THE IMPACT OF NEOBANKS ON THE BANKING SECTOR By:

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Abstract:

Neobanks represent a new wave of digital-first, branchless financial service providers that are gradually reshaping the financial landscape both globally and in India. Their emergence reflects a significant transformation in banking, as they integrate innovative technology, cost efficiency, and a customer-oriented approach into sectors that have traditionally been conservative and resistant to rapid change. In India, the growth of neobanks can largely be attributed to strategic partnerships with licensed banks and non-bank financial companies (NBFCs), which have not only facilitated product innovation but also spurred digital inclusion. Operating entirely online, these institutions aim to bridge the existing gap between traditional banking services and the evolving preferences of a tech-savvy clientele. However, despite their groundbreaking advancements, neobanks often find themselves navigating a regulatory grey area, as there is no specific licensing framework guiding their operations. This ambiguity not only impacts market dynamics but also influences how risks are allocated and affects public trust in digital finance. This research delves into the evolution, adoption, and regulation of neobanks in India, drawing insights from various studies focused on regulatory frameworks, financial inclusion, cybersecurity, and operational challenges. It emphasizes the vital role of government institutions, particularly the Reserve Bank of India(RBI), in shaping the neobank ecosystem while highlighting ongoing issues related to service autonomy, user trust, and regulatory oversight. The findings suggest that while advancements in technology have fueled rapid growth and inclusion, the long-term sustainability of this ecosystem necessitates a careful balancing act between innovation and stability, achieved through enhanced governance and risk management practices. The paper argues that the future success of neobanks in India will hinge on the establishment of a clear licensing framework, bolstered digital safety, increased financial literacy, and improved public confidence through well-structured supervision and accountability mechanisms.

Introduction:

Since 2017, the term “neobank” has gained substantial traction within global financial conversations. Often synonymous with virtual or internet banking, neobanks are digital-first financial institutions that operate without physical branches. By leveraging technology, they provide seamless, efficient, and highly personalized banking experiences to a primarily tech-savvy customer base. The role of neobanks in reshaping consumer engagement with financial services has expanded quickly. Their early iterations, like Simple and Moven, which launched in the United States back in 2009 and 2011, respectively, set the stage for what was to come. As of 2025, there are roughly 400 active neobanks worldwide, catering to close to one billion clients, a testament to the global surge in preference for accessible, technology-driven financial solutions The landscape of India’s financial ecosystem creates a fertile breeding ground for neobanks due to its robust digital infrastructure, widespread smartphone usage, and a national focus on enhancing digital payments. Initiatives such as the Unified Payments Interface (UPI) and Aadhaar-enabled Know Your Customer (KYC) systems, along with policy-driven measures aimed at promoting financial inclusion, have all collectively fostered an environment ripe for digital banking innovation. However, the unique challenges present in India’s context cannot be overlooked. Unlike certain international jurisdictions, Indian neobanks do not carry autonomous banking licenses. Instead, they typically operate in collaboration with existing banks or NBFCs, which hold the regulatory power to accept deposits and manage essential banking functions. This partnership model allows neobanks to position themselves as front-end innovators while relying on licensed financial institutions for compliance, liquidity, and risk management.

Despite their operational success and a growing customer base, several regulatory and structural issues linger. The cautious approach taken by the RBI, evident in actions such as a 2018 ban on cryptocurrency trading and the absence of a distinct neobanking license, highlights a policy dilemma. Regulators aim to encourage innovation while simultaneously mitigating systemic risk. The current environment has inadvertently concentrated operational risk within the licensed partner banks, as they are responsible for the prudential and compliance obligations. Meanwhile, neobanks continue to benefit from strong customer engagement and innovative, data-driven solutions. The objective of this research is to provide a thorough examination of the evolving neobank landscape in India, with special attention given to regulatory, operational, and security perspectives. The study aims to map out the regulatory architecture governing neobanks, which encompasses authorities such as the RBI, Securities and Exchange Board of India (SEBI), Insurance Regulatory and Development Authority of India (IRDAI), and emerging data protection initiatives. It will also assess how the absence of a dedicated regulatory framework impacts financial stability, competition, and consumer protection. One central hypothesis of the research is that banks partnered with neobanks will likely see increased retail deposit growth due to enhanced user engagement, yet they may also face margin pressures reflected in lower net interest margins (NIM). Additionally, it posits that the reliance on partnership-based models amplifies systemic risk by concentrating operational exposure within regulated banks and creates potential blind spots for regulators. Another significant question this research seeks to explore is the extent to which neobanks contribute to financial inclusion and whether their growth is equitably distributed across both digital and non digital demographics. While neobanks have successfully broadened access for urban and digitally literate users, unintentional exclusion may persist for rural populations. By synthesizing existing literature and empirical observations, this study intends to tackle these complex challenges while identifying actionable policy measures aimed at establishing a sustainable, inclusive, and secure neobanking framework in India.

Literature Review:

1) The Evolution of Neobanks and Their Role in Financial Inclusion:

Neobanks have become substantial disruptors in both developed and emerging markets, fundamentally changing how consumers interact with financial service providers. Their mobile-first, branchless operational model has been particularly effective in reducing service delivery costs and expanding access to underserved market segments. In India, where achieving financial inclusion has been a long-standing policy goal, neobanks play a crucial role by simplifying the digital onboarding process, enabling microtransactions, and offering user-friendly interfaces that cater to a wide array of demographics. Utilizing data analytics, automation, and artificial intelligence, these digital banks have managed to scale personalized banking experiences, delivering quicker transactions and improved transparency in digital interactions.

However, existing academic literature and industry analyses highlight that neobanks still encounter significant challenges regarding their ability to reach unbanked and rural populations comprehensively. They may excel in engaging digitally literate urban customers, yet barriers such as limited access to smartphones, language diversity, and low levels of digital literacy remain prominent issues, further solidifying socio-economic divides. This situation emphasizes the need for suitable regulatory and infrastructural frameworks that genuinely foster financial inclusion rather than merely providing superficial access.

The operational model based on partnerships also subjects neobanks to unique constraints. Being heavily reliant on traditional banks for essential functions, such as deposit-taking, credit issuance, and regulatory compliance, imposes limitations on their autonomy. Various studies indicate that while this operational arrangement reduces entry barriers into the market, it also shifts prudential risks onto partner banks, who manage capital adequacy, anti-money laundering (AML) and know your customer (KYC) requirements, and data protection obligations. The resulting structure is a hybrid setup that blends the agility of fintech with the oversight of traditional banking, creating a dual phenomenon of synergy and complexity.

2) Regulatory and Policy Developments in India:

The role of policy and regulation has been pivotal in shaping the contours of India's neobank sector. Institutions such as the RBI, along with allied regulatory bodies including SEBI and IRDAI, have been instrumental in constructing the broader framework of India's digital financial ecosystem. However, the absence of a dedicated licensing framework for neobanks creates significant ambiguity regarding operational boundaries, governance roles, and risk-sharing responsibilities. Recent moves by the RBI, aimed at supervisory consolidation and reforming payment systems, such as its 2025 overhaul of payment regulations, signal a cautious yet progressive shift toward facilitating fintech-driven innovation within a structured regulatory landscape.

Regulatory instruments, such as regulatory sandboxes, have served as controlled environments for testing innovative banking models. Concurrently, initiatives aimed at establishing Self-Regulatory Organizations (SROs) for fintech firms seek to bolster compliance monitoring and enhance consumer protection frameworks. Moreover, newly proposed policies focusing on data security, transparency in outsourcing arrangements, and compliance with AML/CFT regulations underscore the intent of regulators to encourage innovation while ensuring prudential stability.

Notably, India's digital public infrastructure, particularly the UPI and Aadhaar-enabled services, has significantly reduced entry barriers for neobanks. These platforms not only promote interoperability but also enhance competition, allowing smaller digital entities to cater to larger user bases without the heavy financial burden of physical capital. However, the literature indicates a persistent trade-off: without clear licensing norms, the rapid growth spurred by innovation may lead to regulatory fragmentation. Establishing a well-defined supervisory framework is essential to ensuring resilience, clarity in risk-sharing, and systematic integrity.

3) Security, Trust, and Consumer Protection:

As the neobanking sector increasingly relies on digital channels, concerns surrounding cybersecurity, customer privacy, and data protection have taken center stage. The acceleration of digitalization has broadened the attack surface for cybercriminals. Incidents involving phishing, malware, identity theft, and large-scale data breaches have been reported across various global digital banking systems, including those of neobanks. In response, many institutions are incorporating advanced preventive measures such as multi-factor authentication (MFA), biometric verification, and AI-driven fraud detection mechanisms.

Despite the implementation of these technological safeguards, consumer trust in neobanks remains delicate and precarious. Research shows that perceived security, the confidence customers have in the safety of their personal information, plays a more significant role in influencing user adoption than the actual technical strength of security measures. Limited transparency surrounding data handling practices and inadequate communication during security incidents diminishes user confidence, which in turn can hinder adoption figures among risk-sensitive demographics.

Regulatory oversight pertaining to cybersecurity is gradually improving, but it remains inconsistent across the board. The RBI's guidelines surrounding digital security, in conjunction with existing data protection regulations, form a foundational basis for secure banking operations. However, enforcement challenges and varying levels of compliance across different platforms reveal notable gaps. Comparative regulatory frameworks, exemplified by the EU's Second Payment Services Directive (PSD2), showcase the importance of establishing standardized protocols for data access, user consent, and liability distribution areas wherein India continues to evolve. The existing shortcomings in regulatory oversight, compounded by an increasing reliance on third-party digital infrastructures, necessitate immediate attention to create cohesive consumer protection and data governance protocols.

The interrelationships between trust, transparency, and regulatory assurance thus serve as critical elements influencing both user adoption rates and systemic stability within the neobank ecosystem.

4) Operational and Service Limitations:

Despite rapid expansion from 2022 through 2025, neobanks still operate within constraints regarding core banking functions. Essential services such as large-scale lending, deposit-taking, wealth management, and insurance underwriting are still primarily confined to regulated banks or NBFCs. While neobanks can secure specific licenses, such as those for Prepaid Payment Instruments (PPI) or wallet authorizations, they still lack the full authority to perform critical banking functions independently.

Industry analyses have estimated that the Indian neobanking market boasted a compound annual growth rate (CAGR) of 50.5% from 2022 to 2025, driven primarily by technological innovations and customer-centric designs. However, persistent barriers relating to trust, compliance, and capital adequacy continue to hinder their scalability. The operational dependence on partner banks not only imposes limits on autonomy but also generates layered trust issues, as consumers are confronted with front-end entities backed by traditional financial institutions.

Several hypotheses emerge from the literature relevant to this topic: firstly, that neobanks which obtained PPI and wallet licenses during 2022-2025 will continue to face limitations regarding large-scale lending and deposit activities; secondly, that increasingly stringent regulations surrounding data protection and payment aggregation correlate with a restricted service environment; and lastly, that user adoption of more advanced services is significantly influenced by perceived safety and institutional trustworthiness. Addressing these challenges will require cohesive policy intervention that fuses regulatory reforms with improved transparency and consumer education initiatives.

Collectively, the reviewed studies posit that neobanks encapsulate both the immense potential and inherent dilemmas of financial innovation: they democratize access while concurrently intensifying regulatory and operational complexities. The future trajectory of neobanking in India hinges on finding an equilibrium between expansion and oversight to ensure that innovation does not eclipse stability.

Research Question:

This study seeks to examine how partnership-based neobank models influence traditional banks' operational risk exposure, financial performance, and consumer trust within India's existing regulatory framework.

Research Objectives:

The primary objectives of this study are to:

1) Examine the regulatory structure governing neobanks in India and assess its implications for risk allocation and accountability.

2) Analyze how neobank–bank partnerships affect retail deposit mobilization and net interest margins at partner banks.

3) Evaluate the extent to which partnership-based models concentrate operational and cybersecurity risks within licensed banks.

4) Assess whether perceived security, transparency, and institutional trust influence user adoption of neobanking services beyond basic payment functionalities.

5) Explore the limitations faced by neobanks in delivering core banking services under current licensing constraints.

Hypotheses:

H1: Partner banks associated with neobanks exhibit higher retail deposit growth, alongside observable pressures on net interest margins.

H2: The partnership-based operating model leads to a concentration of operational and compliance-related risks within licensed partner banks.

H3: Despite obtaining PPI or wallet authorizations, neobanks remain structurally dependent on licensed institutions for core banking functions.

H4: User adoption of advanced neobanking services is positively associated with perceived security, transparency, and institutional trust.

Methodology:

This study adopts a qualitative, interpretive research design based on structured secondary data analysis and thematic synthesis. The approach is exploratory and policy-oriented, appropriate for examining emerging financial models where primary data access is limited.

Data Selection Criteria:

Secondary sources were selected based on (i) institutional credibility, (ii) relevance to India's neobanking ecosystem, and (iii) publication between 2022–2025 to ensure contemporaneity. Sources include RBI circulars, government working papers, peer-reviewed academic journals, and industry reports published by established institutions such as PwC, KPMG, Grant Thornton, and Ken Research.

Analytical Framework:

The selected literature and reports were coded using thematic analysis across four predefined dimensions:

1) Regulatory architecture and supervisory responsibility
2) Operational dependency and service limitations
3) Cybersecurity, trust, and consumer protection
4) Financial inclusion and innovation outcomes

Evidence relevant to each hypothesis was mapped to these themes. Rather than causal inference, the study relies on pattern identification and cross-source triangulation to evaluate consistency across regulatory records, market disclosures, and empirical surveys.

Scope and Limitations:

The study does not attempt causal identification or counterfactual analysis. All empirical observations are interpreted as associative rather than causal, reflecting the constraints of secondary qualitative data.

Results and Discussion:

(A) Retail Deposit Growth and Net Interest Margins.

Partner banks show noticeable retail deposit growth (YoY) in Q2 FY26, such as Federal Bank (partner to Jupiter and Fi) at +7.4% YoY, IDFC FIRST Bank (partner to Fampay and Freo) at +21.4% YoY (customer deposits), and YES Bank (partner to ANQ, InstantPay, among others) at +6.9% YoY. Rating agencies and market reports indicate that Indian bank net interest margins (NIMs) have been under pressure. Fitch projected an average margin impact of approximately 10 basis points for Indian banks in FY26 following policy rate cuts, although this impact is expected to be partly cushioned by improved liquidity conditions. In Q2 FY26, Federal Bank recorded a 12 basis point quarter-on-quarter improvement to 3.06%, while YES Bank and IDFC FIRST Bank experienced relatively flat to negative movements in their NIMs.

Partner banks engaged in neobank and fintech partnerships have experienced contemporaneous retail deposit inflows, as licensed banks provide regulatory and balance-sheet infrastructure while neobanks contribute user experience, digital onboarding, marketing, and promotional pricing. Slightly higher savings rates and digital incentives have further supported customer acquisition. During the same period, NIM compression has been observed at the sector level alongside intensified competition in digital banking.

Neobanks attract digital customers through streamlined onboarding processes, superior user interfaces, referral-driven growth, and value-added tools such as cashback features and expense management. Since customer accounts are hosted on partner bank balance sheets, deposit growth is reflected at the bank level. Partner banks have acknowledged the contribution of digital partnerships in their disclosures and have reported deposit growth exceeding system averages.

While increased deposits and margin pressures are observed concurrently, the available evidence does not permit causal attribution of deposit growth or NIM compression solely to neobank partnerships. Margin trends also reflect broader macroeconomic conditions, including monetary easing and competitive pricing dynamics across the banking sector. The impact is heterogeneous across institutions: larger banks with diversified asset bases may absorb promotional costs more effectively, while retail-focused or smaller banks may experience higher deposit growth accompanied by more volatile margins. These findings therefore indicate associative rather than deterministic outcomes.

(B) Operational Risk Concentration of Partnership Models

Multiple nationwide and intermittent disruptions of the Unified Payments Interface (UPI) were recorded in 2025, arising primarily from technical issues at partner banks, such as API or host-side failures, rather than from outages at the National Payments Corporation of India (NPCI). These disruptions affected major payment platforms and impacted millions of transactions, with daily transaction volumes exceeding 600 million during peak periods.

A ransomware attack in 2024 on a banking technology provider forced nearly 300 small Indian banks to temporarily suspend payment services, illustrating systemic vulnerability created by shared technology dependencies. Rapid digital expansion has outpaced cybersecurity preparedness in certain areas, resulting in gaps linked to outdated practices and insufficient resilience planning.

Several large-scale data exposure incidents in India have been associated with cloud misconfigurations and third-party vendor breaches, highlighting how outsourced services and integrations can serve as points of operational vulnerability. These incidents underscore the risks arising from concentrated infrastructure and vendor reliance.

Regulatory guidance issued by the Reserve Bank of India emphasizes that licensed banks retain ultimate responsibility for operational risk management, even when services are delivered through fintech partnerships. Operational resilience frameworks introduced during 2023–2024 stress the importance of governance controls, vendor oversight, and continuity planning. The incident record indicates a concentration of operational risk within licensed partner banks and shared service providers; however, the evidence reflects correlation rather than causal certainty. These risks remain mitigable through diversified infrastructure arrangements, strengthened third-party risk management, and enhanced incident-reporting mechanisms.

(C) PPI and Wallet Authorizations in Relation to Core Banking Functions:

The Reserve Bank of India has granted certain neobanks in-principle approvals for prepaid payment instrument (PPI) or wallet licenses, such as Revolut India and Jupiter. These authorizations expand payment and remittance capabilities but do not alter the legal authority required to conduct core banking activities.

There is no publicly available evidence that any Indian neobank has obtained a full banking license during the period under review. Partner banks and non-banking financial companies continue to handle large-scale lending, deposit-taking, and other balance-sheet-intensive activities.

PPIs and non-bank wallets remain subject to balance caps, tiered KYC requirements, and limited consumer protection mechanisms, including restricted access to deposit insurance. As a result, neobanks remain dependent on licensed institutions for regulatory compliance and prudential oversight. Observed product structures, combining wallet-led services with sponsored bank accounts or NBFC-originated loans, support the conclusion that PPI authorization does not confer autonomy in core banking functions.

(D) Perceived Security, Transparency, and Institutional Trust

Secondary survey evidence indicates that institutional trust and perceived security are critical determinants of neobank adoption in India. Survey findings report relatively high trust in banks compared to other digital service providers, alongside increasing adoption of digital authentication mechanisms. At the same time, behavioral vulnerabilities such as password reuse and rising cyber fraud incidents continue to affect user confidence.

Empirical findings from secondary surveys suggest that while convenience and cost efficiency drive initial engagement with neobanks, security and trust concerns remain the primary barriers preventing users from adopting them as full-service financial platforms. These findings represent associative patterns rather than causal behavioral outcomes.

As neobanks lack the long-standing reputational capital of traditional banks, sustained user trust depends on demonstrable cybersecurity safeguards, transparency in data practices, and regulatory assurance. Without addressing these factors, neobanks are likely to remain complementary rather than substitutive financial service providers within the Indian banking ecosystem.

Conclusion:

The evolution of neobanks in India highlights the transformative potential of technology-driven financial services to enhance accessibility, efficiency, and user experience, particularly for urban and digitally literate populations. Partnership-based operating models have enabled innovation within existing regulatory constraints, but they have also introduced ambiguity in accountability, operational control, and risk ownership.

From a regulatory perspective, the absence of a dedicated licensing framework continues to pose governance and supervisory challenges. While the Reserve Bank of India has introduced important guidelines, sandbox initiatives, and operational resilience frameworks, a more harmonized regulatory approach remains necessary to strengthen consumer protection and systemic stability. The future of neobanks in India will depend on achieving a balance between innovation, institutional trust, and regulatory discipline. Establishing clearer licensing norms, strengthening cybersecurity standards, and improving transparency in outsourcing arrangements will be critical for sustainable growth.

This study is subject to limitations arising from its qualitative, secondary-data-based design. The absence of primary data and causal identification restricts the ability to draw definitive conclusions regarding behavioral or financial impacts. The findings should therefore be interpreted as exploratory and associative. Future research incorporating primary surveys, transaction-level data, or comparative international analysis could provide deeper empirical validation. Despite these constraints, the study offers policy-relevant insights suitable for conference-level academic and regulatory discussions.

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