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BLOG

Can neobanks survive the COVID-19 crisis?

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Neobanks, which revolutionised and posed a threat to the traditional banking systems, are facing unprecedented challenges due to the COVID-19 pandemic. Neobanks are digital fintechs that offer banking services only through mobile and web platforms, without brick-and-mortar branches. Their systems and processes are more flexible and faster than the rigid, legacy systems of the traditional banks. They operate on low overhead costs, as they are able to avoid the expenses traditional banks have to incur. They are mostly funded by venture capital and private equity firms, and had very high valuations prior to the pandemic due to their growth potential in the financial services industry.

However, as the economic crisis unfolded, global funding for fintechs dropped to USD5.78bn in the first quarter of 2020 from USD7.77bn in the last quarter of 2019. Funding will likely decrease further as investors avoid riskier assets. Investors who have backed digital banks so far are moving towards safer assets, taking a risk-averse approach. Most banks are operating with losses, needing constant financial support from investors, and far from breaking even. Deprived of funding, financially weaker banks are likely to face serious challenges to their liquidity and solvency.

Most neobanks follow a strategy of offering services at low cost to attract customers. Their pricing mechanisms rely on “freemium” models, where the basic products are free, but additional features come with a price tag or follow a tiered pricing model. They attract deposits with higher returns and lower charges, compared to traditional banks. However, depositors have started to move funds out of small banks to larger, more traditional banks due to the likely risks in this uncertain environment. The traditional banks are seen as comparatively low in risk, as they are financially stronger, and government support could be expected in adverse situations. Acquiring deposits has always been a significant challenge, and current conditions are likely to make it harder.

Neobanks operate with smaller interest margins than traditional banks, due to their higher cost on deposits. As further fall in interest rates is expected globally, and providing high interest on deposits would become financially unviable. As a result, margins could be further threatened, subsequently affecting these banks’ profitability. They are also likely to face problems in the lending aspect of their business. Demand for credit is expected to decrease, making it harder for the banks to grow their balance sheets. Bad debts, which have not been a major problem for digital banks so far, are expected to increase, with the repayment ability of borrowers projected to deteriorate.

Prior to this crisis, competition within the fintech industry was high, as many startups had entered the market offering similar services. Competition forced a number of neobanks to wind up operations and a few to be acquired by larger banks. We expect this trend to accelerate given the nature of the crisis, as financially weaker banks do not believe it is viable to continue operations. However, the situation will likely provide opportunities for larger and stronger banks to consolidate their shares in the market.

Despite the uphill battle neobanks face due to the crisis, we believe they are far from being removed from the financial industry. The revolution initiated by fintechs has made even the large traditional banks follow them towards digitalisation. Furthermore, the COVID-19 pandemic has reiterated the necessity for digital banking, without physical presence. We believe the ongoing crisis will force the financially weaker neobanks towards merger or exit, providing the opportunity for stronger banks with adequate capital to consolidate their positions in the market.

We at Acuity Knowledge Partners have the expertise to assist investors and banks with support on research and analysis, financial modelling and valuations, M&A solutions, lending research, predictive analysis and other services for effective decision making.

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