WHITE PAPER

HOW CAN COMMERCIAL BANKS THRIVE AMIDST THE RISE OF NEOBANKS?

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Summary

Commercial banking has dominated the industry for many years now. FinTech's have been rising as we have seen new payment solutions become very successful. In the past few years, neobanks have become very attractive in Europe and expanding to different countries. Neobanks projected growth is much higher than commercial banks within the limited offerings they provide, but they have their own set of challenges they need to face.

The authors of this whitepaper interviewed various industry leaders to receive their thoughts on neobanks and how commercial banks can respond. After these discussions and researching more about current trends and financial positions, we have created a solution for how commercial banks should view neobanks.

Defining neobanks and commercial banks

Nearly 95% of households in the United States bank.[1] Majority of the people utilize commercial banks for their needs. In the past few years, neobanks have increased popularity for specific needs and created competition against commercial banks.

Commercial Banks

Majority of people utilize commercial banks, or as many people call them "traditional banks." These banks are defined as financial institutions that accepts deposits, offers checking account services, makes various loans, and offers basic financial products like certificates of deposit and savings accounts to individuals and small businesses.[2] These banks have physical locations where people can utilize the banking services and seek advice. The top commercial banks in the world include Industrial and Commercial Bank of China, JPMorgan Chase & Co., Japan Post Holdings Co., China Construction Bank Corp., Bank of America Corp., Wells Fargo & Co., and Truist.[3]

Neobanks

Neobanks have grown tremendously in the past few years but are not as widely used as commercial banks. Neobanks are defined as financial technology firms that offer internet only financial services and lack physical branches. Their offerings are usually more limited compared to traditional banks[4] There are two types of Neobanks including full -stack and front end. Full- stack neobanks have a banking license and can offer products and services without a partner bank.[5] They tend to focus on a platform model and control most operations including front and back end.[5] The second type is front – end – focused Neobanks which do not have a banking license and partner with licensed banks.[5] They typically focus on legacy banks and only control front end operations.[5] The top full stack neobanks include N26, Monzo, Atom Bank, SoFi and NuBank. The top front end neobanks include Chime, Revolut, Monese, and Tide.[5]

Neobank strengths

Neobanks have been growing very rapidly over the past few years due to their agility. They are attractive due to the focus on customer experience and low cost.

Agility

When interviewing business leaders across various companies, their number one strength of neobanks is agility. Agility is the ability to respond rapidly to opportunities and disruption.[6] Consumer expectations have been changing for years now as digital transformation has increased. The recent changes due to the pandemic has accelerated many of these expectations and exemplified the need for companies to be agile.[7] Neobanks are much more agile than commercial banks. They are software centric, and many imbibe a tech company culture, therefore they are often keen to adopt digital transformation at a faster pace. Additionally, neobanks typically do not have as many hoops to jump through since they are smaller companies and changes are easier to make.

Cost

Users are attracted to neobanks because they tend to have lower fees and interest rates. Since neobanks do not have any physical locations, their operating costs are typically lower. Meanwhile commercial banks have high operational costs, and they are typically pushed into utilizing services they may not need. The acquisition costs for users are also much lower for customers compared to commercial banks.

Customer Experience

The focus of Neobanks is providing a great and effective customer experience. They offer items such as 24/7 chats, innovative investment tools, user friendly applications, and more. They are very specific in their offerings, so customers utilize them for that one specific need instead of bundles.

Neobank challenges

Commercial banks have a long history and customers really enjoy staying with one bank. Neobanks have a challenge when competing against them such as building similar trustworthiness, operating only online, limited offerings, and many neobanks are not regulated.

Building trustworthiness

The biggest challenge business leaders saw for neobanks were the lack of trustworthiness. Many of these neobanks are start ups and have not established credibility with users. Customers want to utilize trustworthy companies with their money where they perceive it to be safe. This is especially true for different generations. One financial advisor mentioned his older clients have a hard time trusting even large commercial companies and would not feel comfortable putting their money in a company that does not have a large reputation or physical locations.

Physical branches

Physical branches have multiple advantages. First, they are a great way to market the company.
One marketing executive discussed how customers can see the company name and start to build more credibility. Since people see company names often, they are more familiar with these companies and more likely to use them. Additionally, many customers want to meet with advisors and do a portion of their banking in person. If people are not tech savvy, then they especially rely on these physical branches. Commercial banks have been able to utilize building trust through physical locations and keep customers by making banking simple through digitalization.

Limited offerings

Some customers want a "one stop shop" where they make the original decision of where they want to bank and stay there. They do not want to focus on individualized products, and they do not want to continuously make decisions on where they should be banking. Therefore, they would rather stay with the commercial banks where they have everything in one place.

Regulations

There are a few of the larger neobanks that have attained banking licenses, such as Monzo. In some places, they have created limited banking license specifically for neobanks, such as Australia. For some neobanks though, they are not regulated. This can be a concern for many customers. They may feel they will not have any legal recourse or well-defined processes to follow if there is an issue.[8] There may be confusion as to who is responsible for potential fraud and errors.[8] Customers are responsible for ensuring their neobank offers some sort of deposit insurance.[8]

Trends

The past two years disrupted many industries, including the financial industry. Covid – 19 led to many shutdowns worldwide, which impacted many commercial banks. It also allowed an opportunity for neobanks to grow.

COVID – 19

Shutdowns from COVID-19 disrupted commercial bank's operations. They needed to shift their focus from physical locations to operating completely online.

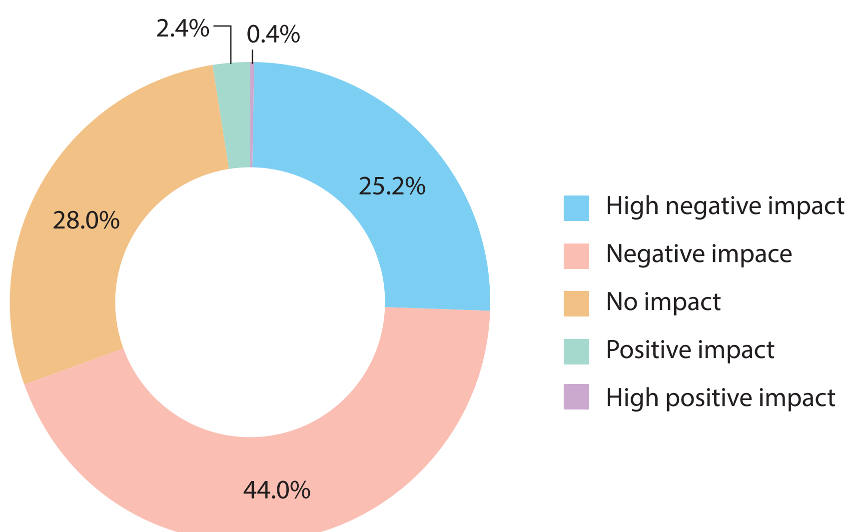
Companies that focused on digital transformation and updating their applications thrived. One commercial bank discussed how COVID-19 did not change their strategies but did speed them up. They were focused on improving their technology, so they did that at a much faster rate to meet customer's expectations moving online.

Other companies were not prepared for this and struggled to meet demands. In the United Kingdom specifically, many corporations experienced negative impacts from COVID-19 shown in the graph below.

Many of the companies that struggled during shutdowns stemmed from lack of connectivity with customers from quickly moving to digital. They also had issues with credit and an increase on borrowing.

Moving forward, we will see banks respond differently to returning in person. Some people believe the next few months will display the companies barely hanging on by a thread and the ones thriving in the new normal.

Neobanks had an opportunity to grow rapidly during the shutdowns. More people were looking to focus on digital applications that were seamless. Additionally, some neobanks focused



Source: Greenwich Associates

on incorporating the government lending into their platforms. Chime incorporated the stimulus payments into the SpotMe feature which allowed people to overdraft their accounts before receiving their stimulus.[9] Some neobanks tried to focus on the small bank loans that were given out too. They had many opportunities during this time, but their challenges were also highlighted. Neobanks focus on capital raising, but those plans were dramatically affected. Additionally, neobanks are not very profitable, but this was exasperated when the entire industry profitability was being squeezed.[10]

Growth

Neobanks have been launching at a rapid rate as the graph below portrays.[11]

Their growth differs for different regions. In Europe, has been the center of the neobank competitive landscape. Europe implemented the Financial Service Act of 2012 and Payment Services Directive to support neobanks conduct business. Neobanks focus both on deposits and payments equally in this region. In Asia, many neobanks focus on small businesses. Neobanks are more volatile in this region due to regulation and operating online only. In North America, Neobanks focus on the deposit accounts and offering lower costs. Neobanks have not started growing rapidly in the United States until more recently. In South America, neobanks are payment led and have a clear focus on creating accessibility to credit. In Africa, neobanks focus on deposits and offering digital payment solutions. The market is volatile, especially because many neobanks are not regulated. In Australia, the focus is on deposits and they are now regulated to be authorized deposit taking institutions. Neobanks are positioned to compete across multiple banking lines and towards full-service solutions.

The growth rate from 2021 to 2028 is projected to be 47.7%.[11] Meanwhile the projected growth rate for commercial banking is projected at 7%.[12]

While neobanks are growing rapidly, their financial positing has not been as successful.

Demographic changes

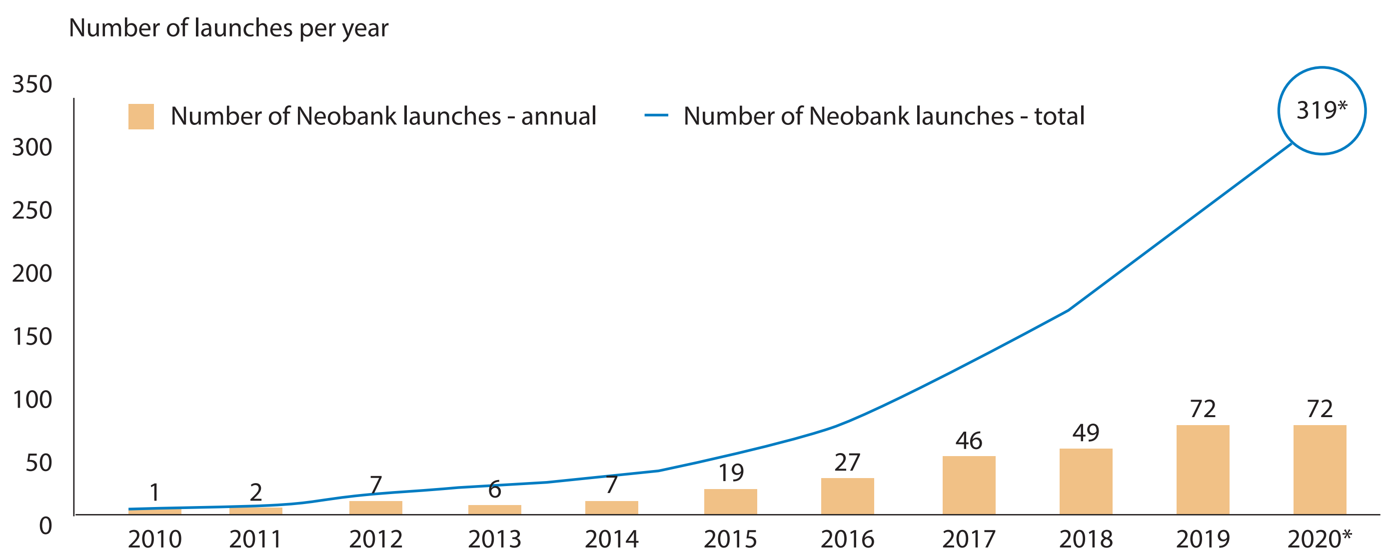
More than 40% of the United States population include Millennials and Gen-z.[13] This subset of the population is projected to grow to become a larger part of the population in the next decade. This powerful cohort, the Millennials and Gen-z, grew up with the internet and with the smartphone. They may have more trust in utilizing digital applications and possibly less loyalty to the retail branch as previous generations.

We believe this is driving more digital native offerings and adoption of Neobank offerings.

Financial positioning

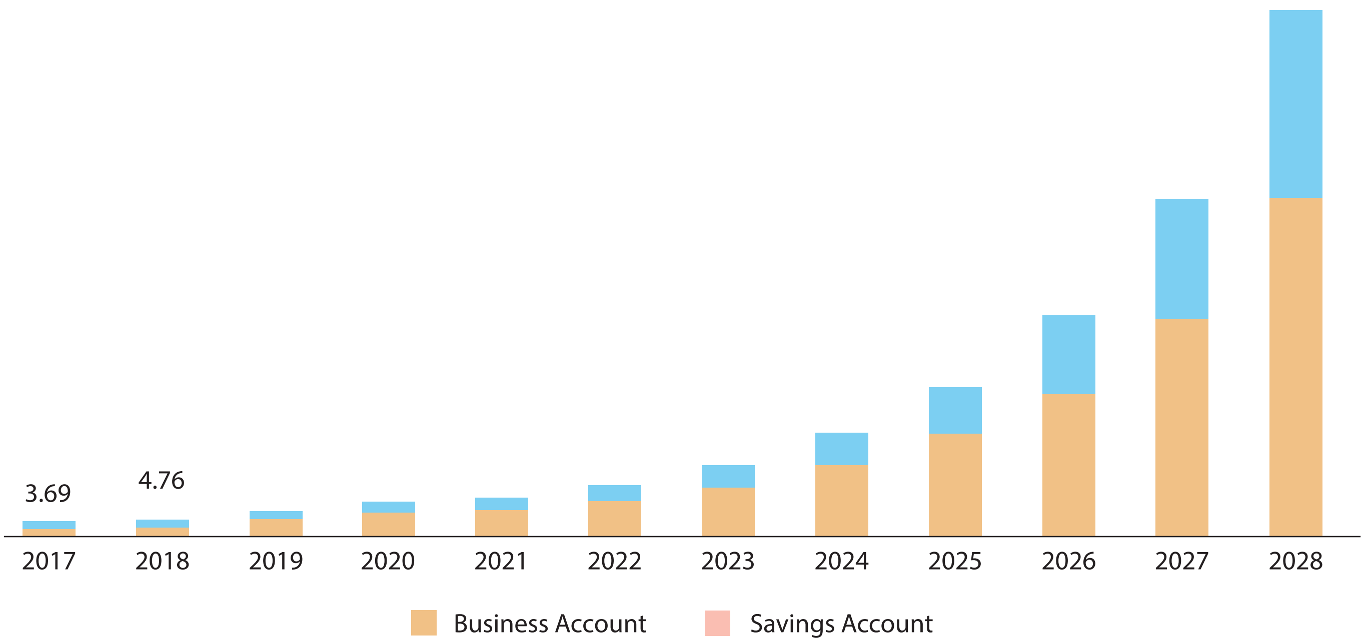
Neobanks market size is valued at 47.1 billion in 2020.[14] They struggled in the past with being profitable, but with their growth may provide an opportunity to change that.

Neobank worldwide launches from 2010



*Includes Neobanks launched until July and planned to launch throughout 2020

U.S. Neobanking market size, by account type, 2017 - 2028 (USD Billion)



Source: www.grandviewresearch.com

Acquisition costs

Research indicates that digital only banks have much lower acquisition costs.

The graph above compares digital wallets and commercial banks.[14] Many neobanks focus on building a customer base and monetizing it at a later date while commercial banks already have customers. One of the neobanks, Monzo, has a customer acquisition costs of approximately $5 while traditional banks can spend close to $1,000.[15] Part of the drastic different is the marketing type, where neobanks focus on items like social media and banks focus on TV ads.[15]

Once they can attain customer though, companies need to look at the lifetime value and how to make a profit from the customers. Commercial banks are good at this already, but they do have a portion of that taken away by their legacy systems. Therefore, even though commercial banks are making a lot of money from their customers, there is a lot of that money being eaten up by acquisition costs and high operation costs.[15]

Revenue

Traditional banking services like accounts and transactions are not that profitable. Most neobanks generate revenue from interchange fees on debit cards, but they have very low interest rates. Some neobanks, such as Revolut, are exploring subscription-based models where the standard subscription is free, but the premium is $9.99 a month and metal is $16.99 a month.[16] The revenue forecast for 2028 is expected to grow to 722.60 billion.[17]

Commercial banks create revenue streams through investments, interests rates, and banking fees.[18] In 2018, JP Morgan led revenues with $131.41 billion with Bank of America and Wells Fargo following closely behind with over $100 billion in revenue.[19] Commercial banking continues to grow, but as a lesser rate than neobanks since they have been around longer.

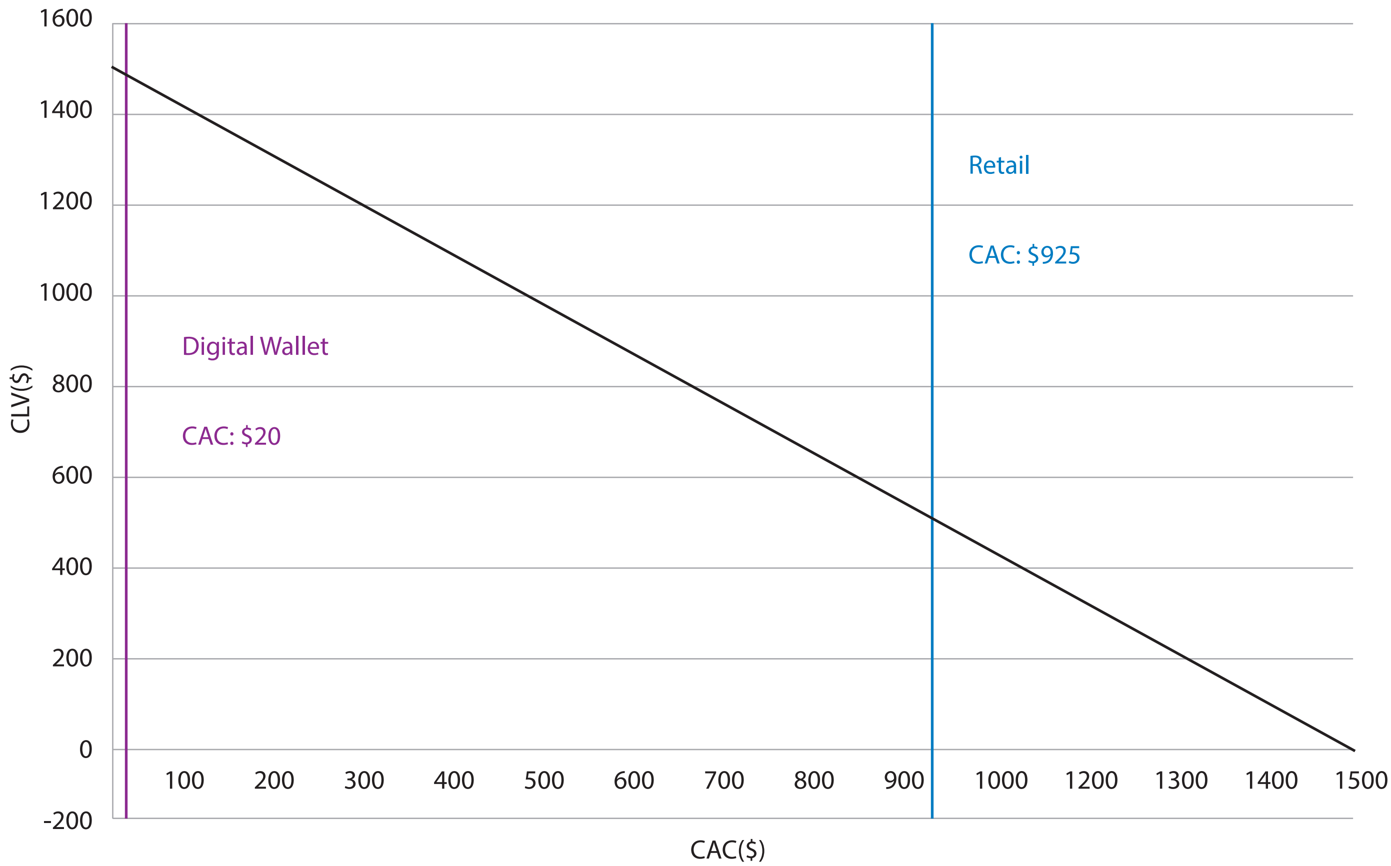
Profitability

Amazon is a perfect example of a company focusing on growth without being profitable for many years and then finally turning the corner to be very profitable. Many companies cannot sustain this model though. Many investors would like to see neobanks become profitable before continuing to invest.

One of the largest Neobanks, Revolut, is valued around $5.5 billion, but tripled their losses in 2020.[20] In October 2020, Starling Bank was the first retail neobank to make a profit. [20] Since then, some neobanks are starting to make a profit, but Accenture has noted that UK neobanks lose around $12 per customer.[20] The Chime CEO said they could be profitable if they reduced their marketing spend, but do not believe they need to do that at this point.[20]

As bigger banks, such as JP Morgan, announce they are launching digital banks though, it will force current neobanks to shift their focus on becoming profitable. They will most likely try to keep their fees low and focus on items such as subscription-based services, boosting lending, branching into banking as a service. Since they are becoming more popular, they will also be able to cut their marketing expenses.

Lifetime value of checking account custumer (CLV) vs. customer acquisition costs (CAC) (over 16 years)



Source: ARK investment management LLC, 2019 | ark-invest.com

Commercial banks on the other hand focus have a history of being profitable and making it a priority. Through the revenue structure mentioned previously, banks have had success with being profitable for their shareholders. Many banks do not need to focus on marketing expenses as much as neobanks because they have already created a good reputation in the area, they operate in. Commercial banks do have more operating expenses since they have physical branches, but they typically make up for that through their fees and slightly higher interest rates.

Industry outlook

Industry leaders have a few concerns for the outlook on the future. The two biggest ones are cybersecurity and recruiting talent. They believe this could be a big differentiator into who the winners are in the next five years.

Cybersecurity

Cybersecurity has been an increasing concern over the past few years. In 2014, JP Morgan had a cyberattack that breached the data of 76 million householders and 7 million small businesses.[21] Customer information including names, addresses, phone numbers and email addresses were stolen. The breach did not include account numbers, but it did impact their reputation and trust with customers. Implementing cybersecurity measures can be expensive. This gives commercial banks an advantage to spend more money on it. Commercial banks do have a disadvantage with the agility to change rapidly as technology changes though. Trust is very important when handling money, so if companies are having data breaches then customers will not want to put their money with them. As technology changes over the next few years, it will be extremely important for all companies to take the threat of cybersecurity attacks seriously. How companies prepare and respond to these attacks will differentiate them.

Talent

The past two years dramatically changed work environments and employee expectations. Many employees enjoy working from home or at the minimum having the opportunity to work from home a few days a week. Many fintechs are comfortable with their employees working remotely and do not even need them in one location. Additionally, start ups can be an attractive opportunity for younger employees. One executive discussed how he has dealt with neobanks and fintechs trying to recruit their employees. He mentioned these have become attractive opportunities and companies will need to focus on being competitive. Many commercial banks hope to return to working in person, but that may become a disadvantage to top talent. This may not be an immediate issue, but you will be able to tell the companies recruiting the best talent in a few years.

Next steps for commercial banks

As Neobanks continue to rise, commercial banks will need to strategize how to respond to them.

Threat or opportunity?

Many leaders from commercial banks view them as a threat and opportunity. There are mixed opinions on the level of threat they provide and who they are challenging. Some leaders have them fall under the fintech category and believe they will not gain that much traction. Other leaders though view neobanks as a serious threat, especially if they find their digital capabilities to not be up to the industry standard. Additionally, some leaders of commercial banks believe they only really challenge regional banks and credit unions.

Neobanks create more of a challenge for credit unions and regional banks because of their specialized services and advantages of lower costs. Many regional banks may not have the money to spend to keep up with digital capabilities that will be needed in the next few years. Many larger banks believe they do not pose a real threat to them. They understand the importance of picking and choosing their battles. As of right now, many of them believe the specialized services will not really harm their business. If they do pose a real threat in the future, then they will probably start to buy some of them or at the minimum use them as a partnership.

Partnerships

As I mentioned, there is an opportunity for these commercial banks to partner with neobanks. The biggest strength neobanks have is their agility, and many traditional banks can use that to their advantage. Additionally, neobanks are constantly focusing on their technology and including more artificial intelligence. Commercial banks can create long standing partnerships with these companies or utilize a limited partnership to see how their company responds to having these newer capabilities.

Currently, Bancorp Bank is trying to partner with multiple neobanks so the neobanks have a banking license. There have not been many partnerships at this point, but some investment starting to occur with the regional banks. Some of the largest commercial banks are interested in the new technology but have not started focusing on partnerships with neobanks. I believe in the net few years partnering with one another could create a win – win situation. Commercial banks can experiment with the technology and agility of neobanks, while neobanks have more banking and a license to work from.

Technology

If commercial banks are not looking to partner, then they will need to focus largely on their internal technology. If companies are not keeping up with customer expectations, they will fall behind with the increase competition of neobanks. Customers are really looking for phone applications that are not only easy to use but have many options. In many regional banks and even some larger banks, you do not have the option to try and budget through the app. Many customers are starting to focus on these capabilities. Artificial intelligence has been a trend to watch spending and potentially look for investments. If it feels the company cannot keep up with new technology, then customers will start to leave.

Additionally, all companies will need to focus on cybersecurity as I mentioned previously. If companies start losing trust from their customers from data breaches, then people will move their money to a place they believe is safer. Commercial banks have the advantage of perceived trustworthiness but could easily lose that to neobanks if they become vulnerable to cyber-attacks. Additionally, commercial banks will need to continue to make sure their physical locations are on the cutting edge of technology.

Leverage neobank's challenges

Neobanks have a few challenges that commercial banks can really leverage to be successful. Commercial banks did not utilize their physical locations that much this past year. Some banks have closed more branches to spread them out, while other banks have continued to open more in new areas. It will be interesting to see how many people will utilize physical branches in the next two years, but it is a perfect opportunity for commercial banks to re-evaluate how they are utilizing the branches.

One technology leader at a commercial bank spoke to the idea of changing the branches to look more like an Apple store. The focus would be on advising clients of their financial future. They would also teach customers how to utilize their technology. There are many people who have not deposited checks on a mobile phone, so there would be an opportunity to teach people how to become tech savvy. Now this may also depend on the customers. Some customers may not have the technology to do this but having the option to teach can be beneficial.

Many commercial banks have a good reputation in the area they operate in. They will want to focus on protecting that operation and find ways to create even more trust in the community. This includes focusing on customer experience first. Customers who switched to neobank may have felt their commercial banks were not focusing enough on customer experience. One example is the overdraft fees banks have. Neobanks discarded these and it has been a huge attraction for customers. If banks re-evaluate their cost structure regarding their revenue, then they may be able to cut some of these down.

Lastly, commercial banks will want to focus on staying the "one stop shop." They want to make customers feel they can do everything they need to with their own company and do not have to move to other places. This may include being more competitive with their rates and increasing their product offering. Customers tend to like to stay with one company if possible, to create simplicity throughout offerings. If customers start utilizing a neobank for one item, they may feel more comfortable utilizing other ones more often. This could lead to losing more customers once they become comfortable operating these services.

Agility

One of the biggest hurdles for commercial banks is not being agile. The pandemic forced many of the banks to focus on agility, but they still have many hurdles on their operations. These banks have legacy systems that can cause delays in data and tend to only focus on quick fixes. Different systems can even become entagled to make it more complicated to operate business than before. Leaders need to evaluate their current operating systems on a regular basis and understand that there may need to be times where you find a new system.

Additionally, companies can be slow to decide to make a change because of the culture and hoops to jump through for approval. This can be very costly as technology is changing rapidly. Banks need to strategize a plan for approval to make changes in the company in a thoughtful, but effective way.

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