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NEOBANKS ROLE IN SUPPORTING FINANCIAL INCLUSION

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ABSTRACT

Financial inclusion has a significant impact on economic growth and development and improves the living standards of individuals in emerging economies. However, today, there are still individuals and businesses in developing and low-income economies that are unbanked or underserved with limited access to basic banking services. It must be noted that during the last two decades, many instruments, tools, and programs have been developed to support financial inclusion, which yielded positive results. However, the challenges and barriers remain to be further addressed and resolved to increase financial inclusion. The challenges originate on the supply side as well as the demand for financial services.

Neobanks, as technologically advanced financial institutions, are valuable instruments in overcoming key barriers to financial inclusion. The manner in which neobanks' operations are structured enables them to easily adapt their products and serve even the smallest groups or segments with similar needs. Affordable financial services are also provided by neobanks as a result of their higher operational efficiency compared to traditional banks.

Keywords: Neobank, financial inclusion, traditional banks, financial services, financial literacy.

JEL Classification: G21; G23

1. INTRODUCTION

Financial inclusion is recognized as one of the key factors for promoting economic growth and development, decreasing poverty, improving living standards for individuals in low-income regions, and supporting business activities. Accordingly, many actions have been implemented to address different barriers to financial inclusion. Policymakers, organizations, and financial institutions developed programs, established funds, and created microfinancing institutions to provide access to unbanked and underserved individuals and businesses. While the results from past actions are significant, the problem with low levels of financial inclusion still exists today in emerging and low-income economies.

Developing an inclusive financial system imposes the need for overcoming challenges and barriers like low financial literacy, inadequate infrastructure, costly financial services, low profitability of serving small segments and groups, and irregular income.

Neobanks, as a new form of financial institution with in-depth utilization of technological advances, are recognized as a crucial instrument for improving financial inclusion. Neobanks' features and characteristics offer a plethora of opportunities to decrease or even eliminate certain barriers while effectively managing some of the key challenges. Using innovative technology, neobanks are able to swiftly adapt their financial services and cover the needs even of the smallest segments and groups of users while making reasonable revenue. Moreover, the business model which eliminates the need for brick-and-mortar locations has higher efficiency and lower operating costs. Accordingly, neobanks offer cheaper financial services compared to the services offered by traditional banks. In addition, neobanking apps take the role of an educational platform offering resources to users to expand their personal finance knowledge.

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2. THE PHENOMENON OF FINANCIAL INCLUSION

Financial inclusion gained popularity in the last couple of decades after it was initially considered in 1997 (Sarigul, 2020).). The phenomenon of financial inclusion has been discussed in terms of its importance for the overall economy and its impact on development. Accordingly, it is argued that a high level of financial inclusion supports economic development and alleviates poverty issues (Sarigul, 2020; Kaligis et al., 2018; Cámara & Tuesta, 2015). Moreover, it is anticipated that financial inclusion will not only decrease the wealth gap but also contribute toward the growth of financial institutions in specific areas (Kaligis et al., 2018).

The importance of financial inclusion has made it one of the key challenges that need to be addressed by policymakers, international institutions, government, financial institutions, and central banks (Cámara & Tuesta, 2015). It is emphasized that this importance is particularly evident in less developed countries and regions and individuals with irregular income who are usually underserved by banks and other traditional institutions (Cámara & Tuesta, 2015).

Economies facing high levels of financial exclusion of individuals and businesses experience higher degrees of income inequality and increased social instability (Bekele, 2023). Consequently, Bekele (2023) argues that financial inclusion can be utilized as a policy tool to promote economic growth while simultaneously decreasing poverty. Furthermore, Kabakova and Plaksenkov (2018) state that benefits from an inclusive financial system can be noticed on micro and macroeconomic levels, making it a crucial element of economic development.

The importance of financial inclusion can be discussed in terms of its impact on the savings levels in the national economy and individual savings habits. The limited availability of affordable savings accounts and opportunities for individuals to save money in the formal financial system may impede the motivation to save (Shankar, 2013). The inability to maintain adequate saving levels could indicate that individuals and households might depend on alternative sources from the informal system to cover unexpected expenses (Shankar, 2013). Moreover, exclusion from formal saving products and services negatively affects the level of savings in the economy, which is of crucial importance for economic growth and development.

3. CHALLENGES FOR FINANCIAL INCLUSION

Financial inclusion remains one of the challenges for many economies in the 21st century. Limited access or no access to basic financial products and services at an acceptable cost is among the most notable limitations for a vast number of the population across the globe. It was estimated that in 2011, there were nearly 2.5 billion unbanked adults who were not able to access basic financial products (Financial Inclusion, 2022). Nevertheless, the number of unbanked populations has decreased during the last decade as a result of different activities undertaken by policymakers, organizations, and financial institutions. However, nearly 1.7 billion people around the globe are still unbanked or have limited access to needed financial products and services such as savings accounts, credit, insurance, and banking accounts (World Bank, 2019).

Although significant progress has been made in increasing financial inclusion and positively influencing development, the number of unbanked adults in today's global economy remains high. There are a vast number of factors causing exclusion, along with numerous challenges that should be addressed. Low literacy levels, low income, and psychological barriers are some of the factors stated by Kempson et al. (2004). Dharmesh et al. (2021) point out that exclusion from products in the formal financial system is influenced by the limited availability of bank branches and understanding of financial products. Additionally, they state that factors such as low levels of trust in financial institutions, limited

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access to education, limited finances, and geographical distance hinder financial inclusion (Dharmesh et al., 2021).

Sarigul (2020), Atkinson & Messy (2013), and Simatele & Loyiso (2022) argue that factors impeding financial inclusion can originate from the supply side and demand side. They select socio-economic factors along with individual perceptions and attitudes regarding finance issues as supply factors. An important challenge originating on the supply side could be the unwillingness of financial institutions to offer products to small customers, who are often unprofitable and lack stable income levels (Varghese & Viswanathan, 2018).

Furthermore, Sarigul (2020) also stresses the importance of trust in financial institutions, inadequate pricing, inadequate product design, and limiting eligibility as crucial factors that should be managed to increase inclusion. Important demand-side factors are income level, level of education, and familiarity with financial products (Shankar, 2013). Varghese & Viswanathan (2018) and Simatele & Loyiso (2022) state that low-income population may be reluctant to use financial services due to high transaction costs, making the services expensive while the value they receive is perceived as limited.

Many factors obstruct access to financial services globally. Some of the most important challenges and barriers that negatively affect financial inclusion are inadequate infrastructure, low financial literacy, cost of financial services, and regulations.

Inadequate infrastructure or limited infrastructure is among the primary obstacles to accessing finance for the population in rural areas. This barrier to financial inclusion is present in areas where banks don't have physical branches or ATMs, which makes it difficult for users to be included in the formal financial system (Atkinson &Messy, 2013).

Low financial literacy is yet another major obstacle that hinders financial inclusion, and this is especially evident in low-income economies (Khan et al., 2022). Users who are not able to understand financial products are not able to make informed decisions about their financial needs. Hence, they might end up in an unfavorable financial situation as a result of applying for inadequate financial services or inappropriate use of products such as credit cards. Consequently, individuals may be unaware of the opportunities and benefits brought by using adequate financial products. Moreover, a lack of knowledge could make them victims of predatory practices such as services with unfair fees or high-interest loans.

The cost of financial services as a challenge for financial inclusion can be considered from the perspective of users and from the bank's perspective. Usually, banks and other financial institutions set minimum balance requirements and different types of fees, like account maintenance fees. The minimum requirements, along with bank fees, can be a limiting factor for low-income individuals, which may discourage them from using financial services from banks and other financial institutions in the formal system.

For a bank to provide its services in different regions and areas, it needs to make a cost-benefit analysis to assess the impact on its profitability and other areas of its operations. In some cases, the cost of serving users and offering access to formal banking services outweighs the benefits for the bank, making the area unprofitable. Users in rural areas commonly need basic services, and they have limited financial resources, which may not be sufficient to cover the minimum required balances or offset the cost of offering specific products. For instance, due to the need for smaller loans, the interest income from the loan is lower than the cost that would be incurred to offer the loan.

Strict regulatory requirements impede financial inclusion in multiple ways. First and foremost, changes in banking regulations associated with risk management and capital requirements increase the cost for banks to lend money to borrowers with higher risk. Accordingly, some users may lack credit history or may be assigned higher risk scores for different reasons, making them too costly for banks to serve them because of the high capital requirement imposed for high-risk borrowers. This also applies to users operating in the informal economy, which lacks data on their past financial behavior.

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Second, the strengthening of identity verification and new KYC (Know Your Customer) procedures and regulations makes it nearly impossible for people without formal identification documents to be part of the formal financial sector. Nowadays, it is rather difficult to open a bank account and use financial services without any valid government-issued identification document.

Financial inclusion is a complex issue caused by a vast number of intertwined factors, bringing numerous challenges to policymakers, organizations, financial institutions, and users of financial services. Although challenges and barriers are still present, addressing them in the past has yielded positive results. The combined efforts of actors promoting financial inclusion created different methods and techniques to support the access and delivery of financial services to underserved population and population without access to basic services.

4. OVERVIEW OF ACTIVITIES FOR FINANCIAL INCLUSION

Limited financial inclusion is an obstacle that has existed for many decades; thus, in the past, numerous activities and measures have been undertaken to cope with this challenge. Different types of activities have been implemented to manage different aspects and factors that hinder financial inclusion, such as financial literacy, access to loans, access to payment accounts, access to savings and withdrawal services, and methods to manage risk profiles.

Financial literacy programs were developed to augment individual's knowledge and skills for better management of personal finances. Literacy programs and initiatives were delivered through courses and modules organized in local centers, schools, or financial institutions (Atkinson & Messy, 2013; Nicolăescu & Toderașcu, 2023). These programs enable individuals to understand personal finances in terms of budgeting, savings, productive use of loans, and different elements of financial products and services that will enable them to make adequate decisions.

Microfinancing institutions have been created in some developing countries to offer small loans to support financial inclusion and local entrepreneurial activities (BK & Bhandari, 2021). Unlike traditional banks and other big financial institutions, microfinancing institutions (MFIs) specialize in offering small loans and basic financial services with a special focus on individuals and entrepreneurs in low-income countries or regions (Shankar, 2013). MFIs had a significant contribution to increasing financial inclusion and offering access to finance by developing tailored products and services for the specific needs of unbanked or underserved communities. One of the most successful examples of an MFI that has a significant impact on promoting financial inclusion is Grameen Bank, founded in 1976 in Bangladesh.

The way in which traditional credit scoring models are developed limits the ability of individuals with limited or no formal financial history to use banking and services. Thus, alternative credit scoring models have been developed as an instrument to increase financial inclusion (Ganapathy, 2022; Nopper, 2020). The new models enabled institutions to make an adequate risk assessment for different users and accordingly offer financial services (Wijaya, 2023). The risk assessment of individuals is performed through the utilization of alternative data like patterns in utility bill payments, spending habits, and data from media behavior profiles.

Social collateral was also used in some rural areas and poor regions around the world in combination with or as part of microfinancing programs. Social collateral enables individuals and businesses with irregular income to access credit products to finance their entrepreneurial activities or cover financial needs. As an instrument, social collateralization enables users to apply for loans, and a group of close relatives or acquaintances with comparable economic status guarantees the loan, takes the role of collateral, and pledges to repay the loan (Postelnicu et al., 2014).

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Today, mobile banking refers to a form of banking that uses mobile phones. However, not long ago, mobile banking referred to a form of banking in which banks set up a vehicle that served the purpose of mobile branches or mobile money vans that were moving between different low-income or poverty regions within a country. The mobile money van could also have the role of a mobile ATM, enabling users in rural and other excluded areas to withdraw money. Overall, the mobile banking branch and ATM offered a solution to overcome challenges for banks to serve the population in regions that were not profitable for setting up a brick-and-mortar branch.

International organizations, together with policymakers, financial institutions, and organizations, have developed multiple strategies and programs and undertaken a vast number of activities across the globe to augment financial inclusion. Organizations such as the World Bank provide technical assistance to low and middle-income economies to develop a financial system that is accessible and offers financial products and services to individuals regardless of their income status. Organizations support financial inclusion initiatives and promote financial literacy through the dispersion of materials, organizing training, courses, and free consultations.

Setting up funds aimed at boosting the degree of financial inclusion is another instrument used by governments and organizations. A notable example is the Financial Inclusion Fund established in 2019 by the European Investment Bank and the government of the Grand Duchy of Luxembourg. The Fund's objective is to increase the level of financial inclusion and access to finance for small businesses in emerging and developing economies.

Since the inception and popularization of the financial inclusion phenomenon, proponents that support it have undertaken a vast number of activities and created multiple instruments and programs to overcome barriers. The implemented activities yielded positive results in promoting financial inclusion and decreased the number of underserved or unbanked individuals and businesses. However, despite the numerous efforts, the problem with financial inclusion is still evident today when t**he number of adults with no access to basic financial services remains high compared to the global population. Accordingly, reducing exclusion and increasing the level of financial inclusion imposes the need to design an approach and create tools that will implement the newest technological developments.**

5. NEOBANKS AS CATALYSTS FOR FINANCIAL INCLUSION

The advancements in technology combined with changing trends and preferences promoted the creation of the fintech industry, with a vast number of fintech companies offering different financial services traditionally offered by banks. Neobanks emerged as financial institutions that utilize technological developments to deliver financial services. Neobanks swiftly become recognized as digital disruptors with a significant impact on the financial services industry. The new form of financial institutions eliminates the dependency on brick-and-mortar locations in the process of offering products and services to individuals and businesses. The innovative features and characteristics in offering financial services positioned neobanks as a crucial player in the process of financial transformation of services that will enable the overcoming of barriers that obstruct financial inclusion (Ravichandran, 2022). Neobanks offer innovative banking services such as automated financial advisors, peer-to-peer lending platforms, crowdfunding platforms, cryptocurrency exchanges, payments, and savings, supporting the inclusion of the population living in low-income areas (Josyula, 2021).

The neobanking business model has lower operating costs due to the utilization of technology and the elimination of physical locations. Consequently, they can charge lower fees or even eliminate some of the fees charged by traditional banks, decreasing the cost of using financial services. Moreover, commonly, neobanks set low minimum balance

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requirements or even eliminate the requirement for maintaining a minimum balance, which makes their services more affordable to individuals. Thus, users with limited financial resources who had limited access to services in the formal financial system are now included in the formal system.

As a digital-only financial institution, neobanks remove the geographical location as a major obstacle in the process of offering traditional financial services. Individuals and businesses are no longer bound by their location and have access to financial services through neobanking mobile apps.

Neobanks eliminate another barrier that impedes financial inclusion. More precisely, the digital onboarding process leveraged by neobanks simplifies the account opening process which can be complex with traditional banks. The process to open an account through mobile applications is relatively fast and easy to understand while it abandons the need for physical presence and lengthy approval procedures.

Furthermore, the neobanking role in augmenting financial inclusion is not only in terms of the account opening process and delivery of financial services but also in the ability to offer customized and highly personalized products. Neobanks are able to swiftly adapt their products and services to cater to the needs of different users and niche segments, offering financial inclusion for specific groups of individuals.

Neobanks' business models enable them to offer products and services to much smaller and targeted niches, which are commonly neglected by traditional banks due to lack of profitability. The vast quantities of data are used to analyze financial needs and behavior and identify potential changes in users' preferences or segment specific groups of users with similar needs. Consequently, neobanks are able to swiftly design, modify, and employ new financial products and adapt them to the needs of different niche segments. Moreover, unlike traditional banks that rely on credit history, neobanks offer services to individuals without formal credit history and enable them to build credit scores using traditional and alternative data. Hence, no credit score and lack of profitability as barriers to financial inclusion are partly or fully eliminated within the market for neobanking services.

The low level of savings among low-income population and in low-income economic areas is a direct result of financial exclusion and lack of access to saving products. However, neobanking apps and services are structured in a way that offers micro-savings services and motivates users to develop saving habits. Additionally, these apps integrate budgeting tools to ease the process of managing personal finances for individuals and businesses that have been excluded from the formal financial system and have low financial literacy.

Neobanking applications could serve the purpose of educating users to increase their financial skills and financial literacy. They integrate educational resources along with micro-saving options and budgeting tools. Hence, when users have access to financial products and services, they can become knowledgeable on how to manage their finances. Neobanks promote savings habits and smart spending behavior, assisting users in achieving favorable financial positions in the future.

Monis and Pai (2023) argue that financial technology, such as the one employed by neobanks, could be the driving force to increase financial inclusion levels. Estimates indicate that today, neobanks have nearly one billion users globally, and many neobanks offer their services to underserved segments (Monis and Pai, 2023). For instance, in Nigeria, neobanks' products and services have quickly become popular among users, recognizing their potential to increase financial inclusion by serving an unbanked population with access to mobile phones and the internet (Agpaytech, 2023). Neobank's offerings in Nigeria are widely accepted because they enable access to affordable and easy-to-use banking services (Agpaytech, 2023).

Furthermore, Amon et al. (2024) highlight that neobanks not only increase financial inclusion but also stimulate the development of competitive and innovative financial markets. Neobank's business model overcomes the inefficiency found in the model of traditional

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banking by augmenting users' experience, simplifying financial services, and increasing revenue (Shanmugam, 2022).

Even though neobanking is relatively young, the services offered by neobanks were swiftly accepted by users globally. The benefits of these new digital financial services become particularly popular in emerging and low-income markets and among underserved or unbanked population. The way in which neobanks conduct their activities and offer financial services overcomes significant barriers that hinder financial inclusion in markets that are not served by traditional banks.

6. CONCLUDING REMARKS

Financial inclusion is considered to be among the driving forces for economic growth and development. An inclusive financial system offers a plethora of benefits for individuals and businesses and the overall economy. Financial inclusion is used as a tool to decrease poverty and improve the economic position of households in low-income regions. Since its first recognition in the late 1990s, much has been done to increase the inclusion of low-income population and create systems that support inclusion. Actions undertaken by policymakers, financial institutions, governments, and organizations yielded significant positive results. However, there is still much to be done because a significant number of adults around the globe still lack access to basic financial products and services. The barriers and challenges in promoting financial inclusion can be found on the supply side as well as on the demand side for financial services.

Neobanks have a major role in promoting financial inclusion and providing banking services to unbanked and underserved individuals. The utilization of technology in the creation and delivery of financial services enables neobanks to resolve challenges and overcome barriers that hinder inclusion. Neobanking apps have more efficient operations compared to the operations of traditional banks, thus offering cheaper financial services. Moreover, they offer educational resources to enhance financial literacy and help users to make informed financial decisions. Neobanks also support the creation of competitive financial systems that promote economic growth.

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