NeoBanks: Future Prospects, Challenges and Strategies

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Introduction

The first Neobank was First Direct, launched in the UK in 1989. The possible use of the term “neobank” can be traced back to the year 2017. They have been around for over a decade, but they have only recently started to gain traction. The rise of neobanks is due to the fact that they offer more convenient and user-friendly banking experience than traditional banks. They are also able to offer lower fees and better interest rates because they do not have the same overhead costs as traditional banks. In India, Niyo Solutions is one of the first companies to emerge in this sector. These are digital-only banks that offer a wide range of services through digital platforms. They originated when technology-based financial service companies challenged traditional banks. Some of the first players emerged in the United Kingdom and Germany. Neobanks are online-only financial institutions that are similar to banks. The offerings of these banks are usually limited compared to traditional banks. The slimmed-down model often allows neobank customers to enjoy lower fees, competitive interest rates and customized products. They bridge the gap between the services that traditional banks offer and the evolving expectations of customers in the digital age.

Overview of Growth of Neobanks

During the past decade, neobanks have smartly carved a niche for themselves by consistently expanding the range of services they offer their customers (Bradford, 2020). The growth and adoption of neobanks show no signs of slowing down, with Statista’s (2023) estimates predicting a user base of 376.9 million worldwide in 2027, a twenty-fold increase from 18.95 million users in 2017. These trends indicate a shifting dynamic in banking, but the extent to which neobanks challenge traditional banking remains unclear. Between 2018 and 2022, neobanks witnessed their transaction value soar from \$0.45 trillion to \$3.21 trillion and their user count during the same period increased from 32.61 million to 188.4 million users worldwide (Statista, 2023). The significant growth potential for neobanks is mainly driven by their low-cost model for end consumers with no or very low monthly fees on banking services such as minimum balance maintenance, deposits and withdrawals. Factors such as faster process of loan approval and funding compared to traditional banks with lower-interest rates via banking applications are driving the growth of the market. The main growth factors concerning neobanks—mainly related to regulatory frameworks, customer preferences and competition—will undoubtedly continue to exist during the next few decades.

Significance of Neobanks

The phenomenal growth of neobanks and completely digitised banks have brought a paradigm shift in the entire banking system, resulting in drastic shift in the offering of financial services to customers (OECD, 2020). They differentiate themselves through a wholly digital methodology and contemporary, innovative business models, making physical branches unnecessary for their operations (Buchi et al., 2019). During the major portion of the 20th century, traditional banking entities dominated the financial services industry. These entities initially offered services like

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deposit, lending and wealth management. Later in the 20th century, traditional banking witnessed a trend shift towards consolidation and significant deregulation, giving rise to large multinational banks. These institutions efficiently leveraged technology to enhance efficiency and broaden their operations in the 21st century (Gorton, 2015). In spite of the considerable influence of digitalisation on the structure and operations of conventional banking, many still heavily depend on physical locations and face-to-face interactions as part of their customer offering. Neobanks symbolise a novel banking reality stemming from evolving customer preferences and needs. First appearing in the early 2010s, they are fully accessible via the internet or mobile devices, utilising their technology to offer a customer experience that includes services like account opening, mobile payments, deposit facilities, savings and investment management tools and various loan services. They also provide access to trading markets like the stock market, raw materials market and cryptocurrency markets (Martinčević et al., 2022).

Although numerous studies such as those by Gulieva et al. (2019) and Temelkov (2020) discuss how the neobanks' business model could challenge traditional banks, statistics show that neobanks are still in developing stage. Therefore, academic literature on this topic should continue to evolve. The quick growth of neobanks, the introduction of new services and emerging trends have created a gap in theoretical knowledge concerning current and future competition within the banking industry, as well as shifts in customer preferences and behaviors. Thus, significant void exist in the literature that assesses the emerging prospects of neobanks in the financial services industry, potential risks posed by their newly established role, how they distinguish themselves for customers and their relationship with traditional banks.

Key features and innovations offered by neobanks

Neobanks represent a peculiar category of financial institutions that exclusively carry out their operations online, typically without physical branches. They deliver their banking services through mobile apps and websites, focusing on offering their customers an effortless, user-friendly and entirely digital experience. To provide innovative features 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, neobanks often lean on technological advancements (Gulieva et al., 2019).

On the contrary, traditional banks are long-established financial entities with physical branch networks. They offer a basket of banking services including savings and time deposits accounts, loans, mortgages and select investment services. Due to their physical presence and Automated Teller Machines (ATMs), customers can avail the traditional banks' services in person. Additionally, they typically offer an array of additional services such as wealth management, insurance and financial planning.

Thus, neobanks offer several key unique features and innovations that set them apart from traditional banks. The main landmark feature of neobanks is their mobile-first approach. They are designed to be used primarily on mobile devices, which makes them more convenient for customers who are always on the go. Another key feature is their focus on user experience. Neobanks are designed to be simple and easy to use, with intuitive interfaces that make it easy for customers to manage their finances. They also offer a range of innovative services such as budgeting tools, savings goals and real-time notifications. Neobanks are also known for their affordability and easy accessibility. They do not have the same overhead costs as traditional banks, which allows them to offer better rates to their customers. Finally, neobanks are known for their fast and efficient customer service. They use technology to provide quick responses to customer enquiries and complaints.

Future Prospects for Neobanks

The future potentials for neobanks are seemingly bright. The primary reason for the growing popularity of neobanks is their fully digital nature and the simplicity of their services. These services enable customers to perform banking tasks from the comfort of their homes or any location of their choice, eliminating the need to visit physical branches (Padmanabhan, 2021). Despite the shift towards digitization in traditional banks, they still maintain a significant market share in the banking industry. Nevertheless, recent trends and research indicate a consistent migration of customers towards banks that provide "online-only" solutions (Statista, 2023). The global neobank market is expected to grow at a CAGR of around 46.5% between 2019 and 2026, generating around USD 394.6 billion by 2026. The growth of the market is driven by several factors such as the increasing adoption of smartphones, the growing demand for digital banking services and the increasing number of partnerships between traditional banks and fintech companies. Some of the future prospects for neobanks are discussed below:

- **Market Expansion**

  As internet penetration and smartphone usage are on the rising trend, neobanks are expected to onboard more customers, especially among the younger generation, who are more open in using digital banking services (Nasir & Rizvi, 2020). Furthermore, neobanks are well-positioned to expand their services to unbanked and underbanked populations in emerging markets (Demirgüç-Kunt et al., 2018).

- **Technological Innovation**

  Efficiency is the area that has undergone a significant transformation with the advent of modern and sophisticated technology. Banks have been able to automate a substantial proportion of their operations, reducing their dependence on manual labor and in turn, contributing to greater efficiency and a leaner cost structure (Gulieva et al., 2019). Nowadays, banks extensively employ Artificial Intelligence (AI) for a variety of tasks, including fraud detection, automation of customer services (Digalaki, 2022), etc. In this context, neobanks are poised to continue leading the way in the adoption of advanced technologies such as Artificial Intelligence, blockchain and biometrics to provide more efficient and secure banking services (Jabbari & Ouerghi, 2020). For instance, AI can be utilized for better risk analysis and personalized financial recommendations.

- **Partnerships and Ecosystem Development**

  Neobanks typically rely on alliances and partnerships with other financial service providers to offer their services due to a variety of reasons. One of the leading causes of this is that these institutions generally face the paucity of the required infrastructure, regulatory clearances and licenses necessary to directly offer services, such as loans and credit cards.They are in a position to offer these services owing to the fact they collaborate with established financial institutions, which enables them to do so without having to invest in the infrastructure or obtain regulatory permissions and licenses on their own (Koibichuk et al., 2021). They are likely to build extensive ecosystem through partnerships with fintech firms, traditional banks and non-financial companies to offer a broader range of services, from lending and insurance to retail and travel (Chen, 2020).

- **Novel revenue generation models**

  Neobanks use various strategies for revenue generation and monetisation. A prevalent model involves levying charges for special services, including overdraft protection, foreign currency transactions and ATM withdrawals. Some neobanks also impose fees on specific transaction types, like wire transfers. Many neobanks attract customers with high-interest savings accounts, allowing customers to accrue interest on their savings. Some neobanks also provide investment options such as mutual funds and Exchange-Traded Funds (ETFs), enabling customers to invest their savings. Some collaborate with retail businesses to offer cashback rewards when customers use their debit cards for purchases. Other partnerships may be with fintech companies to provide auxiliary services, including insurance products.

In short, the future prospects for neobanks are bright. They are expected to continue growing at a rapid pace over the next few years, driven by several factors such as the increasing adoption of smartphones, the growing demand for digital banking services and the increasing number of partnerships between traditional banks and fintech companies. Neobanks are also expected to benefit from the increasing use of AI and ML technologies as well as blockchain technology.

Challenges for Neobanks

While neobanks enjoy a multitude of advantages over conventional banks, they also face several challenges. Considering that the use of neobanks and digital banks is a new concept that has emerged in the last decades, there are potential challenges.

- **Security issues and cyber threats**

  Cybercrimes and hacking are some challenges or risks that can haunt the banking industry and others that conduct their businesses online (Larisa et al., 2019). The banking sector is particularly vulnerable to cyber threats due to the vast amount of sensitive financial information it handles, the unauthorized exposure of which can have significant consequences. Ahsan et al., (2022) delineate a few of these risks such as malware attacks, Distributed Denial of Service (DDoS) attacks, phishing attacks and insider threats.

- **Lack of brand recognition**

  Another challenge is the lack of brand recognition. Neobanks are relatively new to the market and many people are not familiar with them. This can make it difficult for neobanks to attract new customers. Moreover, over-relying on a partner comes up with several dangers, including possible conflicts of interest, a loss of control over the client experience and complete lack of brand recognition. (Leffert, 2022).

- **Lack of customer loyalty**

  As the number of neobanks and digital banking platforms proliferates, a key obstacle these new-age banks encounter is the lack of consistent customer loyalty. This presents a notable challenge in maintaining a stable customer base (Corander, 2021).

- **Regulatory challenges**

  Compliance with various regulations is another challenge that neobanks have to encounter. Just like their traditional counterparts, they are legally required to follow the same regulations, which can be both resource-intensive and time-consuming. Furthermore, they must prioritize strong security protocols to safeguard their customers' data. Another issue faced by neobanks is implementing the necessary laws and regulations to conduct banking operations effectively. Kokh & Kokh (2020) highlight the licensing dilemma faced by many neobanks. This often leads them to register their businesses and collaborate with conventional banks, which ushers in another issue — a heavy reliance on such partnerships.

- **Profitability and Scalability issue**

  Majority of neobanks are still in the growth phase and are not yet profitable. Achieving scalability while maintaining a lean cost structure remains a significant challenge (Stoughton & Nagar, 2019). Offering services at lower cost, a common practice among many neobanks, may impede their ability to generate and sustain revenue. Furthermore, their operational model demands substantial investments in technology, leading to high expenditure.

- **Competition**

  With a saturated market, competition is fierce. Neobanks need to continuously innovate and differentiate their services to retain customers and attract new ones (Nasir & Rizvi, 2020). Conventional banks have started offering digital banking services almost similar to those offered by neobanks. Other fintech companies are also entering the market, which can make it difficult for neobanks to stand out.

Strategies for Overcoming Challenges

Despite the numerous challenges and security threats looming over the neo-banking sector, there exist several measures that neobanks can implement to mitigate or avoid these challenges. Some are discussed below:

- **Building strong compliance and risk management systems:** It is essential for neobanks to align with all relevant regulations and enforce robust security measures to safeguard their customers' data. They should also identify potential risks and devise strategies to handle them effectively.

- **Creating solid customer relationships and engagement:** Neobanks should strive to build strong bonds with their customers to instill trust. This can be achieved by delivering superior customer service, maintaining transparency about fees and costs and innovating with their products and services.

- **Discovering innovative revenue channels and partnerships:** Neobanks should explore new avenues for revenue and partnerships. This could involve collaborating with other companies to offer additional services or designing new products tailored to their customers' needs.

- **Improving customer acquisition and retention tactics:** Neobanks must formulate efficient strategies for customer acquisition and retention. This could include offering incentives for account creation, providing top-notch customer service and creating loyalty programs.

- **Investing in enhanced cybersecurity and data protection:** Neobanks must prioritize investments in cybersecurity to protect their customers' data. Like all other industries, banking continues to adapt and discover ways to shield itself from the constant threat of cyber attacks. Some of these protective measures include: enhanced cyber security awareness among employees and suitable training. (Abdulrahman et al., 2020), data encryption (Lakhani, 2018), multi-factor authentication (Ometov et al., 2018), incident response planning (Ghelani et al., 2022) and third party risk management (Serkebayev, 2023).

Conclusion

Neobanks have potential to redefine the banking experience through technological innovation and customer-centric approaches. There is no doubt that neobanks have emerged as a disruptive force in the banking industry. However, they face several challenges, including regulatory compliance, cybersecurity risks and customer acquisition and retention. Despite these challenges, neobanks have a bright future ahead of them. To sustain growth and compete effectively, they need to address challenges like regulatory compliance, scalability, cybersecurity and differentiation. They are well-positioned to take advantage of the growing demand for digital banking services. As more consumers adopt mobile banking and other digital technologies, they will continue to grow and expand. To succeed in the competition, they will need to innovate and develop new products and services. They will also need to build strong relationships with their customers and establish trust. By doing so, they can overcome the challenges they face and continue to grow and thrive in the years ahead.

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Bank Quest included in UGC CARE List of Journals

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