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Digital-Only Banking at a Crossroads: Challenges and Future Directions of Neo-Banks

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Abstract
Neo-banks, digital only banking institutions operating without physical branches, have gained traction in recent years as part of the broader fintech revolution. They offer convenience, speed, and often lower costs compared to traditional banks. However, they also face significant challenges including regulatory uncertainty, cybersecurity risks, profitability concerns, and customer trust issues. This paper presents a comprehensive review of existing literature on neo-banks, analyses their key challenges, and explores future prospects. Drawing on empirical and theoretical work, this study situates neo-banks within the evolving landscape of digital finance and outlines research gaps and future directions.

Keywords: Neo-banks, digital finance, fintech, regulatory compliance, cybersecurity, financial inclusion.

1. Introduction

The global financial landscape is undergoing rapid transformation as digital technologies disrupt traditional banking models. Neo-banks have emerged as a distinctive category within this transformation. Unlike traditional banks, neo-banks operate exclusively through digital platforms such as mobile apps and web interfaces, eliminating the need for physical branches. This allows them to deliver services with greater speed, personalized features, and often at lower costs (Gomber, Koch & Siering, 2017).

The increasing penetration of smartphones, widespread internet access, and growing customer preference for digital-first services have contributed to the rapid adoption of neo-banking globally. Neo-banks appeal especially to millennials and digitally savvy consumers who value convenience and ease of use. However, the transition from traditional banking to fully digital models presents a host of challenges that could affect the long-term sustainability of neo-banks.

2. Objectives of the Study

This paper aims to:

1. Examine the concept and evolution of neo-banks.
2. Provide an in-depth review of literature relevant to neo-banking.
3. Identify and analyze the major challenges faced by neo-banks.
4. Explore future prospects and strategic directions for neo-banks.

3. Research Methodology

This research is descriptive and analytical, relying on secondary data. Academic journals, books, industry reports, and credible web resources were consulted. A systematic literature review methodology was used

to synthesize findings across studies from multiple disciplines including finance, information systems, and business management.

4. Literature Review

The literature on neo-banks spans multiple strands, including fintech innovation, banking transformation, customer behavior, regulation, and technology risk. This section synthesizes the major findings and trends from peer-reviewed articles, industry reports, and empirical research.

4.1 Evolution of Fintech and Neo-Banks

The rise of neo-banks is rooted in broader developments in digital finance. Arner, Barberis, and Buckley (2016) argued that fintech innovations gained momentum after the 2008 financial crisis as regulators and markets sought alternatives to traditional banking systems. Neo-banks leverage cloud computing, open-banking APIs, and mobile technology to deliver services that were once the exclusive domain of legacy institutions.

Gomber et al. (2017) emphasize that neo-banks represent a new paradigm in financial services, often characterized by agile development cycles and customer-centric offerings. Their research outlines how digital finance and banking platforms are reshaping customer expectations and competitive dynamics.

4.2 Regulatory Frameworks and Compliance Issues

Regulation is a central theme in neo-banking literature. Traditional banks are subject to extensive regulatory oversight designed to protect depositors and ensure financial stability. Neo-banks, in many jurisdictions, operate on the periphery of these regulations. In countries like India, neo-banks often partner with licensed banks to provide deposit accounts because the central bank has not yet issued standalone digital banking licenses (Reserve Bank of India, 2023).

Scholars such as Sohal and Singh (2024) highlight that regulatory uncertainty can deter investment and slow expansion. The absence of clear guidelines around digital banking licenses, capital requirements, and consumer protection mechanisms makes it difficult for neo-banks to scale confidently.

4.3 Customer Adoption and Behavioral Factors

Understanding customer attitudes toward neo-banks is critical. Studies by Modi, Sharma, and More (2025) found that customers appreciate the convenience and intuitive interfaces offered by neo-banks. However, trust remains a significant barrier. Many users are hesitant to shift fully from traditional banks due to concerns about security and perceived instability of digital startups.

Research also indicates demographic variations in adoption. Younger consumers show higher willingness to embrace neo-banks, while older customers often remain loyal to traditional institutions due to familiarity and perceived security.

4.4 Competitive Dynamics with Traditional Banks

The relationship between neo-banks and traditional banks is complex. Neo-banks initially positioned themselves as disruptors, but now traditional banks are rapidly improving their digital offerings. This blurs the competitive line and forces neo-banks to innovate continuously.

Traditional banks benefit from established customer bases, robust regulatory frameworks, and deeper financial resources. In response, some have partnered with or acquired fintech firms to enhance their digital capabilities.

4.5 Technological and Security Risks

Cybersecurity is one of the most critical concerns in neo-banking literature. Waliullah et al. (2025) argue that as digital banking usage grows, so does exposure to cyber threats including identity theft, phishing,

and malware attacks. The digital-only nature of neo-banks means that any breach can have immediate and extensive consequences on trust.

Emerging technologies such as artificial intelligence and blockchain are proposed as solutions to improve security and fraud detection. However, integrating these technologies also poses operational challenges.

4.6 Profitability and Business Sustainability

While neo-banks excel in user experience, many struggle with profitability. A study by PwC (2022) emphasizes that low fees and free services, while effective for customer acquisition, limit revenue generation. Neo-banks often rely on external funding rounds, making them vulnerable to market fluctuations.

Diversification of revenue streams, such as premium services and lending products, is considered a potential path to profitability. However, this requires robust risk management systems.

4.7 Financial Inclusion and Economic Impact

A key positive in the literature is the potential of neo-banks to enhance financial inclusion. By reducing barriers to entry such as minimum balance requirements and complex account opening procedures, neo-banks can attract underserved populations (Raut, 2025). This is particularly relevant in emerging economies where large segments of the population remain unbanked or underbanked.

Neo-banks' digital platforms can also facilitate micro-finance services, savings products, and budget tools that empower users to better manage their finances.

4.8 Gaps in the Literature

Despite extensive research, gaps remain. There is limited longitudinal data on neo-bank performance over time, especially in developing markets. Furthermore, comparative studies between different regulatory environments are scarce. More research is needed on the long-term financial sustainability of neo-banks and their systemic risk implications.

5. Challenges Faced by Neo-Banks

Based on the literature review, the primary challenges include:

5.1 Regulatory Compliance

Neo-banks often operate without full banking licenses. Regulatory ambiguity requires them to maintain partnerships with traditional banks, which can constrain innovation and autonomy.

5.2 Cybersecurity and Data Privacy

Digital-only operations expose neo-banks to significant cyber-risks. Customers' personal and financial data must be protected through advanced security protocols.

5.3 Profitability Pressures

Low or no fees attract customers but limit revenue. Neo-banks must diversify into services like lending and insurance to build sustainable revenue models.

5.4 Competitive Intensity

As traditional banks improve their digital services, neo-banks face heightened competition. They must continuously innovate to retain market share.

6. Future Prospects

Despite challenges, neo-banks have strong growth potential:

- **Technological Innovation:** AI, data analytics, and machine learning can help in personalization and fraud prevention.

- **Financial Inclusion:** Digital platforms can reach populations underserved by legacy banks.
- **Strategic Partnerships:** Collaboration with fintech firms and traditional banks can enhance capabilities and compliance.
- **Customized Products:** Personalized financial solutions tailored to customer behavior will drive adoption.

7. Conclusion

Neo-banks are reshaping the banking industry by leveraging digital technology to provide customer-centric services. While they face regulatory challenges, cybersecurity risks, and profitability pressures, their potential to innovate and include underserved populations remains significant. To ensure long-term sustainability, neo-banks must address risk management, regulatory compliance, and diversified revenue generation.

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