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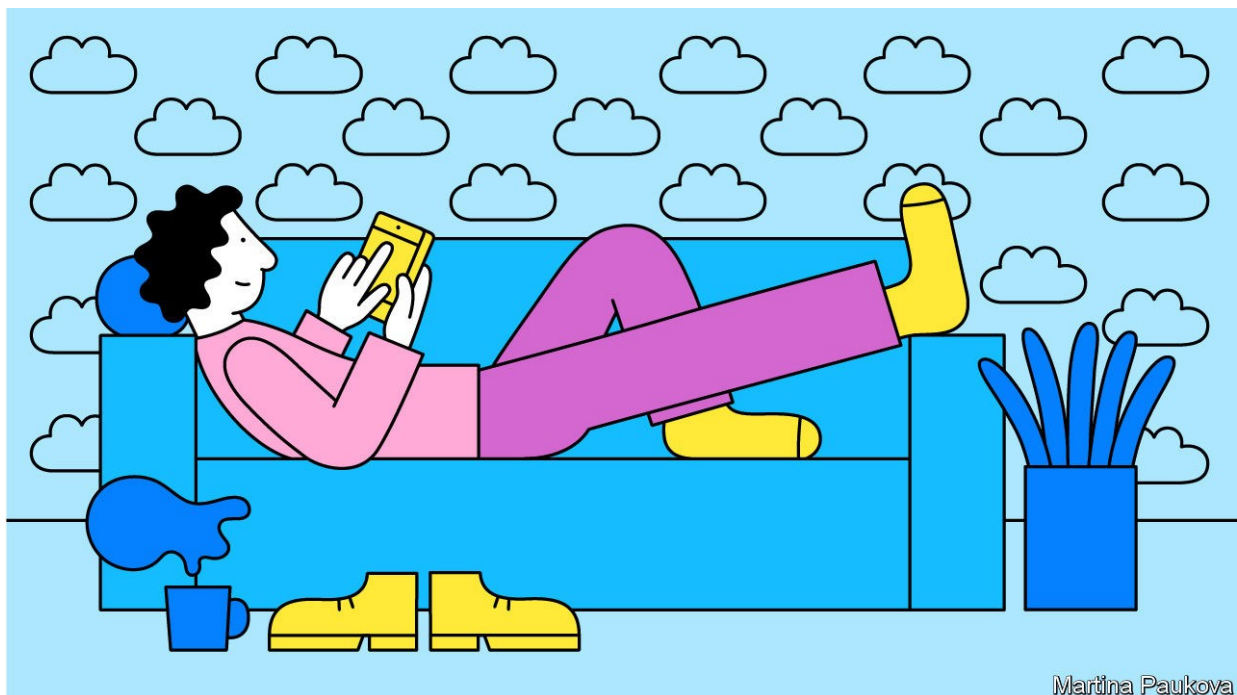
 Menu**Special report**

May 2nd 2019 edition

Neobanks

# Neobanks are changing Britain's banking landscape

Regulators have set up a "sandbox" to allow fintech experimentation



May 2nd 2019



Aranks, in 2012 she became chief operating officer at Allied Irish Banks. As she helped pick up the pieces after Ireland's banks had blown up its economy, she started thinking that banking needed root-and-branch reform. And even as bankers

were distracted by the aftermath of the financial crisis, the wider world was changing. "People were running their lives on mobile phones," she says. "They were living on social media and buying music on Spotify, and financial services hadn't caught up."

At the end of 2013 she resigned to travel and visit the most innovative banks she could find. But they seemed to be merely patching up their computer systems and closing branches, rather than rethinking their business models. Starting again, she concluded, was the only way to do something better. So she decided to launch a digital-only "neobank", Starling, in Britain. Since getting a banking licence in 2016 it has opened 520,000 personal accounts.

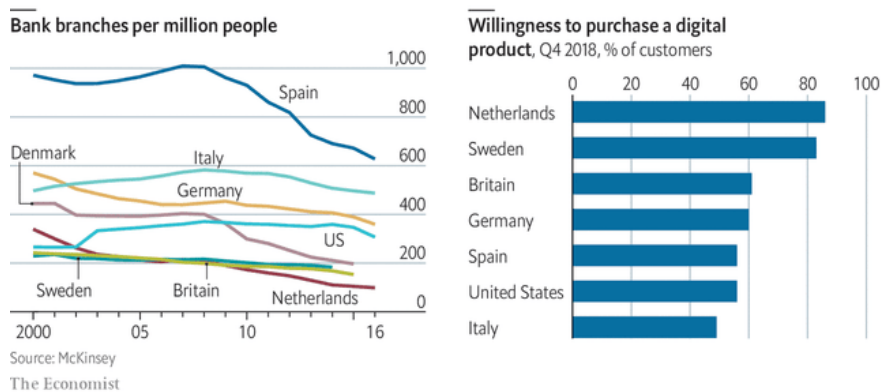
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Starling is one in a flock of neobanks in Europe aiming to let digital natives bank on their mobile phones. Britain has the largest number; some 15 licences have been granted since 2005. These new banks are capturing a third of new revenue growth in Britain, says Alan McIntyre of Accenture, a consultancy. All are raising large amounts of capital and seeing customer numbers grow at a speedy clip. According to a survey by finder.com, a comparison-shopping website, 9% of British adults—and 15% of 18- to 23-year-olds—now have a neobank account.

Monzo has opened 1.6m new accounts in Britain, with 30,000 more each week. Revolut, which started by offering foreign exchange and then added an e-money licence, now has a banking licence in Lithuania and will soon have deposit protection and be able to offer credit across the euro zone. N26 (named for the number of cubes that make up a Rubik's cube), which launched in Austria and Germany in 2015, is now in 24 European countries. Starling is moving into "banking as a service": enabling businesses to carry out activities such as payments by handling the regulated parts.

Branches are closing and customers are becoming keener on digital financial products in many developed markets (see chart). But neobanks have flourished particularly in Britain. One reason is that high-street banks' reputations were even more thoroughly wrecked in Britain than elsewhere, not just by the financial crisis but also by the mis-selling of insurance policies in the 1990s, for which compensation of more than £34bn (\$44bn) has been paid so far. Another is that the regulator, the Financial Conduct Authority (FCA), is keen on new entrants. It has a mandate not just to protect the integrity of the financial system but to promote competition. When the FCA sets policy, says Chris Woolard, its director of strategy and competition, it considers "not just the risk that bad things will happen, but the risk that good things will not".

### Bye bye, bank manager



Britain's approach to financial innovation also helps fintechs move towards bank status step by step. Its "open banking" rules were shaped partly by an investigation in 2016 into the retail-banking market that concluded more competition was needed. They include a particularly fintech-friendly interpretation of the "revised payments services directive", an EU-wide rule requiring banks to give third parties direct access to account information (with the account-holder's permission). The aim is to encourage startups that offer payment services, account aggregation and the like.

Since 2016 the FCA has run a "sandbox" for financial innovation. Twice a year around 25 firms are allowed to sign up customers for a new product or operational approach, with full disclosure and an FCA guarantee that they will not lose out if things go wrong. Firms must comply with all the usual prudential measures and checks for money-laundering, fraud and so on, but are granted permission to innovate within the spirit of the rules.

Mr Woolard draws an analogy with pharmaceutical trials, where a new medicine is tested against the standard treatment for a disease. Firms seem to value the opportunity to prove to investors that their approach works in a regulated setting,

he says: applications for the sandbox exceed the number of places by a factor of three. The approach has spread: more than a dozen regulators elsewhere have set up sandboxes in the past couple of years.

Neobanks have two big cost advantages: the absence of branches and their up-to-date cloud-based software. Branches and the associated staff are responsible for as much as half of a high-street bank's costs. And if it is still running on a legacy mainframe, three-quarters of its IT budget is likely to go on "keeping the lights on", says Dharmesh Mistry of Temenos, which sells cloud-native banking software. Industry insiders say that a conventional bank has to make in the region of \$200-400 a year per customer to break even, and each new account adds significant marginal cost. For a neobank, even including product development, customer acquisition and so on, the equivalent figure is around \$50-60, and the marginal cost of maintaining each extra account is close to zero.

Economies of scale are encouraging a sprint for global growth. Starling is moving into the euro zone, with a base in Dublin; Monzo's post-Brexit backup plan is an Irish licence, too. Revolut is entering several countries in Asia. In Singapore, says Rishi Stocker, who is leading Revolut's expansion, the regulator seems more interested in supporting incumbents than in encouraging competitors. But the island's large foreign-born population makes it an attractive proposition for a bank with a reputation for cheap foreign exchange. Australians, with their penchant for travel, are also an appealing target. And Japan is just asking to be disrupted, says Mr Stocker. "The existing banks are ultra-expensive, and most don't have apps or even desktop applications."

N26 and Revolut are open about their plans to break into America; Starling and Monzo are less forthcoming. The country's handful of home-grown challengers, such as Simple and Moven, have been hampered by the patchwork of federal and state regulations, and rules that make it hard to operate without branches. Like the natives, the newcomers will take responsibility for customer service while partnering with local "white-label" banks—any of several dozen fully licensed banks that specialise in carrying out regulated activities such as holding deposits, handling payments and originating loans for institutions that lack a banking licence.

The main criticism of challenger banks is that customers will use them merely to ring-fence discretionary spending, with their salaries still going into a high-street bank. But that is changing. Nearly two-thirds of Monzo's active accounts have at least £500 a month coming in and a third have £1,000 a month.

More important, they are realising that even secondary accounts can be monetised in novel ways. All want to act as marketplaces, not just for financial products but for other services, too. If a payment for an adventure holiday or mobile-phone bill goes out from your N26 account, muses Valentin Stalf, one of its co-founders, you could

de snown options for travel insurance or phone contracts. Monzo allows customers to put money into interest-bearing pots held by Investec, a separate institution

(Monzo's own current accounts do not pay interest). It is working on offering the best deals on utility bills, and mortgages from across the market to customers whose fixed rate is ending, says Tom Blomfield, its chief executive, rather than leaving them to default to a worse product. "Monzo wants to liberate its clients from the 'loyalty tax,'" he says. "There are a lot of industries in the UK where you get one year at a good rate and then you're transferred to a rubbish one."

A balance-sheet-light business model that depends more on selling third-party products than on recycling deposits into new loans requires top-notch data analysis and frictionless service. All the neobanks spend heavily on data scientists and app developers; they roll out frequent updates and constantly tweak their recommendation algorithms. Since they have access to account data and have already checked their customers' identities, referrals to third-party suppliers could potentially be done with fingerprint or facial recognition—as simple as one-click shopping on Amazon.

For any of this to work, customers must trust their bank. This means no more sneaky charges, such as allowing a scheduled payment to put them in the red and charging a fee, rather than alerting them in advance. "The most successful thing about these new banks is that they are on the customers' side of the table," says Mr McIntyre of Accenture. "The possibility is fading of building your business model on the fact that customers make mistakes."

*Correction (May 9th 2019): The original version of this article said that N26 and Revolut were both entering several countries in Asia. In fact, N26 has no plans for Asia in the near future.*

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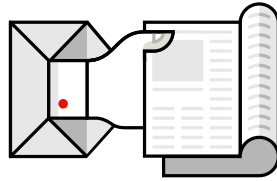
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