ISCTBL 2020

INTERNATIONAL SCIENTIFIC CONFERENCE

Универзитет „Гоце Делчев“ – Штип

Goce Delchev University Shtip

Факултет за туризам и бизнис логистика

Faculty of Tourism and Business Logistics

Трета Меѓународна Научна Конференција

Third International Scientific Conference

# ПРЕДИЗВИЦИТЕ ВО ТУРИЗМОТ И БИЗНИС ЛОГИСТИКАТА ВО 21 ВЕК

# CHALLENGES OF TOURISM AND BUSINESS LOGISTICS IN THE 21ST CENTURY

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**FACULTY OF TOURISM AND BUSINESS LOGISTICS**

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# OVERVIEW OF NEOBANKS MODEL AND ITS IMPLICATIONS FOR TRADITIONAL BANKING.

*Zoran Temelkov*[1]

## Abstract

*Traditional banks enjoyed a favourable position in the financial markets for many decades, as the number of threats coming from outside the sector was almost non-existing. Nevertheless, the changing landscape of the banking industry in the post crises period opens up the gates for new entrants to become a significant disruption for the traditional banks. One such disruption comes from neobanks which represent an institution operating under a new type of bank business model.*

*This new model may be considered as the opposite of the existing banking models since it is a fully online bank while conventional banks rely heavily on the physical presence through a network of branches. Hence, the development of new ways for the creation and delivery of financial products have some major implications for the traditional bank. These implications predominantly can be found in the cost levels and cost structure, products and service delivery, personalization of products and acquisition of new customers.*

Keywords: *Neobanks, traditional banking, disruption, fintech, bank business model*
JEL classification: *G21, G23*.

## Introduction

Traditional banks have been a crucial player in the financial markets for a long time and the number of potential competitors was rather limited because it was difficult for new entrants to enter this industry. However, the last financial crises, along with technological innovations, have removed some of the main barriers and enabled easier access in the industry for baking products and services. Also, a new form of competitors has emerged during the last decade, which pose a serious threat to the traditional banking model and they are considered to be a significant disruption for the overall banking industry.

Neobanks are among the most severe competitors that have appeared during the last decade. This type of banks operates fully online and exclude the need for delivery of financial services through the physical presence and brick-and-mortar branches. Consequently, this new model of financial institutions has some significant implications for conventional banks as it threatens to disrupt their long-standing comfortable positions.

Implications can be found for different areas of traditional banking activities since neobanks rely heavily on technological innovations and fintech in every aspect of its operations. The

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implications for conventional banks show the need for replacement of existing technology, removal of non-value adding costs, modifications of different internal processes and simplification of the existing bureaucratic structure.

## Banking terminology associated with fintech developments

The last decade, or the period since the last financial crisis, is characterized with significant innovations which caused changes in the financial markets and the way financial products and services are delivered. The banking industry has experienced significant changes due to the revision of the regulatory framework and the relaxed entry barriers. Banking institutions are also under heavy influence coming from the developments and growth of the fintech industry. Accordingly, a variety of non-banking institutions, the fintech companies, entered the market for financial products and services traditionally provided by the banking sector.

The new type of competitors utilizes the benefits brought by the innovations in financial technology up to a level where they may be more efficient in the delivery of certain services compared to the large and sleepy banking institutions. Consequently, analyzing the implications, coming from what may be considered the ultimate bank competitor, imposes the need for certain terminology to be defined. Accordingly, the developments in the fintech industry had spurred the creation of new types of banks and also assigned different labels to existing banking models. However, confusion may arise in the correct usage of the different terms and they are sometimes used interchangeably even though they may refer to different aspects. Hence, a distinction should be made between the following:

- Challenger banks - The term challenger bank is among the most heavily used terms to refer to a specific type of banks in terms of how they affect the existing banking institutions. Accordingly, challenger banks can be defined as a newly created banks or an established institution that aims to enter into direct competition with large, well-established institutions (Carmona, F. A. et al. (2018)). Moreover, the term challenger bank can also be used for institutions offering specialized services to markets which are neglected by the conventional banks.
- Big tech – or Tech giants is a term assigned to technology companies such as Google, Apple, Amazon and Facebook that have a significant influence in different areas, including the financial markets. These companies are also considered to be among the major threats which could jeopardize the position of banking institutions.
- Digital banks - This bank model may be perceived as the model which announces the arrival of neobanks models based on its characteristics. A digital bank is essentially a traditional bank which moves a step further and makes its products and services available online (Laloux, G., 2015). Digitization of activities and services enables banks to lower their costs and augment the process of service delivery.
- Neobanks – represent a financial institution (with or without banking license) offering its services fully online without a network of physical branches. This bank model employs innovative technology to provide personalized services to targeted niches.

The financial markets and the banking industry may be considered to be among the most dynamic industries and areas in the economy. Accordingly, the constant developments mean that there is a need for new emerging terminology to be clearly defined and understood. For instance, what was once known as a major innovation and the latest business model, is now labelled as a traditional model or a digital model. Also, it may be noted that a large portion of the newly created terminology comes from the developments in the fintech industry and the way this industry affects the sale and delivery of financial products and services.

## Evolution of neobanks

Technologically advanced and fintech based banks and financial institutions had gained popularity during the last decade when drastic changes in the regulatory frameworks were initiated under pressure from the last financial crises (Alvaro, M. et al., 2016). However, the digitalization of bank activities, in one form or another, has started a couple of decades ago. Consequently, it can be said that, to some extent, neobanks are a modern version of traditional banks as they offer financial products and services through the application of fintech and other innovative technology. Noteworthy mentioning is that these types of banks have begun their operations by offering simple and basic products such as current accounts or debit cards (Gabriel Hopkinson et al. (2019). Afterwards, they have managed to broaden their range of products in a relatively short period of time. Table 1 provides a brief overview of the developments in direct banking models that took place during the last 30 years.

Table 1: *A short history of direct banking models*

| **1990___________________2000_________________2010_____________Today__________** | | |
|---|---|---|
| **First generation direct banks** | **Second generation direct banks** | **Neobanks** |
| • Starting point in the 90's – peak before the dotcom bubble<br>• Call Center as pivotal point of the business Model<br>• In most cases affiliated with one of the incumbent banks<br>• • No long-term economic success | • Launched as direct alternative to traditional banks<br>• Strong growth in the 2000s – reaching scale through acquisitions (e.g. ING DiBa) or organically (e.g. DKB)<br>• Focus on Online (desktop) and process automation (cost reduction!)<br>• Different types of direct banks emerging: brokerage specialist, savings monolines, or primary banking alternatives to branch banks | Five common identifiers for Neobanks:<br>• Disrupting a specific segment, product or process<br>• Extreme focus on customer experience and "journeys"<br>• Smartphone as primary distribution and communication channel<br>• Based on new, flexible IT-architecture – no "Legacy"<br>• API-Native and Open Banking oriented |

Source: Exton definition, presented in - Lance Daniels and Christoph Stegmeier (2018) Facing the arrival of the new wave of digital banks: The Neobank, Inside Financial Services – The Neobanks, Exton Consulting – Strategy and management

At the time of its introduction, the call centre model has been considered a significant step in the augmentation of the direct bank model from 1990 to 2000. The second generation of direct banking post-2000 aimed at online and process automation with the ultimate goal of cost reduction. Neobanks developments took place during the decade when it took the form of a fully online bank. Its business model is significantly more advanced compared to the previous two generations as it is focused on a specific niche, customer experience and product customization delivered through innovative technology.

## Neobanks business model defined

Even though there might be a lack of generally accepted definition of neobanks, this type of institution could be defined as a financial institution which offers its products and services fully online excluding the need for physical branches which is a distinctive characteristic of traditional banks. Neobanks may also be defined as an institution offering financial services with the application of apps with the aim to serve specific niches in a more efficient manner (Bradford, T., 2020). Furthermore, because neobanks are fully online institutions, they are focused on developing their own IT infrastructure and the associated technology through cloud-based operating systems (Gabriel Hopkinson et al., 2019). However, Bradford, T. (2020) states that neobanks should not be considered to be a full bank institution per se because not all of them are a chartered financial institution. Alternatively, neobanks may operate through a partnership with a licensed bank or fintech institution or it may obtain a license from the relevant authority when it fulfils the regulatory requirements (Ahishek, K. and Mishra, V., 2019). Hence, in essence, they can operate under either of the two basic models which impose a different way of conducting the activities. The primary difference between the two models is in the bank license with which they conduct their operations. Accordingly, a distinction can be made between full-stack neobanks and front-end focused neobanks. The basic characteristics of these two fundamental neobanks models are presented in table 2.

Table 2: *Overview of full-stack and front-end Neobanks*

<table>
<tr><th>Full-stack Neo Banks</th><th colspan="2">Features</th></tr>
<tr><td rowspan="4"><ul><li>Built on Platform model</li><li>Have a banking license</li><li>Control most of the value chain from front-end to back-end</li><li>Use a lean/asset-light approach</li><li>Have their own/proprietary CBS</li><li>Leverage unsoiled data to gain customerinsights/offer personalized services</li></ul></td><td colspan="2">Asset-light platform</td></tr>
<tr><td colspan="2">N26; Starling Banks; Monzo</td></tr>
<tr><td colspan="2">Full Services (in-house)</td></tr>
<tr><td colspan="2">Atom bank; Tandem</td></tr>
<tr><th>Front-end Focused Neo Banks</th><th colspan="2">Features</th></tr>
<tr><td rowspan="6"><ul><li>Do not have a banking license</li><li>Partner with a larger/established bank</li><li>CBS/tech systems are off-the-shelf or sourced externally</li><li>Control only front-end of the value chain (customer interface)</li><li>Support B2C and B2B apps</li><li>Target niche segments (young millennials, SMBs, Entrepreneurs)</li></ul></td><td>B2C</td><td>B2N</td></tr>
<tr><td>Targets young people</td><td>SMB Focus</td></tr>
<tr><td>Osper; Loot</td><td>Qonto; Revolut</td></tr>
<tr><td>Basic Banking Services</td><td>Solo Entrepreneur</td></tr>
<tr><td>Revolut; Compte Nickel; Monese</td><td>Holvi; N26; Kontist</td></tr>
</table>

Source: Finnovate, 2018: Neo-Banks: Performance and New Ideas, Finnovate Research – Ideas for financial innovation, October

It is evident that the full-stack neobanks have a bank license and could offer their products and services without the need for partnership with a traditional bank. Also, this type of neobanks has almost full control of the value-chain. On the other hand, the front-end neobanks cannot operate independently and they need to establish cooperation with an existing bank with a valid bank license.

Furthermore, in terms of the products offered, neobanks may be focused on providing a specific product or a group of related products. Through the offerings of specialized products, neobanks attempt to satisfy the need of a particular market which is commonly underserved by the conventional banking sector. Also, their products may be developed with the aim to offer financial products to the underbanked populations.

Diogo Silva and Peter Ward (2016) argue that neobanks may take three basic approaches when developing their product lines in the process of attracting new customers. These approaches are the savings-led, credit-led and account-led approach. As the name implies, products developed within the first approach are intended to acquire a higher number of savers looking for higher yield. The credit-led approach serves the purpose to attract new customers in need of a specific credit product. The last, or account-led approach offers enhanced app experienced that support better management of finances.

Regardless of the product offered, neobanks business model is oriented toward improvements of the traditional services and adaptation to the changing environment through innovations. According to Gabriel Hopkinson et al. (2019), neobanks business model stimulated innovation in areas such as:

- Customer experience – since they offer a high degree of personalization and have well-established customer support infrastructure. Also, neobanks enable the customer to swiftly open a bank account or use specific types of services at a lower cost compared to the cost when using traditional banking institutions.
- Features and money management tools – the neobanks apps help its customers to better understand their personal finances by providing different types of notifications and details related to the way money are spend or saved.
- Agility and low-cost structure – as a fully online bank, neobanks have better operating efficiency compared to brick-and-mortar banks. Consequently, they may offer lower fees or remove fees charged by conventional banks. Neobanks are based on technology which means that they can swiftly adapt to potential changes in customer preferences or market innovations.
- Transparency – neobanks are focused on providing as much information as possible to the public and their users. Neobanks activities and operations are presented through a variety of financial reports, documents, blogs and other types of communications.

Since neobanks operations are centred around the utilization of financial technology and because it is a fully online institution, its business models have a low-cost structure while offering features rich products and services (Finnovate, 2018). Consequently, these business models disrupted the long-standing model based on the delivery of financial products through a network of physical branches. Accordingly, the widespread acceptance and increased popularity of the new, technologically advanced models come from the benefits it brings for its customers as well as shareholders.

## Fundamental advantages of neobanks

Neobanks are classified as fintech based bank because its business model is developed through the application of specific financial technology. Consequently, the utilization of technological innovations and the elimination of brick-and-mortar branches bring a variety of advantages for this business model.

The most distinguished advantages of neobanks come in the form of simple structure, low operation costs, the ability to charge lower fees and offer higher rates, swift product creation, leveraging technology, lower risk aversion and superior user experience (FinTech Futures, 2019; Alvaro, M. et al., 2016).

Needless to say, is that the most obvious advantages of low operating costs come from the elimination of a network of physical branches as neobanks offer their products and services fully online. It is stated that certain operational costs of neobanks compared to the costs of conventional banks may be lower by 40% - 70% (FinTech Futures, 2019). Moreover, the simple structure and the utilization of advanced IT solutions additionally supports the low costs structures since potential changes in processes, products or operations are implemented much faster compared to the traditional banks.

Having lower cost structure means that neobanks are able to charge lower fees or even remove certain fees while offering interest rates which are usually higher than those offered by most traditional banks. Moreover, neobanks are also able to offer a higher degree of personalization in their products and services, unlike mainstream banks which tend to have a bureaucratic structure which complicates the product development. Superior customer experience is another advantage and it comes from the possibility of neobanks to provide financial services in a much faster and in a more user-friendly manner which is rather hard or even impossible to be offered by traditional banks.

Ahishek, K. and Mishra, V. (2019) add that another advantage of a neobank is its ability to integrate modified or new business processes and products in their current platform in a faster and efficient manner where the ultimate benefit is utilized by the customers.

## Neobanks influence of traditional banking institutions

Going through the neobanks business model and the advantages of this new type of banks show why neobanks are considered to be a major threat for traditional banks and why they gradually become one of the most serious competitors. Hence, the development of these fintech based banks has certain implications for the industry historically dominated by the conventional banking business model.

First, it can be said that traditional banks are faced with low flexibility and a high degree of rigidity when it comes to the brick-and-mortar model of providing financial services. This is in a sense that the process of attracting new and retaining existing customers is much harder and incurs higher costs compared to the neobanks (Clara Grillet and Louise Pacaud, 2020). Neobanks has shown that nothing can beat the fintech innovations when it comes to selling and delivery of financial products and services and satisfying the financial needs of customers.

Since neobanks are serving specific segments of customers usually served by traditional banks, it is implied that banks should find a way to increase their flexibility.

Therefore, if wondering when is the right time for banks to start adapting to the new changes, it could be said that the right time is yesterday considering the speed at which new competitors such as neobanks change the market for financial products and the speed at which they attract new customers (Skan, J. et al., 2018). Noteworthy mentioning is that the danger doesn't come only from neobanks and other fintech companies but also from players who are not part of the banking industry such as the big internet platforms and the big tech companies.

Examining the implications coming from neobanks means that banks should understand which institution is the real threat. While neobanks are quoted as the major danger, it should be noted that not all neobanks pose an equal threat to conventional banks. A better understanding of the real threat means that a distinction should be made regarding the effect coming from the two basic types of neobanks, i.e. full-stack neobanks and front-end focused Neobanks (Finnovate, 2018).

Consequently, while full-stack neobanks may have negative implications, front-end focus neobanks may affect the traditional banking industry in a positive manner. The need for front-end neobanks to partner with an established bank means that they can be considered to be an opportunity for banks to expand their activities and offer specific products to targeted niches. Ultimately, this might have a positive effect on the bottom line as well as the customer base.

On the other hand, full-stack neobanks are considered to be a danger for the traditional banking institutions because they operate under own bank license and they have control over most activities related to the development and delivery of financial products and services.

It is expected that neobanks developments have significant implications for traditional banking because they affect multiple areas of the business operations and activities. Consequently, the affected areas, along with recommended actions to be taken, are presented in table 3.

Table 3: *Areas of conventional banks under the influence of Neobanks*

| Traditional banking | Brief explanation | Suggested actions |
|---|---|---|
| Operational costs | The high cost of maintaining a network of branches | Reduce the number of branches or increase branch efficiency |
| Fee structure | High fees for non-value adding activities due to the high operational costs. Fees may have a negative effect on customer satisfaction, especially because Neobanks charge lower fees. | Increase operating efficiency through improvements in business processes and the application of advanced IT solutions. |
| Technology | Higher maintenance costs and outdated internal systems | Although costly, switching to new technology may have a significant positive impact on multiple business processes. |

| | | |
|---|---|---|
| Availability of services | In general, services are available during bank working hours. Outside of working hours, customers have access to limited services. | Enable 24 hours of access to most services through the application of new technology while maintaining low costs. |
| Products and service development and modification | Inflexible and stiff products and services as offering customized products are almost non-existing. | Remove the bureaucratic decision-making processes and increase the responsibilities and flexibility of branch employees. |
| Number of products and services and markets served | Offering a large variety of products my impede the competitive advantage | Traditional banks may want to primarily gain a competitive advantage in serving specific segments or package of products. Other products may also be offered after reaching adequate market share in the served niche. |
| Processing time | Outdated technology and the need for physical presence (which may form queues) limits the speed at which products are delivered to the end-user. | Utilization of adequate technology and the elimination of unnecessary steps in the business processes |
| Delivery of services (level of complexity to use products and services) | High level of paperwork complicates the delivery and usage of bank products which creates dissatisfaction. | Reduce the number of steps in the delivery of different products and services. |
| Utilization of collected data | Traditional banks lag behind to grasp the benefits of collected data to understand their customer's needs better. | Employment of technology which will augment the analysis of existing data. AI technology may be used for the analysis. |

Source: Compiled by the author

Aside of the aforementioned implications of Neobanks on traditional banks, the new bank models may also create a strategic and profitability risks along with disturbances in the liquidity levels and the level of funding sources (BCBS, 2017). Since neobanks gain popularity, especially among millennials, they have the potential to attract a higher number of savers which usually held their deposits and savings with traditional banks. Consequently, the banks may lose a portion of this type of funds used to finance their lending activities further.

It can be freely said that neobanks become a serious threat for the traditional banking industry and it affects traditional banks in numerous ways. The major drawback is that neobanks doesn't affect only a couple of areas of the bank operations. Instead, they affect the majority of processes for the creation and delivery of products and services as it can be seen from the table. Consequently, banks need to pay attention to this threat and initiate adequate actions which will ensure that they will not lag.

However, it should be noted that the effects from these implications are not severe since neobanks need to grow even further before they can become a serious danger for conventional banks. Nevertheless, banks should not take this new type of competitors for granted, as they have the potential to grow substantially.

## Conclusion

Banks have been conducting their activities on the basis of the traditional bank business models for many decades without any major threat. However, the actions initiated with the last financial crises have jeopardized the commodity of these models in a way that they impose the need for conventional banks to modify their models if they want to remain competitive. Also, the fintech developments have opened up a playground for the development and creation of new, modern, business models, which utilize innovative technology and improve the processes of traditional banks. Consequently, one of the major disruptions for the banking industry comes from the neobanks which sell and deliver the financial services fully online.

Accordingly, traditional banks should not ignore the implications which are brought by the neobanks, since this new type of business model has some significant advantages compared to the conventional banks. Hence, couple of primary implications which have been identified are in the areas of types of costs, operating efficiency, fees structure, the flexibility in the personalization of products and services, degree of customization of products, ability to utilize gathered data, the speed of adaption of new technology, the complexity of organizational structure, etc.

The implications coming from the developments of neobanks show that conventional banks should initiate the process of modifying and adapting their existing operations if they want to remain competitive in the market for delivery of financial products and services. There are multiple approaches which can be used by the traditional banks in their efforts to suppress the effects coming from neobanks and the fintech industry. Of course, the selection of an adequate approach depends on a variety of internal and external factors.

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