

Neobanks in India: Innovation, Challenges and Opportunities in the Banking Industry

Sandipam Palit

Research Scholar, The Icfai University, Jharkhand, India

Abstract

Neobanks, also known as digital banks, is a new form of financial institutions that operate exclusively online, without the presence of physical branches. These banks leverage advanced technology for offering innovative and customer-centric banking services. This paper provides a comprehensive review of the evolution, growth, and current landscape of neobanks, highlighting their key differences compared to traditional banks and some of the specific challenges they face in India. The study also assesses the scope and future prospects of neobanks in India, analyzing opportunities for growth amidst regulatory challenges and market situations. This paper also focuses on the global performance of neobanks, particularly in Europe and Korea, and draw comparisons with the Indian context. This paper aims to explore the transformative potential of neobanks in the financial sector. The findings suggest that despite significant regulatory and cybersecurity challenges, neobanks have the potential to redefine the banking experience by offering seamless, user-friendly services tailored to the modern, tech-savvy consumer.

KEYWORDS: Digital Banking, FinTech, Financial innovation, Neobanks, Regulatory Challenges

Introduction

Neobanks, also known as digital banks, are financial institutions that operate exclusively online without physical branches. These new age banks provide innovative and customer-centric banking services by leveraging advanced technology. Since their introduction in the larger FinTech industry, the idea of neobanks has seen substantial development. These banks were once thought to as online-only institutions that dealt directly with customers; however, as other banks have also made major improvements to their digital presence, they now hope to transform traditional banking by providing an even better digital experience. Their goal is to offer seamless, user-friendly services that enhance the overall banking experience, distinguishing themselves from conventional banks through their commitment to digital excellence. The surge in internet usage, online banking, digital payment methods, and UPI over the past decade has created a substantial opportunity for neobanks or digital-only banks. These institutions are uniquely positioned to serve a vast population by offering innovative, user-friendly financial services that cater to the modern, tech-savvy consumer. Neobanks are not allowed to obtain a banking license by the RBI because they only conduct business online and do not have any physical branches. Neobanks, on the other hand, collaborate with conventional banks to provide services including money transfers, loans, and quick payments. Neobanks differentiate themselves from traditional banks by utilizing cutting-edge solutions and being fully digital. They accomplish this by utilizing technology and artificial intelligence to provide individualized, affordable financial services. While neobanks deliver end-to-end financial services via their apps, they lack some offerings of

conventional banks, such as physical branches and personal managers. This absence can be challenging for less tech-savvy customers who may struggle without in-person support or access to personalized managers, limiting their ability to fully benefit from neobank services. Neobanks face significant cybersecurity challenges due to their digital-only nature, making them prime targets for cyberattacks such as phishing, malware, and data breaches. Implementing strong security measures and fostering customer trust is essential. Additionally, regulatory compliance and constant updates to security protocols are necessary to protect sensitive financial data. Despite many challenges, Neobanks have emerged as a powerful force, attracting attention and admiration for their innovative approaches to financial services. They are constantly reshaping the banking landscape setting new standards for digital financial services.

RESEARCH OBJECTIVES:

To conduct a comprehensive review of the evolution, growth, and current landscape of neobanks, focusing on key differences compared to traditional banks and the specific challenges faced by neobanks in India.

To assess the scope and future prospects of neobanks in India, analyzing opportunities for growth amidst regulatory challenges and market dynamics.

RESEARCH METHODOLOGY

This study is in the form of a comprehensive literature review and comparative analysis to examine the evolution, growth, and challenges of neobanks. Data from various websites, academic journals, industry reports, and regulatory documents were analyzed to assess the current landscape and future prospects of neobanks in India.

LITERATURE REVIEW

The literature review covers the rise of neobanks in India, their operational model compared to traditional banks, and their challenges, including regulatory and cybersecurity concerns. Several authors highlight the differences between neobanks and traditional banks, noting that neobanks operate entirely through digital platforms, offering a full range of financial services but lacking in physical infrastructure. Authors such as Sardar & Anjaria (2023) explore the expansion of neobanks in India and the growth driven by technological advancements and customer expectations.

DATA ANALYSIS

The data analysis focuses on the current state of neobanks in India, their global performance, and a comparative analysis of neobanks with traditional banks.

Growth and Development in India:

According to Sardar & Anjaria (2023) the Indian neobanking sector has experienced significant growth over the past few years. Despite the presence of over 36 companies trying to expand their businesses, each neobank offers unique products and targets specific consumer groups, highlighting their vast growth potential in the coming years. The expansion of India's financial services sector is driven by the increase in the number of banks, stricter regulations, advanced FinTech innovations, and an improved focus on customer expectations. They provide customized services in lower fees, higher interest rates, improved customer experience, fast credit approvals and etc. The growth of neobanking in India is also

fueled by interest from private equity firms and the strategic partnerships formed by traditional banks with neobanks.

Challenges and Regulatory Landscape in India:

Despite major prospects, regulations and compliance requirements, security issues, data privacy etc remain major challenges in the growth of neobanks in India. Reserve Bank of India does not regulate or recognize neobanks. There are requirements of international standard of technology and security practices. Data privacy is crucial for the success of any digital product or service. Neobanks' survival relies heavily on customer data and cross-selling products due to the low charges for traditional product offerings (Asma, Johnson, & George, 2022).

Kansal (2024) highlighted that the current regulatory guidelines does not enforce full digitalization of the financial product provision process. In light of neobanks' digital capabilities and their ties to financial institutions, there is an urgent need to reassess existing indirect restrictions. It is crucial to explore a legal framework that empowers regulated entities to conduct essential functions like fund administration and settlements. Meanwhile, FinTech partners oversee the user interface and technological aspects. Moreover, The RBI's guidelines currently define "branch" broadly to include full-fledged branches, specialized branches, remote offices, off-site ATMs, administrative offices, controlling offices, and service branches. However, this definition does not account for the digital operational model of neobanks. Moreover, the RBI's criteria for mobile banking services restricts this capability to banks with physical presences, excluding neobanks that operate primarily in the digital sphere.

Neobanks in Europe:

In the European context, performance of neobanks is poor as compared to their traditional competitors. This is majorly due to higher interest rates in lending due to the risk premium in lending to high-risk borrowers. Furthermore, they generate lower commissions which is in line to their entry strategy. It is also observed that neobanks incur less staff expenses but comparatively higher non-employee expenses. However, as non-employee expenses fade away with more product lines reflecting potential and scope in digital banking (Citterio et al., 2023).

Digital Banks in Korea:

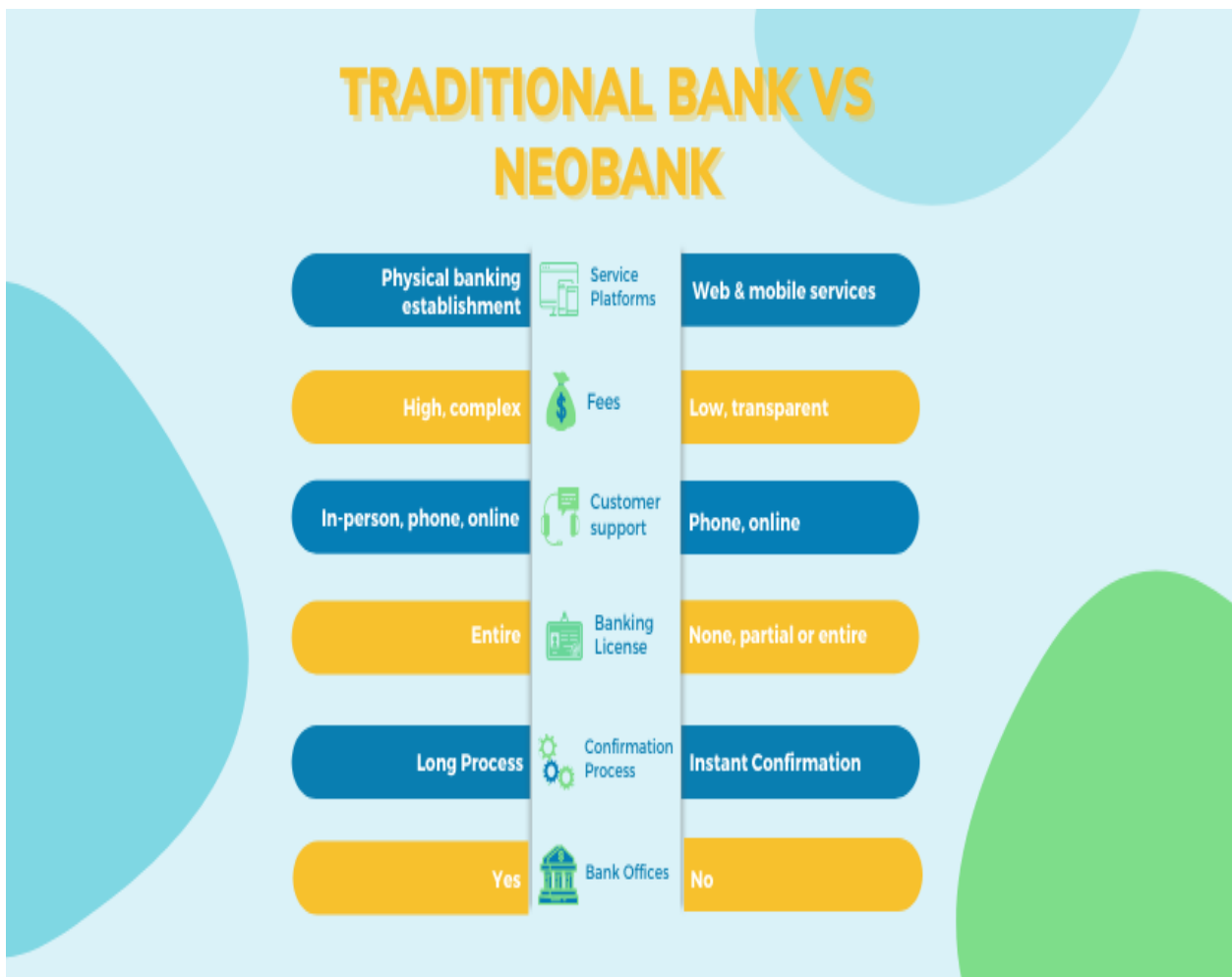
Digital banks in Korea have introduced significant competition in the local banking industry, prompting older banks to lower fees, offer more competitive rates, accelerate digitalization, and enhance mobile app convenience. These digital banks are also expanding credit access to underserved segments, particularly individuals with credit ratings of 4 to 7, such as the self-employed and young professionals. Despite Korea being overbanked in terms of savings and payments, these segments face challenges in accessing affordable credit due to difficulties in tracking their income or sales. Traditional banks have focused on high-income individuals, neglecting this "medium credit lending" market (Choi, 2020).

Neobanks V/S Traditional Banks

Neo banking is often misinterpreted and confused with other forms of banking due to a lack of understanding of its concept. To address this confusion, we will explore some key differences in them:

Neobanks	Traditional Banks
Offer services entirely through digital platforms	Traditional banks have historically maintained a physical presence, but in recent years, they have increasingly embraced digital banking.
Neobanks are user-friendly/fast and	Traditional banks often have lengthy and complex

feature intuitive interfaces that make managing your finances straightforward.	procedures for account opening, loan applications, and other financial transactions, which can be time-consuming.
Neobanks, while innovative, face challenges in regulatory recognition and compliance compared to traditional banks.	Highly regulated and monitored
Less Fees/ Less hidden charges	Fees/ Charges are comparatively higher
Neobanks excel in providing fast, user-friendly, and flexible services, though they often specialize in one or two primary offerings.	Traditional banks offer a comprehensive range of financial services, including personalized advisory services
Neo banking leverages app-based functions and cutting-edge technology to provide a seamless and superior banking experience	They encounter technological inefficiencies and glitches, potentially leading to a less satisfactory customer experience. However, slowly they are upgrading their technologies for better customer experiences.
More popular to the tech friendly younger generation.	More popular to the older generation who prefer face to face contact.



Source: <https://www.sproutasia.com/>

Future Directions:

According to (Sharma & Patil, 2023) Neo-banks are transforming financial services in India by functioning solely online and having no physical branches. Neo-banks have a lot of room to grow, as

evidenced by their rapid growth and rise in digital transactions. With the assistance of the "Digital India Platform" and its goal of digitalizing the banking industry, they provide digital retail and SME banking services.

Neo banking in India has grown substantially, with over 15 neo-banks offering consumer and corporate banking services. The COVID-19 pandemic accelerated digital and contactless payments, revolutionizing the "FinTech 2.0" wave led by neo-banks. These digital-only banks provide flexible, innovative services at lower rates than traditional banks, aiming to revolutionize customer-centric banking experiences and reduce paper-based banking. Wealthtech also saw a surge in new companies during this period (Tripathi & Tabassum, 2022).

MAJOR CHALLENGES FOR NEOBANKS IN INDIA

The Government of India has initiated significant steps in advancing the fintech sector, focusing on bridging gaps in market through digital banks and products. Neobanks, which operate across the RBI, SEBI, and IRDAI, have gained traction. The "buy now, pay later" (BNPL) industry is being watched over by the government, but as of right now, there are no plans for regulation. Recently, NITI Aayog pushed for neobanks to obtain full banking licenses as digital banks. The RBI has raised concerns about a few risks and uncertainties, though, and as a result, full-stack digital banks are not yet approved (NITI Aayog, 2022).

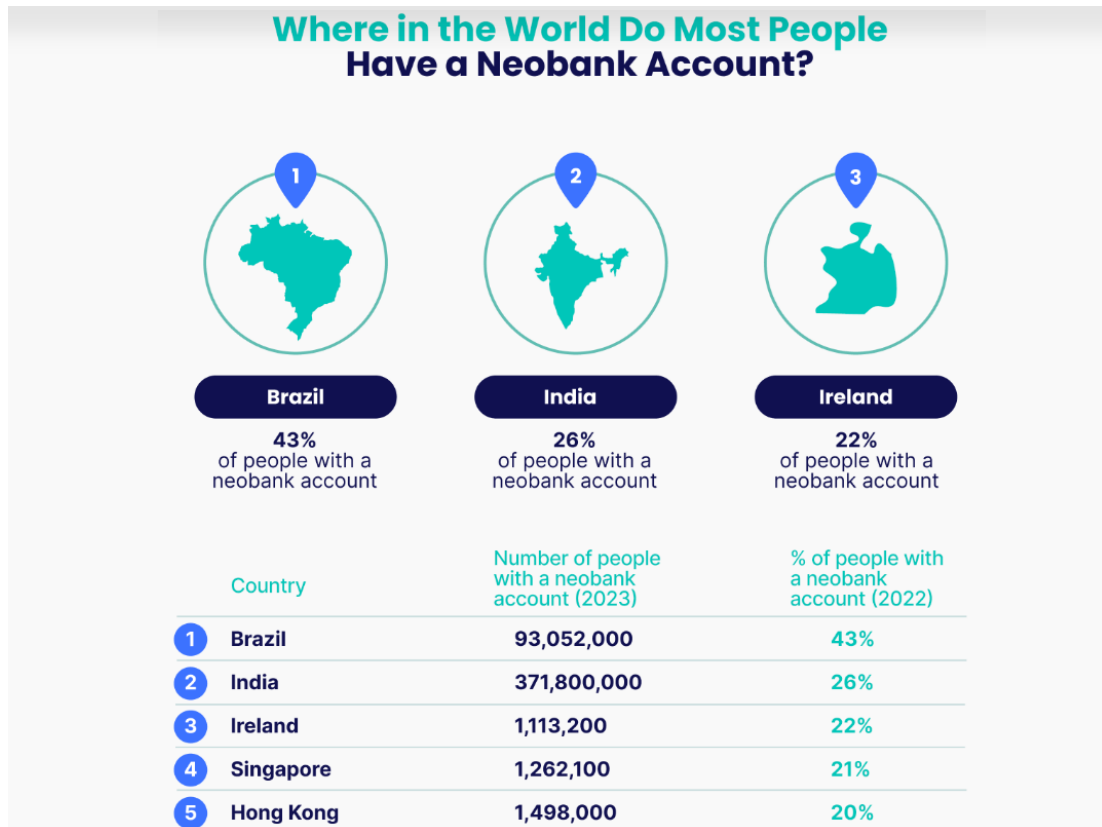
According to Barodawala and Patel (2022), neobanks face a lot of challenges when it comes to data security and privacy. The sharing of private client information among other organizations in their network gives rise to chances about possible fraudulent activities and system malfunctions. Furthermore, international criteria for neobanks' infrastructure and security procedures must be met by conventional banks before they may collaborate with them. The need for strong infrastructure and high levels of security means that neobanks must make huge investments, which puts a hefty financial strain on them. As a result, maintaining data privacy and fulfilling security requirements continue to be crucial concerns for neobanks in their efforts to build alliances and gain confidence within the banking industry.

Long-term relationships are always linked to acceptance and trust, which makes them crucial for gaining a competitive edge. Gaining confidence is particularly difficult for neobanks since they have to overcome suspicions in the digital sphere and demonstrate their dependability in the absence of the customary face-to-face encounters. Therefore, developing strong, long-lasting relationships with customers and cultivating trust are key issues facing neobanks in the financial sector (Nocera, 2022).

the road ahead

Neobanks are successful worldwide because they provide convenient, affordable banking along with individualized services in one location. Fintech companies are also developing customized solutions for small enterprises and blue-collar individuals with short credit histories. By combining banking services with other financial tools, such as creating bank accounts for immigrants through innovative onboarding procedures, neo banking can improve financial inclusion. Neobanks can grow gradually over time by introducing new features and functionalities, starting with targeted services.

The following data provide insightful data on the global penetration and projected growth of neobank accounts –



Source: SEON. (2023). Data source: Finder.com. Retrieved from Neobanking Index: The State of Neobanks in 2023, <https://seon.io/resources/neobanking-index/>

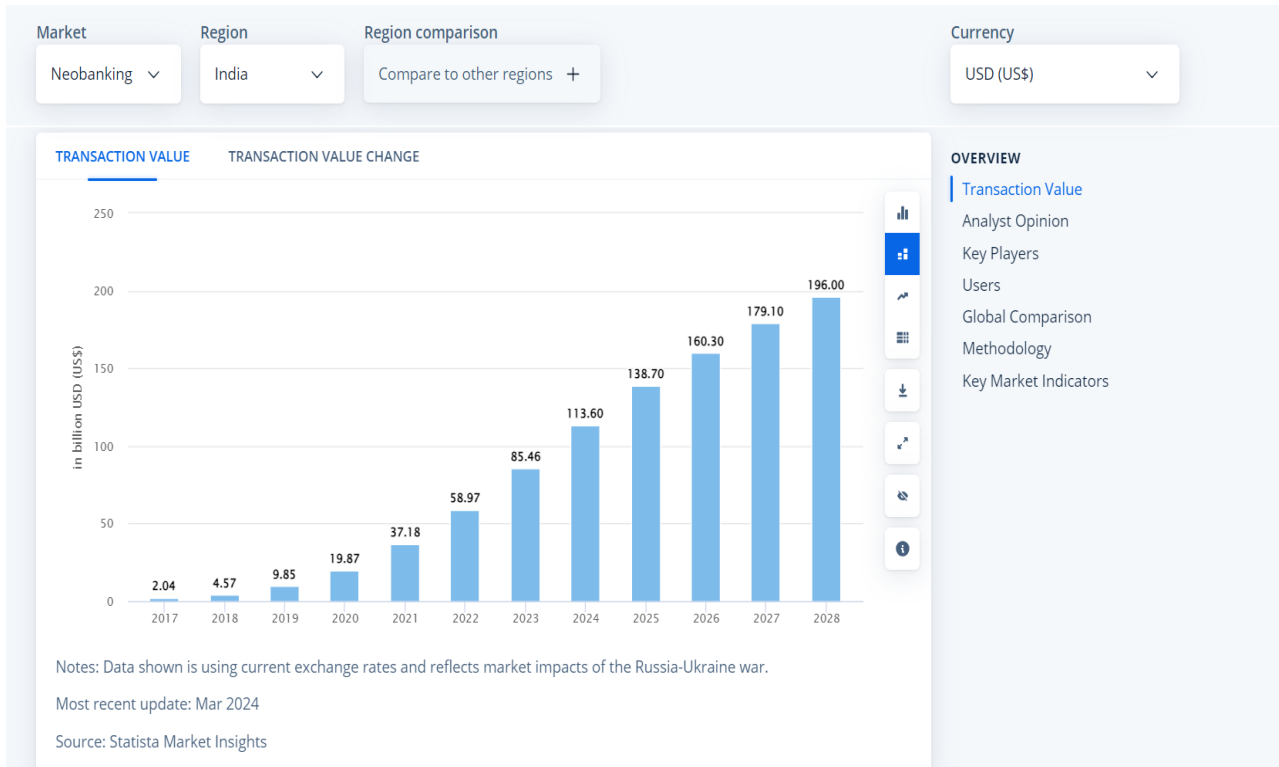
The above data clearly reflects that the penetration of neobanks is growing globally, including in India. With over 371 million people holding a neobank account, India is undoubtedly a significant market.

Country	Predicted number of people with a neobank account (2027)	Predicted % of people with a neobank account (2027)	Predicted increase from 2023
1 Philippines	39,788,800	32%	161%
2 Mexico	54,144,600	41%	148%
3 Portugal	3,349,500	33%	133%
4 United Arab Emirates	4,022,100	41%	122%
5 Malaysia	10,001,600	28%	122%
6 South Africa	19,505,200	31%	115%
7 United States	52,065,000	15%	91%
8 Spain	14,663,000	31%	82%
9 India	685,400,000	46%	84%
10 Germany	19,934,400	24%	71%

Source: SEON. (2023). Data source: Finder.com. Retrieved from Neobanking Index: The State of Neobanks in 2023, <https://seon.io/resources/neobanking-index/>

Number of people having a neo bank account is expected to rise significantly by 2027. India is expected to achieve a growth of 84% as compared to 2023 with around 685 million accounts making India the biggest Neo banking market.

As per Statista market insights Neo banking in India is expected to grow over 72% in 2028 as compared to 2024 in terms of transaction value too –



Source: <https://www.statista.com/>

CONCLUSION

Neobanks have emerged as a significant platform in the financial sector, offering a completely digital banking experience that caters to the needs of tech-savvy consumers. Their ability to utilize advanced technology and provide innovative, customer-centric services sets them apart from traditional banks. In India, the growth of neobanks has been significant, driven by increased internet usage, digital payment methods, and an encouraging fintech ecosystem. However, neobanks face some challenges, including regulatory constraints, cybersecurity threats, and the need to build customer trust without physical branches which has been the core of banking business in India over the years.

Despite these challenges, neobanks continue to sustain by forming strategic partnerships with traditional banks and offering unique products that cater to specific consumer groups. The regulatory landscape in India remains a critical factor, with ongoing discussions about the need for a legal framework that accommodates the digital operational model of neobanks

The future of neobanks in India and worldwide looks promising, with projections based on data available indicating substantial growth in the number of neobank accounts and transaction values. If they continue to innovate and adapt to regulatory requirements, neobanks are expected to play a major role in

the digital transformation of the banking industry, offering convenient, affordable, and personalized services that meet the growing needs of consumers.

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