

Fintech

The end of free bank accounts is bad news for Monzo and its rivals

Banks might be forced to charge millions of people to keep their bank accounts open. For fintechs fighting to break even, it could be fatal

By **RYAN WEEKS**

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Credit **Getty Images / WIRED**

In September, Starling Bank became the first UK lender to start charging customers to park their cash in a current account. The move only affected a minuscule amount of the startup's customers, who now pay an interest rate of -0.5 per cent on any balance over €50,000. It made economic sense: after launching euro accounts the previous year, the new charge was designed to bring the product in line with rates in the Eurozone.

But these kinds of charges could become the norm for every bank account in the UK in the coming months. The economic instability caused by the pandemic could trigger negative interest rates, causing banks to stop paying money out to savers, and charge people to hold money with them instead.

For the first time in its history, the Bank of England is mulling over whether to set the base rate – which is the rate at which banks can borrow money – below zero. The impact of such a move would affect all kinds of businesses, but the timing is disastrous for Britain's highly valued crop of neobanks. The threat of negative interest rates looms large for digital banks that are in the early stages of building lending businesses – the bog standard way of making money as a bank. Through a combination of app-based banking, low cost products and bells and whistles, neobanks have built empires on low margin retail customers. Any changes to their model, especially those that introduce higher costs, have the potential to threaten their very existence.

Led by the trio of Monzo, Revolut and Starling, neobanks, which skyrocketed in popularity in the past five years, have a combined customer base numbered roughly 12 million as of January this year, according to research carried out by [comparison site Finder](#). But the Covid-19 pandemic hit this predominantly loss-making group of startups hard.

Lockdowns in the UK and abroad curtailed both travelling and spending, two key revenue streams. Both Monzo and Revolut were forced into cutting hundreds and dozens of staff respectively, and the former saw its valuation slashed in a £60 million fundraising that closed in June.

Jaidev Janardana, chief executive of peer-to-peer lender and digital bank Zopa, says the less neobanks are lending, the more negative rates will worry them, because regulated banks typically hold the money they are not lending out with the Bank of England in a reserve account, which earns them interest at whatever the base rate is.

These reserve accounts, together with government debt instruments like bonds and gilts, are what Nick Lee, head of regulatory affairs at the SoftBank Vision Fund-backed neobank OakNorth, describes as “high quality liquid products”. Banks also park the regulatory capital they are required to hold in these kinds of instruments.

If the base rate turns negative, both neobanks and incumbents will suddenly have to start paying interest to hold money with the central bank. This is a much more worrying scenario for neobanks, because they have not yet built loan books large enough to offset the costs of what they’ll have to pay in negative rates.

The rate they will have to pay may only be small, but it could prove significant for loss-making startups which have not yet worked out other ways to generate revenue. Declan Ferguson, Starling Bank’s chief strategy officer, says that negative interest rates’ “biggest impact will be on neobanks that don’t have an asset strategy, that are relying on central bank rates”.

According to its latest annual results, Monzo’s deposits grew £930.7m to nearly £1.4 billion in the 12 months to February 2020. In the same period, however, its gross lending grew from just £19.2m to £143.9m – volumes that were nowhere near sufficient to cover the company’s costs. Losses in 2020 doubled to £113.8m and the bank has since scrambled to set up new ways of making money. Without business banking to pivot towards, in the past four months alone, Monzo has produced two new paid-for retail accounts. Monzo Premium, unveiled this week, costs £180 a year and comes with travel and phone insurance, £600 of fee-free withdrawals abroad each month and a steel card. Whether Monzo’s customers take the bait remains to be seen. Monzo did not respond to a request for comment.

Unfortunately for those in the foothills of trying to make money, negative interest rates may present a much more slippery slope to profitability.

“When it comes to lending, whilst [neobanks’] lending book is relatively small, we would expect the price of credit to fall, and with it, reduced ability to earn a profitable margin,” says Tom Graham, a managing director in Accenture’s UK banking practice.

Other so-called neobanks in the UK are not yet able to lend because of their regulatory status. Revolut, which is the largest of the lot by user numbers, does not have a banking licence in the UK, which limits its ability to lend money. The startup is currently only offering loan products in Lithuania, where it launched a fully licensed banking product in May.

Ashutosh Bhatt, head of credit for Revolut in the UK, thinks negative rates will in fact improve the startup’s ability to compete with its rivals. “How it helps Revolut as of now is we are not a bank,” says Bhatt. If Revolut began lending today, he says, it would likely have to use its own money or the capital of a hedge fund, or another financial institution. Bhatt argues that the cost of that type of non-bank lending will fall in a negative interest rate environment.

For now, Revolut is regulated as an e-money institution, which means that customers’ funds are held in ring-fenced accounts by partner banks – Barclays and Lloyds, in Revolut’s case. This could shelter the company from negative interest rates, but that will depend on whether those partner banks are forced to pass on costs of their own.

It is not exactly plain sailing, either, for the neobanks that are already lending at scale. Edward Twiddy, chief customer officer at Atom Bank, a neobank backed by American rapper Will.i.am, says the startup is reviewing its business lending products, which are linked to a base rate tracker. The company is also looking at its accounting and regulatory reporting systems to try to ensure they are up to the task of charging negative rates, should it come to that.

“You’d be fools not to contemplate it,” says Twiddy.

But for neobanks that rely heavily on business lending, the threat of negative interest rates does not loom quite so large.

Starling Bank has been lending out cash at breakneck speed over the past 12 months, and has become a prolific distributor of the government’s 100 per cent taxpayer-guaranteed Bounce Back Loans, which are designed to shield micro-businesses from the impact of the pandemic.

Starling had a loanbook of roughly £1.3 billion as of 30 September, which compares to total deposits of £3.7bn and 1.7m customers, according to Ferguson.

OakNorth, which has built a profitable business doling out secured loans to mid-sized companies, says it has amassed a £3.5bn loanbook since 2015 according to a company spokesperson.

“That really protects our margins, if you like, where the Bank of England interest rate goes negative,” says OakNorth’s Lee, who prior to working for the startup spent five years as head of new banks at the Bank of England.

OakNorth has its loans linked to the Libor rate – a key benchmark for bank borrowing costs – but the bank’s loans have a “floor” to prevent them dipping below a certain rate “when unprecedented things happen”, according to Lee.

The fact remains, though, that neobanks would much rather be sitting on a lucrative loanbook right now than not.

“If you were relying on revenue from interchange, that’s come back, but it hasn’t come back in quite the scale that we were seeing 12 months ago. If you were relying on revenue from holding cash reserves with the bank, that’s just about disappeared. Lending looked quite staid and boring twelve months ago, but it’s kind of something every bank should have,” said Twiddy.

There is one clear silver lining for neobanks. On 12 October, the Bank of England and the Prudential Regulation Authority wrote to British banks requesting information on their “operational readiness” for negative interest rates – and were particularly keen to get a sense of the technological problems negative rates would pose.

With their more modern systems, and indeed without vast and tangled historic loanbooks, being able to process negative interest rates from a technological standpoint should be straightforward for neobanks. For their old school rivals, on the other hand, commentators have gone so far as to liken the advent of negative interest rates to the Y2K bug.

“At least with the year 2000 there were parties, there were fireworks, there was champagne,” says Atom’s Twiddy. “We won’t get the champagne, we won’t get the fireworks, but banks and a whole load of other financial institutions are going away and finding out how their systems would respond.”

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