

The Rise of Neo-Banks and Challenger Banks

I. INTRODUCTION

For a long time, the banking business was considered to be among the most difficult to get into. Market leaders such as HSBC and JPMorgan Chase have been around for over 150 years and have market capitalizations in the hundreds of billions of dollars. There are undoubtedly more accessible markets that a new business may enter and shake up.

However, in recent years the EU's forward-thinking approach to financial regulation has fostered increased competition within the sector. The initial Payment Services Directive, enacted in November 2009, enhanced industry transparency and facilitated entry into the market. This has opened a significant opportunity for emerging fintech companies to safely access customer account information that was previously exclusive to traditional banks.

As a financial analyst, it is interesting to note the emergence of neo-banks, which provide banking services with a digital-first approach. Neo-banks have become increasingly popular since the 2008 financial crisis, appealing to customers who value transparency, convenience, and affordability. Yet, they must overcome obstacles like establishing credibility, adhering to regulations, and expanding their range of services.

II. LITERATURE REVIEW

The purpose of this literature review is to examine the concept of neo-banks, including their classification and primary business model. Furthermore, this also highlights the influence of neo-banks on traditional banks. The literature study is conducted by consulting electronic databases such as Google Scholar, articles from reliable newspapers, blog pieces from various websites, and the websites of neo-banks.

1. Concept of neo-banks

In a broader sense, a white-label neo-bank is a digital banking platform that operates exclusively online, providing financial products and services without the need for a physical branch.

Neo-banks can be categorized into three groups based on their execution. There are different types of neo-banks available, each with their own unique features and offerings. Neo-banks should not be mistaken for challenger banks, as the latter are banks that prioritize digitizing their services and have limited physical branches.¹

¹ Beck, S. (2022) Council post: What factors affect the development of Neobanks?, Forbes. Available at: <https://www.forbes.com/sites/forbestechcouncil/2022/10/04/what-factors-affect-the-development-of-neobanks/?sh=15cd541d4f81>

Full-stack neo-banks, unlike front-end ones, have the advantage of operating with a full banking license. *Front-end neo-banks*, in contrast, must establish partnerships with traditional banks to provide financial services. Neo-banks primarily prioritize the development of their applications' technical and user interface aspects, while their partnering banks handle regulations and legal requirements. It is quite uncommon for a neo-bank to provide a hybrid approach. *Hybrid neo-banks* integrate DeFi (decentralized finance) into their operations, enabling direct peer-to-peer transactions for their users, bypassing intermediaries.²

2. Neo banks business model

According to SAXE Global – market leading banking orchestration and legal structuring, neo-banks utilize different business models, and here are four of the most common strategies with unique revenue drivers.

- *Revenue from interchange fee*: neo-bank charges a fee when users utilize their neo-bank-issued cards for making payments. Moreover, these neo-banks have the potential to generate revenue through the interest accrued on ATM fees and cash transactions.
- *Credit-led approaches*: these are employed by certain neo-banks, wherein they adopt business structures that prioritize credit and offer credit cards as their principal product. Interchange fees, interest rates, and carrying credit card balances are the primary sources of revenue generation.
- *Ecosystem-based strategy*: neo-banks frequently employ ecosystem-based tactics by constructing environments that revolve around their primary offering, leveraging APIs to seamlessly interact with diverse services. This technique is shown by Revolut, which provides access to investing possibilities in many sectors such as the stock market, cryptocurrencies, commodities, insurance, and other areas. Neo-banks enhance their revenue streams through the expansion of their product offerings.
- *Product extension strategy*: certain challenger banks prioritize product expansions as a fundamental component of their business plan. This necessitates diversifying their range of services beyond conventional banking offers. To broaden their sources of income, they could provide supplementary financial goods and services, such as loans, savings accounts, or wealth management solutions.

3. The impact of neo banks on traditional banking

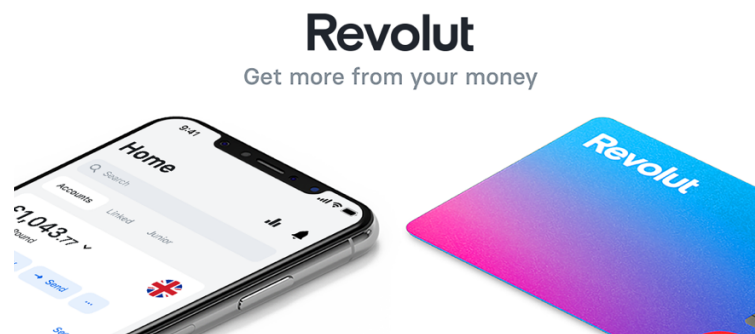
Neobanks have significantly transformed the banking landscape, compelling traditional banks to adjust and find new ways to thrive in the digital era. With the emergence of neobanks,

² Ibid

the banking industry has witnessed a significant shift towards digitalization. Traditional banks are now heavily investing in their digital platforms to stay competitive in the market. Nevertheless, neobanks possess a notable edge in terms of their agility and ability to provide a superior customer experience. Their adaptability in responding to market dynamics and customer input establishes them as industry frontrunners. Thus, conventional banks, grappling with antiquated processes and legacy systems, are making significant efforts to narrow the divide and keep pace with their more agile rivals.³

III. CASE STUDY - REVOLUT

1. Overview



Revolut entered the market in the UK in 2015, making it the first of the top challenger banks to launch. Revolut was established by Nikolay Storonsky (CEO) and Vlad Yatsenko (CTO). It was introduced with a convenient feature of free currency exchange and ATM withdrawals, enabling individuals to effortlessly spend and transfer money internationally.

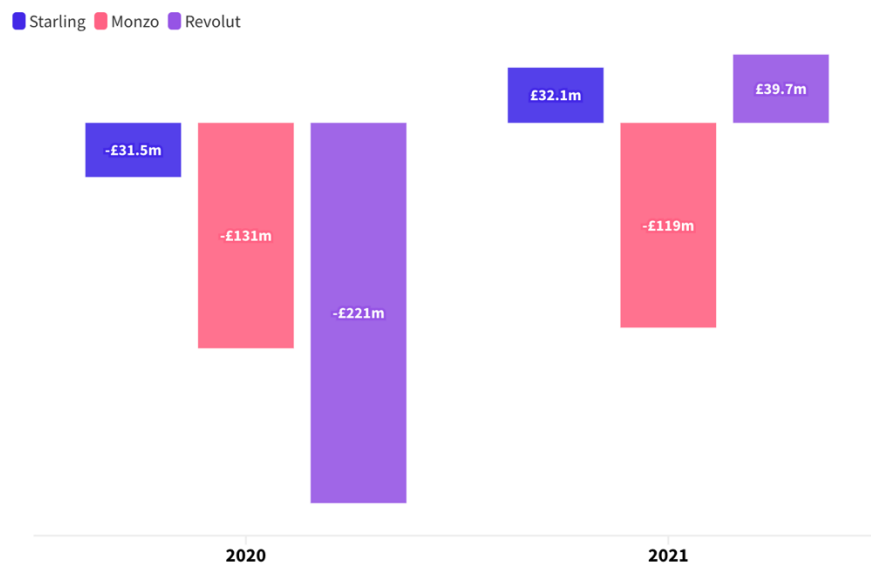
In 2020, Revolut started its global expansion by entering the markets of Japan and the US. Available functionalities encompass currency conversion, debit cards, virtual cards, Apple Pay, stock trading, and cryptocurrency trading.

Revolut's website states that it boasts an impressive user base of 35 million spread across 38 countries as of 2023. The engagement experienced significant growth from 2021 to 2022, with over a 50% increase in monthly active customers and businesses compared to the previous year. Additionally, there was a 55% rise in the total number of customers on pain plans.

2. Discussion

This part will compare the top three neo-banks in the UK to highlight the impressive growth of Revolut within its sector.

³ Vyas, R. (2021). The Disruption of Traditional Banking: An Analysis of the Impact of NeoBanks on the Industry. *Journal of Applied Finance and Banking*, 11(2), 12-22

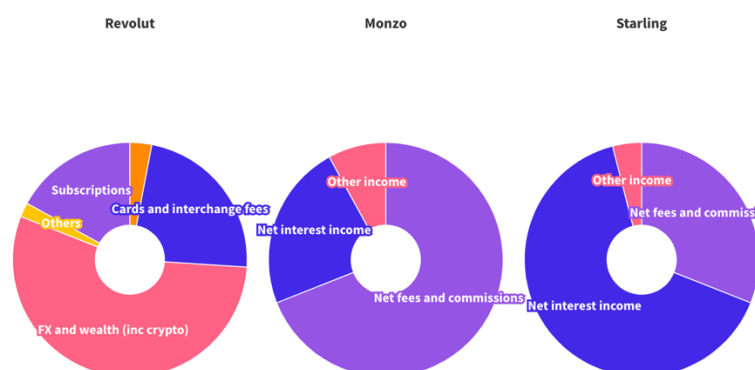


Starling, Monzo and Revolut's profit and loss for 2020 and 2021

Source: sifted

Revolut has experienced a remarkable transformation in terms of its financial performance. In 2020, it experienced the largest loss among the three digital banks (£221m), but successfully turned things around to achieve the highest profit (£39.7m) in 2021.

Starling's impressive turnaround to profitability was fueled by a significant 93% surge in revenue, reaching £188m in 2021. On the other hand, Monzo experienced a loss, although it did manage to reduce its total losses by a modest 9%, from £131m to £119m between 2020 and 2021.



Comparison of Neo-bank Revenue Streams in 2021

Source: sifted

As can be seen from the graph, Revolut has the most diversified revenue streams. In 2021, card transaction fees (also referred to as interchange fees) remained a significant component of the business models of all three banks.

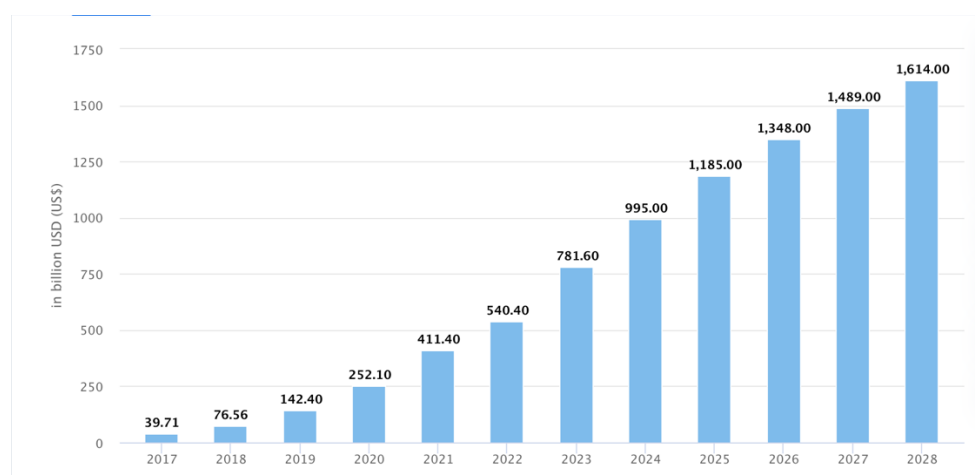
However, Starling and Revolut have successfully expanded their revenue streams, which greatly contributed to their achievement of profitability in 2021. In 2021, more than half (55%) of Revolut's total revenues came from its foreign exchange and wealth division, which also includes its crypto trading arm. It experienced significant gains during the period due to the surge in cryptocurrency popularity caused by the pandemic.

Starling, on the other hand, shifted its attention from retail customers to businesses during the Covid pandemic. Its involvement in the UK's Covid rescue loan schemes resulted in a significant increase in lending to small businesses, surpassing £2.2bn in 2021.

The majority of Monzo's revenues still come from card spending, accounting for 69%. In 2021, the company experienced significant revenue growth primarily due to an expansion in its customer base. According to its financial report, the company attributed this growth to the high demand for its newly introduced subscription products.

IV. ANALYSIS

1. Industry growth outlook



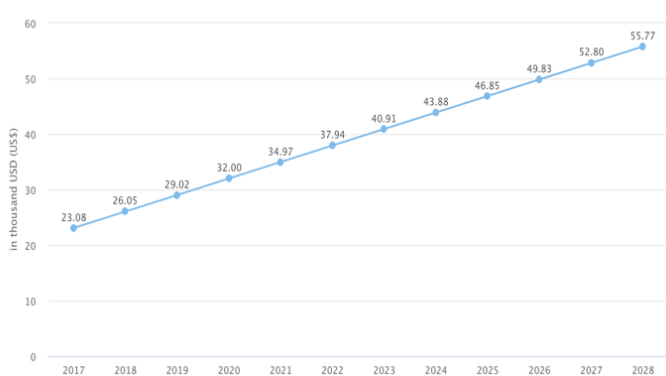
Transaction value in 2017-2024 period and projection until 2028.

Source: Statista Market Insights

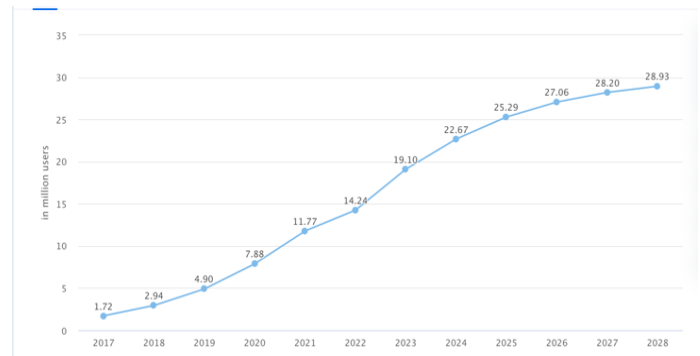
Looking at the big picture, there was a substantial increase in the transaction value from 2017 to 2023, going from \$39.71B to \$781.60B. It is evident that the neo-banking market is experiencing significant growth and global expansion. There are various reasons behind the expansion of the neo-banking market. These include the growing need for convenient and easily accessible banking services, the emergence of digital technology and the internet, and

the evolving preferences and behavior of consumers. In addition, the popularity of neo-banks has been fueled by their lower costs and increased flexibility compared to traditional banks.

It also predicts that by 2028, the corresponding figure will increase to \$1,614B. Various factors, including the widespread adoption of smartphones, a growing desire for digital banking services, and ongoing advancements in fintech infrastructure, are anticipated to drive this expansion. In addition, neo-banks are forming more partnerships with traditional banks and financial institutions, which is anticipated to boost the adoption of neo-banking services.



Average transaction value per user in the period



Number of users in the period

Source: Statista Market Insights

As the transaction value increased, average transaction value per user and number of users during the period also increased dramatically. It is indicated that neo-banks have been successful in building trust from customers. Average transaction value per user was \$40.91 thousand in 2023 and is predicted to continuously increase to \$55.77 thousand by 2028. Along with that, number of users also rose up notably from 1.72M users to 19.10M users in 2017-2023 period. Nowadays, there are more numbers of challenger bank have a banking license, are authorized by the authorized by the Prudential Regulation Authority, are regulated by the Financial Conduct Authority and are backed by the Financial Services Compensation Scheme, a government fund that protects savers' money such as Monzo, Starling Bank and Revolut, plus their advantages in the banking market, which will be discussed in the next part, makes customer have more preference in using their product.

2. Innovation of Neo-banks

- *Lower costs:*

Neo-banks reach customers through brokers and online platforms rather than brick-and-mortar branches like their larger competitors.

- *The fees:*

Neo-banks rarely charge monthly maintenance costs, international transaction fees, or transaction fees between the neo-banks and the customers' traditional bank.

- *Wide customer base:*

For example, it is difficult for SMEs to secure a loan from banks as many of them cannot provide valid collateral or pass the strict credit test. Accordingly, challenger banks focus their businesses on SME financing, which not only helps smaller businesses to obtain funding to grow, but also wins them numerous clients overlooked by large lenders.⁴

- *Convenience:*

They deliver their banking services through mobile apps and websites, focusing on offering their customers an effortless, user-friendly and entirely digital experience.

- *Special features:*

Using technological advancements, neo-banks provide services such as real-time transaction notifications, budgeting and investment tools, straightforward account setup procedures, as well as access to a broad spectrum of trading markets, including cryptocurrency and stock exchanges.

3. Downside of Neo-banks

- *Limited physical presence:*

This lack of physical presence can make it difficult for customers to interact with the company directly, ask questions, or seek assistance when needed. While many companies offer online chat support or email assistance, these channels may not always be sufficient for addressing complex issues or urgent concerns.⁵

- *Limited range of financial products:*

Due to their limited physical presence, some companies struggle to provide customers many financing options. This lack of financial product diversity can hinder customers' ability to make decisions and maximize their financial potential.

- *Security and privacy:*

Digital financial service providers have to pay more attention to safeguarding the personal data of their users as well as combating phishing websites and mobile apps, and preventing other fraud mechanisms that might be exploited by financial crimes. Heavy reliance on

⁴ Lu, Lerong (2017) 'Financial Technology and Challenger Banks in the UK: Gap Fillers or Real Challengers?', *Journal of International Banking Law and Regulation*, 32(7), pp. 273-282., Available at SSRN: <https://ssrn.com/abstract=2988599>

⁵ What are the downsides of Neo Banks? Available at: <https://www.finextra.com/blogposting/24712/what-are-the-downsides-of-neo-banks>

technology to execute business operations comes with certain risks such as technical risks, connection risks, cybercrime.

4. Challenges

- *Building trust*

Customer acquisition poses a significant challenge for neo-banks in the current landscape. Despite the current state of consumer confidence and the lack of strict regulations, it is still challenging to alter deeply ingrained consumer behaviors that have been established for over a century. It's worth noting that the three biggest UK Neo-banks, Revolut, Monzo, and N26, have a combined customer base of 2.5 million, whereas the largest UK traditional bank, Lloyds, proudly serves 30 million customers. It appears that while the public may not have confidence in traditional banks to provide them with the most advantageous financial options, they do have faith in these banks to safeguard their funds. However, with the rising number of cyber-security attacks on traditional banks, the sustainability of this perception is up for debate unless significant measures are taken.

- *Profitability*

Neo-banks have successfully enticed customers by offering the attraction of reduced fees. Due to the absence of expenses associated with maintaining physical branches, these institutions can provide services at no cost that are typically charged for by more established organizations, like currency withdrawals abroad. Nevertheless, neo-banks may have lower costs, but their earnings are also relatively low.

Revolut, the neo-bank pioneer, has reached a significant milestone by achieving a monthly break-even point. However, they are currently facing challenges in monetizing their service. If neo-banks want to stay competitive in the long run, they need to find a way to effectively monetize their services while remaining an attractive alternative.⁶

This brings up the important question of whether neo-banks need to simply increase their customer base to become profitable, or if they need to make significant changes to their business model.⁷

- *Other challenges:*

The rising number of cyber-attacks and cyber-crime can have a significant impact on consumer confidence. These attacks can also lead to operational losses that can be

⁶ O'Brien, A. (2023). Which UK neobank performed best in its latest results?. Sifted, <https://sifted.eu/articles/uk-neobank-revolut-monzo-starling-financials/>.

⁷ Bakhtar, M. (2023). Is the neobank bubble about to burst?. Fintech Magazine, <https://fintechmagazine.com/articles/is-the-neobank-bubble-about-to-burst>.

devastating for emerging neo-banks, potentially leading to bankruptcy and insolvency. Given the online nature of neo-banks, their vulnerability to threats is heightened. Therefore, it is crucial for them to implement robust security measures to effectively address these issues.⁸

According to Jimmy Fong, the chief commercial officer at SEON, he expresses concern about the potential for fraudsters to take advantage of the simple process of opening neo-bank accounts. “They recognize the disparity between their approach and the conventional methods of security,” he explains.⁹

Another challenge they encounter is the insufficient amount of capital available. For example, Revolut’s impressive \$250m funding round last year, the amount of capital they have access to still falls short when compared to traditional banks. Without a significant increase in investment or the development of a truly distinctive product, it remains uncertain if neo-banks can successfully compete in the long-term against traditional banks, which possess significantly greater capital to allocate.¹⁰

5. Future of Neo banks

The future appears bright for neo-banks as digital banking gains popularity. It is anticipated that their growth will persist, and they will continue to capture a larger portion of the market. If neo-banks can demonstrate their strong security measures and regulatory compliance soon, they may be able to gain the necessary time for public opinions to increasingly align with their favor.

A more strategic approach may involve neo-banks focusing on specific selling points instead of trying to compete with the major established banks in all areas. There is clear evidence of this happening, as neo-banks such as Revolut is targeting individuals who are constantly on the move, such as travelers. Similarly, Varo is directing its efforts towards savers building financial health.

⁸ Koibichuk, V. (2021). Innovation technology and cyber frauds risks of neobanks: gravity model analysis. Marketing i menedžment inovacij.

⁹ Lumley, B. (2022) Neobank market grows against complacency of traditional banks, The Banker. Available at: <https://www.thebanker.com/Neobank-market-grows-against-complacency-of-traditional-banks-1665561597>

¹⁰ Sutton, J. (2020) The rise of the Neobanks in the UK, The Corporate Law Academy. Available at: <https://www.thecorporatelawacademy.com/knowledge/the-rise-of-the-neobanks-in-the-uk/>

Market Segmentation	
STASH For Middle Class Americans STASH was built with one mission: to create financial opportunity for all Americans, and is helping millions work towards their financial freedom, one day at a time <ul style="list-style-type: none"> ✓ Unites investing, banking, saving, and education into one seamless experience ✓ Banking with no hidden fees, debit card with Stock-Back rewards, simple and flexible investing 	deserve For Millennials and Gen Z Leverages machine learning and alternative data to help millennials and Gen Zs gain financial independence through access to fair credit products <ul style="list-style-type: none"> ✓ Credit card products for students and young professionals ✓ Credit history not required ✓ White label Card-as-a-Service platform for businesses
Revolut For Travelers Launched to help travelers get lower foreign exchange fees on cross-border transactions and money transfers <ul style="list-style-type: none"> ✓ Free international money transfers ✓ No-fee global spending ✓ FX always at the interbank exchange rate 	VARO For Savers Building Financial Health Built to help customers improve their financial health through technology and transparency <ul style="list-style-type: none"> ✓ High-yield savings account ✓ Automated saving tools ✓ Tools to track spending, forecast cash flow
Better PFM Tools	
MoneyLion For Financial Wellness and Advice Financial Heartbeat™ provides actionable guidance around saving, spending, shield and credit score <ul style="list-style-type: none"> ✓ Unique Credit Score factors explained ✓ Credit Monitoring ✓ Scenario-based credit improvement ✓ Credit Reports 	upgrade For Lower-Cost Credit Products Credit Health tools help customers understand and improve their credit scores <ul style="list-style-type: none"> ✓ Helps users better understand their credit scores and the key factors influencing them ✓ Credit Score Simulator shows how different scenarios would impact credit score
Mission Driven / Value Oriented	
Aspiration to build the good Banking / Investing Tied to Causes "A financial firm you can fall in love with - Banking and investing that puts you, your conscience and the planet first" <ul style="list-style-type: none"> ✓ Invest in 100% Fossil Free companies ✓ "Pay what you think is fair" ✓ 10% of Aspiration's earnings go to charity ✓ Integrated tools for donating to causes 	TANDEM "Win Win Banking" <ul style="list-style-type: none"> ✓ Tandem is the good bank that puts purpose over profit ✓ Tandem makes more money for customers than it does for itself every year ✓ Tandem donates its late fees to charity ✓ Tandem shares commission on any third party products sold

Source: FT Partners

V. CONCLUSION

The creation of Neo-banks has the potential to challenge traditional banks, although currently they are mostly viewed as supplementary rather than core services. It is undeniable that the credibility and trust that traditional banks have built over time could be concerning for neo-banks, as it suggests that they are frequently utilized for lower-value transactions. However, since Neo-banks gradually prove themselves to a wide range of users, there are possibilities that eventually their consumer trust shall be on par with traditional banks. Moreover, the big news is traditional banks already see neo-banks as competitors, and this competition will only grow as more UK consumers start to use them as their main current accounts.

Furthermore, there are potential opportunities in providing unique and customized financial products, along with advanced user experience technologies. In the future, it is highly unlikely that traditional banks will be replaced, despite the increasing usage of new banks. Traditional and new banks can coexist and cater to diverse customer needs in the ever-changing banking landscape.