

Navigating Regulatory Arbitrage in Neo-Banking: Analysing Emerging Challenges in Financial Regulation

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Abstract

The research article is about the neo-banking and its regulatory arbitrage. The traditional branch-based banking is shifting towards digital-only banking platforms. Therefore, the new system of neo-banking is renowned globally. As neo-banking ease the work with technological efficiency as compare to traditional banking. But the absence of substantial regulatory framework has raised the significant risk to the customers financial activities. Hence, article circumnavigate around regulatory arbitrage of the neo banks in Indian banking sector. With the help of judicial decisions from different jurisdiction of India, the problems are apparently observed. The breach of consumer trust, loyalty and digital engagement is prominent in all the cases. The qualitative research methodology is adopted to clarify the research problem. The subjective analysis is based on financial regulations, legislation, IMF (International Monetary Funds) reports and journal articles to address the problem. For the redressal, the comparative solutions are derived from the IMF Global Financial Stability Report.

Research Article

1. Introduction

The global banking system has undergone a significant transformation in its structure with the advent of technological innovations. Neo-banks – “*digital-only financial service providers*” have gained prominence by offering payment services, cards, budgeting tools, digital lending and account interfaces through mobile applications. Compared to traditional banking, neo-banks typically do not hold full banking licenses and instead operate through partnerships with licensed banks or under payment system regulations. This regulatory positioning has given rise to regulatory arbitrage, “*which means a practice whereby firms capitalize on loopholes in the regulatory system to circumvent unfavorable regulations.*” (Hayes A, 2020). Hence, neo-banks lawfully avoid the stringent prudential norms applicable to traditional banks. Traditional banks include commercial banks, public and private banks, which are strictly regulated under the Banking Regulation Act, 1949 in India. While arbitrage promotes innovation and competition, it also raises serious legal concerns relating to consumer protection, regulatory consistency and systemic risk. The increase in the popularity of neo-banks, also known as digital-only financial service providers, has brought an incredible structural shift to the Indian banking environment. These are institutions that work mainly on the internet and mobile apps. They provide banking-related services, but do not have the traditional brick-and-mortar branches. Neo banks allow immediate transfer of funds, opening an account without papers, fast and efficient account opening processes and design customized financial services based on the needs of a particular consumer by using innovative technologies like Application Programming Interfaces (APIs), cloud computing, artificial intelligence and data analytics (Viju S,2025). Consequently, neo-banks have greatly increased both convenience, accessibility and efficiency in the banking ecosystem, especially for the digitally literate and underserved customer groups.

The neo-banks in India operate in a very complicated and fluctuating legal and regulatory framework, in spite of their innovative business models and consumer-oriented services. In contrast to the traditional banks, neo-banks are often not independently licensed banks but rather collaborate with licensed banks or are “*brokers in the payment system*”. The critical legal issues associated with this hybrid form of operation are especially in the areas of consumer protection, regulatory responsibility and liability capping. The consumers usually expect neo-banks to be equal to regular banks, but the legal safeguards of their finances and information might vary, which can pose a threat in case of service disruptions, fraud or data leaks.

To address the above challenges, the Indian legal framework has created a series of regulatory protections in the form of guidelines, that are targeted to safeguard consumer interests in the digital banking ecosystem. The Reserve Bank of India (RBI) takes the center stage by providing policies and principles that require the practice of sound data security, customer due diligence, transparency in digital transactions and well-constructed grievance redressal policies to regulated organizations and their technology vendors. Also, the Consumer Protection Act, 2019, has empowered the consumer dispute redressal system under *section 34-58*. All these regulatory and statutory actions aim to strike a balance between innovation and consumer protection to ensure that technological progress in the banking sector does not occur at the expense of legal responsibility and consumer confidence (Viju S,2025). The laws are available in patches no uniform single law exist to resolve the issues of financial frauds. Therefore, consumer safety and remedies are at stake.

The explicit example to understand the detailed correlation of Indian neo banks with licensed banks under the Reserve Bank of India. *The Federal Bank* is a licensed bank under the Reserve Bank of India, registered as a financial intermediary private Indian Bank listed at serial no. 7. Under this, the neo bank partnered with Jupiter App with terms and conditions. Federal Bank has also partnered with digital lending platforms to perform and provide digital loans to customers. According to the definition of Federal Bank terms and conditions, “Jupiter” shall mean Amica Financial Technologies Private Limited, 32, 3rd Floor, Viraj Building, Plot No. 124, S V Road, Khar West, Mumbai, Maharashtra, the entity which has developed the Jupiter App and has been engaged by the Bank as Mobile Banking Service provider (Reserve Bank of India, 2025).

The news reported in The Times of India, in the financial year 2023-24, Freo the digital-only banking platform reported strong financial performance with gross revenue of Rs. 350 crores (TOI Tech Desk, 2024). As mentioned by company, its user base increased from 15 million in FY22 to 25 million by the financial year 2024. The Freo’s growth is driven by “*low-cost customer acquisition*” by “*product-led growth*”. At a single platform, the company’s app provides wide range of products like credit lines, bill payments, loan bills and credit on UPI, insurance solutions and financial utilities and saving account deposits. The government financial body Small Industries Development Bank (SIDBI) invested in Freo. In the words of Anuj Kacker, co-founder at Freo said, “*Freo’s journey from being only mono-product (Money Tap) to becoming India’s leading financial app (Freo) has been one of perseverance, innovation and an unwavering focus on serving the overlooked millions of middle-income Indians. Our remarkable growth, profitability and the trust of over 25 million registered users is a testament to the power of our technology, customer-centric products and our mission of democratising financial inclusion. As we look ahead, we remain committed to breaking new ground and transforming how India accesses financial services through our secure, unified one app ecosystem*” (Twimbit,2022).

India's neo-banks according to the industry survey. There are 9 major banking partners that present in India.

<i>State Bank of India (SBI)</i>	Public sector anchor, as well as digital platforms like YONO
<i>ICICI Bank</i>	Partners with neo-banks such as Chqbook, Instant Pay, ZikZuk, and Zyro
<i>Kotak Mahindra Bank</i>	Backed support for Airtel payments and digital arm Kotak 811
<i>IDFC First Bank</i>	Associated with platforms such as Fampay and InstantPay
<i>Yes Bank</i>	Frequently used partner by neo-banks, including Niyo, Open, Junio, and Payzello
<i>HDFC Bank</i>	Supports co-branded offerings (e.g., NiyoX with Equitas)
<i>RBL Bank</i>	Integral to the operations of RazorpayX, Tide, Walrus, and Junio
<i>Federal Bank</i>	Power Jupiter, Fi, and other digital banking solutions
<i>Lakshmi Vilas Bank</i>	Previously partnered with platforms like Payzello before the merger

The state of neobanks in India as per the *Twimbit Report, 2022*. The key finding on India's Neo banking landscape (Twimbit,2022):

1. **Market Activity:** Current, they are 36 operational neobanks in the Indian market.
2. **Customer Acquisition:** In 2021 alone, neobanks collectively acquired an estimated 350 million customers.
3. **Pioneering IPO:** Fino Payment Banks achieved a significantly milestone by becoming the first neobank in the Asia-Pacific (APAC) region to conduct an Initial Public Offering (IPO), raising approximately US \$150 million at a valuation of around US \$700 million, and reporting US\$128.1 million in annual revenue.
4. **Profitability in Payments:** A third of the six existing payments banks are generating profit, with an average net profit of US \$3 million recorded in 2021.
5. **Funding Peak:** The year 2021 marked the highest level of funding for neobanks by value, reaching US\$1.05 billion.
6. **Unicorn Status:** Razorpay and Open are two prominent neobanks that have achieved unicorn status, each valued at over US\$1 billion.
7. **Target Demographic:** Most neobanks are primarily focusing their efforts on the rapidly expanding millennial and Gen Z populations.
8. **Profitability Hurdle:** The reliance on sponsored banking licenses restricts neobanks' control over their operations, which in turn presents a challenge to establishing a clear route to sustained profitability.
9. **Product Depth:** Neobanks have successfully built a comprehensive range of products catering to both retail and Small and Medium Enterprise (SME) customers.
10. **Growth Enabler:** Banking-as-a-Service (BaaS) is emerging as a critical avenue for expansion for both established financial institutions and neobanks.

With this dynamic growth various barriers are beating around the bush. Therefore, the research article articulates the legal challenges faced in the Indian neo-banking ecosystem.

2. Methodology

The study is based on a qualitative legal research methodology to analyses the phenomenon of regulatory arbitrage with regard to neobanks. The research is mainly based on the secondary sources of law, such as legislations, regulatory frameworks, judicial rulings, scholarly works and industry reports, to look at the manner in which neobanks operate in the context.

The qualitative analysis is aimed at determining banking, financial regulation, fintech and digital governance legislation in India. This will involve an overview of the licensing regulations, prudential standards, consumer protection standards and supervisory strategies that apply to neobanks. The aim is to evaluate regulatory loopholes, discrepancies and structural imbalances that can facilitate regulatory arbitrage.

Moreover, the study extensively utilizes the official reports in the industry as well as the policies, such as the reports published by Twimbit, international financial organizations, and regulators. The reports are used to learn about the market practices, business models of neobanks, regulatory trends, and the emerging risks of digital banking ecosystems. A legal analysis receives contextual reflection in such materials.

A case law analysis is also included in the study, considering the available judicial decisions and regulatory enforcement measures regarding the areas of concern of financial licensing, compliance breaches, consumer protection, and jurisdictional concerns in digital banking. They are assessing the practical interpretation and reaction of courts and regulators to neobank. Moreover, a comparison of legal approach has been applied to compare regulatory reactions across various jurisdictions, especially between developed and emerging financial markets. This comparative lens makes it possible to identify best practices, regulatory innovations and systemic frailties, which provide some insights on how regulatory frameworks can be aligned or reinforced in order to overcome arbitrage risks. All in one, this study offers a full-fleet of the legal landscape and regulatory arbitrage

of neobanks and the administrative regulation, as well as offer informed suggestions on regulation and change in management.

3. Literature Review

Buchak et.al (2018) examines the transformation of the U.S. mortgage market after the 2008 financial crisis, highlighting a significant shift from traditional banks to shadow banks, particularly fintech lenders. The study shows that the share of mortgage lending by shadow banks increased rapidly between 2007 and 2015 indicating a major structural change in financial intermediation. A key explanation provided by the authors is regulatory arbitrage where financial activities move from highly regulated institutions to less regulated ones. After the crisis, traditional banks faced stricter regulations including higher capital requirements, increased supervision and exposure to legal actions. These constraints made lending more costly and limited their ability to operate freely. In contrast, shadow banks which are not subject to the same regulatory framework were able to expand by filling the gap left by traditional banks. Alongside regulatory arbitrage, the study emphasizes the important role of financial technology in accelerating this shift. Fintech lenders use digital platforms automated systems and advanced data analytics to provide faster, more efficient and user-friendly lending services. These innovations reduce processing time and improve customer experience, making fintech lenders attractive to borrowers. Interestingly, the study finds that fintech lenders often charge slightly higher interest rates than traditional banks, yet they continue to gain market share. This suggests that borrowers are willing to pay a premium for convenience, speed and accessibility. Additionally, fintech firms rely on alternative data sources for credit assessment, indicating a shift from traditional credit evaluation methods. The authors further estimate that regulatory factors contribute the most to the growth of shadow banking, while technological advancements also play a significant role. Overall, the article concludes that the rise of fintech-driven shadow banking is the result of both regulatory arbitrage and technological innovation. This dual influence has reshaped the financial system and raises important concerns regarding financial stability, consumer protection and the adequacy of existing regulatory frameworks in addressing emerging risks in the evolving digital lending environment.

The concept of shadow banking and neo banking are interchangeable terminology and the digital lending is the dominating role played mainly in the new banking system.

Pollman E., 2019 *“legal strategy know as “regulatory arbitrage” has been defined in various ways, such as “transactions designed specifically to reduce costs or capture profit opportunities created by different regulations or laws.”* The concept of regulatory arbitrage revolves around the solutions of strategic choices such as offshoring business or assets created by financial maneuvers such as tax shelters and shadow banking.

Temesvary, J. (2018) regulatory arbitrage has been widely identified in the literature as a critical driver of risk accumulation in an increasingly globalized banking system. Scholars argue that differences in regulatory frameworks across jurisdictions incentivize banks to exploit gaps by shifting activities to regions with comparatively lenient rules thereby undermining the effectiveness of domestic financial regulation. In this context, the absence of a harmonized international “best practice” in bank regulation exacerbates uncertainty and creates opportunities for excessive risk-taking (Agur,2013; Klomp & de Haan, 2013). Empirical studies further demonstrate that banking globalization, while beneficial for financial integration, significantly amplifies systemic risks when arbitrage opportunities are present (Gulamhussan et al., 2014; Hoque et.al., 2015). In particular, lax capital adequacy requirements have been linked to the excessive buildup of risk on bank balance sheets, as financial institutions tend to migrate toward jurisdictions with weaker prudential norms (Duran & Lozano-Vivas, 2014; Cubillas & Gonzalez, 2014). Consequently, the literature suggests that regulatory divergence across countries not only facilitates arbitrage but also intensifies financial instability, highlighting the urgent need for greater international coordination in banking regulation.

4. Discussion

The Legal Analysis by the Case Laws

The growing judicial engagement with disputes arising from neo-banking arrangements in India reveals an emerging recognition of regulatory arbitrage embedded within digital banking models. The absence of a distinct statutory framework governing neo-banks has resulted in courts increasingly being called upon to resolve conflicts where technological platforms exercise de facto banking functions without corresponding de jure responsibility. The cases of *Karan Singh Parmar v/s Union of India*, *Suhan Saleem N v/s Federal Bank (Neo-Banking- Jupiter)*, and *Indmoney Tech Private Limited v/s Ashok Kumar* collectively illustrate how Indian courts are responding to this regulatory vacuum by applying established principles of banking law, consumer protection, and administrative fairness.

A recurring judicial concern evident across these cases is the diffusion of accountability created by neo-banking partnership models. In *Karan Singh Parmar v/s Union of India*, the Kerala High Court dealt with the freezing of a customer's account operated through the Jupiter neo-banking platform. Although the operational interface was controlled by the neo-bank, regulatory action was executed through the licensed partner bank. The court's firmness on disclosure of the requisition and the reasons for freezing the account demonstrates judicial unease with cloudy compliance mechanisms characteristic of neo-banking arrangements. This case highlights how regulatory arbitrage arises when fintech platforms remain insulated from direct legal scrutiny while materially affecting customer access to banking services.

The other case in Kerala High Court "*Suhan Saleem N v/s Federal Bank (Neo Banking- Jupiter)*" the pending writ petition before the Honorable High Court. Directions are noticed under which court on 25th March, 2025, in the interim order posted on 23rd May 2025 by the authority amplified were addressed the legality and proportionality of account freezes. Directing respondent bank not to debit any amount from the petitioner's bank account till next hearing. Further, the bank is not allowed to freeze the entire account. Instead, it can restrict withdrawals only up to exact amount that is under dispute marked in this case Rs. 45,000 by the court. Under this, the doctrine of proportionality is applied as a judicial resistance to exercise regulatory action facilitated by digital banking structures. The judicial orders are legally significant as they explicitly reject the regulatory arbitrage inherent in neo-banking structures. The court approach reflects a substance-over-form analysis, as neo banks are not licensed entity under the Banking Regulation Act, 1949. The court treated the service as a unified banking operation for the purpose of consumer protection. By highlighting that fintech intermediaries cannot avoid responsibility by relying on contractual groupings.

The judicial trajectory further strengthens in *Indmoney Tech Private Limited v/s Ashok Kumar (2025)*. In this case, the court examined whether a neo-banking platform under the title of technological facilitator disclaim liability, while exercising significant influence over financial transactions (ET Government,2022). The court emphasized that when a digital platform materially affects customer access to funds and financial decision making, they cannot escape accountability. Therefore, this reasoning directly linked to regulatory arbitrage by rejecting artificial distinctions between "technology providers" and "financial service providers" when consumer interests are at stake.

The Indian courts collectively demonstrating the unwilling to permit neo-banks to operate in regulatory grey zones. The judiciary has prioritized procedural fairness, transparency and proportionality specifically in matters involving account freezing and access to funds. The courts are indirectly curbing the regulatory arbitrage that arises from fragmented oversight on licensed banks and fintech platforms. Economic Times reported on 18 June 2022, The Reserve Bank of India rejected the proposal of digital-only banks work as full licensed banks as compare to other countries and as a traditional bank. As mentioned by Governor Shaktikanta Das "*we had received suggestions on digital bank, but we felt that the idea came with certain risks with it. So, we have therefore, not accepted it at the moment*" (ET Government,2022).

5. Conclusion

The dedicated statutory framework is not available. The complex and evolving regulatory landscape marked with structural ambiguities in the operation of neo-banks in India. With equivalence to traditional banking neo-banks are innovative alternative. But their operational dependence on licensed banks has given rise to regulatory arbitrage. As they are not accountable and fragmented by compliance responsibility. This study indicates the tangible infringement of consumer rights, transparency and access to funds.

The Comparative Regulatory Solutions: Lessons from IMF framework

The vulnerability of neo banks is highlighted by the International Monetary Fund (IMF), mirrors the regulatory challenges posed by neo-banks in India. IMF unveils three risks firstly “*higher risk-taking in the securities portfolio, secondly an inadequate liquidity management framework and high risk of taking retail loan without appropriate provisioning and underpricing of credit risk*” (IMF,2022). According to IMF, neo banks are left within fragmented regulatory frameworks, may promote regulatory arbitrage, weaken consumer protection and introduce systematic risks. For addressing the concern, the research article proposed comparative solutions which is relevant for Indian neo banking ecosystem. A recommendation directed by IMF framework is based on functional regulation. Under which, the label of service provider is widen enough to addresses the approach directly performed by neo banks for the safeguards of consumers.

The regulatory arbitrage observed in Indian neo-banking models, where fintech platforms perform monopolistic control over customer onboarding, transaction interfaces and compliance trigger but avoid direct accountability. As the Indian judiciary’s evident from the above cases, freezes the account and align himself with IMF’s guidance. Further IMF advocates *proportionate licensing* and graduated supervision of digital banking and fintech intermediaries. As proportionate licensing framework would dimmish the reliance on *ad hoc* judicial remedies by providing clear regulatory standards for neo-banks.

The most prominent IMF guidance is *clear allocation of responsibility* within bank-fintech partnerships. The most common term given by IMF is *merger and acquisition approach*. However, third party service provider pose challenges as they are integral part of risk management. The articulate the cyber risk at a higher rate. The other framework ingredient of IMF is consumer centric safeguards and dynamic regulatory coordination. In Indian multiple authorities has bifurcated the supervision between banking regulators, cybercrime agencies and data protection authorities, which has contributed the regulatory uncertainty. But IMF advocates coordinated approach to ensure consistency and clarity. Therefore, the closing statement emphasizes the functional, proportionate and accountability driven regulatory models. For the protection of consumers and financial stability.

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