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SHAPING A VIBRANT INDIA

The banking matrix:
Emergence of open and integrated neobanks

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Contents

Introduction

The Indian growth story is counting heavily on its young population, with more than 50% of the population being below the age of 28. Banking will see the first generation of truly digital natives who rarely visit branches for transactions and may not relate to a time before digital banking. They have very different expectations from their banks on products, service delivery and the transaction experience.

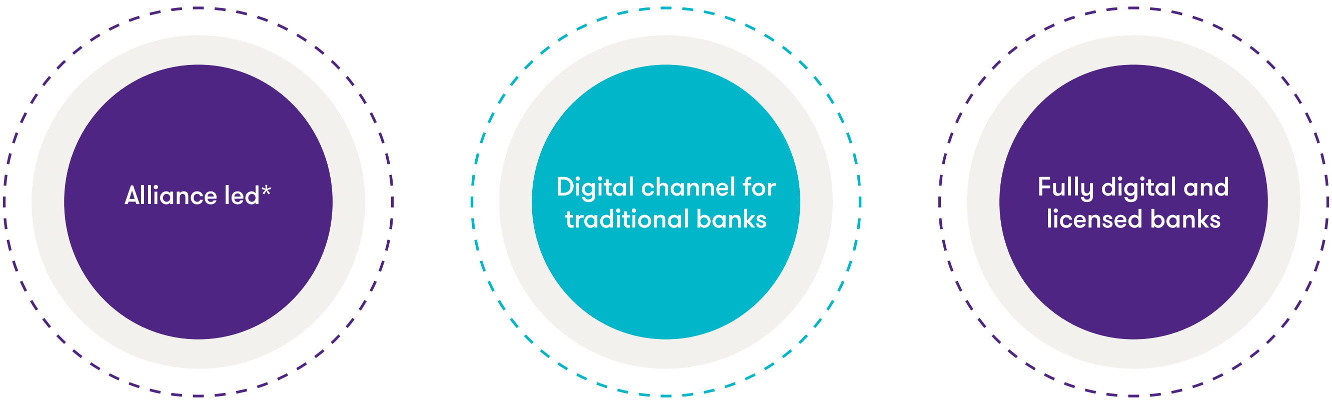
Banking has traditionally been dependent on legacy physical infrastructure. However, the last decade has seen a shift to a digital operating model. Growth in the adoption of the internet globally and in India has meant that customers are becoming more financially literate and confident with alternative banking models.

Traditional banking services are being transformed and customers are today deeply accustomed to hyper-personalised digital banking services. In the era of embedded finance, where financial services products are embedded into social, business and consumer apps, financial transactions are no longer being thought of as a post-facto action. Institutions are building the ability to access data which is available in real-time and making decisions quickly based on algorithms. While moving from physical to digital, building trust and keeping the digital interactions humane will be key to building a strong customer base.

The access to these digital avenues and increase in their adoption has led to the birth of neobanks. Neobanks can be defined as branchless digital banks interacting directly with customers providing a seamless banking experience. Neobanks are curating customised financial services products delivering them completely online either through strategic partnerships or creating their own products after approvals from concerned regulators.

India stack has played a central role in India's digital banking growth allowing banks, non-banking financial companies (NBFCs), fintechs, governmental agencies and other financial services players to enable digital, paperless and cashless delivery of services. The Unified Payment Interface (UPI) is a subset of the India stack that has been instrumental in transforming India's payment landscape from cash-first to digital-first. In addition to this, the regulatory sandbox and innovation hub put in place by the Reserve Bank of India (RBI) have been a support for fintechs in India.

Neobanks globally operate on a banking as a service model and the landscape can be categorised into three major types:



*without banking license

Neobanks that operate today in India fall into the first or second type as mentioned above, and the RBI is still deliberating on the need to issue licenses for fully digital banks. Hence, Indian neobanks need to have a banking partner.

Neobanks collaborate with these established players to offer customised, flexible, accessible and scalable solutions acting as the bank's acquisition and service layer.

Global context

While neobanking might have had its roots in Europe, other economies have actively pursued this concept and have devised unique approaches tailored to their markets and regulatory policies. For instance, the development in North America, South America and South-East Asia has been driven by customer needs in the domestic markets, while in regions, such as Australia and the United Kingdom, the development was driven by regulatory mandates. In contrast to the global developmental path, India's neobanking ecosystem is being built on a hybrid method where both the market as well as the government have collectively impacted the development of the industry.

The Indian neobanking market was estimated to be worth **USD 3.42 billion** in FY2022 driven by rapid change in technology and growing levels of internet and smartphone penetration. Neobanks have been gaining momentum in driving customers to shift from the traditional banking channels for better experience.

Product heatmap

Product heatmap

	Product type	Are neobanks already offering this product / service	Ease of digitisation	Current level of digitisation	Likelihood of neobanks entering the space
Loan	Personal loan	✓	High	High	✓ (Existing)
	Buy now pay later	✓	High	High	✓ (Existing)
	Consumer durable loan	✓	High	High	✓ (Existing)
	MSME loan	✓	Medium	Medium	✓ (Existing)
	Vehicle loan	X	Medium	Medium	High
	Mortgage loan	X	Low	Low	Low
	Gold loan	✓	High	High	✓ (Existing)
	Home loan	X	Low	Low	Low
	Education loan	✓	High	Medium	✓ (Existing)
Investments	Savings/Current account	✓	High	High	✓ (Existing)
	Deposits	✓	High	High	✓ (Existing)
	Mutual Fund	✓	High	High	✓ (Existing)
	NPS/PPF	X	Medium	Low	Medium
	Trading & demat	✓	High	High	✓ (Existing)
Value added services	Internet banking	✓	High	High	✓ (Existing)
	Mobile banking	✓	High	High	✓ (Existing)
	Branch banking	X	Low	Low	Low
	ATM	X	Low	Low	Low
	Locker services	X	Low	Low	Low
	Forex	✓	High	Medium	✓ (Existing)
	Domestic money transfer	✓	Medium	Low	✓ (Existing)

Existing | Low | Medium | High

Neobanks v/s traditional banks – how do they differ?

Neobanks v/s traditional banks: How do they differ?

	Traditional banks	Neobanks
Operations	Physical branches with app-based support	Digital onboarding and service using apps
Partnership arrangement	Partnership for non banking products - Insurance, payments and investment tie-ups	Multiple banks, NBFCs, insurance players and other FS services providers
Products and services	Standard products	Customised product proposition from multiple alliances
Operating cost structure	High	Low
Onboarding	Physical for certain products	Digital
Access	Branch timing is typically 9 a.m. - 5 p.m.	24/7

Success ingredients of neobanks

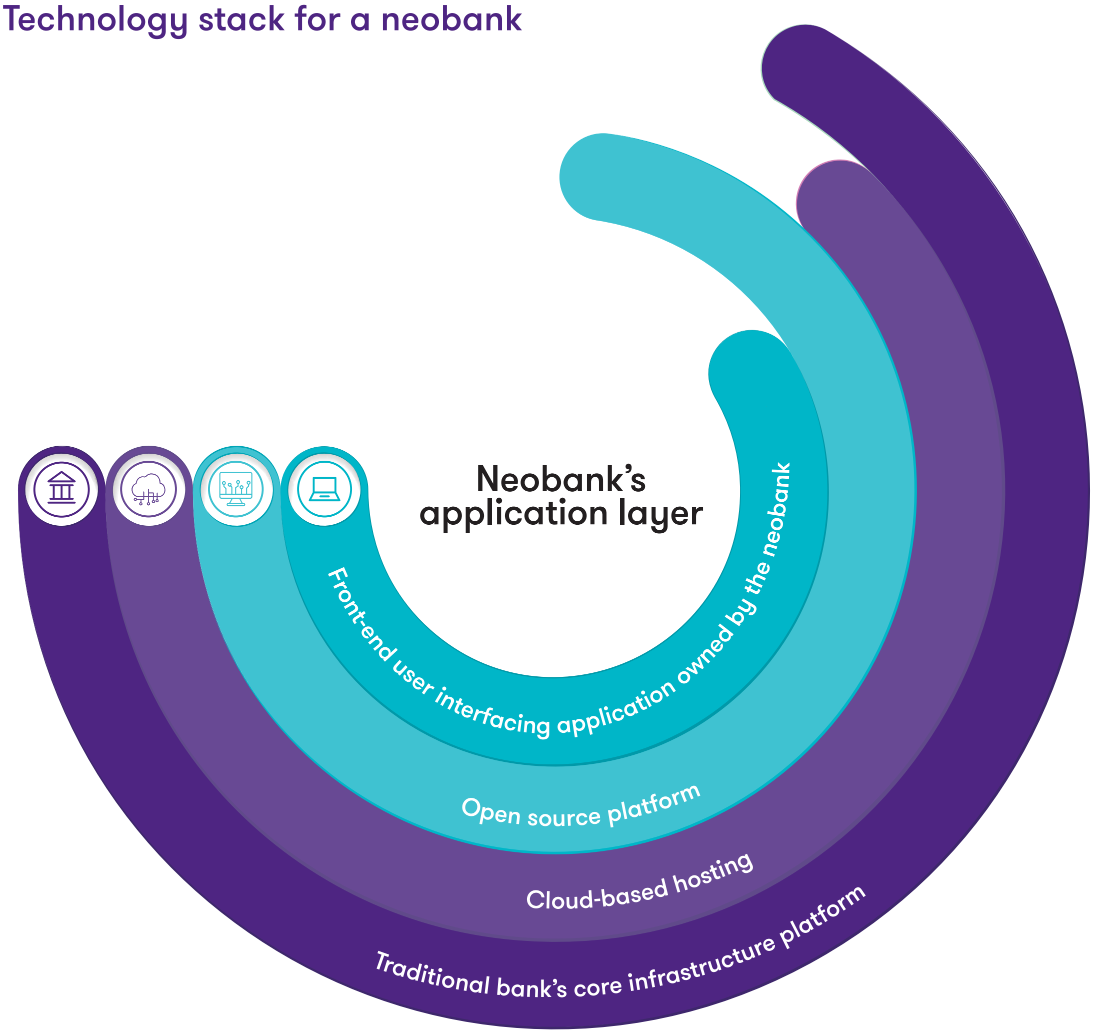
Technology

Technology is driving a fundamental shift in banking with automation, predictive analytics and machine learning finding beneficial applications in multiple functional areas within the retail banking sector. Banks globally are leveraging these technologies to not only improve customer experience but also to drive down servicing costs.

While neobanks focus on enhancing many of its customer-facing, front-end operations with digital solutions, the reality is that many processes at traditional banks still rely heavily on people and paper to process customer requests. This high degree of manual processing is costly, slow and it can lead to inconsistent results and a high error rate. These inefficiencies in turn have a significant impact on customer experience. While most banks have been focused on transforming customer experience using digital technologies and channels, many are at the risk of missing a potentially bigger opportunity that they have right in their backyard – the digitisation of operations.

The application of these technologies is delivering benefits such as faster and more effective customer servicing, improved staff productivity, reduced costs for customer on-boarding and staff training and increased lead generation through contextual targeting.

Technology stack for a neobank



Digital experience

The success of neobanks largely depends on their ability to provide a superior customer experience compared to traditional banks. One large shift imparted by neobanks is the fun, gamified and interactive experience compared to the standard environment of traditional banks. Neobanks keep the customer experience at the crux of design as front-end interfacing application is the primary customer engagement tool. The following strategies are adopted to meet and exceed customer expectations:

- Launching the application across platforms and digital channels
- Ensure smooth downloading and sign-up process
- Integrations with other fintechs and third-party data sources
- Straight Through Process (STP) and minimum Turn Around Time (TAT):
  - An app with less size to make downloading faster
  - Registration process with a minimum number of steps to submit the application and relevant documents
  - A quick verification and account activation
  - Multiple payment and withdrawal options
- Enhance the use of chatbots to cater to typical queries such as bank statements, loan inquiries, information on portfolios, etc.
- Interactive and gamified saving and spending process
- Automated alerts and nudging for falling behind monthly/weekly/daily financial goals
- Create an immersive banking experience using AR/VR
- Continuously assessing the data and proactively recommending customer on the best next action (robo-personal assistants)
- Providing multiple forms of identity recognition such as facial recognition, fingerprint sensors, retinal scanning, voice print, etc.

Products

Neobanks' platformisation strategy helps bring all financial services products and services under the umbrella of an app, and such a super app experience is critical in acquiring and retaining customers.

01 Deposit products

Neobanks are offering a variety of deposit products to customers:

- Savings
- Current (for both retail and business segments)
- Joint accounts
- Salary accounts

Customers can open and operate these accounts without going through the tedious and time-consuming process of a traditional bank.

Neobanks make it easier for people to save money in a very personalised and gamified manner. They use a dynamic algorithm to track current account spending, then analyse the results to find the optimum amount to save each month and automatically depositing the amount into user's savings account.

02 Lending products

While the typical loan application process in traditional banks takes weeks to complete, neobanks can receive application, underwrite using predictive algorithms and sanction loans within minutes via a straight-through process. Neobanks are transforming the underwriting process by collecting data from a myriad of sources such as transaction data, social media, shipping data and other sources to create a comprehensive credit profile of customers and deliver financial options including:

- Loans (personal/business/consumer durable/gold)
- BNPL (buy now pay later)
- Customised credit cards
- P2P lending
- Overdrafts

03 Payments

The digital payments ecosystem in India has evolved to become one of the best in the world, racing past other large economies on the volume of transactions processed. Payments come at the core of any neobank, enabling their customers to transact seamlessly with the products they offer.

Neobanks have actively promoted the adoption of digital payments in the country by offering customers a superior payment experience combined with rewards and cashbacks. In addition to this, neobanks have also developed payment acceptance and processing products such as payment gateways and reconciliation solutions to enable smooth payment operations for business customers.

Neobanks in India have effectively utilised the digital payments infrastructure put in place by the regulators to develop unique products such as wallet linked contactless payments, UPI/QR payments and have now established themselves as a benchmark for players globally.

Payment products from neobanks include:

- Customised (and virtual) debit cards
- Payment gateways
- Money transfer
- Wallet management
- Contactless payments
- Reconciliation

04 Wealth management

Neobanks apply gamification concepts to increase the saving habit of customers. They have launched micro-investment schemes catering to customers' wish-list and setting gamification logics linked to spending patterns and other events.

For providing mutual funds and stock investments, some neobanks partner with third-party service providers who offer investment solutions and robo-advisory services. This marketplace integration helps neobanks to generate additional revenue too. Some neobanks also provide a smart dashboard to customers showcasing all their investments such as mutual funds (MF), stocks, savings accounts, employees' provident fund (EPF), public provident fund (PPF), etc. at one place and track their real-time market movements. Using AI and analytics, neobanks bring practical insights to customers on managing their budgeting and spending habits. Some of the wealth management products from neobanks include:

- MF investment
- Stock trading
- Robo-advisory services
- Investment dashboard
- Personal money management:
  - Saving, spending, and budgeting analytics
  - Goal setting

05 Insurance

Neobanks have been partnering with insurance companies to offer customers fully digitised insurance products through their platform. The key offerings in the insurance space by neobanks include:

- Comparative platforms, risk underwriting and policy approval
- Digital claim management services
- Customer centric insurance policy management (coverage limits, upgradation or buying new policies, updating customer details, etc.)

From a customer's perspective insurance brokers can sometimes be troublesome and can be repetitive in follow-ups. Neobanks replace these insurance agents with hassle-free mobile applications and helpline services which customers prefer as there are less interference and more transparency.

06 Tools for business customers

Neobanks additionally offer value added services for B2B customers such as bank reconciliation, accounting and bookkeeping, Goods and Services Tax (GST) invoicing, cashflow monitoring, payroll management and vendor management. Such value-added services increase the stickiness of customers.

07 Third-party integration services

Neobanks integrate various third-party services into their product stack by using a platformisation strategy, which targets to provide a hyper-personalised service that are unique to customers' preferences and choices. Platformisation strategy makes the neobank a super app from where customers need not switch over to other applications for satisfying their needs; thereby increasing customers' face time and stickiness with neobank.

E-commerce

- Raw materials and sourcing from small and medium sized enterprises (SME)
- Grocery
- Electronics
- Vehicles
- Knowledge/Education
- Food/Beverages

Entertainment

- Movies/Shows/Activities
- Restaurants/Bars
- Sports
- Travel and stay
- Train/Flight/Bus/Cab booking
- Hotel booking
- Car rentals
- Tour packages

Customer

Rather than competing head-on with traditional banks, neobanks target niche segments such as millennials who are tech-savvy and likely to be part of the gig economy. Neobanks, with their flexible and inclusive nature, also target the unbanked population, MSMEs and thin-file customers.

The millennial segment of customers is looking for instant turn-around, flexibility and accessibility to cater to their needs and are disappointed by the experience at traditional banks.

Neobanks also target new-to-bank customers such as students and the migrant workforce by leveraging paper-less and quick digital onboarding process, zero-balance accounts and almost free debit card services.

50% of the Indian population is below the age of 28. Banking will see the first generation of truly digital natives, who rarely visit branches for transactions and may not relate to a time before digital

They play an important role in the financial inclusion agenda by bringing the bottom of the pyramid customers into the ecosystem. This segment still finds it non-lucrative to bank with traditional banks or microfinance institutions (MFIs) due to the high-cost structure made up of high maintenance fees, fines for insufficient funds and other opaque charges. Neobanks are targeting this segment with incentives and offerings such as cheaper fees, zero-balance accounts, no ATM fee, higher deposit interest, a myriad of savings options and free financial education. India's surging internet penetration provides neobanks with extended reach to unbanked customers.

Neobanks have the capabilities to create a deep impact on the MSME segment by providing built-in merchant services and tools. Neobanks, by integrating themselves to MSME's business workflow through application programming interfaces (APIs), provide ground-up capabilities on bank reconciliation, automated accounting and bookkeeping, GST invoicing, real-time cashflow monitoring, payroll management and vendor management solutions which were previously available to large business institutions only. MSMEs are also attracted by the enhanced customer experience using innovative technologies such as faster account opening, easy tracking of Unique Transaction Reference (UTR) numbers and easily understandable transaction histories. Most neobanks provide access to dashboards wherein MSME owners can get key insights on their business (accounting, payments, receivables, etc.). Neobanks are able to efficiently underwrite MSMEs with custom-made advanced underwriting algorithms and also provide hassle free services to MSMEs characterised by faster TAT, digital onboarding, collateral free and straight through processes.

In essence, neobanks cater to customers from a wide range of segments including retail and business.

Partners

The partnership ecosystem of neobanks can be classified into four distinct layers. These are core banking, value added services, strategic enablers and support functions.

Figure 2 – Neobanking partnership ecosystem

Products and services delivered		Partners
• Savings and deposits • Lending • Debit and credit cards	**Core banking**	• Banks • NBFCs
• Payments (PG, P2P, wallets) • Insurance broking • Forex and money transfer • Wealth management • Payroll • Cash management • Expense management	**Value added services**	• Banks • Fintech • Payment solution provider • Wealth techs • Insurance companies
• KYC and compliance checks • Credit scoring • Underwriting • Data analytics and insights • Reconciliation	**Strategic enablers**	• Government database • Regtechs • Fintechs • NBFC - Account Aggregator • Open Network for Digital Commerce (ONDC)
• Technology • Cyber security • ERP • HRMS	**Support functions**	• Cybersecurity tech partner • Banking technology and fintechs • ERP and HRMS vendors

The core banking layer of the partnership ecosystem is the primary service delivery enabler for neobanks. Neobanks through partnerships with other licensed players such as banks and NBFCs, deliver primary banking products such as savings and deposit accounts, lending, debit and credit card to customers. From a customer journey standpoint, neobanks look to remain the program manager for these products and services.

Value-added services support the core banking layer by offering customers additional services that would help in enhancing customer stickiness to the neobanks. Neobanks in India have a gamut of value-added services targeting both retail and SME customers that are currently being offered, including payment gateway, digital wallets, insurance broking, forex services, money transfer, wealth management, payroll, cash and expense management, etc. To offer such services, neobanks partner with a wide variety of institutions such as banks, NBFCs, fintechs, insurance firms, wealth management firms, etc.

The third layer of the neobanking partnership ecosystem is the strategic enabler layer. These are services and processes that are critical to the smooth functioning of the core banking and value-added service layers such as KYC compliance checks, credit scoring checks, alternate underwriting mechanisms, data analytics, etc. Strategic partners who can facilitate this layer for neobanks include regtech institutions, governmental databases such as UADAI, PAN, fintechs and business intelligence solution providers.

The fourth layer of the neobanking partnership ecosystem consists of support functions that enable the smooth functioning of the organisation. Services and solutions utilised in this layer include cyber security solutions, Enterprise Resource Planning (ERP) systems, Human Resource Management Systems (HRMS) and other backend technological interventions. Neobanks partner with other technology solution providers, cybersecurity experts and ERP/HRMS vendors to facilitate the functioning of this layer.

Revenue model

One of the key factors that helps neobanks differentiate themselves from the traditional banking players is the relatively lower and transparent nature of fees charged to customers. Some of the prevalent revenue generating models are banking as a platform and banking as a service.

Neobanks that operate on a banking as a platform model aggregate multiple financial services onto their platform to give customers a one-stop-shop that offers multiple financial services products. Typical products on such neobanking platforms include lending, savings, personal financial management and insurance products. Revenue generation avenues for neobanks that operate on this model include convenience fee charged to customers for banking services rendered, the transaction fee charged to the banks or fintechs for enabling services, Merchant Discount Rate (MDR) from merchants and fees for providing value-added services to customers. Some neobanks who hold NBFC/Payment licenses also generate revenue through Interest income, transaction charges and fee income.

Neobanks that operate on a banking as a service model partner with traditional financial services institutions such as banks, NBFCs, insurance firms, etc. to offer API driven banking solutions that would help them scale their businesses faster and offer their customers a more seamless banking experience. Direct revenues correspond to transaction fees, API call fees, licensing, and support charges – these charges are levied from the banking partners typically on a per transaction based on a pre-agreed commercial structure. Indirect revenue on the other hand involves income from revenue sharing and other charges for providing data related insights to the banks.

Differentiators

Aggregation and integration

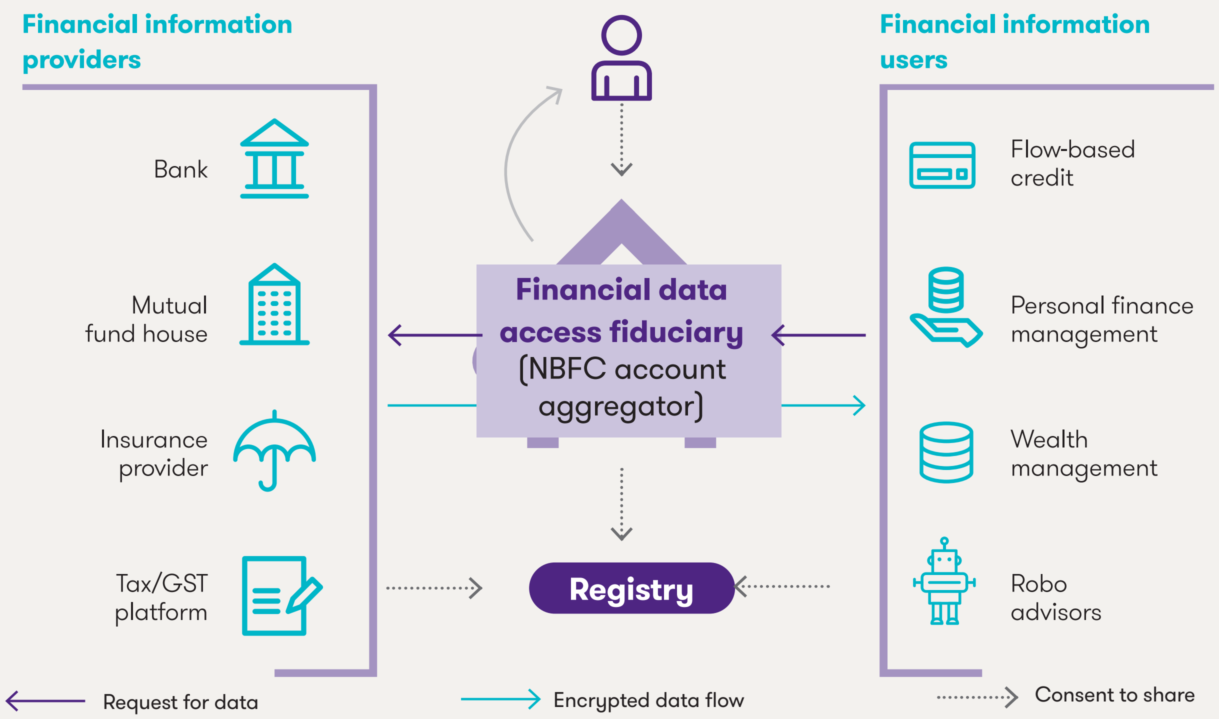
There are two types of aggregation at play in neobanks – product aggregation and account aggregation. Product aggregation deals with the aggregation of various financial products of the same nature onto a same platform – a marketplace for customers to pick and choose the financial product offering of their choice. Account aggregation on the other hand relates to the aggregation of financial data for the purpose of consumption by financial institutions such as banks, NBFCs, fintechs and insurance players. Financial data of a customer can be shared between these financial institutions with the account aggregator serving as the intermediary and after receiving explicit consent from customers.

Neobanks have been at the forefront of offering customers several different options for the same financial products. This is primarily because neobanks do not possess valid banking licenses issued by the regulators. As such, they rely on partnerships with banks and other financial institutions to offer products on their platform. For example, a leading Indian neobank has partnered with a growing small finance bank to offer a completely digital solution for savings bank accounts.

At first glance, the lack of a banking license may seem like a major disadvantage that would put neobanks on the backfoot. The lack of the regulatory boundaries lends them a high level of innovation and agility in launching new products and increasing the diversity of their product portfolio. From a customer perspective, neobanks not only offer the convenience of choice but also pit products from multiple traditional players against each other. The intense competition from the incumbents also results in significant price advantages and rewards for customers.

Neobanks have also been active advocates for the formalisation of account aggregation norms. In September 2016, the Reserve Bank of India officially rolled out the formal guidelines for account aggregation and has been receiving increasingly positive responses from the BFSI sector with several banks, NBFCs, insurance companies and fintechs joining the bandwagon. The account aggregation framework will help neobanks to improve their alternative underwriting capabilities and offer personal financial management advice to customers.

The account aggregator by RBI/SEBI/PFRDA/IRDA will facilitate consented sharing of financial information in real-time



While the aggregation of products and data has brought in several benefits to both neobanks and their customers, aggregation is enabled through the various integrations that neobanks have set up on the backend with other banks, fintechs, credit information companies (CIC) and other regulatory and governmental bodies. Neobanks with their digital nature, rely on integrations to facilitate transactions and customer onboarding. For example, let's consider a neobank onboarding a customer for a new credit card product released in partnership with an Indian bank. Through API-based integrations it can fetch the customer's PAN, GST, income and credit score details. This data is then used, via a fully automated system, to verify the customer, complete the KYC process, receive credit score information to underwrite the customer in real-time and generate his/her eligible credit limit. Such integrations will continue to serve as the lifeblood for neobanks and fintechs going forward.

Personalisation and value added services

Since neobanks are fully digital in nature with minimal human intervention, it is imperative that they maintain a connect with customers to ensure stickiness. In this pursuit, neobanks provide customers with highly customised and personalised services driven by data. Neobanks collect and analyse data to identify distinct patterns in customer behaviour to develop products and solutions.

Neobanks additionally give a customer complete control over their banking experience and enables them to pick and choose what services they wish to retain and disable the rest. For example, a neobanking customer can choose when to switch on their credit card (be it virtual or physical) or withdraw from their savings bank account or choose when to enable their multi-currency accounts.

However, off late banking has become about more than payments. Neobanks utilise AI to propose alternative financial services such as bookkeeping, personal financial management, robo-advisory, budgeting and expense management, insurance services, etc. to consumers based on their account information, customer data and trends identified. Typically, these recommendations are backed up by statistics driven insights that are displayed to the customer on the interface.

Banking license

Neobanks in India have relied on strategic alliances and partnerships to offer customers traditional services in a non-traditional method. Niti Aayog, the government think tank, has suggested the need to have a digital banking license and is currently under active consideration of the banking regulator in India. This would enable neobanks to operate as individual entities without relying on allliances with traditional banking players. In addition to this, the Indian government has also announced that it would set up 75 digital banking units across India, to act as centres of financial excellence and boost digital financial services adoption across rural regions. These units are expected to establish successful proof of concepts and build scalable profitable operating models that can be replicated across the country and will further accelerate the roll out of more digital initiatives driven by marketplace demand.

In more developed international markets, banking regulators have accepted neobanking and have issued licenses to such companies, thus designating them as challenger banks. Challenger banks are authorised to provide the same set of services as a traditional bank albeit in a branchless fashion. For example, one of the largest neobanks globally, based in the United Kingdom, received its full banking license from the European Central Bank (ECB) in 2021. The neobank offers customers a multitude of core banking services such as deposits, loans, cards and other value-added services including insurance, rewards, etc.

India and global market landscape

Category	Indian neobank			Global neobank		
Company	Leading Indian player #1	Leading Indian player #2	Leading Indian player #3	Leading global player #1	Leading global player #2	Leading global player #3
Type	Front end	Front end	Back end	Front end	Front end	Front end
Banking license	No	No	Not applicable	Yes	Yes	Yes
Mode of operations	Retail banking through alliances with traditional banking players	Retail banking through alliances with traditional banking players	Banking as a service	Retail banking	Retail banking	Retail banking
Focus customer segment	B2C	B2C	B2B2C	B2C	B2C	B2C
Key customers	SME customers	Retail customers	Banks and other fintechs	Retail and SME customers	Retail and SME customers	Retail and SME customers
Banking product suite	• Current account • Payments • Cards	• Savings account • Cards	API based core banking stack that includes: • Loans • Deposits • White label mobile apps	• Accounts • Cards • Payment • Lending	• Accounts • Cards • Loans • Payments	• Accounts • Cards • Loans
Other value-added services	• Accounting and cash management • Invoicing and payout • Payment gateway • Payroll	• Rewards programme • Cash Management and insights	• Web based backend admin panel • Financial Risk Management • Access Control Server	• Wealth management • Forex • Insurance • Retail rewards programme	• Insurance • Budgeting • Expense management	• Insurance
Key revenue streams	• Subscription fee • Value added services	• Commission for account opening • Commission for payments made • Other commissions	• Subscription fee based on usage	• Interchange fee • Subscription fee • Commission and fee income • Interest income	• Interest income • Interchange fee • Subscription fee • Commission and fee income	• Interchange fee • Interest income
Valuation (USD billion)	Over USD 350 million	Over USD 100 million	Over USD 1 billion	Over USD 33 billion	Over USD 3 billion	Over USD 45 billion

Source : Grant Thornton Bharat research

Key challenges – impact areas

01 Dependency on banks

- One of the key challenges associated with neobanks is their inability to operate independently. Neobanks in India need to partner with traditional banks and such a dependency on processes/procedures increases the operationalisation timeline
- Additionally, neobanks are incapable of rolling out new core FS products and are dependent on traditional banks
  - Even though neobanks issue co-branded credit/debit/pre-paid cards in partnership with banks, neobanks' role is limited to only marketing or distribution of these cards
- Traditional banks are permitted to do all that neobanks are doing while also maintaining physical branches. Hence, neobanks can expect stiff competition from the traditional banks going forward.

02 Regulations

While the regulators in India are welcoming and conducive to fintech innovations, neobanks face several regulatory challenges such as

- There is considerable ambiguity with respect to regulation of neobanks as the RBI neither recognises purely virtual banks nor regulate them. Additionally, in such an unregulated environment, non-compliance and fraudulent behavior exhibited by any of the incumbents would bring about a regulatory compliance review of the fintech partnerships of banks/NBFCs, thus bringing neobanks under the radar of RBI radar can put the entire sector under challenging supervisory norms and curtail the field of play In May-2022, RBI announced the cancellation of the Certificate of Registration (CoR) of five NBFCs who had offered digital lending solutions in partnership with third-party companies for the violation of regulatory norms
- Indian neobanks are not allowed to perform some of the key banking functions including loan sanctioning, management of investment portfolio and determining compliance with KYC norms
- RBI has put restrictions on app based Aadhar linked KYC* verification through OTP. Customers who are getting verified through the mentioned process are limited to have a maximum transaction of only INR 200,000 per year

*Know Your Customer (KYC) Master Direction, 2016, Reserve Bank of India

03 Intensity of competition

- The entry of several super apps that combine e-commerce, food delivery, payments and financial services, have ensured that the complete digital needs of a customer are fulfilled on the same platform. This makes the customer acquisition process for neobanks challenging as they would need to offer considerably more value to entice customer adoption
- Traditional banks are also rolling out neobanks like offerings, making the market space more crowded. While banks may lack the agility of neobanks, they have the backing of large resource pool, existing access to large scale of consumers and also offer physical presence to customers
- The technology behemoths such as Facebook, Amazon and Google could also enter the neobanking marketplace further tightening the competition. With access to numerous customer data points, existing loyalty and state-of-the-art technological capabilities, these players could disrupt and re-construct the neobanking space

04 Technology and security

- Traditional banks would require neobanks to comply with international standards on cyber security practices before partnering with them. For this, neobanks would need to invest in their systems and processes, upgrade them and make them undergo periodic technology audits
- Ability to collect and analyse customer data and enabling cross-sell of products and services is key for neobanks to stay afloat. Such an ability could get compromised owing to passage of various law and regulation on customer data protection
- Neobanks deal with large quantity of confidential and essential data such as login credentials, account details, personal data, etc. Security of these data may get compromised due to neobanks' integration with third party components like analysers, identity check tools, digital signing systems, social networks, underwriting systems and API gateways (payment, SMS, e-mail, etc.)

05 Carving a niche

- Neobanks have differentiated themselves by offering very distinctive product packages to customers via their app – such as micro-savings through gamification, quick investment in wide array of funds, spend analysis, etc. Some of the traditional banks have now started to offer these features through their mobile banking applications thereby eroding neobanks points of differentiation
- Neobanks need to constantly innovate on products and processes to keep differentiate themselves from their high-street competitors

06 Sustainable business model

- Being a 100% online pursuit, customer acquisition is done largely via advertising and product marketing. Acquiring customers through high levels of marketing spends will impact the neobank's bottom line and would make reaching their breakeven point difficult
- Additionally, being more of a freemium* platform that relies on fee income from facilitating services from partners' side puts a stress on sales. There's a risk of losing customers to new incumbent platforms who provide better offers and cashbacks

*Freemium is a business model which offers users basic or limited features at no cost and then charges a premium for supplemental or advanced features

Risk and regulations

Regulatory landscape

Alliance-driven neobanks

In an alliance-driven neobank, the primary responsibility for regulatory compliance lies with the partner banks, NBFCs, insurance companies, etc. Neobanks in partnerships with conventional banks provide an array of products and services like loans, utility bill payments, prepaid card services, debit and credit cards, etc. Neobanks are not currently part of the regulatory framework and is dependent on their alliance partner meeting and complying with the regulatory guidelines set forth by RBI, SEBI and IRADAI Although Neobanks do not come under the purview of India's financial regulators, they should ensure that adequate measures are put in place to ensure the right checks and compliances.

Digital banking license

Niti Aayog recently proposed the introduction of a digital only banking license and have made neobanks optimistic of becoming part of the country's regulatory framework. This would enable them to command a substantially higher of level of trust among customers owing to the additional compliance and reporting requirements.

Information and privacy

Data and Information has become an extremely valuable asset in this digital age and there is an increased scrutiny from the regulatory bodies on KYC collection, personal data privacy, fraudulent usage of data, etc. Neobanks must ensure it complies with the KYC norms established by the regulators while ensuring that they have the right security infrastructure and data usage policies in place to become complaint with the regulations such as the recently introduced Personal Data Protection Bill, 2019, which will protect the sensitive personal data that could be used to identify an individual.

Global regulations on neobanks

The increased technological adoption in financial services across the globe has brought about significant oversight in the operations of neobanks. The level of regulatory oversight on neobanks have varied notably across geographies. The below listed case studies will highlight the varied depth of digital banking regulations across geographies:

Neobanking in Australia

- In Australia, the fintech companies that act like neobanks need to hold an Australian Deposit-Taking Institution (ADI) license which is being issued by the Australian Prudential Regulation Authority (APRA). This implies that the neobanks must have a license as an ADI or partner with an existing entity who has an ADI license. For neobanks to be authorised by ADI's, they need to show adequate capital in reserves for every dollar they hold in deposits. Apart from ADI, neobanks need to have an Australian Financial Services Licence (AFSL) issued by the Australian Securities and Investments Commission (ASIC).
- As a result of the failure of a leading neobank in Australia, the regulatory bodies have made governing norms more stringent. Applicants would need to showcase an income-generating asset like loans apart from capital reserves. They also need to submit a risk mitigation plan for any financial pressure which may result in selling of assets or taking loans. Additionally, an exit plan needs to be prepared to make sure that all the stakeholders are given their share of the business during winding down. APRA's stricter governing norms have resulted in fewer neobanks opening up in Australia. The other side of the coin is that neobanks who pass these strict norms will be able to sustain in the long run and likely avoid any dramatic collapses making them trustworthy for customers.

Neobanking in Brazil

The Brazilian Central Bank (Banco Central do Brasil) (BACEN) and the National Monetary Council (Conselho Monetário Nacional) (CMN) govern the open banking regulations on which the neobanks operate. There are direct credit companies (called Sociedades de Crédito Direto, SCD) which carry out banking services across the internet. Apart from the balance sheet lending, SCD are allowed to: i) provide credit services to third parties, ii) undertake collections on behalf of third parties, iii) act as insurance agents. SCD's are not permitted to raise funds from the public except via issuance of shares and their services must be executed from own reserves.

Neobanking governing bodies across other countries

Monetary Authority of Singapore (MAS), which regulates the digital banks in Singapore, has approved banking licenses to four digital banks – two Digital Full Banks (DFB) and two Digital Wholesale Banks (DWB).

The Financial Supervisory Commission (FSC) approves licenses to internet only banks in Taiwan. Internet-only banks will be required to enforce strict policies for corporate governance and protection of consumer information and privacy.

Risks

Neobanks' security challenges are diverse and most of which stem from the fact that neobanks are autonomous firms that mostly rely on third-party security solutions. Neobanks are generally not able to invest in full-time security professionals to create and configure full-fledged on-premises security systems. As third parties are responsible for the security controls for neobanks, several security concerns weigh them down.

Risks posed to neobanks

Data privacy

Ensuring data privacy is the cornerstone of any successful digital offering. Considering that neobanks are offerings products at a cheaper rate, their success would depend on the ability to leverage customer data for effective cross-sell. Such an ability could be affected by the passage of India's Personal Data Protection Bill which was passed in 2019 by the GoI to protect the sensitive personal data that could be used to identify a customer. This includes financial data, biometric data, caste, religious or political beliefs, or any other data that the government deems sensitive.

Data security

Executives of neobanks have to adopt a security-first mentality to avoid exposure to critical security risks. But the security of digital financial systems requires expertise for which neobanks, being smaller than traditional banking institutions, cannot allocate substantial budgetary resources. While establishing an in-house team is the best option, neobanks are often constrained by the costs involved and often outsource this activity to third party service providers. However, their dependency on third party service providers, increases the risk of data breaches and warrant additional efforts to oversee security standards and ensure safe storage of data.

Hacker threats

A salient feature of neobanks is their digital nature, which attracts consumers but makes neobanking platforms extremely vulnerable to hacking attacks. If any of the devices connected with a network is compromised by malware, the security of whole platform could potentially be breached. Networks of IoT devices, if employed, might become insecure after being exposed to a malicious hacking.

Partner attrition

Neobanks in India are currently dependent on their partners to deliver core financial services products to its customers. The attrition of partners would disadvantage neobanks as it would cause disruptions in its operations and service delivery.

Customer trust

As neobanks are wholly digital banks, the trust factor is a challenge as in cases of compensations or problems pertaining to their accounts the customer is unable to visit any physical branch and may have to wait for their complaints to be resolved digitally.

Compliance

Security compliances need periodic reports on vulnerability assessment and penetration testing assessment to conform with the security norms. Neobanks must test networks, web apps and endpoints for security and conduct tests for authorised and unauthorised access. This way, compliances keep neobanks well aware of their security status and ensure that required security measures are in place.

Regulatory changes

The RBI has recently issued multiple circulars, which could have disruptive impact on the fintech and neobanking space.

Not allowing to load PPI instruments with credit lines: Fintechs that offer BNPL products via credit card challengers will now need to think of changing their current business model immediately. At the same time, the RBI's move on allowing eligible NBFCs to issue credit cards will favour non-banks with millions of customers looking to move into a formal credit card product after getting used to challenger cards.

Limiting the role of co-branding entities to only marketing and distribution of cards: With this regulation, neobanks, who are co-branding partners, will not have access to information relating to transactions undertaken through cards.

Neobanks' business models are built on accessing such data and this circular can hamper their growth plans and disrupt their business models. Neobanks are required to be flexible with their business model & technology architecture in order to swiftly react and make the good out of the changing regulations.

Potential disruptions to ecosystem players

Direct selling agents

Neobanks are taking over the fintech industry by a storm, on a global level. They leverage tech via cloud computing, artificial intelligence and machine learning and employ customers' data to build diverse products and customised services. By leveraging their fintech capabilities, they can replace the traditional lead generation process of sales leads for individuals, corporates, or businesses and provide excellent credit lines with the banks, thus rendering Direct Selling Agents obsolete.

CRM and other related software vendors

Neobanks are digital banks without any physical branches. They leverage technology and artificial intelligence to offer personalised services to customers. They have inbuilt analysis tools, forecasting tools, and calculation tools which act as a CRM system on itself. As neobank-traditonal bank alliances increase, the need CRM and other related softwares would significantly reduce.

Landlords

With neobanks taking over the customer acquisition and customer management activities, the scope for branch-based banking will reduce considerably reduce and banks might opt to consolidate smaller and more dispersed branches into larger hub branches.

Field officers and other sales staff

Through neobanking partnerships, banks have been able to swiftly onboard new customers digitally as compared to the traditional/physical channels at a much lower cost of acquisition. Banks might shift their customer acquisition strategy to leverage neobanking partnerships customers faster and cheaper in lieu of the more expensive field-based channel. This would lead to lower requirements for field officers and other feet on street sales staff.

Enterprise Risk Management solution providers

Measuring credit risk for banks is particularly challenging because of the importance of financial linkages in the banking system. Neobanks can use AI & ML for research and development to come up with sophisticated risk analysis tools which can perform deep customer analytics. Neobanks are a potential threat to large technology companies in this space, with long legacies.

Loan origination/management system providers

In today's transforming financial landscape, neobanks will provide a modern, technologically superior loan management system that automates key processes. The need of the hour is for systems which is scalable, fast, flexible, and agile while being cost-efficient. Neobanks will emerge as a leading global loan management software provider to partner banks due to its modular API-based methodology and highly customisable product, that can integrate with many systems and a superior credit rating process, thus making standalone loan origination and management systems obsolete.

Way ahead

Measures for success

Success factors	Measures to be undertaken
Generate revenue	• Wallet maximisation by providing 360-degree services, for which more third-party lifestyle products need to be added to the mobile banking interface. This way, neobanks would be able to achieve attractive returns at a much lower customer base level compared to traditional banks • Monetisation of data including customer, geography, product data to offer customised products and services to customers
More customer reach	• Micro-segmentation of customers and target them with tailor made propositions. For example, zero-balance accounts and free debit cards for students, AR/VR enabled banking to cater to the needs of specially enabled and blind customers, etc. • Gain access to more consumers by platformisation and reverse platformisation, i.e., embed other services on the neobanking platform and vice versa
Retain customers	• Positive engagements around service proposition through customers' unique persona-based gamification and rewards and offers • Application of AI and machine learning for contextualised recommendations and customised saving accounts • Natural language processing powered advanced chatbots/voice bots in vernacular language • Design KPIs that focus on customer centricity such as Net Promoter Score (NPS), Customer Lifetime Value (CLV), Customer Satisfaction Score (CSAT), Customer Churn Rate, etc. • Ongoing customer feedback collection and using them for continuous improvement • Being transparent by not attaching any hidden fees/conditions
Innovate on product and positioning	• Design products that can be embedded into customers' life cycle stages/events (for example, sell an insurance against delayed flight departure/arrival when customer books a ticket, recommend an investment option when customer receives yearly bonus, etc.) • Application of IoT to acquire customer data and offer need-based services (for example, recommend an electronic product, along with consumer durable loan option, preferred by customers when the existing product becomes obsolete)
Top priority to be given to cybersecurity	• Use the least amount of customer's personal data – Since neobanks deal with sensitive customer data, it is very pertinent that neobanks have in place robust security systems to prevent data breaches, malware attacks and other cybersecurity crimes • Give top priority to the security of customer sensitive data • Take measures to buy-in customer confidence by periodically educating them on the step taken by neobanks to ensure digital security • Eliminate any kind of down-time for mobile banking application
Keep up-to-date on technology	• Continuously investing in technology to upgrade capabilities and refresh systems • Invest on human resource for some of the brightest growth marketing and product development minds in the country to provide the smartest services and applications to customers • Transforming from a front-end to a full stack-based model will eliminate neobanks dependency on traditional banks and help them control most of the value chain from front-end to back-end • A full stack neobank, with its lean and cost-effective approach, can innovate faster and respond proactively to changing customer needs compared to its competitors • A full stack neobank would also be able to achieve profitability faster by rolling out high income products such as loans and credit cards • Having a complete control on the entire value chain gives full stack neobanks access to data which otherwise lie in silos. Such silos would slow down potential of innovation/cross-sales and reduced the impact of data driven approaches

Front-end focused neobank

- Lighter cost structure
- Doesn't have baking license
- Dependent on partner bank's CBS
- Control only front-end of the value chain
- Data and analytics capability could get limited by data that lie in silos

Full stack neobank

- Lighter cost structure
- Have a banking license
- Full control on CBS
- Plug and play model
- Control value chain from front-end to back-end
- Achieve full potential of data and analytics by leveraging un-siloed data

Future market potential

The global trend of digitisation and the rapid adoption of smartphones and internet across the world have significantly boosted the market available for internet-based banking. Neobanks using their state-of-the-art technology and superior customer experience are winning customers who have hitherto been banking with traditional players such as banks and other non-financial banking institutions. From an Indian context, the rise in the number of fintechs and other ecosystem players have ensured that the market available for neobanks is evergreen and progressively expanding. Neobanks have drawn the interest of Indian customers by offering them attractive incentives for signing up and by providing several class leading features on a freemium model. Through such offerings, neobanks have been constantly capturing segments of customers who have been traditionally associated with banks and NBFCs.

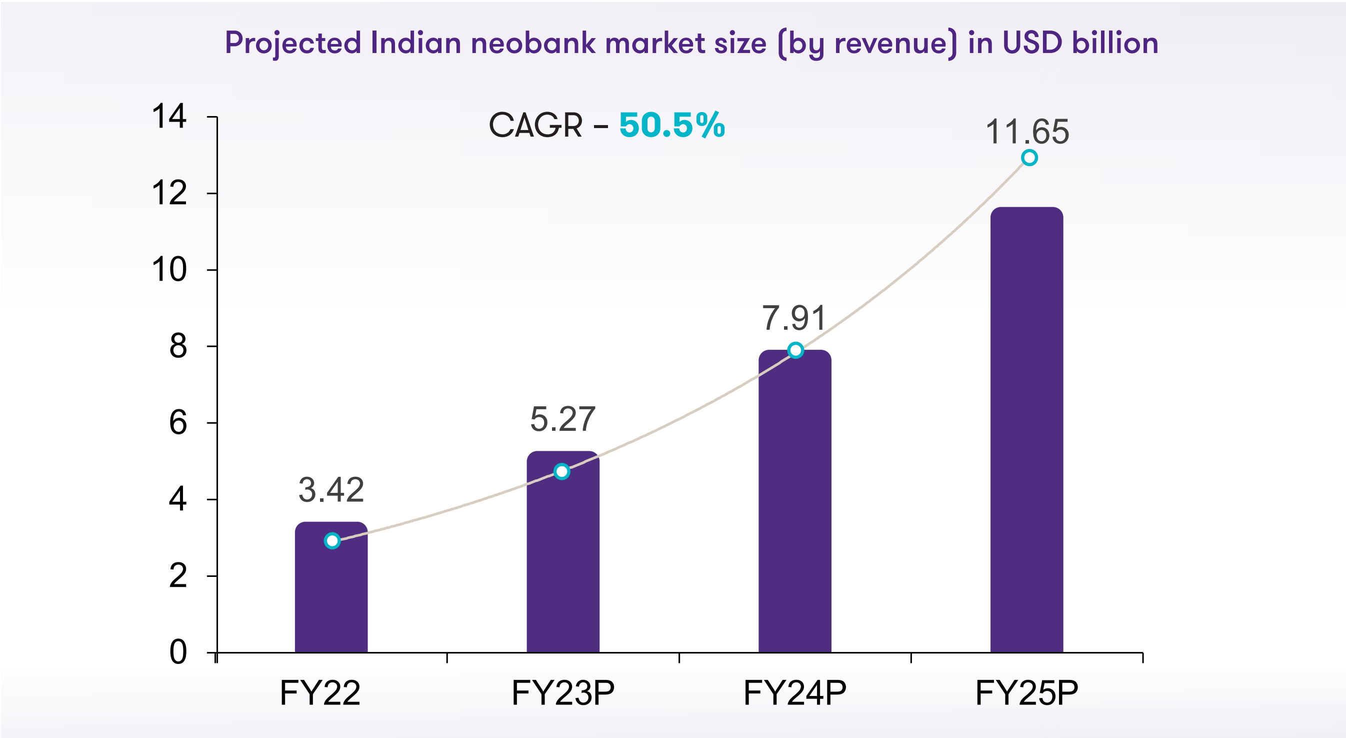
The Indian neobanking market is set for rapid expansion, driven by the outreach to customers from the SME segment and salaried segments. Due to the sheer scale of the Indian market, there is a substantial opportunity for neobanking to create value for a large segment of customers, all while leveraging the large talent pool available to create high quality technology driven banking products. The Indian neobanking market is well positioned to capitalise on the growing digital economics and achieve rapid growth due to the very dynamic local market with significant upside in terms of the revenue generation potential.

With over 63 million SME companies[6] in India contributing to ~30%[7] of the country's GDP, the opportunity for neobanking penetration in this segment is significantly higher than in other global economies. An Indian neobanking fintech is rewriting the traditional banking experience for MSMEs by offering them a seamless digital experience, low-cost structures and several value-added services in addition to banking products such as bookkeeping, invoicing and reconciliation among others. Since its inception in 2015, this neobank has been able to onboard over 1 million SME customers on to their neobanking platform and expects to grow their customer base to over 5 million SME customers by the year 2025. Another neobank operating in SME segment, currently onboards over 60,000 businesses to its platform every month. The increased adoption of internet across Tier 2+ cities in India have meant that the financial literacy and awareness among SME customers has increased significantly, thus contributing to the growth of neobanks[8].

The Indian neobanking market was valued at **USD 3.42 billion** as of FY2022 and is expected to grow at a three-year compounded annual growth rate (CAGR) of **50.5%** to reach **USD 11.65 billion** by FY2025[9]

Source:
6. Annual Report, FY2021-22, Ministry of Micro, Medium and Small Industries, Government of India
7. IBEF Report, December 2021
8. Company Website, Annual Reports and Grant Thornton Bharat research
9. Grant Thornton Bharat research

Figure 4: Projected Indian neobank market size[10]



Neobanks have also been disrupting the banking experience for the salaried class of customers with their freemium model of services, thus attracting a wide user base. Salaried customers also adopting neobanking services due to their various benefits offered such as personal finance management features, personalised cards, low-interest rates, high levels of security and a fully digital user experience, etc.

Source:
10. Grant Thornton Bharat research

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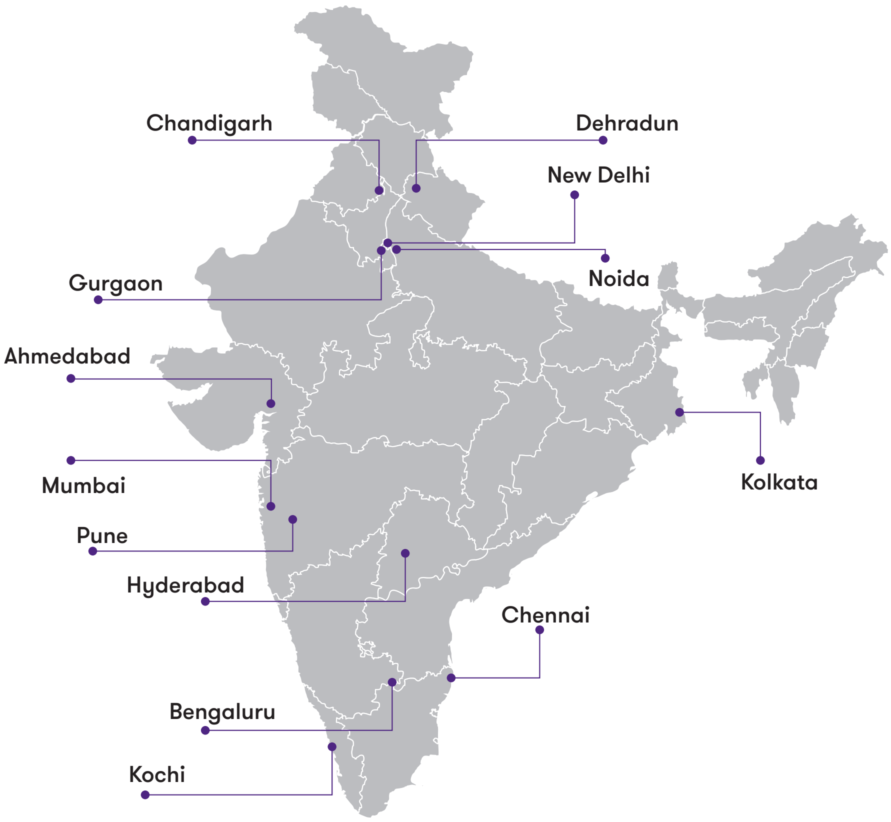

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