of long-established institutions and passively benefitting from the technology boom is insufficient. Regulatory hurdles and lacklustre market penetration will pose significant challenges. They will need to offer a unique value proposition, one that is more convenient, more affordable, more secure, more agile than the status-quo.

The Innovation of Neobanks

A User-centric Approach

Neobanks prioritize customer experience (CX) and convenience with its user-friendly and personalized content. Consumers can easily navigate, access and manage their finances via an intuitive app, which can be surprisingly difficult and unnecessarily convoluted in the online offerings of big banks.

They leverage data analytics and user insights to offer tailored financial products, such as savings accounts, investment portfolios or financing options. This level of personalisation was once reserved for the likes of high-net-worth individuals or those with family offices but has now been made accessible to anyone with a phone and internet connection. It's ironic that customer-centric banking can be at all described as innovative; after all, what is a bank if not a pool of its clients' money?

Further, the user-friendliness of the apps invites young people to learn more about money: managing it, investing it, budgeting it and so on. For parents, neobanks offer their children partial financial freedom whilst they can maintain control of an underlying, primary bank account. Firms such as Monzo have not shied away from targeting teenagers: incentives for students, flashy coral-coloured bank cards and a punishment-free unarranged overdraft are some of the tactics Monzo has employed to make banking seem trendy and tap into new corners of the market [10].

Agility and Flexibility

Arguably a neobank's greatest advantage is its ability to swiftly adapt its services to match market trends and changing customer preferences. Their nimbler size makes them more agile when rolling out new features or adjusting existing ones, allowing them to stay ahead of the competition. Artificial Intelligence is playing a key role in product personalisation, development and rapid release by identifying underlying trends in customer data [11]. Whilst consistently being at the front of the technology adoption curve is oftentimes advantageous, it does come with risks, notably investing already-limited capital and manpower into ventures that never take off.

Their close relation with users facilitates iterative development and testing, allowing them to continuously refine and release improvements with a reduced time-to-market. This test-and-learn culture of experimentation further places customers at the heart of their strategy. It's an acknowledgement that their product is not perfect but by working together, it can be improved, something you'd never image a centuries old bank admitting. Established firms would be hesitant to take risks on ambitiously innovative products. Their reputation and internal bureaucracy force them into a position of needing to win big to warrant playing at all, oftentimes observing apathetically if the stakes aren't high enough.

Business model and Accessibility

The lower costs and greater transparency of neobanking has massively contributed to its popularity, especially the fee-free accounts with no minimum balances and no overdraft/maintenance fees. When making large transfers or exchanging currency, customers know what to expect, oftentimes inter-currency transactions are processed only when exchange rates are favourable [12]. These could be classed as quality-of-life (QoL) improvements rather than innovations, yet it's amazing how only recently they've become commonplace.

One benefit from the discrepancy in banking regulations is that neobanks are allowed to charge six-times higher transaction fees to merchants versus banks with assets higher than \$10bn, up to 0.2% for every debit card transaction [13]. Whilst this may be unsustainable in the long term, it certainly shapes their current business model and is a key difference from institutional banks who's profits typically come from investments and interest repayments. Another difference, for some neobanks, is their offering of subscription services where users can pay more to unlock certain features, including higher interest rate savings account, phone and travel insurance, higher fee-free withdrawals and other CX/QoL improvements [14]. This 'freemium' model has suited them well in terms of attracting users; the free version offers enough to satisfy, but not in profitability. However, very few customers are willing to pay the monthly subscriptions, perhaps because an overwhelming majority still use neobanks as a secondary, experimental service [15].

Decentralisation and digitalisation of the business drastically facilitates expanding to new geographies. Their services can be readily offered in new regions or countries without the typical overheads associated with physical branches. This makes them considerably more scalable than traditional banks, whilst also promoting open banking principles by encouraging partnerships with other international firms [16]. Blockchain-based solutions can also enable faster cross-border payments for neobanks, as well as improved data security [17].

Whilst there is no doubt that larger institutions have the capacity to develop and deploy the above innovations themselves, they simply haven't done it fast enough, if at all, creating a gap in the market for neobanking to thrive and seize the first mover's advantage.

The Effects of Neobanks

On Customers

Neobanks are lowering the barrier to entry for customers. Accounts can be set up in as little as 8 minutes and they accept individuals who would otherwise not qualify for a traditional bank due to lack of credit history, stable employment or permanent address, to name but a few reasons [18]. They cater to underserved, or entirely unserved, populations, bringing financial inclusivity to marginalized groups whilst enhancing convenience and accessibility for everyone. Some neobanks incorporate social or community features such as splitting bills or group savings, encouraging financial collaboration amongst friends and family.

Additionally, neobanks are highlighting the important of financial literacy by educating their customers and those around them. Tools to track spending and budgeting akin to a fiscal advisor's services help users manage their money effectively and make informed decisions. They often publish educational content and articles on their website or within the app, providing openly available insights and tips [19].

Whilst neobanking is more analogous with apps than platforms, network effects can increase its value as more users sign up: savings rates increase, investment in UX increases, products diversify, and loyalty is rewarded. Referral programs are perfect for expanding the user base and building trust, something Revolut has exploited successfully [20]. Data-driven optimization of products is facilitated further as the platform expands. Maintaining robust security measures and quality of customer services/product offerings must be balanced with growth, a slip in either could permanently damage public opinion and cause customers to retreat to established banks. Governance frameworks in line with industry are paramount for protecting customers from cybersecurity threats, although some neobanks claim to be safer than existing alternatives [21].

On the Market

Without a doubt, neobanking is reshaping the financial market, forcing the industry to rethink how it does business. The digital-first disruption of the traditional banking landscape has spurred competition into investing more in technology, enhancing its virtual presence and focusing on innovation to remain competitive. New standards have been set for customer-centricity, pushing big banks to re-evaluate their strategy and shift towards delivering personalised services for all customers, not just the highest earners. Whilst some of the largest UK banks appear unbothered and unthreatened, others, particularly investment banks such as JP Morgan Chase and Morgan Stanley, have come out with their own online-only offerings, hoping to piggy-back off their reputation and resources to spring themselves upward [22].

Furthermore, the rise of neobanking has accelerated the digital transformation of the financial industry; traditional banks must match, if not exceed, the agility and convenience of neobanks. User-friendly interfaces, faster logins and improved global accessibility were previously overlooked; these and more must be quickly addressed to retain clients.

There is of course the argument that neobanking has had little real-term impact on the market and whilst the disruption has certainly been eye-opening, its effects are barely a passing wave, more a gentle ripple. Monetarily, the ambitious $100 billion global neobanking market sizing is a fraction of retail banking's $5 trillion mark [23]. The industry has taken inspiration from what neobanking offers and whilst the fiscal market remains relatively unperturbed, leaders should take care in not falling too far behind technologically and innovation-wise.

On Governments/Regulators

Governments and regulatory bodies have had to explore new policies and guidelines to accommodate emerging financial entities, ensuring the market remains competitive whilst protecting consumers. Closer attention and oftentimes support has been paid to entrepreneurial fintechs from a regulatory perspective, especially regarding handling of customer data. High visibility lawsuits against the likes of Facebook and Cambridge Analytica sensitized the everyday person to data privacy [24]. Neobanks' reliance on digital platforms has prompted governments into enacting or revising data protection laws, such as GDPR in Europe [25]. Furthermore, standard banking regulations such as liquidity ratios or deposit insurance are required of neobanks to protect customers' funds, although providing these on another firm's behalf through partnering has now been made possible [26].

Unfortunately, widespread financial inclusivity and fewer barriers to entry can attract criminal and illicit users. The lax identity verification processes and potential for anonymity in transactions is proving a challenge for both regulators and neobanks. Collaboration with law enforcement to enhance security measures is benefitting both parties and the industry as a whole [27].

The Future of Neobanking

Profitability is the biggest threat to neobank existence; aggressive strategies for attracting new members such as fee-free accounts, fiscal incentives and no-minimum initial deposit means almost all neobanks are operating at a loss [28]. Currency fluctuations increase the risk of incurring losses with foreign exchange whilst having to share their revenue with underlying banks and partners is also biting into their margins.

In 2022, most of the world's 291 neobanks were not able to turn a profit, investors were losing patience and the focus shifted from growth at all costs to profitability. There are doubts as to whether neobanks can pivot quickly enough to survive. Driving profitable growth will require realignment of their products, policies, marketing strategies and other integral processes, all whilst adhering to stringent regulations [29].

It's unclear whether reaching a critical mass of users will suddenly turn neobanks profitable, or if the business model is fundamentally flawed. In 2018, Monzo revealed that a three-quarter-million increase in user base had in fact led to a four-fold increase in per-annum losses, stating that while customers are happy to give neobanking a try, few innovators/early adopters are willing to make them their primary bank. On average, Monzo customers have less than £150 in their accounts, making them financial burdens rather than assets [9].

Continued innovation and monetization of the user base are vital for growth and future profitability. Neobanks could stretch into new geographies, although pressure from investors to convert platform traffic to cash and risk of market oversaturation will push them toward product diversification. Some firms have gained licenses allowing them to offer riskier investment products or small & medium business (SME) loans, thus diversifying their revenue stream although imitating what institutional banks already offer, without the centuries of trust [29]. Ethically leveraging customer data by selling copies to third parties can help raise capital, although risks lowering public perception and consumer trust.

An emphasis should be placed on attracting more fully committed users to the platform, rather than second account holders. This allows both parties to benefit from the network effects, makes premium account features worthwhile for the user and gives neobanks more capital with which they can offer higher investment returns. Incentives for switching such as a free premium account trial could prove effective, although costly. Trust in neobanks is a point of contention, decentralised can put potential 'full-time' customers off [30]. Old habits die hard.

Ultimately, can they ever compete with the big players? The likely answer is no, but one could argue that was never their objective. Once the inevitable mergers, acquisitions, buyouts and deaths occur, as expected in any emerging market, a handful of frontrunners will settle from the dust. And even after the chaos, a top retail or investment bank could easily acquire or imitate the leading fintech firms, such is the extent of their power and capital. What is guaranteed however, is that neobanks will continue to push both industry and regulators to become more agile, more accessible, more technological oriented, all whilst shining the spotlight back on the customer.

Lessons from Neobanking

Neobanks are challenging the seemingly unquestionable hold big banks have on the financial industry. It can be better understood as an optimization of the existing banking system rather than an industrial uphaul, a sizeable revolution nonetheless. Customer-centricity has been brought back into focus and financial inclusivity championed. The convenience, innovation and simplicity that has propelled their growth and thus far defined their success will require continuous evolution and diversification. A greater focus on profitability is paramount if they are to live to fight Goliath another day.

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