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Neo-Banks – will they overthrow traditional Banks ?

Abstract

This text, written at the time when Turkey is enacting a new law on Neo-Banks, aims to show some experience from Europe/UK/US on Neo-banks, how some interesting and surprising models are emerging that combine Neo-banking and Open Banking … and how traditional banks should position themselves in the face of these new developments.

Background

There has been a resurgence in Neo-Banks – sometimes called Digital-only Banks, Challenger Banks[1] - for some years now. There are ca 250[2] in the world and some have become quite successful: Revolut has 15M customers and a, possibly surprising[3], valuation of 33bn$. Similar stories exist for N26, Monzo, Starling, etc. But so far, the impact on traditional banks has been modest: very few customers trust the new banks enough to put their monthly salaries there or to take out a mortgage or plan their retirement with them. Instead, the Neo-banks currently seem to occupy niches: Revolut is great for those who travel and need multiple currencies at competitive rates or who want to speculate with crypto, Monzo says its USP is "To build a smart phone hub for all financial needs, with importance placed on each user having control and knowledge of their finances" and has had much success with millennials by issuing a strikingly pink debit card:

[1] in Turkey only the term "Digital Bank" has a legal meaning being essentially defined as "branchless banking". The other terms of Neo-Bank, Direct Bank, Challenger Bank are not defined in any regulation, however they are used in the sector, also in Turkey. Some (e.g. https://www.linkedin.com/posts/pkriaris_fintech-disruption-technology-activity-6893794898760609792-Z8YM) have a more formal view that "challenger banks refer mostly to FinTechs holding a banking license, whereas the term Neobanks tends to refer to players without a full banking license, which instead rent one from a licensed institution. Revolut and N26 are good examples of the first category, whereas Chime or Monese come to mind for the second."

[2] https://neobanks.app/ with a total valuation with the top 15 independent players approaching together a valuation of almost $200 billion (according to https://www.c-innovation.eu/product-page/ins-and-outs-of-digital-banks).

[3] https://www.theguardian.com/business/nils-pratley-on-finance/2021/jul/15/revolut-valuation-makes-little-sense-compared-lloyds



Fig 1: The Killer Differentiator ? A pink debit card

Some have demonstrated huge success, such as Markus by Goldman Sachs, which has managed to amass $50 billion in deposits, $5 billion in consumer loan balances and 4 mn customers in the US and the UK since launch in 2016.

All Neo-banks have the ambition to expand their services to cover the wider range of banking (not only cards and payments but also loans, mortgages, investments, pension plans etc) – but most are discovering how hard and expensive banking really is. This may go some way to explain why the original 40 UK Neo-Banks are now down to 28. This due to consolidation but also because investors are increasingly less keen to pump money into general digital Neo-banks, instead looking more for focused approaches with high potential.

Neo-banks often claim that they will revolutionise banking, making the experience entirely digital and convenient – arguing that they are digital-born and have created the bank with modern technology from the outset rather than carrying heavy legacy burdens with them from the old paper-and-batch banks.

"To completely transform the banking world" … "Banking is %@&#$" …
„An entirely new kind of bank"
„The ultimate mobile bank account"
„Banking services of the future!"
„We do banking differently"

„100% free"
„No credit check, no minimum balance, no monthly fees, no overdraft fees, free ATM use"
„The best rates"
„We don't charge any fees for spending abroad, and we don't mark up the exchange rate – unlike normal banks"
„Deposits are credited 2 days earlier"
„100% free … Here, see the list of fees" 😊

„includes an impressive credit card (!) and checkbooks (!!)"

Fig 2: Typical claims of Neo-Banks

The truth is, however, often different. The onboarding of customers is equally awful at all banks, whether old or new (since KYC processes are defined by law and allow few short cuts – such as digital onboarding via video identity – which the incumbents have largely already also embraced). With traditional banks you can reach your human adviser/bank manager and get help if you have any problems, whereas a Neo-bank will typically only offer a "bot"[4].

[4] exceptions do exist: Sofi – contrary to most neo-banks - offers phone and mail access to real specialized humans https://www.sofi.com/contact-us/, not just to automated bots. Great for customers but a large cost factor for the bank.

All the “free” services raise some questions about the sustainability of the Neo-Banks’ business models. Mobile apps are nowadays also offered by traditional banks and – looked at unemotionally in the cold light of day – are often just as good as the new snazzy neo-entrants. Indeed many of the “Neo-“banks do not have a newly constructed fully digital core at all, but rely on traditional Visa/Mastercard at the front end and a traditional bank’s IT at the back end:

Neo-Bank	Actual Bank
Chime	Bancorp Bank
Monzo	Sutton Bank
N26	Axos Bank
Revolut	Metropolitan Commercial Bank
Simple	BBVA (previously Bancorp)

Fig 3: Many “Neo-“banks are actually traditional banks inside

Learning from the past

We have seen the hype about Digital Banks overthrowing the incumbent banks before. When the internet “hit” traditional banks in the 1990s, many thought the future would lie in “Direct Banks” which, built entirely new on digital, would offer clients a much improved 24/7 service. Many traditional banks were scared into creating their own digital bank (e.g. Deutsche’s “Bank24”). Meanwhile almost all of these have folded and have been re-integrated into the traditional mother bank[5]. One of the few survivors who succeeded in setting up a digital daughter was ING – but one can see from recent news[6] that in some countries this is also in retreat. Thus the wide success of Direct Banks still remains to be proven.

A globally more successful strategy was and is “multi-channel”. Instead of forcing the customer to set up with a new digital bank, register a new account and do all his digital dealings there (whilst retaining his classical physical business with his old bank and his old account), a single multi-channel bank offers the customer *both digital and physical* services in one place. The account is just accessed over different channels – either in branch, at ATM, over the internet, via mobile app – all at his traditional bank on all his existing accounts.

This success model has been implemented from the start for example at the German Cooperative Banks (1600 banks with 30% of the German retail market share). This saved this banking group hundreds of millions of Euros in investments in a Direct Bank (and later many more costs in re-integrating the digital daughter back into the parent when that model would have inevitably failed). The author may be permitted to share that he was deeply involved in the strategy for these banks and heavily championed the multi-channel model in the face of much adversity from proponents of the Direct Banking model in which so many believed. The multi-channel strategy clearly won over the direct banking model and saved

[5] e.g. „Bank24”, created in 1995, was re-integrated back into its mother, Deutsche Bank, in 2020 with further severe costs and customer disruption

[6] „After more than twenty years of losses, ING leaves online bank market in France“ https://www.lemonde.fr/economie/article/2021/12/21/apres-plus-de-vingt-ans-de-pertes-ing-quitte-le-marche-de-la-banque-en-ligne-en-france_6106943_3234.html

this banking group large amounts of money, management time, development effort and customer disruption by going straight to the model of the future.

So let us learn a lesson from the hype, the eagerness to please millennials, the real and understandable need to move quickly on internet, mobile, open banking but to avoid the temptation to build a new bank each time to serve those needs. Instead let us build on existing banks, existing customers (and their complex, already done expensive enrolment) and add functions and channels onto existing banks.

Turkey

In Turkey the traditional banks seem very well placed to take up any challengers, since most have a vibrant technology arm[7] which largely seem very well prepared to take the bank to the future:

Bank	Tech Subsidiary	Year Founded
Yapı Kredi	Yapı Kredi Teknoloji (Bilpa A.Ş.)	1980
Denizbank	Intertech	1987
Garanti BBVA	Garanti BBVA Teknoloji	1990
Ziraat Bankası	Ziraat Teknoloji (Fintek A.Ş.)	2001
QNB Finansbank	IBTech	2005
İş Bankası	Softtech	2006
Kuveyt Türk	Architecht	2015
Albaraka Türk	Albaraka Tech	2019

Fig 4: Technology subsidiaries by Turkish banks[8]

Now that the new law on Neo Banks is coming into force[9], we will see the appetite of new entrants to challenge incumbents. This should surely be welcomed as it brings more competition, more innovation, more choice to the customer. But the road for an entirely new digital-only bank to become the financial services centre for all a customer's earnings, his loans, his financing will be a long and thorny.

[7] One sometimes finds this in Europe too, e.g. BBVA's 16.000 developers hub https://www.finextra.com/newsarticle/39537/bbva-creates-global-software-development-unit

[8] Source: "The State of the FinTech Ecosystem in Türkiye", Turkish Finance Office 2021, https://cbfo.gov.tr/en/news/state-fintech-ecosystem-turkiye-2021-prepared-under-coordination-finance-office-presidency

[9] the regulation on "The Operating Principles of Digital Banks and Service Model Banking" will take effect on 1st January 2022. Regulation: https://www.mevzuat.gov.tr/mevzuat?MevzuatNo=39158&MevzuatTur=7&MevzuatTertip=5 Commentary: https://www.mondaq.com/turkey/financial-services/1105510/draft-regulation-on-digital-banking-and- banking-as-a-service-baas-in-turkey

However, some[10] are already going down the route of having a no-branch, e/m-only service and one will see whether just being cheaper[11], with reduced service range, will be enough.

One particularly fruitful avenue in countries with large underbanked population, such as Turkey[12], may be to have dedicated Fintech/Neo-Bank services to attract new clients who previously rely only on cash. Some see opportunity also in particular verticals in this area[13].

Open Banking and Neo-Banking

Maybe a smarter approach for those wanting to challenge existing banks is to leverage the opportunities in the process of now being afforded by Open Banking.

One can already see as Eastern super-apps and Western Neo-Banks evolve, they are employing Open Banking to leverage creativity from the third-party API developer community:

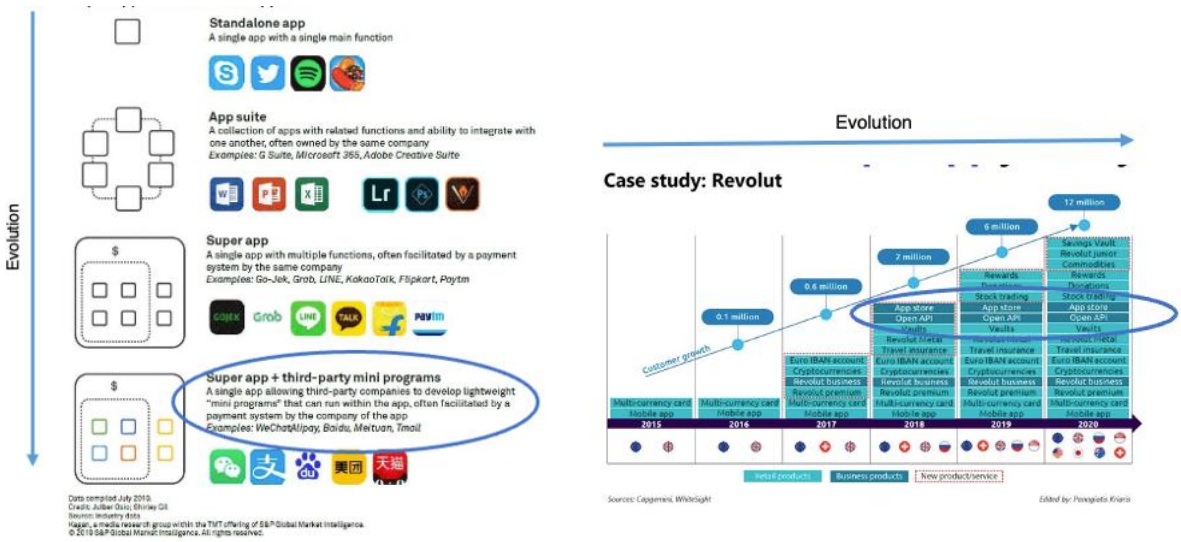

Fig 5: A single app (either Eastern super-app or Western Neo-bank app) allows third parties to develop new add-ons that will add further value to the apps

Beyond this, Open Banking allows a challenger to focus on his differentiating product (the customer-facing side, the revenue generating side) and leave the back-end (the core banking, the account management, the KYC/onboarding, the compliance – i.e. all the expensive and non-revenue earning efforts) to the traditional banks.

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[10] most prominently: https://www.qnbfinansbank.enpara.com/

[11] However, some new players, such as Nu-Bank are capturing large markets by offering free digital accounts – this is clearly not sustainable in the long term but a good entry strategy (if sufficient funding is available) to gather many customers on which a revenue-generating pivot can later be developed

[12] Turkey has over 30% unbanked population according to https://www.gfmag.com/global-data/economic-data/worlds-most-unbanked-countries

[13] With thanks To Arzu Kutlu on this point and the potential also in the agricultural vertical in Turkey

We are seeing this migration from being a *bank-challenger* to instead sitting *on top* of banks and adding a value-added layer in many geographies:

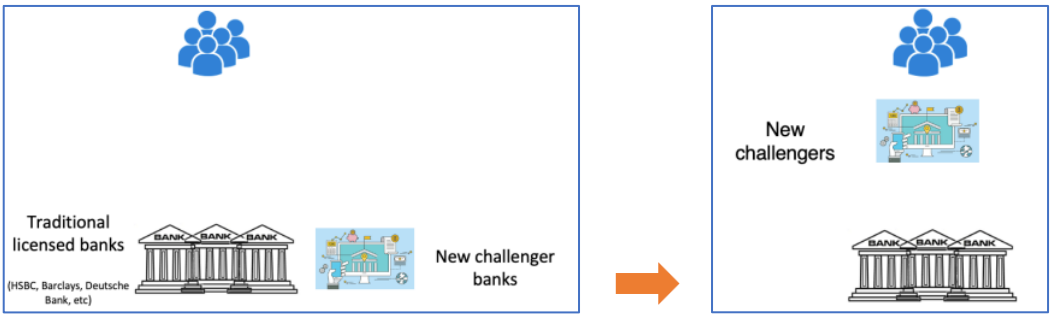

Fig 6: Neo-Banks giving up banking license to sit on top of existing banks

Indeed, some neo banks who thought they would challenge traditional banks but are now discovering how hard complete banking (not just in a niche product) is, are giving back their banking licenses[14] and becoming a player on top of banks and thus offering their new digital solution *to all clients at all banks*, thanks to the access that Open Banking permits.

A further example of this, is an investor who contacted the author to set up a new Islamic Banking bank – but was advised instead to add an "Islamic banking" layer on top of existing banks using Open Banking. This much smarter strategy gives any client at any bank in Europe access to Islamic banking services if he chooses. Much better for the banks, for the clients and for the provider of Islamic banking services than building a new bank.

A final example of how Open Banking can turbo-charge intelligently the development of Neo-Banks (or, more accurately, new banking services) is Cure[15]. This new platform is being created by management already deeply versed in neo-banking[16] to challenge some so-called vertical banks. Vertical banks address a specific market, often B2B, such as health industry (doctors, dentists, hospitals, pharmacies), or shipping (vessels, containers, harbours), or real-estate, or the self-employed etc. These vertical banks offer the clientele in that segment specific financing, investment products etc based on deep understanding of that industry. Traditional general-purpose banks usually struggle to serve these specific markets lacking both the deep industry knowledge of shipping/health/..., lacking connection to that industry's specific systems and lacking the specific products needed (e.g. handling bills of exchange, letters of credit, inspection certificates etc initiating real-time one-off insurance and tax payment for ship to leave harbour – needed as basis for doing business in the shipping industry).

Cure – the new challenger for the health industry – could have set up a greenfield Neo-Bank and hope to attract doctors, hospital administrators etc over, to open an account at their

[14] e.g. https://www.finextra.com/newsarticle/32357/square-takes-a-breather-in-banking-licence-battle, https://www.computerweekly.com/news/252438486/UK-challenger-bank-gives-up-banking-licence-to-focus-on-fintech, etc

[15] https://www.cure.finance/

[16] key management and staff come from digital champion FIDOR bank

new bank with its shiny new digital services. They wisely chose not to do this but are instead allowing doctors, pharmacies etc to keep their existing banking relationships and provide a value-added Fintech layer on top. The health industry professionals are typically already enrolled in a traditional health vertical bank[17] who has been serving them for decades. By putting a layer *on top* of the traditional bank, offering new and better digital services, they become a serious innovator and competitor.

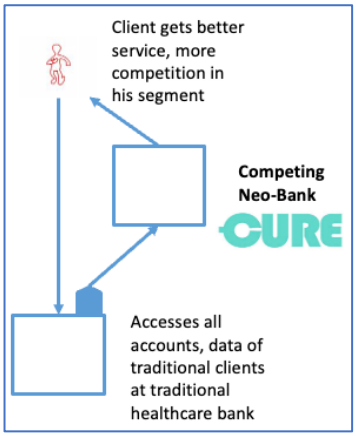

Fig 7: Neo-Bank attacking traditional healthcare vertical bank using Open Banking

Finally, the new developments of embedded finance – where new players and incumbents can insert their financial services into the platforms *of others* using APIs (a technology much driven by Open Banking) and BaaS (now also enabled by the new Turkish law) – will lead to many further really exciting and heavily business-driven opportunities, which for now must remain beyond the scope of this paper. This area may actually be much more of a threat to traditional banks, if they do not position themselves well, than the Neo-Banks. Please contact the author for more background and evidence on this.

Summary and Outlook

Thus, we can see that Neo-Banks have a great deal of potential. But this lies not in simplistically duplicating a bank on a digital greenfield but on providing really new value-added services which can either be provided native (i.e. not just with a traditional core bank or card inside[18]) or, maybe more smartly, "on top" of existing banks/existing accounts using the power of modern technologies such as Open Banking.

Once extensive customer migration has taken place and the user – either the general private user or the B2B user such as treasurer, doctor or freight manager etc – have moved over to the new bank/platforms' services, then one can think about expanding the portfolio to cover more financial services and maybe even – at some more distant date – become the central point of call where consumers' salaries are deposited, mortgages taken out, and where industries' specific B2B financing is provided.

[17] e.g. https://www.apobank.de/

[18] or, heavens help us, with a chequebook as most US "Neo-"banks propose

Until then it may be best to remember the stark fact that "most people are more likely to change their spouse than their bank account"[19]. Getting people to switch to a new bank is really hard[20].

For reasons given, traditional banks should thus not be panicked by the hype into knee-jerk reactions, but should instead look rationally at the Neo-banks' key figures:

- the real market penetration (compared to bank customer and bank volumes)
- the real customer satisfaction (try to talk to their bots instead of your bank adviser)
- the real fraud/compliance record (see the many Neo-bank scandals[21])

But traditional banks should not be complacent. They must monitor the development closely and be particularly wary of attrition, especially since new customers more often open accounts at the new banks:

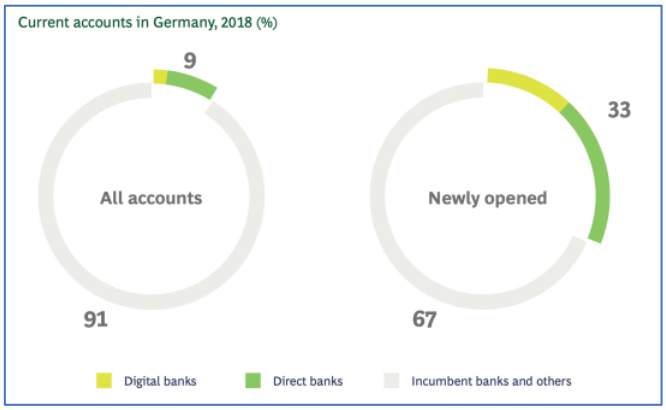

Fig 8: New accounts are opened more at Neo-banks

Also, some Neo-banks *have* built their IT, processes and business model from scratch, they have a digital culture and mindset in tune with millennials – these may become a serious threat due to their agility, scalability as more and more banking, customers and processes become more and more digitized.

The Neo-banks' PR (not necessarily always the delivery) has also raised the *expectations* of the customers on modern digital financial services, so incumbent banks really need to adapt to satisfy these needs – otherwise mass migration to digital will surely take place without them. In the short term they need to be particularly wary of any cherry-picking by new entrants both in B2C and B2B. As part of this strategy traditional banks could maybe also consider becoming more aggressive in communicating their great real assets to counter some the hype of some of the new entrants.

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[19] https://www.theguardian.com/money/2013/sep/07/switching-banks-seven-day

[20] the UK Regulator enforced an bank switching scheme to enhance competition; although it is free, quick and easy only very few people made use of this https://www.bbc.com/news/business-44522630 "Don't bank on it: Why we fail to switch our accounts". Similar findings are everywhere, e.g. only 0.2% of users switched in the Netherlands, see https://www.henrystewartpublications.com/jpss/v15 "The payments industry in the Netherlands: Status and future developments"

[21] e.g. those of „Europe's leading digital bank" N26 https://www.heise.de/suche/?q=n26&make=&sort_by=relevance

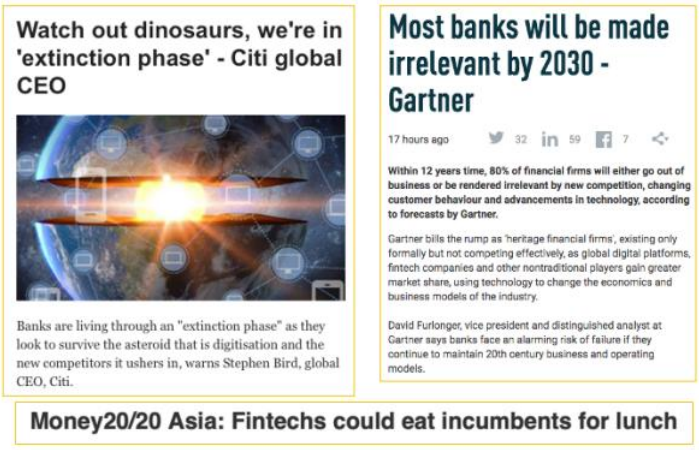

Fig 9: Rumours of banks' death are regularly exaggerated

Every few years, after every new crisis or technology, the "extinction phase" of the "dinosaur banks" is predicted. Banks have regularly been predicted to die due to:

Direct Banking
Mobile Banking
Open Banking/FinTech
Digitisation
Blockchain
BigTech
Neo-Banks
…

However, traditional banks have enormous assets (security, trust, capital, client base, brand, global networks, …) and have, so far, always survived – but they do need to be wary, flexible and continuously change. A steady hand on the tiller is required that monitors the development – without being shocked into irrational and expensive dead-ends; have a strategy that is aware of the threats; without succumbing to unwarranted extinction fears; and act sagely to protect and expand the business by leveraging all the great assets that traditional banks have.

That way incumbent banks will succeed (in a more digital form) and some of the Neo-banks will ensure that competition and innovation keeps everyone on their toes.

Dr Michael Salmony
salmony@fintechistanbul.org
https://www.linkedin.com/in/salmony/

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