kcFED Payments System Research Briefing

Neobanks: Banks by Any Other Name?

By Terri Bradford

Neobanks, or digital banks, are bank-like providers of financial services that operate through apps and aim to appeal to different consumer groups through innovative features and design. Whether or not neobanks evolve into full banks, they have the potential to affect the traditional banking model.

Technological innovation has significantly shaped the banking and financial sector, giving rise to fully digital banking services. Providers of these services, referred to as challenger banks, neobanks, and digital banks, aim to be more accessible and innovative than traditional banks, usually operating from an app rather than a physical branch or office. Although some of these providers may seem like a bank—and have even named themselves such—many lack the required charters, oversight, and range of bank services and thus are merely bank-like. Nevertheless, they have sought to disrupt the traditional banking model by offering financial services in ways that appeal to different groups of consumers. This *Payments System Research Briefing* looks at the appeal and proliferation of neobanks and the implications they may have for traditional U.S. banks going forward.

The Appeal and Proliferation of Neobanks

To understand what a neobank is, it is helpful to understand what it is not. Without a charter, a neobank is not a bank; by definition, a bank is a chartered financial institution licensed to receive deposits and make loans, and may also provide other financial services such as wealth management, currency exchange, and safe deposit boxes (Barone 2020). A neobank is not a "challenger bank" either, because a challenger bank is also a chartered financial institution, a relatively small, more innovative retail bank set up with the intention of competing for business with large, long-established national banks (Lexico 2020). Instead, a neobank is a fintech that relies on relationships with chartered banks that facilitate the provision of the neobank's financial services.[1]

Simple and Moven were among the first neobanks, launched in the United States in 2009 and 2011, respectively. Both targeted consumers who were not satisfied with traditional banks and offered fee-free accounts that were easy to open and provided personal financial management services such as budgeting, spend tracking, and automated savings linked to everyday actions. Today, there are more than 30 neobanks, many of them launched in just the past few years, and the features offered by the earliest entrants now are merely table stakes. In addition, the advent of the "sharing economy" has created opportunities for neobanks to provide innovative banking solutions.[2]

Neobanks seek to differentiate themselves from traditional banks by offering novel services via a strong digital interface, often designed to appeal to specific groups of consumers. Although these groups are not mutually exclusive, they can broadly be categorized as savers; unbanked, underbanked, and hourly workers; students and millennials; small business owners, entrepreneurs, and freelancers; and affinity groups.

Savers take responsibility for their finances; they like to control their spending and put savings on autopilot. U.S. consumers have opened more than 7 million accounts with fintech savings tools like Acorns and Stash, and have said that in 2018, those tools helped them save nearly $5.6 billion (Shevlin 2019).

Neobanks such as Empower, Qapital, and Simple target savers by offering higher-yield savings accounts and facilitating the setting of specific goals. Some also use artificial intelligence (AI) to study consumers' income and expenses on a daily basis to detect opportunities to save more, while others use behavioral psychology to help users boost their saving. Simple is the leading provider in this segment, with nearly 3 million customer accounts.

According to a 2017 FDIC survey, 25 percent of U.S. households are unbanked or underbanked.[3] More than half of unbanked households cite not having enough money to keep in an account. They may also have difficulty accessing financial services due to low credit scores.

Neobanks such as Branch, MoneyLion, Motiv Money, and MyBambu aim to attract unbanked, underbanked, and hourly workers by providing accounts that function like a demand deposit account, complete with a debit card, and by facilitating access to funds up to two days ahead of payroll. Neobanks can also provide short-term, no-interest cash advances as well as opportunities to build and repair bad credit, which can impede some consumers' use of traditional banking services.[4] Branch is among the leading providers in this segment, with 3 million customer accounts.

Students and millennials are another consumer segment neobanks try to target. According to Credit.com, the current average outstanding student loan debt is an estimated $32,731 (Issa 2019). Student loan obligations in the United States total nearly $1.5 trillion distributed across all age groups, and millennials (born between 1981 and 1996) carry more than half of that debt. Having grown up in the shadow of the 2008 financial crisis and economic recession, Generation Z is also generally cautious about excessive consumption (Du and Milligan 2019).

Neobanks such as BankMobile, Dave, Digit, Chime, Current, GoBank, MoneyLion, SoFi Money, and Varo aim to appeal to students and millennials by offering tools to help manage debt, increase savings, or begin investing, as well as person-to-person (P2P) payments, early access to pay, and gamification of financial literacy.[5] Chime is the leader in this consumer segment, with 8 million users between the ages of 25 and 35.

Small business owners, entrepreneurs, and freelancers are often not a good fit for a commercial bank account, but want to keep their business and personal finances separate. There are over 30 million small businesses in the United States with nearly 60 million employees; in addition, there are more than 31 million entrepreneurs and 57 million freelancers (U.S. Small Business Administration Office of Advocacy 2019).[6] Small businesses need support managing accounts receivable and payable, expense monitoring, and employee benefits. Entrepreneurs and freelancers also need additional support with tax calculations and withholding.

Neobanks such as Azlo, BankNovo, Current, Joust, Lili, MoneyLion, NorthOne, and Oxygen target these consumers by offering tools that often are not readily available to businesses of their size from traditional banks. Such tools include invoicing; bill payment and ACH credit push and debit pull payments; integration with merchant platforms such as Kabbage, Stripe, Square, and soon PayPal; accounting and budgeting, instant credit, and early access to pay; and creation of LLCs, cash flow projection, and tools that enable the building of application programming interfaces (APIs) on top of the bank account. Joust is among the leading providers in this consumer segment, with 4 million customer accounts.

Affinity groups, such as the "prebanked" (those age 21 or younger who rely on cash), business travelers, HENRYs ("high earners not rich yet"), and those who are environmentally or socially conscious are also being targeted by neobanks through benefits and services that meet more specific needs and goals.[7] Neobanks such as Aspiration, Be Money, Marcus, Revolut, Step, and Unifimoney seek to appeal to people linked by common interest or purpose.

For the prebanked, neobank offerings include tools to manage money while learning financial literacy and independence, P2P payments, spending notifications, and rewards. For business travelers, offerings include no-fee international transfers, budgeting, savings, and split payments. For HENRYs, neobanks offer high-yield savings and checking accounts, AI built into investment apps, and cash-back credit cards. For the environmentally or socially conscious, offerings include the ability to spend with, invest in, and donate to like-minded businesses.

Traditional Banks and Neobanks

Traditional banks have reacted to neobanks in different ways. Some have worked with neobanks for mutual benefits, some have chosen to create their own neobanks, some have directly competed with neobanks, and others have not yet taken significant action.

Banks that have chosen to work with neobanks allow them to connect with their banking systems and infrastructure either through a banking-as-a-service (BaaS) platform or direct-to-bank integration. A BaaS platform connects a neobank and a bank via APIs and enables the neobank to build financial offerings on top of the banks' regulated infrastructure. With a BaaS platform, three entities could be involved: a neobank, a bank that allows the neobank to use their system or infrastructure, and a fintech that offers a BaaS platform.

Some banks that facilitate neobanks via direct-to-bank integration have developed partnerships with fintech companies, while others have developed their own BaaS-type platforms as a separate division. In a similar way, neobanks use APIs to fulfill customer-initiated onboarding, account funding, and other banking activities. However, in these relationships, the neobank has greater responsibility for building out compliance, implementation, and end user support.

Through BaaS platforms and direct-to-bank integration, neobanks offer accounts to their customers that are Federal Deposit Insurance Corporation (FDIC) insured, as well as payment cards and investment services. Banks that offer BaaS platforms or direct-to-bank integration services can benefit from entering into these relationships because the neobanks become their customers rather than just competitors. In addition, the banks are able to monetize their infrastructures and establish strong relationships with fintechs, which can enable them to prepare for new banking opportunities and accumulate additional data from third parties.

More than half of the 35 neobanks researched for this article received services from one of seven banks: Evolve Bank and Trust, The Bancorp Bank, BBVA, Choice, MetaBank, Metropolitan Commercial Bank, and Wells Fargo. Of note, Evolve Bank and Trust provided BaaS to six neobanks that target many of the consumer groups. Three banks in the Tenth Federal Reserve District—CBW Bank, nbkc bank, and UMB Bank—also provided services to neobanks.

Instead of working with existing neobanks, some banks have opted to create neobanks of their own. Goldman Sachs launched its neobank, Marcus, in 2016. Marcus targets consumers who are seeking a no-fee, high-interest savings account. It also offers no-fee personal loans that are issued by Goldman Sachs. GreenDot Bank, in partnership with Walmart, launched its neobank, GoBank, in 2013. GoBank targets those who are looking for an extremely simple checking account and offers tools designed to help set concrete budgets, pay bills, and keep spending within financial means.

Still other banks are choosing to compete directly with neobanks by introducing new products and services that target the same groups of consumers. For example, according to Payment Systems for Credit Unions (PSCU), the largest credit union service organization in the United States, many credit unions are catering to microbusinesses and expanding their offerings as the group and its revenue potential come more clearly into focus. PSCU's research shows that 40.8 percent of credit union executives plan to increase the number of products designed with microbusinesses in mind. The share is even higher among small credit unions, as 55.3 percent aim to introduce more products focused on microbusinesses in the future. Just 32.7 percent and 27.3 percent of mid-sized and large credit unions, respectively, have announced such a goal (PYMNTS 2020).

However, the majority of banks are not taking significant actions in response to neobanks, perhaps viewing neobanks as too novel to significantly influence their business model. It may be tempting to discount neobanks because of the prevalence of traditional banking options and their size relative to the consumer groups they target. Yet evidence suggests their market share will continue to rise. A survey conducted by Finder.com, an independent comparison platform and information service, revealed that although more than 177.0 million Americans (roughly 69.7 percent of the total U.S. population) bank with traditional banks, some 22.5 million Americans (8.8 percent of the total U.S. population) intend to open a digital-only bank account in the coming months (Wells-Barrett).[8]

The Future of Neobanks

Given that neobanks are able to work with banks to provide financial services, most have not sought to become independent banks through appropriate licenses or a national bank charter. However, U.S.-based Varo and UK-based Monzo have both pursued a bank charter. In 2017, the same year of its launch, Varo applied to the Office of the Comptroller of the Currency (OCC) for a national bank charter and to the FDIC for federal deposit insurance. After three years and multiple rounds of applications, Varo received FDIC approval in February. During the writing of this article, Varo was officially granted a charter and became the first U.S. fintech to receive a national bank charter; technically becoming a challenger bank.

Monzo, a challenger bank in the United Kingdom, has long planned to enter the U.S. market. In 2019, Monzo established a U.S. neobank and recently has been preparing to open a San Francisco office. While awaiting a full banking license that would allow it to offer fully insured deposit accounts and lending products, Monzo has opened a waitlist to allow individuals to sign up for a service comprising a debit card and mobile app.

Whether more neobanks will take steps to become banks remains to be seen. Other fintechs, such as Square and SoFi, have pursued bank charters. Square's application was granted in March 2020 and SoFi submitted its application in July 2020. Although an OCC fintech charter has been available since 2015, it has not been embraced by fintechs. A recently announced OCC national payments charter 1.0, which could be a national version of the 50-state money transmitter license, may create some interest.

Conclusion

Neobanks offer novel services and leverage technologies that may make them attractive to particular consumer groups. Banks enable the services neobanks provide, either via BaaS platforms or direct-to-bank integration. However, some neobanks are also pursuing bank charters, and a new OCC payments charter 1.0 may affect how neobanks provide services in the future.

Meanwhile, some banks have chosen to view neobanks as customers, and thus have monetized their infrastructures and established strong relationships with fintechs. These relationships may enable banks to get ahead of future banking offerings, as well as accumulate additional data from third parties. Other banks are competing with neobanks by either creating neobanks of their own or offering services and features that target similar consumer groups.

Most banks, however, are not yet taking significant action. The adoption of real-time payments, such as the forthcoming FedNow℠ Service and The Clearing House's Real-Time Payments, may allow banks to compete with neobanks by offering services such as P2P payments, early access to payroll, and push notifications—prevalent among neobank offerings. Still, neobanks are also using AI, platform integrations, analyses, and more tailored services and features than are typically found at traditional banks. Much like traditional banks have seen their markets for mortgages or car loans disrupted by mortgage originators or dealer financing, the sharing economy and expanded offerings from neobanks may continue to disrupt the traditional banking business model.

Endnotes

[1] Although neobanks do not have a bank charter, general business laws and consumer compliance regulations usually apply.
[2] For an explanation of the "sharing economy," see Martucci.
[3] Underbanked consumers have a bank account but still use financial services outside of the banking system.
[4] Some services offered by neobanks are also offered by general purpose, prepaid card providers. For example, NetSpend and other prepaid providers offer access to payroll upon receipt of payment instruction (before funds are settled between banks).
[5] SoFi Money is a brokerage product offered by SoFi Securities LLC. Member FINRA/SIPC. Neither SoFi nor its affiliates is a bank.
[6] The U.S. Small Business Administration Office of Advocacy defines small businesses as firms employing fewer than 500 employees. The latest Global Entrepreneur Monitor report actually shows that one-third of entrepreneurs started their business with family, 11 percent of the adult population is active in the gig or sharing economy, and 8 percent of Americans are starting businesses for their employer (Chmura 2019). By definition, freelancers sell work or services by the hour, day, or job rather than working on a regular salary basis for one employer (Pofeldt 2019).
[7] Prebanked is defined as the 75 million children and young adults under the age of 21 in the United States who are still dependent on cash (Perez 2019).
[8] In the Wells-Barrett work, digital-only banking is used to describe neobanks.

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Terri Bradford is a senior payments specialist at the Federal Reserve Bank of Kansas City. The views expressed are those of the author and do not necessarily reflect those of the Federal Reserve Bank of Kansas City or the Federal Reserve System.