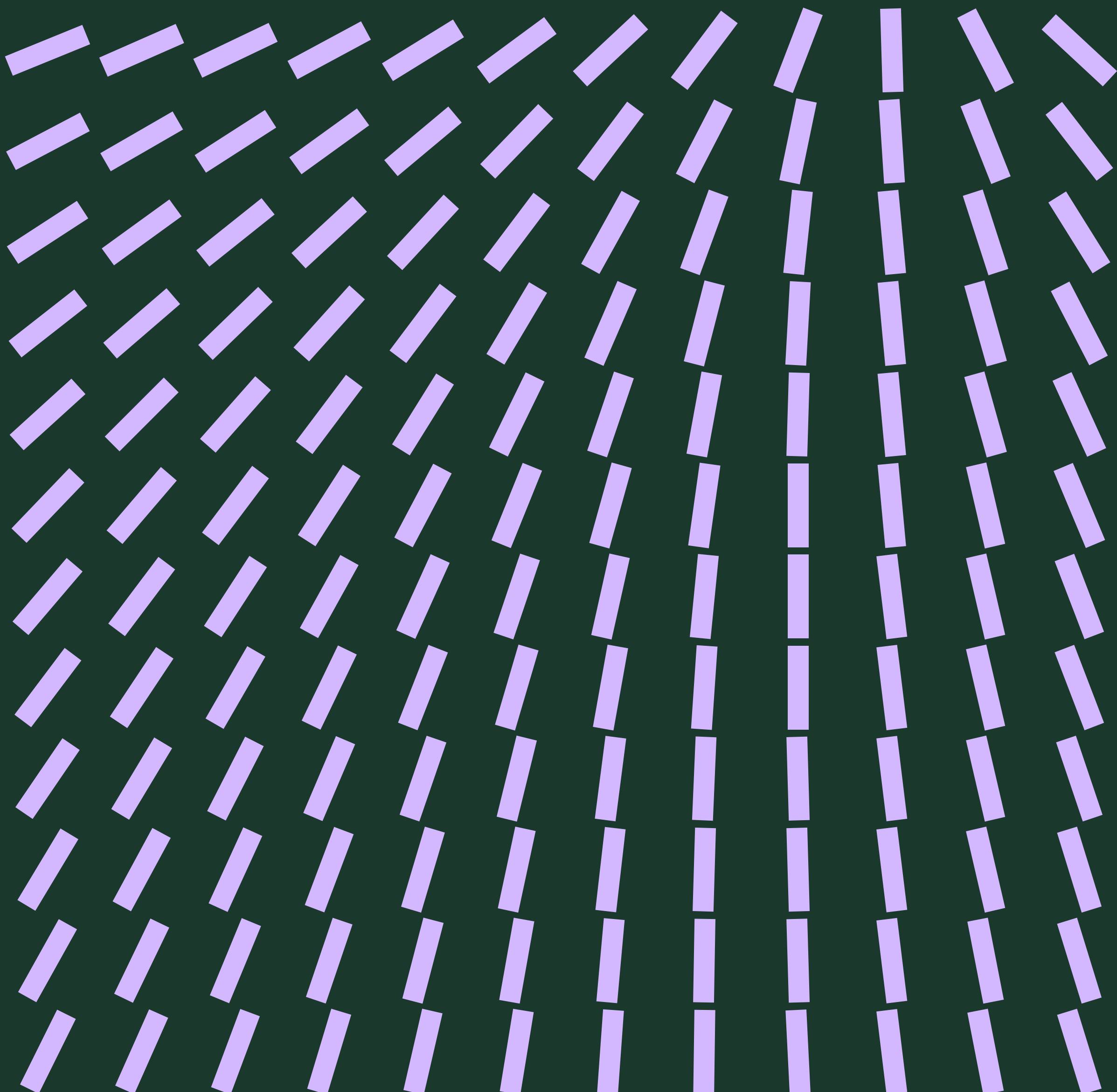
The ascent of Neobanks

RFS
Redesigning Financial Services

How digital banks are upending the traditional industry



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Editorial

The financial services industry is changing. New competitors, modern technologies, and changing market situations make adapting to this rapid change more challenging. However, this change will only continue to accelerate.

In retail banking, new competition has emerged in recent years from so-called Neobanks. Where these players initially focused only on the payment area to build a large customer base, they are now moving into other businesses. And while they have hardly posed a threat to banks so far, they offer a better customer experience in some areas and have thus been able to win over young customers in particular. But traditional banks are not standing still. They are fighting back by investing in online banking and improving the client experience - denying the Neobanks further market share.

This report examines the reasons for the emergence of Neobanks, what makes them so unique, and where they score particularly well. Further, we look at the current state in different geographies. Finally, we offer a glimpse into the future, discussing the challenges Neobanks will have to overcome to remain relevant in the future.

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Introduction

The technological revolution of recent years has severely disrupted many industries - from travel and media to retail - and torn apart the forces that held these industries together. We see a similar seismic shift in the banking industry, driven by changing demographics, customer needs, and technological advances. Technology deployed in other industries and the emergence of e-commerce giants have set new standards for product design, delivery, and customer service that consumers now demand from all their service providers. The banking and financial industry was lagging in this new digital era and had to catch up quickly.

Banks were slow to recognize changing consumer demand, relying on customer inertia and brand loyalty to keep their market stronghold. However, the financial crisis in 2007-2008, primarily perceived to be the banks' fault, permanently changed customer sentiment and made users more inclined to try alternative providers. New entrants, often referred to as Fintechs (financial technology platforms), challenger banks, or Neobanks, emerged from the ashes of the global financial crises and recognized the market opportunity to do things differently. By leveraging new technology, they gave customers better financial products and a completely different customer experience. As the decade progressed, more and more customers saw the benefits of these new banks and platforms, their service-orientated offerings, low fees, and thus migrated in large numbers.

By now most countries have embraced the Fintech revolution. It is hard for most observers to keep up as the industry sees almost weekly new entrants launch new platforms, products, and services and raise large funding rounds. Many traditional banks are racing for these new technologies to try and hold onto their market share. In this report, we will narrow our focus to Neobanks.

The ascent of Neobanks: How digital banks are upending the traditional industry

Chapter 1: What are Neobanks?

Neobanks are digital-only banks without any physical brick-and-mortar branches. They do not rely on legacy operating systems and processes and use the latest technology. Most Neobanks are mobile-first or even mobile-only. Unlike traditional banks, they often do not offer the full range of financial products and services. Instead, one popular strategy is the unbundling of high-margin services and products. They then try to provide these products or services better - at a lower cost or through a better product experience. Their business models often follow a freemium approach. They offer a free basic product consisting of an account and payments solutions, including a payment card on which they hardly earn any money. They then generate revenues with additional services, for example, transaction or trading fees.

Differences between traditional retail banks and Neobanks.

	Traditional bank	Neobank
Regulation	They have a banking license and can act as custodians, i.e., take on deposits and give out loans.	Neobanks started out with Fintech licenses or by partnering with infrastructure providers. Established Neobanks applied for full banking licenses.
Products and services	A large number of different products. Bank and savings accounts, debit and credit cards, investing and retirement solutions, loans and mortgages, financial advice, and much more.	Initially, Neobanks only offered few services such as a bank account and credit or debit cards. Over time, they expanded their service offering, and now they also offer savings accounts, investing, loans, and more.
Distribution	Physical branches, e-banking, and mobile banking.	Mainly purely mobile banking.
Revenues	Yearly fee for basic product and interest rate revenues for loans, mortgages, and prices for payments.	The base product is free, but there may be fees for payments, which tend to be lower compared to traditional banks. Some Neobanks have a subscription-model for additional services.
Technology	Outdated core banking systems and complex historically grown tools.	State-of-the-art technology with superior UX

Chapter 1: What are Neobanks?

What sets Neobanks apart from traditional banks?

The impact of technology on today's world cannot be understated. Besides all the progress, one of the effects of technological change is that industries are converging. The boundaries of different sectors are disappearing. The same is true in the financial sector. Financial services and banking are no longer stand-alone industries. Customers expect payments and other financial services to be integrated into their everyday lives - truly embedded finance. They expect from all their services providers integrated and personalized experiences.

Neobanks were early to recognize this change. Instead of a focus on products, the focus of Neobanks is on customer needs and desires. They design their channels, products, and services entirely around their customers' wishes. Neobanks understand that the way to deliver a fully integrated banking solution is by using a data-driven approach. Traditional banks struggle to do this with incumbent legacy systems. They would need a complete redesign from the ground up.

This is what fundamentally sets Neobanks apart from traditional banks. They are not constrained by inherent inefficiencies and have the distinct advantage of blue-sky thinking. They can design the platform as a consumer-centric business, with customer satisfaction as the ultimate goal for a successful digital enterprise. Using their customer base to operate profitably will be a challenge for the future.

Technology

Fundamentally, there are two types of Neobanks. They are either full-stack Neobanks, which means they have a banking license, can take and manage deposits and control their front and back end, or they only operate a front-end platform, which means they do not have a banking license, and only operate the customer interface, which they built on the back end of an existing bank or infrastructure provider.

Types of Neobanks

Full-stack Neobanks

- Have a banking license; can offer products and services without a partner bank
- Built on a platform model
- Control most operations including front- and back-end
- Some operate a marketplace model

Front-end-focused Neobanks

- No banking license; have to partner with an established bank or banking-as-a-service provider
- Only control front-end operations (i.e. customer interface)
- Some operate a marketplace model
- Often use APIs to connect customers to services from other providers

Source: Business Insider Intelligence, The Global Neobanks Report.

The absence of a legacy technology infrastructure has proven to be a major advantage for Neobanks. Unlike traditional banks, whose modernization and digitization initiatives require large investments, Neobanks can develop and launch new products in much shorter cycles and thus remain more agile to respond to market needs.

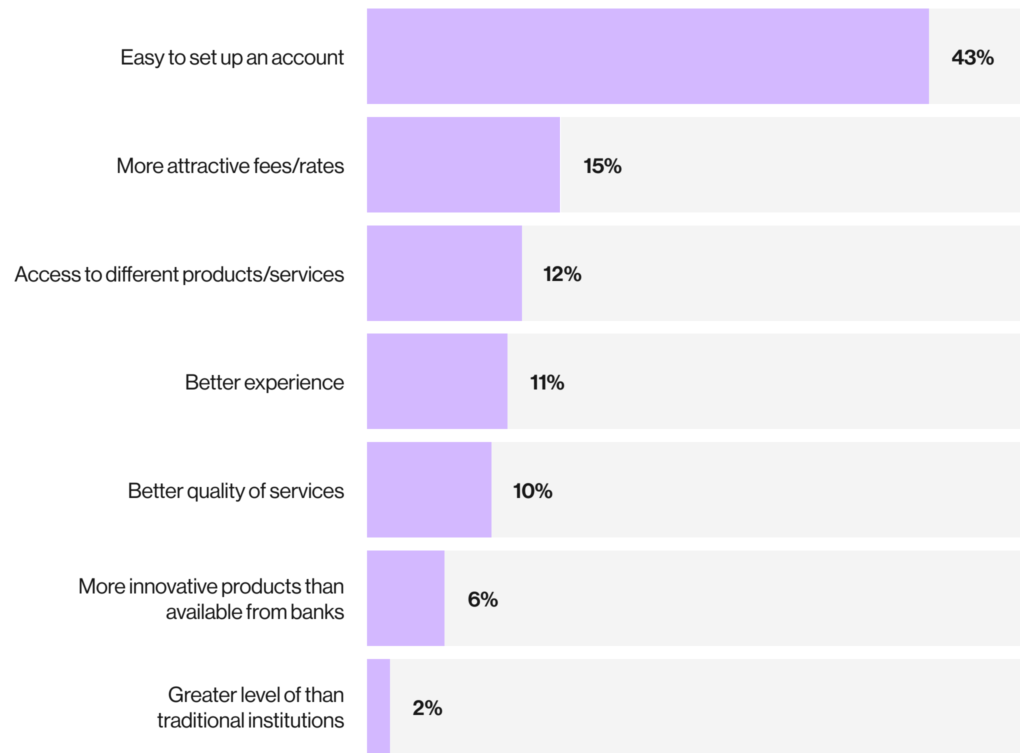
A 2019 Finextra and Virtusa study highlight that in the past, banks' IT spending was primarily driven by regulatory compliance, with nearly 80% of spending used for mandatory items.
In contrast, today, they are mainly focused on the digital customer experience (79%) and cost-cutting (46%).

Fees and simplicity

Neobanks leverage technology to simplify the account opening process. Using ID verification and biometrics technology, they can reduce the manual processes meaning these functions are streamlined for the customer and cheaper for the bank to operate.

A study by Cornerstone Advisors highlighted that ease of opening an account was the primary reason why users selected technology platforms over incumbent banks, with 43% of respondents saying this was the biggest draw. Lower fees and higher service levels are also among the main drivers for customers switching to Neobanks.

Top reasons US consumers adopt Fintech solutions



Source: Business Insider Intelligence, The Digital Banking Ecosystem.

Customer needs drive development

There is no doubt that the last decade has seen a shift in consumer behaviors and preferences, and traditional banks have been slow to adopt their technology, processes, and products to reflect this.

The digital transformation of the finance industry is being driven by retail consumers and small and medium-sized enterprises (SME) with needs that only new technology can execute seamlessly and at a low cost. Therefore, Neobanks target these two main customer groups: consumers and SMEs. They focus on providing the same core services as traditional banks but with enhanced consumer services. They can model products to individual needs and circumstances and deliver these on their customers' preferred mobile and online channels using sophisticated data analysis. In the consumer market, the most significant demographic for banking services is the millennial and generation Z consumers. These users are rapidly becoming banks' largest addressable market, and their needs and priorities are vastly different from older generations. They have grown up with technology and expect real-time information, payment, and borrowing products on the go. They rarely have any brand loyalty and will rely on their friends, peers, or online user-generated content to influence the products and services that they buy. This applies in particular to their choice of financial service providers, which is strongly influenced by recommendations from friends and influencers on social media. As these new market forces accumulate spending power and embrace financial services, the new generation will be the primary target demographic group that banks will need to attract.

Key traits of each US generation

Generation name	Birth years	Smartphone penetration
Gen Zers	1996–2010	96%
Millennials	1981–1995	92%
Gen Xers	1965–1980	85%
Baby Boomers	1946–1964	67%

Source: Business Insider Intelligence, The Digital Banking Ecosystem.

Chapter 1: What are Neobanks?

There are high-level characteristics common to millennials, and Gen Zers and Neobanks must discern these and the implications for each if they want to get and keep them as customers:

Mobile-first

Millennial and Gen Z consumers are the highest adopters of smartphones, smart speakers, and wearables. They use these frequently to access their bank accounts.

Socially engaged

Gen Zers value a bank that engages with them on social media. Eighty-five percent of Gen Zers use social media to learn about new products, and nearly half follow brands on various social channels.

US consumers are interested in social for financial matters
Among 18- to 34-year-olds with checking accounts

Already use Facebook for activity related to financial services and products	64%
Want to see more content on social channels for financial products and services	58%
Already use an app to transfer money to family or friends	53%
Want the ability to conduct all retail banking actions online	47%

Source: Business Insider Intelligence - The Digital Banking Eco System.

Value-driven

Both millennials and Gen Zers want financial products that help them achieve personal financial goals and develop responsible financial habits. Incorporating personalized insights, suggestions, and advice into a banking product will create substantial value over time.

Socially conscious

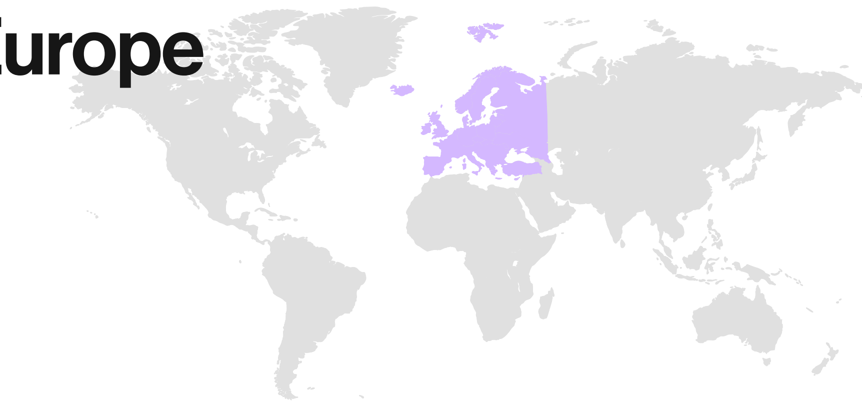
Younger consumers prefer brands to be aligned with their personal values. They are more likely to use a brand that supports social efforts they identify with. Neobanks have harnessed this socially responsible ideology by introducing „ethical" digital consumer products such as green investing and tools that allow customers to donate when they spend or round up „spare change" from card transactions to nominated charities.

Chapter 2:

The global Neobanking landscape

The Neobank ecosystem is relatively well established throughout the developed world and currently consists of newly formed startups to maturing unicorns with a vast user base. The US, UK, and some European markets are ahead of the rest of the world. They have well-established startup ecosystems, including Venture capital investors, a large pool of highly educated talent, and research institutions that have enabled players like Monzo, Starling, Revolut, and N26 to become the most established in Europe. Chime, Varo Money, and Ally lead the US Neobank race.

Europe



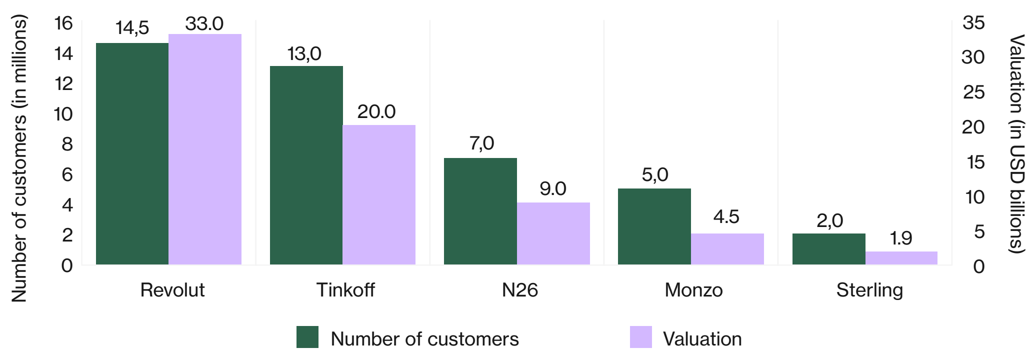
The very first Neobank in the world came from Russia. Tinkoff Bank was founded back in 2006 with the aim of building a bank without branches. Today, Tinkoff may well be one of the most developed Neobanks in the world, also in terms of its service offering, which includes investment products, loans, insurance and much more, in addition to bank accounts and payment cards. With over 13 million customers, it is also one of the world's largest Neobanks. The remarkable thing about Tinkoff is that the bank makes a profit of over USD 500 million, most of it from the lending business.

Apart from Tinkoff Bank in Russia, the UK, in particular, has distinguished itself as one of the pioneering markets for Neobanks. Starling Bank, for example, was already founded back in 2014. Then, in 2015, the UK's other prominent Neobanks, Atom Bank, Revolut, and Monzo, followed suit.

The United Kingdom established itself as a testbed for this nascent industry due to a high level of customer frustrations with traditional banks. Increasing numbers of bank closures, offshore call centers, high fees, and poor-quality service levels led customers to look for alternatives as soon as they became available. Recognizing that competition was only a good thing, the government set about reducing regulation to help the developing Fintech industry. The government eased the process of acquiring banking licenses, mandated open-banking rules, and gave generous tax incentives to investors in these startups. This model set a precedent and was adopted further afield.

Shortly thereafter, several Fintechs sprang up in various countries. German flagship Fintech N26, for example, really took off in 2016 after receiving a banking license from Germany's BaFin. In the meantime, N26 is active throughout the European Union.

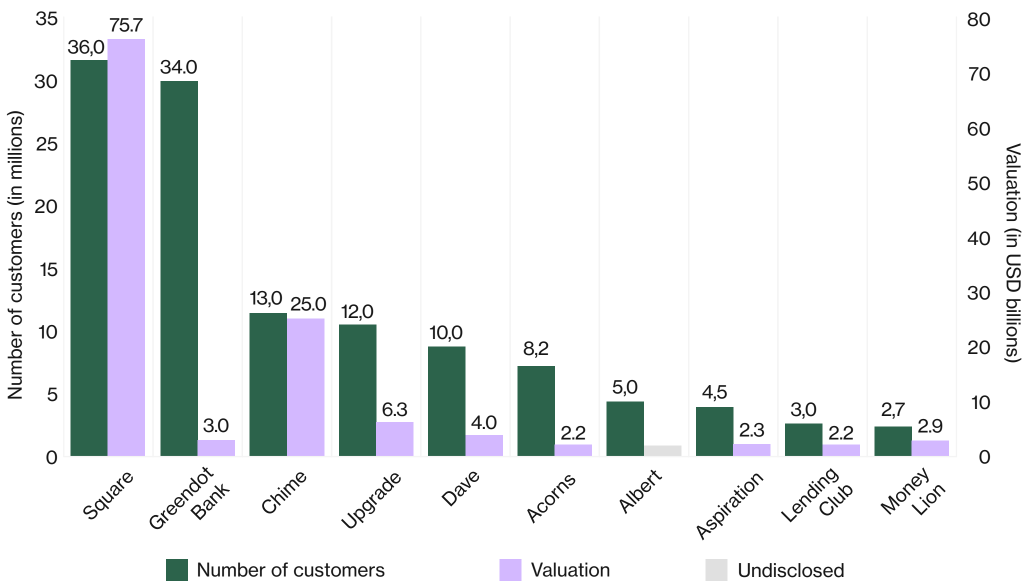
The Neobank ecosystem in Europe



The United States

In the US, Simple was the pioneer in Neobanking. It was officially launched in 2012 and acquired by Spanish bank BBVA in 2014. Simple was then discontinued at the beginning of 2021. Founded in 2013, Chime remains the US Neobank with the largest customer base, with 12 million users. With 4 million users, Varo Bank, which particularly appealed to young customers, follows in second place. Varo Bank was one of the first Fintechs to receive a US national bank charter license in 2020. Other Fintech startups such as Square, SoFi, and MoneyLion offer Neobanking-like services, and the line between personal finance provider, trading platform and Neobank is blurring.

The Neobank ecosystem in United States

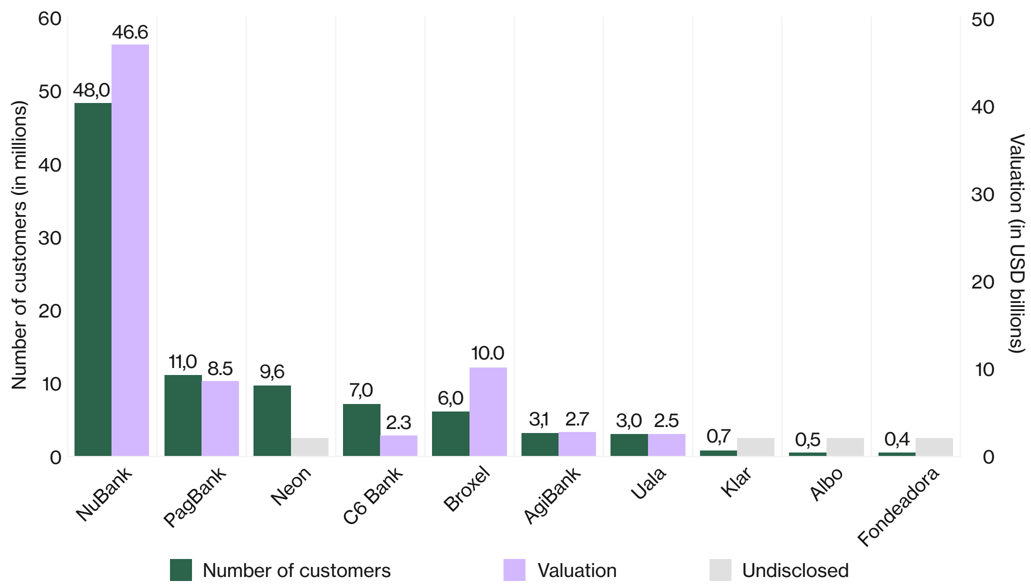


Chapter 2: The global Neobanking landscape

Latin America

The Neobank with the largest global user base, at 40 million users, and an impressive valuation of USD 30 billion is Brazil's Nubank. Overall, Latin America (LatAm) is catching up quickly, having massive market potential with its large population of both consumers and SMEs with high cell phone penetration but limited access to financial services. LatAm-based Neobanks have the common goal of democratizing financial services by addressing the needs of their vast underbanked populations. The funding and technology development infrastructure will take time to evolve, but LatAm offers an attractive future market for Neobanks.

The Neobank ecosystem in Latin America

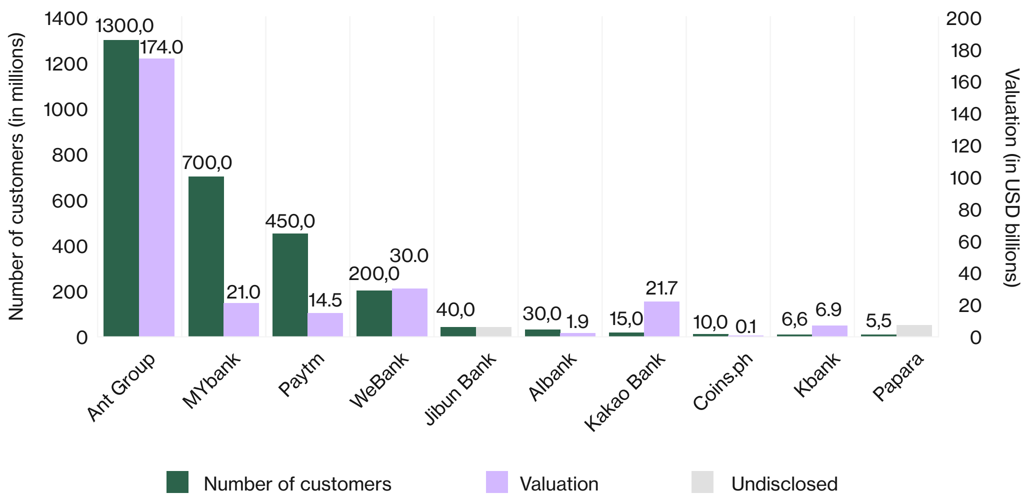


Asia Pacific

Asia is seen as another major region exhibiting promise for Neobanks. China's Neobank market is an anomaly. Its major players are run by the giant tech companies Tencent and Alibaba. They already have access to massive addressable markets and have achieved scale due to their tech integrations. Ant Financial and Tencent, both of which count hundreds of millions of customers, operate banking-like services MYbank and WeBank. However, these two companies are not Neobanks per se, but financial service providers in the Alibaba and Tencent ecosystem.

In South Korea, Kakao Bank should be mentioned in particular. Kakao Bank was launched in 2017 and has since gained 16.5 million customers. The Neobank has more mobile users than any other bank in the country. It is also one of the few profitable Neobanks in the world. In India, Paytm continues to gain market share. However, the superapp-like Fintech offers far more than just financial services and serves as another example of industry convergence.

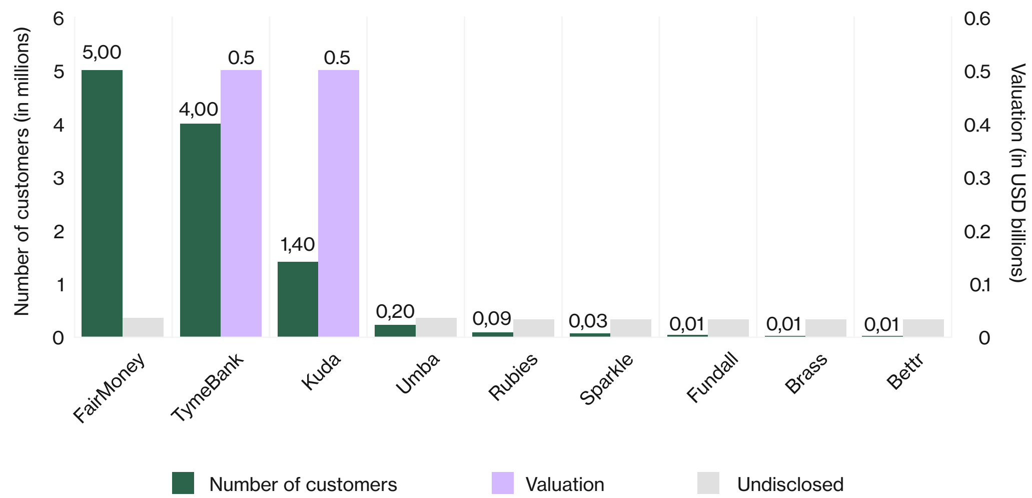
The Neobank ecosystem in Asia Pacific



Africa

Africa has one of the highest rates of unbanked populations globally at 57%. However, the high cell phone penetration rate has also led to the early development of Fintechs in Africa in the areas of mobile payments and e-wallets. As early as 2007, the mobile payment solution M-PESA existed. Building on the payment Fintech foundation, the first Neobanks emerged over time. Particularly noteworthy are TymeBank in South Africa and Kuda in Nigeria.

The Neobank ecosystem in Africa



Switzerland

Switzerland has been a laggard in the Neobanking sector. Some believe this to be due to the high level of efficiency from its incumbents and, therefore, intense entrenched competition for new entrants. While Neobanks have been reluctant to test the Swiss market, its consumers have not been as cautious and have embraced the Fintech revolution. According to the EY Fintech Adoption report, the rate of adoption in the Fintech Swiss consumer sector was at 64% in 2019. Thousands of Swiss used the products of the British Neobank Revolut before there was any domestic competition in the field. The incumbent Bank Cler surprisingly launched the first domestic Neobank. Zak, as the Neobank was called, was already launched in 2018. One year later, in 2019, the most successful Swiss Neobank to date, neon, was launched. Neon soon reaches 100,000 customers in Switzerland. According to public data, Zak has about 40,000 customers, while CSX, Yapeal and Yuh have about 10,000 customers (exact figures are not available).

The cost and complexity of acquiring a banking license is a barrier to entry for new players in Switzerland. However, Yapeal was the first to be granted a lighter ‚Fintech License'.

The Neobank ecosystem in Switzerland

Neobanks	Incumbent digital banks
YAPEAL	yuh
neon	Zak
FlowBank	CSX

Chapter 3: Neobanking challenges ahead

Neobanks have experienced an almost unstoppable rise all over the globe. Now with the Coronavirus-fueled acceleration of digital transformation for all sectors, it is inevitable that the future for some looks positive.

Estimates point to Neobanks surpassing 145 million customers in North America and Europe by 2024; however, the increasingly competitive sector is not without its challenges. Overcoming these will determine who will rise and who will fall.

Some of the biggest challenges for Neobanks include securing both startup and growth capital, the race to differentiate and acquire customers and achieve ever-elusive profitability. Along the way to this target, there are additional hurdles, such as regulation, finding and securing the right talent in a thin market, and macro-economic headwinds.

Access to capital

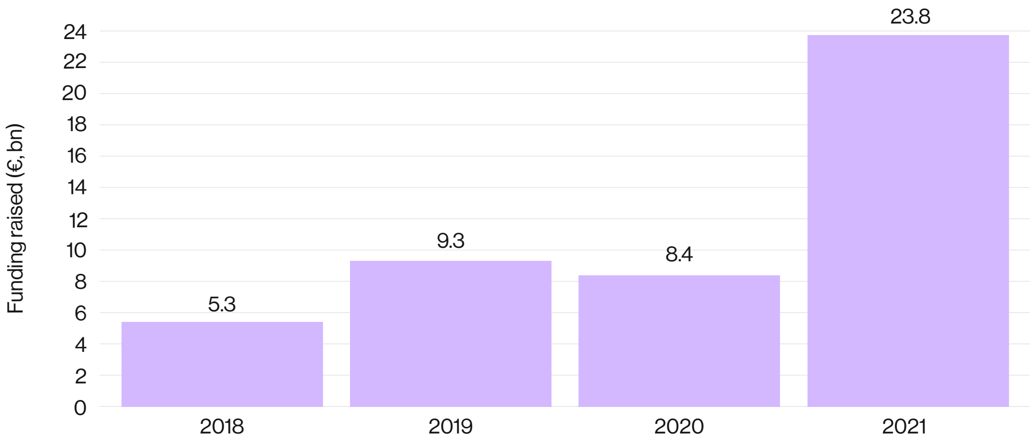
Neobanks initially had a hard time finding investors as banking was seen as a stagnant sector unable to generate the returns expected by Venture Capitalists (VCs).

According to research from CB insights and consulting firm Accenture, venture capital investment in Fintech overall remained relatively flat until between 2013 and 2014, when it trebled from about USD 4 billion to over USD 12 billion. Since then, the Neobanking sector has not been short of investor capital and confidence. It has experienced an enormous inflow of investor money, spurred by tremendous success from early investors and exponential growth in the valuation of many early Neobanks.

Due to the pandemic, VC funding in Fintech experienced a slight retraction in 2020. Many investors reigned in their spending. In the first half of 2020, only a handful of large Fintech deals were completed. Still, Fintech funding rebounded in Q2, with the top five fundraises alone receiving a combined USD 2.36 billion of investment.

The capital-raising downturn of 2020 has bounced back spectacularly in 2021, buoyed by a shift to digital. In fact, 2021 has been a record year for Fintech funding. European Fintechs raised EUR 23.8 billion in 2021 - more than doubling the previous record of EUR 9.3 billion in 2019 according to Pitchbook data.

European Fintech investment
A record 2021



Source: sifted.eu.

Public-Private Partnership

Neobanks flourish in regions where governments have implemented supportive business-friendly policies, light-touch regulation, regulatory sandboxes, and heavy investment in the tech sector is promoted.

The UK started initiatives such as tax incentive schemes for investors, a Patient Capital Initiative from the British Business Bank, and Sandbox initiatives from the Bank of England, which has spurred other countries to follow these models. As a result, the UK has more than 10 percent of the global market share in Fintech, and the sector is now worth more than £11 billion a year to the UK economy.

In France, the state invests massively in the Fintech ecosystem through its support and venture capital arm BPI. In 2015, the French government concluded an extensive research exercise. It announced a plan for 2017-2020 worth EUR 10 billion that includes EUR 4 billion of its capital contributions.

In Singapore, the MAS (Monetary Authority of Singapore) set aside USD 165 million to develop its Fintech sector. The government has also pushed to diversify the startup ecosystem. It also launched a regulatory sandbox for Fintech institutions in recent years, with the ambition to develop world-class financial services in the region.

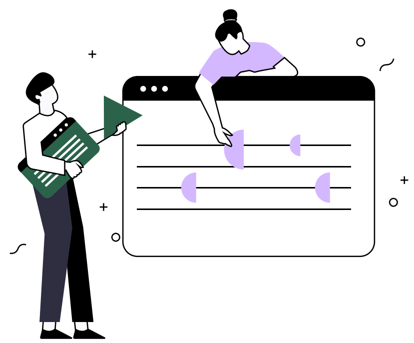
In the Middle East, the Dubai International Financial Center (DIFC) has already taken decisive steps towards financial innovation by creating sandbox frameworks for testing new financial and banking startups in the region.

Government organizations in Switzerland have also recognized the relevance of the Fintech trend. For example, the State Secretariat for International Finance SIF founded the Green Fintech Network in November 2020. A 16-step action plan was then presented in April 2021 to promote sustainable Fintechs in particular. But the regulatory framework has also been adapted. For example, the Federal Council has provided a regulatory sandbox, introduced a new banking license light, made tax relief possible for startups, and the innovation promotion agency Innosuisse offers attractive financing options.

Customer acquisition, retention, and scale

Digital business models take an evolutionary path. The initial strategy is to scale the customer base, secure market share, reduce cash-burn, break-even, and finally become profitable and reward investors with dividends or exit opportunities. Knowing how to harness the new customer landscape is a significant challenge for Neobanks. They must learn how to acquire and retain customers with lower fees. Neobanks target profitable market segments with a differentiated value proposition without offering a wide range of services. Following a scale-first strategy and developing a narrow product offering with a laser focus on particular market segments and strong customer experience has been highly successful for some. Retaining these customers while gaining profitability is a challenge as these factors are abundant in the marketplace, and consumers know how easy it is to switch providers.

Differentiation



To be successful, players must differentiate in this fluid and highly competitive market. A strategy seen in other industry sectors is that once new entrants have secured easy targets, often referred to as ‚low-hanging fruit,' they will creep up-market and encroach into different, more profitable segments.

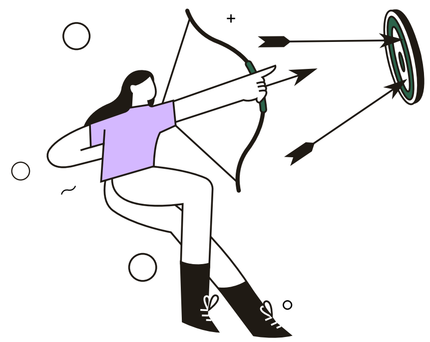
As Neobanks mature, they will seek ways of differentiating themselves to stand apart from the competition. These strategies could be through deeper personalization of customer offerings, the rollout of features such as overdraft cushions, early wage access, and new customer incentives. Investment offerings such as goal-oriented savings, impact investing and financial planning are also becoming increasingly important. However, the development and marketing of a large number of different products and services can also drive up expenses. Especially if these

are to be offered at lower fees than banks, the question is how Neobanks can generate profits. These factors help explain why today, the average Neobank, according to Accenture, loses USD 11 per user. New platforms continue to emerge, hoping to serve just one market segment. Because they operate at a much smaller scale, they may offer a shorter time scale for investor return on capital as niche market players are most likely to be acquired once they are profitable or have secured a subset market segment.

An example of these players is Monese (launched in 2015), which first set itself apart as a bank built for travelers and expats needing to carry out ATM withdrawals and set up current accounts overseas. OakNorth, Atom, and Allica have focused just on the SME lending market. Tandem tried to set itself apart, focusing on ‚green finance,' which offers eco-friendly lending initiatives.

To differentiate, Neobanks need to think broader than just financial services. In the same way big tech has its eyes on banking, banks should offer non-banking services to keep pace with challenges. Offering digital products and services that help with broader business needs related to accounting, invoicing, taxes, and payroll, are some ways Neobanks are divesting and opening new revenue opportunities.

Talent Acquisition / Retention

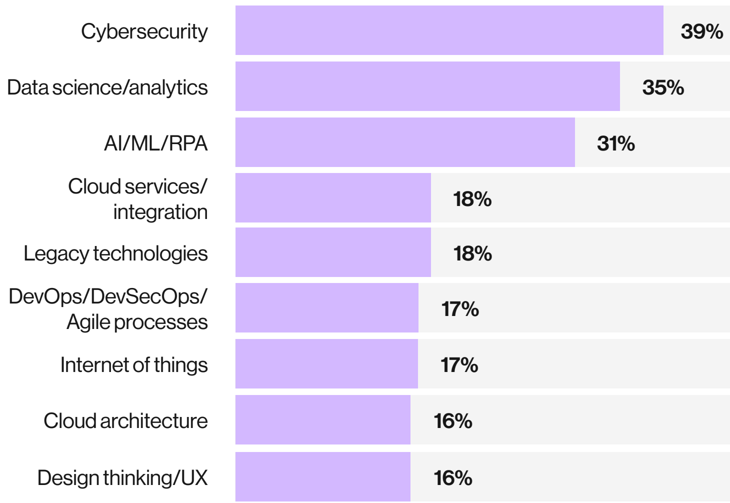


There is no getting away from the fact that a major challenge for Neobanks is finding and securing the right talent. There is a global shortage of data, and computer scientists and forecasts predict this will be the status quo for the foreseeable future.

Emerging roles, including data analysts, AI and machine learning specialists, designers, people who work in innovation roles, are expected to account for 29% of the workforce by 2022. There is concern over how the industry will source these new skills.

Difficulty finding security & data science skillset

250,000
2020
Shortage



Source: The Data Scientist Shortage in 2020 - QuantHub.

According to data from the World Economic Forum, the talent deficit is driven both by the rapid growth of the Fintech sector and by a significant shift in the types of roles in financial services more broadly.

To ensure the industry can meet this challenge, it can focus on reskilling existing staff and consider recruiting talent directly from schools and colleges. We have already seen incumbent banks scrambling to upskill their workforce for a digital environment, 70% of US banks surveyed in a Freedom study shared with Business Insider Intelligence have upskilled their workforce through in-house training operations over the past five years, and 32% of respondents plan to expand or tweak their training programs. One such bank is Lloyds, for instance, which will have carried out 4.4 million hours of training between 2018 and 2020, a 50% increase in training hours per employee from current levels.

Innovation centers that have sprung up worldwide are also helping to foster the skills shortage. Governments are addressing the issue with the rollout of funding for scholarships and best-in-class training centers. France was the first to open an AI-focused high school.

In June 2019, BBVA launched an „AI Factory" in Madrid to build consumer and business-facing AI solutions that can be reused and scaled across other business units.

Profitability

More and more Neobanks are coming closer to reaching their defined scale targets, typically several million customers, and a shift from growth to monetization is now demanded from investors. Investors and analysts are now starting to question if the industry can successfully transition from hyper-growth to a more sustainable path.

All-new digital companies struggle against the common existential threat of profitability. For those Neobanks that have secured sufficient scale and market share, making the switch to profitability is a huge challenge. They have lured customers with the promise of free banking, and they now need to figure out how to charge customers. Questions arise about how consumers will behave; having already switched from traditional banking, they know how easy it is to switch again to save money.

The lack of profits for Neobanks has driven speculation that the banks are not worth their sky-rocketing valuations. Monzo has had a particularly hard time during the pandemic, with losses growing to GBP 113.8 million (up from GBP 47.2 million the year prior), which puts down to the impact of COVID-19. The bank's latest fundraising also saw a 40% drop in its valuation. Starling, however, says it is still on course to becoming the first profitable UK digital consumer bank.

One of the biggest challenges faced by existing retail banks and Neobanks is high cost of customer acquisition.

This high customer acquisition cost (CAC) is compounded by the fact that Neobanks tend to offer a limited set of products. First, this makes it hard to generate a high lifetime value to compensate for the high CAC. Worse, it puts customers at risk as they become more affluent and their needs become more complex.

A clear solution to these problems – high CAC and higher churn – is to embed wealth management services.

This would provide an additional revenue stream. It would also enable Neobanks to retain customers as they move through the lifecycle from earning to saving to wealth creation. There may also be additional benefits by partnering with large wealth managers, as these will confer security and stability that will also help with trust and customer retention.

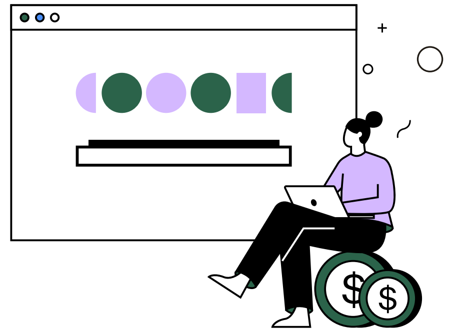
The reason for embedding wealth services instead of building them is manifold and includes speed to market and leveraging the skills and expertise of specialists.

Outside of their own business model, Neobanks must overcome other factors that may determine their profits, such as competition, regulation, home market or specific market nuances, and the macro-economic climate.

Chapter 4: Threats for Neobanks

Neobanks not only face internal challenges, but there are also emerging competitors and threats from outside. From the big tech players who already have all the ingredients to dominate the industry - advanced technology, large customer base and almost unlimited financial resources - to traditional banks unlikely to leave the field to others, Neobanks will not be able to rest on their success. Below, we take a look at the biggest threats for Neobanks in more detail.

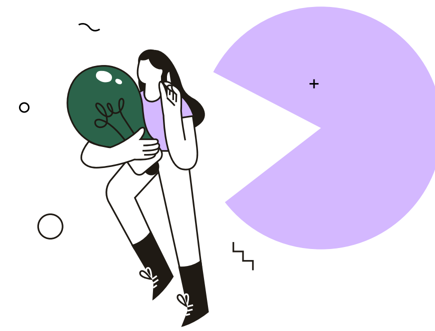
Big tech



Big tech is creeping into financial services. Apple Pay is already established and the tech giant is now pushing into the lending market with its buy-now-pay-later partnership with Goldman Sachs. Google will begin offering checking accounts to consumers next year, Uber has its own debit card, and many other tech firms are planning similar moves into financial services. Both Neobanks and traditional banking institutions should be concerned. These big tech players have the capital, existing digital know-how, and a ready-made user base. Consumers increasingly trust big tech companies with their money more than banks, making them a significant and growing threat.

Others such as Amazon are eyeing the sector, and eBay already offers loans /credit lines to SMEs. Paypal has followed suit with credit facilities to its users.

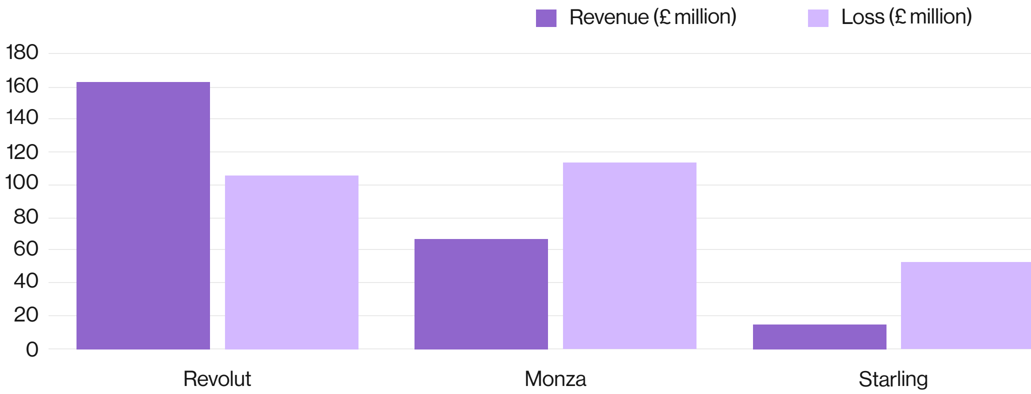
Incumbent competition / acquisitions



While Neobanks may not yet be generating profits, there is no doubt that they are slashing traditional banking profits and fragmenting the bank-customer relationship irrevocably. So, the question that arises is how long will these banks continue to let their market share slip, and how can they stay relevant? More and more of them are eyeing the Neobanks and niche platforms for acquisitions. Most industry commentators agree that mergers and acquisitions between traditional banks and Neobanks are inevitable at some point, but this time could be coming soon.

Neobanks stumbled in 2020, with both Monzo and Revolut revealing deepening losses and increasing customer apathy. Monzo's founder Tom Blomfield recently stepped down as CEO, which caused concern in the industry after flagging „significant doubt" about its ability to continue „as a going concern" due to disruption from Covid-19. This vulnerability may start the predators circling, and many will become a target for acquirers. Previously large valuations have put off potential buyers, but the slew of poor results from these Neobanks and increasing pressure from investors may push some to consolidate or be acquired much earlier than they had initially planned.

Digital banks accounts



Source: A Flourish chart.
Note: Revolut's latest accounts cover the full year ending Dec. 31, 2019, Monzo's the full year ending Feb. 29, 2020, and Starling's the full year ending Nov. 30, 2019.

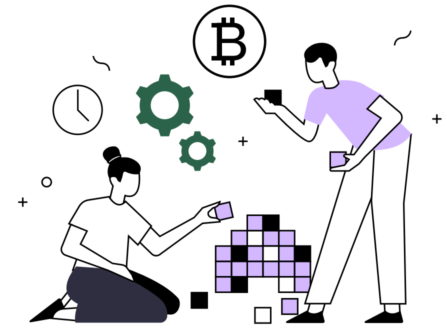
In an interview with CNBC, Nik Storonsky, founder and CEO of Revolut, confirmed his fears that some firms could become the target of takeover bids and said, „Certain banks won't be able to survive this Covid thing because they are too reliant on payments and interchange, especially here in Europe. We'll clearly see some winners and losers in this game in Europe, and maybe some M&A activity as well."

If acquisitions happen, it is unlikely that the sky-high valuations will be realized as most Neobanks have not yet converted to profitability. Thus a valuation reality check is set to happen.

Cyber risk

All digital businesses have a real risk around cybersecurity. The challenges exist and are not specific to Neobanks. However, digitization and the increasing use of cloud services in the banking industry have created more opportunities for cybercriminals leaving the banking industry vulnerable. Neobanks that run entirely digital banking models are more vulnerable and exposed to this risk than traditional banks that might have siloed systems and processes that naturally inhibited the reach of security breaches. Cyber scams and techniques are constantly evolving, and Neobanks face not only the risk of a cyber breach but the loss of customer trust and confidence in the brand should they become exposed.

Digital currencies



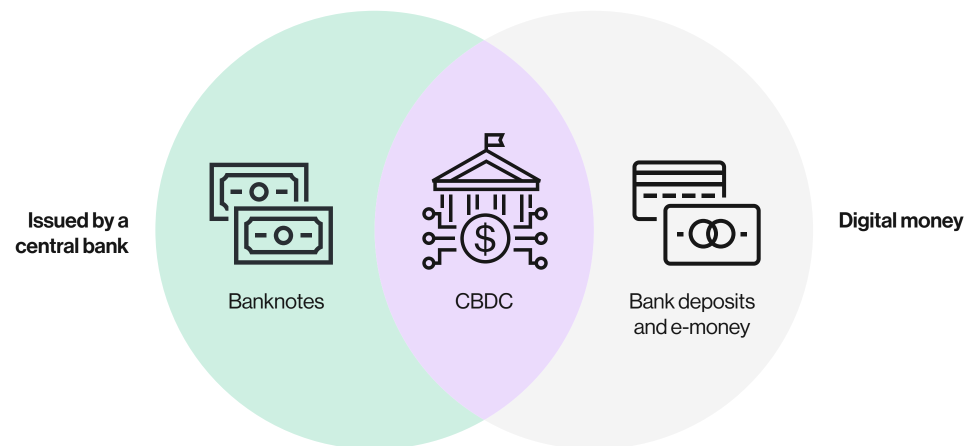
Digital or cryptocurrencies have been around for a while now. Still, they have been used more as an investment tool or speculative play instead of what their originators intended them for, a system of transferring wealth outside of the Central Bank-controlled fiat currency system.

While Facebook has been forced back to the drawing board with its Libra global currency plan, Bitcoin has matured into a USD 1 trillion asset class that more and more fund managers insist belongs in any balanced portfolio.

With ever more central banks discussing launching Central Bank Digital Currencies (CBDC), there is certainty that they will become a fundamental part of everybody's daily life in the medium term. A CBDC would be an electronic form of central bank money that households and businesses could use to make payments. While this disrupter of the existing global financial system has been the least noticed until now, it is likely to end up being the most revolutionary. The creation of CBDCs will allow people to deposit funds directly with a central bank and bypass conventional intermediaries and lenders. The impact this would have on all incumbent banks is immense, and some argue one of the reasons that the Central Banks have been taking a slow and soft approach to their proposals to launch them.

An electronic form of central bank money

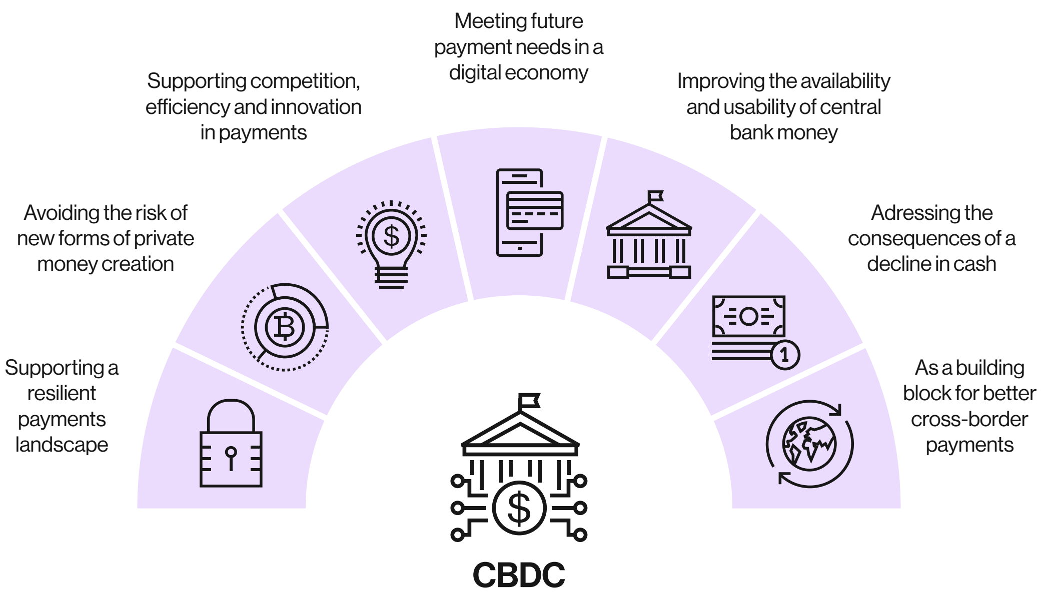
A Central Bank Digital Currency (CBDC) would be an electronic form of central bank money that could be used by households and business to make payments. The Bank has not yet made a decision on whether to introduce CBDC, and intends to engage with stakeholders on the benefits, risks and practicalities of doing so.



While the UK's central bank is taking a cautious route with its plans for a CBDC, other countries are forging ahead. China became the first major economy earlier this year with a blockchain-based digital version of its currency, the cyber yuan. Its citizens already rely heavily on electronic payments, so there is no major cultural barrier to wide-scale acceptance of it. Other central banks around the world are scoping CBDCs, including Sweden, Japan, Turkey, Switzerland, the Philippines, France, Canada, Singapore, and the UK. The US is exploring a digital currency but has ruled out enacting any measures without the support of Congress.

Opportunities for the Bank's objectives

CBDC could present a number of opportunities for the way that the Bank achieves its objectives of maintaining monetary and financial stability.



Source: BOE.

CBDCs contradict the core principles of cryptocurrencies; Bitcoin was introduced in 2009 to be free of control by central banks. If central banks cannot launch digital currencies without public confidence, it will only strengthen the case for decentralized currencies, inflating their value. While the world is increasingly becoming cashless, it is only a matter of time until more countries launch CBDCs.

Regulation

Not only do Neobanks have to go through the costly and time-consuming process of becoming regulated to launch, in the form of banking licenses, but they must also comply with the often complex and wide-ranging continuous regulatory reporting regime in their home territory. Supervisory data to national regulators come in various formats and is continuously evolving as regulators try to keep pace with the fluid banking industry. According to the Global Banking and Finance Review, the financial services industry spends close to USD 70 billion each year on risk, risk data, and regulatory reporting.

For Neobanks, the complexity of having a startup, the regulatory burden, and the increasingly competitive landscape are serious threats they cannot navigate alone and the reason why many choose to partner with incumbents.

Some regions such as Asia and India do not possess adequate regulatory frameworks for Neobanks. Hence, most Neobanks in India and Asia are affiliated with existing incumbent banks. These partnerships with existing banks may prove to be one of their strengths and a model for others to consider following to overcome increasingly complex regulatory frameworks.

Chapter 5: Opportunities & what the future holds for Neobanks

Financial technology is now an integral part of business in any sector that handles money. By the start of 2021, 1.9 billion people worldwide were actively using digital banking services. Both consumers and SMEs have come to rely on financial technology to process payments, carry out online transactions, balance their books and manage payroll.

It's safe to say that Neobanks, with their innovation and scale-first strategy, have succeeded in disrupting traditional banking. Now that consumer needs are being addressed, where do Neobanks go from here?

Investors screaming for returns will undoubtedly damage the sector as these businesses will not have the opportunity to plow revenue back into operations and product development, but those that swerve the investors' clamor for returns do have some opportunities to seize.

Neobanks stalled in 2020, but the pandemic proved to be fuel for all things digital, and banking was no exception. Research from Mastercard found that 42% of Europeans handle their finances digitally more frequently than before the coronavirus pandemic, while 62% think of switching from physical banking to digital platforms altogether. Moving into lending and credit services is a strategy for many.

Lending

Lending is one of the most important profit lines for traditional banks and has thus far only played a minor role in the evolution of Neobanks. Less than 50% of Neobanks are offering loans to their clients either directly or via a banking partner, with a clear regional bias towards Asia and the US, where lending is a more common feature of Neobanks. Neobanks have also missed out on the buy-now-pay-later trend, which is now dominated by Fintechs like Klarna, Affirm and Afterpay.

While lending may be highly profitable, it is not a risk-free business model and requires a large amount of capital. In most jurisdictions' consumer credit is also highly regulated and requires careful navigation around compliance, which can be costly.

Neobanks that chose to venture into this space face tough competition from big tech. Amazon, eBay, and Paypal are some of the platforms offering consumer credit and small business loans and credit facilities.

SME and the changing employment market

Traditional banks completely missed the opportunity that arose from the changing working environment. Gig workers, freelancers, and independent contractors now make up a growing part of the European working population, and this is only set to increase in the short term. Their banking and borrowing needs are not being addressed by traditional banking. For example, the mortgage market is still predominantly geared to traditional full-time salaried workers.

Neobanks have focused their platforms and products on this market of independent workers, giving freelancers and small business owners the tools they need to manage and grow their businesses. They offer value-added products and services to help customers with a broader range of jobs-to-be-done, such as invoicing, receipt, and expense management. There is a worldwide trend of Neobanks integrating third-party tech tools for these small businesses as part of their value proposition.

Integrations include tools to better manage accounts, pay vendors, manage payroll, and trade debtors. Integrating services and creating added value for the customers is much cheaper than building them internally.

Integrations for SME Neobanks (Europe)

	tide	wise	PENTA	HOLVI	Revolut	qonto
Cards/ Payments	Mastercard, PayPal, Apple Pay, stripe, GoCardless	Mastercard, PayPal, Apple Pay, stripe, G Pay	VISA, stripe, Apple Pay, G Pay	Mastercard, stripe, PayPal, G Pay	Mastercard, PayPal, Apple Pay, stripe, G Pay, amazon pay	Mastercard, stripe
mPOS	iZettle		sumup	sumup		iZettle
Accounting	xero, sage, quickbooks, FreeAgent, KashFlow	xero, quickbooks, FreeAgent	lexoffice, debitoor, DATEV	lexoffice, briox	xero, sage, quickbooks, FreeAgent, QuickFile, Bullet, ClearBooks	quickbooks, Pennylane, dougs
Accounting	iwoca		iwoca			edebex
Others	ReckonOne		slack, zapier, board	slack, zapier, integromat		

Source: Arrival Bank.

Investing

In addition to Neobanks, another category of Fintechs has had great success in recent years: Online trading platforms like Robinhood in the US and Trade Republic in Germany, which allow retail investors to invest commission-free in stocks and ETFs. Like Neobanks, these trading platforms offer a simple and intuitive user experience. Neobanks realized that many of their customers were also using these trading platforms and started offering online trading. Investing represents another possible exciting revenue stream for Neobanks. US Fintech Acorns was a pioneer in this field as it automatically invested the difference to the next dollar every time a user made a purchase. In the meantime, this innovative way of automatic investing has been introduced by numerous other Fintechs.

With their large customer base, Neobanks are well-positioned to help their customers better manage their finances and achieve their goals through investing activities. Value-based investing are particularly interesting as they allow clients to invest sustainably or offset CO2 emissions. Such services are very popular with the target groups of Neobanks and represent a great opportunity in the future.

Other activities

Neobanks could look further afield at non-banking activities for revenue growth. Simply competing on the same playing field, improving digital offerings and products, will not be enough for them to stay relevant, as demonstrated by RBS's (short-lived) attempt at launching its own app-only bank Bó. Other non-bank services such as transfers and payments, education and insurance have potential cross-selling opportunities. While this has been the purview of traditional banks for many years, Neobanks have their data assets to leverage. AI and predictive tech can give them a competitive advantage over traditional banks.

New technology, new ideas

Neobanks will inevitably play to their strengths and select core products, target markets, and differentiators. Still, there is always the possibility of new technologies and new ideas emerging outside the current banking industry realm. Embedded finance and banking-as-a-service (BaaS) have emerged as new battlegrounds for Neobanks and traditional banks. A report from Oliver Wyman expects expects these business models to disrupt the current industry dynamics with the potential to generate significant new revenue for financial service providers.

Embedded finance is enabled with the integration of products into other kinds of customer activities, typically on non-financial digital platforms, such as e-commerce. Businesses will distribute financial products under their own brands so that the customer is taking out a loan when checking out of an e-commerce store, for example, but the loan product is provided by a bank.

Financial institutions could achieve major revenue growth by launching embedded finance business models. In fact, embedded finance can create enormous opportunities for fee-sharing-based partnerships and allows existing banks to reach a greater number of customers.

Conclusion

Neobanks have taken advantage of the weaknesses of traditional banks and created a more affordable offer with a better and simpler experience.
Yet, most Neobanks cannot threaten the established banks with their limited service offering. But they are evolving at a rapid pace. They are taking on record levels of financing and serving impressive customer numbers.

But Neobanks also face challenges, both internal and external. The road to profitability is becoming difficult. Attracting customers is one thing, but generating growing revenues from them is another. At the same time, they also face the threat of disruption presented by tech giants and other large Fintechs. They cannot rest on their laurels.

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