

Evolution of Neo Banking in India – A Paradigm shift in the banking industry

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Introduction

The inaugural neobank, First Direct, was established in the UK in 1989. The term “neobank” became popular around 2017. Although these banks have been present for more than a decade, they have only recently started to gain popularity. The growing appeal of neobanks is attributed to their provision of a more convenient and user-friendly banking experience compared to traditional banks. Additionally, they can offer reduced fees and more attractive interest rates since they do not carry the same overhead expenses as conventional banks. In India, Niyu Solutions is among the pioneering companies in this field. These institutions operate exclusively online and provide a variety of services via digital channels. They emerged when tech-savvy financial service providers began to challenge traditional banking models. Some of the initial ventures appeared in the UK and Germany. Neobanks are entirely digital financial entities that resemble banks. Their service offerings are generally more limited when compared to traditional banks. This streamlined approach often enables neobank users to benefit from lower fees, competitive interest rates, and personalized products. They fill the gap between traditional banking services and the changing expectations of customers in the digital era.

Overview of New Banks

Over the last ten years, neobanks have effectively established a unique position for themselves by continuously broadening the array of services available to their clientele (Bradford, 2020). The growth and embrace of neobanks are showing no signs of abating, with Statista’s (2023) projections forecasting a global user base of 376.9 million by 2027, representing a twenty-fold increase from 18.95 million users in 2017. These trends signify a changing landscape in banking, although the degree to which neobanks compete with traditional banks is still uncertain. From 2018 to 2022, neobanks saw their transaction value rise from \$0.45 trillion to \$3.21 trillion, while their user base grew from 32.61 million to 188.4 million globally during the same timeframe (Statista, 2023). The remarkable growth potential of neobanks can largely be attributed to their cost-effective model for consumers, which often entails minimal or no monthly fees associated with banking services such as maintaining minimum balances, and making deposits and withdrawals. Elements like quicker loan approval and funding processes in comparison to conventional banks, along with lower interest rates through banking apps, are propelling market growth. Key factors influencing the expansion of neobanks—primarily linked to regulatory environments, consumer preferences, and competitive pressures—are likely to persist in the coming decades.

Significance of Neo Banks

The remarkable expansion of neobanks and fully digital banks has led to a fundamental transformation in the banking system, resulting in a significant shift in the delivery of financial services to consumers (OECD, 2020). They set themselves apart through a completely digital approach and modern, innovative business strategies, rendering physical branches unnecessary for their operations (Buchi et al., 2019). For a substantial part of the 20th century, traditional banking institutions held a dominant position in the financial services sector. These institutions initially provided services such as deposits, lending, and wealth management. As the 20th century progressed, traditional banking experienced a trend toward consolidation and notable deregulation, leading to the rise of large multinational banks. In the 21st century, these organizations effectively utilized technology to improve efficiency and expand their operations (Gorton, 2015). Despite the significant impact of digitalization on the structure and functions of conventional banking, many still rely heavily on physical branches and personal interactions as part of their customer service offerings. Neobanks represent a new banking paradigm that emerges from changing customer preferences and requirements. Emerging in the early 2010s, they are entirely reachable via the internet or mobile devices, employing technology to deliver a customer experience that includes services such as account creation, mobile payments, deposit options, savings and investment management tools, and various loan offerings. They also facilitate access to trading markets, including the stock market, commodities market, and cryptocurrency markets (Martinčević et al., 2022). Although several studies, including those by Gulieva et al. (2019) and Temelkov(2020), examine how neobanks' business models could potentially compete with traditional banks, statistics indicate that neobanks remain in a developmental stage. Consequently, academic research on this subject should continue to advance. The rapid growth of neobanks, the launch of new services, and emerging trends have created a gap in theoretical understanding regarding the current and future competitive landscape within the banking sector, as well as changes in customer preferences and behaviors. Therefore, a significant gap persists in the literature that evaluates the emerging opportunities for neobanks in the financial services sector, the potential risks they pose due to their newly established roles, how they differentiate themselves to customers, and their interactions with traditional banks.

Characteristic appearances

Key characteristics and advancements provided by neobanks Neobanks represent a unique category of financial entities that exclusively operate online, usually without any physical locations. They offer their banking services through mobile applications and websites, prioritizing an easy, user-friendly, and completely digital experience for their clients. To implement innovative features such as instant transaction alerts, budgeting and investment tools, simple account registration processes, and access to a wide range of trading markets, including cryptocurrency and stock exchanges, neobanks often rely on technological progress (Gulieva et al., 2019). In contrast, traditional banks are well-established financial institutions with physical branch networks. They provide a variety of banking services, including savings and time deposit accounts, loans, mortgages, and select investment options. Thanks to their physical presence and Automated Teller Machines (ATMs), customers can access the services of traditional banks in person. Additionally, they typically offer a wide range of supplementary services such as wealth management, insurance, and financial planning.

In this way, neobanks provide several distinctive features and innovations that differentiate them from traditional banks. The primary defining characteristic of neobanks is their mobile-centric approach. They are designed for use primarily on mobile devices, making them more convenient for customers who are frequently on the move. Another important aspect is their emphasis on user experience. Neobanks are crafted to be straightforward and easy to navigate, with intuitive interfaces that facilitate financial management for customers. They also provide a variety of innovative services such as budgeting tools, savings objectives, and real-time alerts. Neobanks are also recognized for their affordability and accessibility. They do not incur the same overhead expenses as traditional banks, enabling them to offer more favorable rates to their clients. Lastly, neobanks are known for their rapid and effective customer service. They utilize technology to deliver prompt responses to customer inquiries and issues.

Future Outlook for Neobanks

The future possibilities for neobanks appear to be very promising. The main factor contributing to the increasing popularity of neobanks is their entirely digital nature and the ease of their services. These offerings allow customers to conduct banking activities from the comfort of their homes or any other location of their preference, removing the necessity of visiting physical branches (Padmanabhan, 2021). Despite the trend toward digitization in traditional banks, they still hold a substantial market share in the banking sector. However, recent trends and studies suggest a steady migration of clients towards banks that offer “online-only” solutions (Statista, 2023). The global neobank market is projected to expand at a CAGR of approximately 46.5% from 2019 to 2026, potentially generating around USD 394.6 billion by 2026. Factors such as the rising adoption of smartphones, the increasing demand for digital banking solutions, and the growing number of collaborations between traditional banks and fintech firms are driving the growth of the market. Some of the future opportunities for neobanks are highlighted below:

- **Market Expansion**

With the rising trend of internet access and smartphone usage, neobanks are anticipated to attract more customers, particularly among the younger demographic, who are more inclined to utilize digital banking services (Nasir & Rizvi, 2020). Additionally, neobanks are strategically positioned to extend their offerings to unbanked and underbanked communities in developing markets (Demirgüç Kunt et al., 2018).

- **Technological Innovation**

The area of efficiency has seen significant changes due to the introduction of modern and advanced technology. Banks have managed to automate a large portion of their operations, decreasing their reliance on manual labor, which has led to improved efficiency and a streamlined cost structure (Gulieva et al., 2019). Currently, banks are heavily utilizing Artificial Intelligence (AI) for various functions, including fraud detection and customer service automation (Dgalaki, 2022). In this light, neobanks are set to continue leading the charge in adopting cutting-edge technologies like Artificial Intelligence, blockchain, and biometrics to deliver more efficient and secure banking solutions (Jabbari & Ouerghi, 2020). For example, AI can be applied for enhanced risk assessment and tailored financial advice.

- **Partnerships and Ecosystem Development**

Neobanks often depend on collaborations and partnerships with other financial service providers to deliver their offerings for multiple reasons. A primary reason is that these institutions typically

lack the necessary infrastructure, regulatory approvals, and licenses to directly provide services like loans and credit cards. They are able to offer such services through their alliances with established financial entities, allowing them to do so without the need to invest in the necessary infrastructure or secure regulatory approvals independently (Koibichuk et al., 2021). They are likely to develop a comprehensive ecosystem through partnerships with fintech companies, traditional banks, and non-financial organizations to deliver a wider array of services, including lending, insurance, retail, and travel (Chen, 2020).

- **Novel Revenue Generation Models**

Neobanks implement various methods for generating revenue and monetizing their services. A common model involves charging fees for specialized services such as overdraft protection, foreign currency exchanges, and ATM withdrawals. Some neobanks also impose charges on certain types of transactions, like wire transfers. Many of them entice customers with high-yield savings accounts that allow customers to earn interest on their deposits. Additionally, some neobanks offer investment opportunities such as mutual funds and Exchange-Traded Funds (ETFs), facilitating customers in investing their savings. Others partner with retail businesses to provide cashback incentives when customers use their debit cards for shopping. Other collaborations may include fintech firms to deliver supplementary services such as insurance products.

In summary, the future outlook for neobanks appears promising. They are projected to continue expanding rapidly in the coming years, driven by various factors like the increasing adoption of smartphones, the rising demand for digital banking services, and the growing collaborations between traditional banks and fintech companies. Neobanks are also likely to gain from the enhanced utilization of AI and ML technologies as well as blockchain advancements.

Challenges Faced by Neobanks

Though neobanks possess numerous benefits compared to traditional banks, they encounter several challenges. Given that the adoption of neobanks and digital banking is a relatively recent phenomenon, various potential hurdles exist.

- **Security Concerns and Cyber Threats**

Cybercrime and hacking represent significant challenges or risks that can impact the banking sector and other online businesses (Larisa et al., 2019). The banking industry is especially susceptible to cyber threats because of the large volume of sensitive financial data it manages; unauthorized exposure of this information could result in serious ramifications. Ahsan et al. (2022) outline some of these risks, including malware attacks, Distributed Denial of Service (DDoS) attacks, phishing attacks, and insider threats.

- **Limited Brand Recognition**

Another issue is the limited brand recognition. As neobanks are newcomers to the market, many individuals remain unfamiliar with them. This lack of familiarity can hinder neobanks in their efforts to draw in new clients. Additionally, an over-reliance on a partner may introduce various risks, such as potential conflicts of interest, diminished control over customer experiences, and total lack of brand visibility (Leffert, 2022).

- **Inconsistent Customer Loyalty**

With the surge in neobanks and digital banking platforms, a primary hurdle these modern banks face is the lack of consistent customer loyalty. This poses a significant challenge when it comes to maintaining a stable customer base (Corander, 2021).

- **Regulatory Obstacles**

Adhering to various regulatory requirements is another challenge that neobanks must navigate. Like their traditional counterparts, they are legally obligated to comply with the same regulations, which can be both resource-intensive and time-consuming. Additionally, they must emphasize strong security measures to protect their customers' information. Another complication for neobanks is the necessity of implementing appropriate laws and regulations for effective banking operations. Kokh & Kokh (2020) discuss the licensing challenges faced by numerous neobanks, which often leads them to register their businesses and partner with traditional banks, creating another issue—an over-reliance on such collaborations.

- **Profitability and Scalability Challenges**

Most neobanks are still in their growth phases and have not yet reached profitability. Achieving scalability while upholding a lean cost structure presents a notable challenge (Stoughton & Nagar, 2019). Providing services at lower prices, a strategy frequently adopted by many neobanks, can undermine their capacity to generate and maintain revenue. Moreover, their operational frameworks require substantial investments in technology, resulting in high expenditures.

- **Intense Competition**

In a saturated market, competition is fierce. Neobanks must continuously innovate and distinguish their offerings to retain existing customers and attract new ones (Nasir & Rizvi, 2020). Traditional banks have begun providing digital banking services that closely resemble those offered by neobanks. Additionally, other fintech firms are entering the market, making it increasingly challenging for neobanks to differentiate themselves.

Strategies for Tackling Challenges

Despite the various obstacles and security risks facing the neo-banking sector, there are numerous actions that neobanks can take to alleviate or avoid these issues. Some of these are elaborated below:

- **Establishing robust compliance and risk management frameworks:** It is crucial for neobanks to comply with all applicable regulations and implement strong security protocols to protect their clients' information. Additionally, they must recognize potential threats and develop plans to manage them efficiently.
- **Fostering strong customer connections and engagement:** Neobanks should work towards cultivating strong relationships with their clients to promote trust. This can be accomplished by providing exceptional customer support, being transparent about charges and fees, and innovating their product and service offerings.
- **Exploring novel revenue streams and partnerships:** Neobanks should seek out fresh revenue opportunities and partnerships. This could mean working alongside other firms to offer supplementary services or designing new products tailored to their customers' preferences.

- Enhancing customer acquisition and retention strategies: Neobanks must create effective approaches for gaining and retaining clients. This may involve providing incentives for opening accounts, ensuring excellent customer service, and implementing loyalty initiatives.
- Focusing on improved cybersecurity and data protection: Neobanks need to prioritize investments in cybersecurity to safeguard their clients' data. Like other sectors, banking is continuously evolving to find ways to protect itself from the ongoing threat of cyberattacks. Some protective strategies include: increasing cybersecurity awareness among staff and providing appropriate training (Abdulrahman et al., 2020), utilizing data encryption (Lakhani, 2018), applying multi-factor authentication (Ometov et al., 2018), planning for incident response (Ghelani et al., 2022), and managing third-party risks (Serkebayev, 2023).

Conclusion

Neobanks have the capacity to transform the banking landscape through technological advancements and customer-focused strategies. Undoubtedly, neobanks have surfaced as a revolutionary force within the banking sector. Nevertheless, they confront several hurdles, such as regulatory adherence, cybersecurity challenges, and difficulties in customer acquisition and retention. Despite these obstacles, the future appears promising for neobanks. To maintain growth and compete effectively, they must tackle issues like regulatory compliance, scalability, cybersecurity, and differentiation. They are ideally situated to capitalize on the increasing demand for digital banking solutions. As a rising number of consumers embrace mobile banking and other digital services, their growth and expansion will likely continue. To gain an edge in competition, they must innovate and create new offerings. Furthermore, they should establish strong connections with their clients and earn their trust. By doing so, they can navigate the challenges they encounter and continue to progress and prosper in the years to come.