Digital Banks

For Prelims: Digital Banks, Financial Inclusion, UPI, Niti Aayog

For Mains: Digital Banks and its Need, NITI Aayog Report on Digital Bank

Recently, **NITI Aayog** has released a report titled- **'Digital Banks: A Proposal for Licensing & Regulatory Regime for India'.**

What are the Recent Developments towards Financial Inclusion According to the Report?

- **Nachiket Mor Committee Report:**
    - The **Nachiket Mor Committee Report ("Committee"), released in 2014** marks an important milestone towards promoting financial inclusion in a mission mode.
        - One of the salient recommendations of the Committee was **differentiated banking policy**, i.e. issuing **specialized bank licenses** that would harness narrow specialization along a given dimension rather than have every bank do everything and pursue every opportunity on both sides of its balance sheet.
        - Pursuant to the Committee's recommendations, RBI issued guidelines for both **Payments Banks (PBs)** and **Small Finance Banks (SFBs),** in 2014 respectively.

What is the Difference between PBs and SFBs?

- PBs were **essentially "narrow banks"** that issue deposits, offer payments services and not issue credit in any form , thus having no asset side of the balance sheet.
- SFBs are **full fledged banks that focus principally on lending to small businesses.** The motivation appeared to be that with the benefit of the banking license, SFBs could leverage lowcost deposits to lend to micro, small and medium sector enterprises and enable financial deepening.

- **Pradhan Mantri Jan Dhan Yoja:**
    - Under **PMJDY**, launched in 2014, 420 million bank accounts have been opened till date.
        - However, credit penetration remains a policy challenge, especially for the nation's 63-million-odd **MSME (Micro, Small and Medium Enterprises).**
- **India Stack:**
    - **India Stack** refers to an **ambitious project of creating a unified software platform** to bring India's population into the digital age.
- **Electronically Knowing Your Customer (e-KYC):**
    - The electronic Know Your Customer eKYC is the transposition of the KYC process to the digital and online plane.
    - The financial sector and its related industries are the digital pioneers.
        - The digital transformation took place much earlier in these sectors of activity than in others that are still anchored in semi-digitalized models.

- **Unified Payments Interface (UPI):**
  - As of today, UPI **has facilitated Rs. 4 trillion worth of transactions,** making it the bellwether of real-time payment systems.
  - Starting from peer-to-peer use-case, it has **since leveraged third party applications -** fintechs and pure-play technology incumbents - as channel partners to add commercial use-cases across varied contexts.
- **Direct Benefit Transfer (DBT):**
  - The **Financial Inclusion** also resulted in **Direct Benefit Transfer (DBT)** through apps such as **PM-KISAN** and extending microcredit facilities to street vendors through **PM-SVANIDHI.**

What is a Digital Bank and What is its Need?

- **Digital Bank:**
  - It will be defined in the **Banking Regulation Act, 1949**, and shall have its own balance sheet and legal existence.
  - It will be different from the 75 **Digital Banking Units (DBUs)** - announced in the **Union Budget 2022-23** - which are being set up to push digital payments, banking and fintech innovations in underserved areas.
  - Digital banks will be subject to prudential and liquidity norms at par with existing commercial banks.

What are Digital Banking Units?

- **About:**
  - A DBU is a **specialised fixed point business unit or hub housing certain minimum digital infrastructure** for delivering digital banking products and services as well as servicing existing financial products and services digitally in self-service mode at any time.
  - The objective is to **ensure the benefits of digital payments**, banking and fintech innovations reach the grass-roots of India in a consumer friendly manner.
  - Pursuant to the budgetary announcement, the **RBI issued guidelines** ("DBU Guidelines") on DBUs in April, 2022.
- **Difference between the Digital Banks and DBUs:**
  - **Balance Sheet/Legal Personality:**
    - DBUs **do not have legal personality and are not licensed** under Banking Regulation Act, 1949.
      - Legally, they are **equivalent to "banking outlets" ie, branches.**
    - Digital Banks will have a **balance sheet and legal personality** & are proposed to be duly licensed banks under Banking Regulation Act, 1949..
  - **Level of Innovation/Competition:**
    - DBUs **improve existing channel architecture** by offering regulatory recognition to digital channels. However, they are silent on competition.
      - The DBU guidelines expressly state that **only existing commercial banks may establish DBUs.**
      - In contrast, a licensing and regulatory framework for Digital banks as proposed here, is more enabling along competition/innovation dimensions.

- **Need:**
  - **Bridging the Credit Gap:**
    - The success that India **has witnessed on the payments front is yet to be replicated** in meeting the credit needs of its micro, small and medium businesses.
    - The credit gap **reveals a need for leveraging technology effectively** to cater to these needs and bring the underserved further within the formal financial fold.
  - **Reliance on Digital channels:**
    - Banks and fintech businesses that offer digital banking services **rely primarily on digital channels** that organically have high-efficiency metrics relative to incumbent commercial banks.
    - This structural **feature makes them a potentially effective channel** through

which policymakers can achieve social goals like empowering the under-banked small businesses, and enhancing trust among retail consumers.

- **Drawbacks in Neo-Bank Models:**
  - The existing partnership-based neo-bank models face several challenges, such as **revenue generation and viability.**
    - Neobanks **don't have a bank license of their own** but count on bank partners to provide bank licensed services.
  - They **have limited revenue potential, high cost of capital,** and offer products of only partner banks.

- **Global Experience:**
  - The UK has **led the pack in terms of digital banks,** with new entrants in the form of Monzo and Starling Bank.
  - Several jurisdictions in the South East Asian region have witnessed the rise of digital banks.
    - Hong Kong has issued a separate licenses for virtual banks. As of May 2020, the Hong Kong Monetary Authority has licensed 8 entities out of 33 applications.
    - In South Korea, Kakao Bank and K Bank **operate as internet banks licensed under the country's Banking Act.** The Philippines has approved six licenses for digital banks.

What is the "Partnership-Based" Neo-Bank Model?

- **About:**
  - The prevalent Neo-bank business model in India is a function of the regulatory vacuum.
  - In the **absence of a licensing regime for "full-stack" digital banks,** fintechs offering the Neo-bank proposition in India have improvised and adopted the "front-end neo-banks" model.
  - As the name indicates, this is a **partnership between traditional banks and neo-banks** such that the latter bring in the engagement layer and the former bring in the "utility" layer and offer both sides of their balance sheet.
- **Division of Neo-banks:**
  - These Neo-banks have further **specialized into consumer-facing and small business-facing offerings** respectively.
    - **Consumer Facing:**
      - A typical consumer facing Neo-bank offers additional conveniences like digital debit card, Personal finance management tools like spend analytics for better budgeting, investment avenues through its mobile application through its B2B partnerships and potentially a credit line.
    - **Small Business-Facing Fintech Offering:**
      - A typical small business-facing fintech offering neo-banking services will offer expense management products (like employee prepaid cards), payroll management, accounts receivables management platform and a business loan / credit line facility through the banking partner.
- **Challenges:**
  - **Limited Revenue Potential:**
    - Neo-banks **earn revenue from interchange fees** that are levied on customers when they swipe the debit or credit cards issued by the partnered banks.
      - However, the **amount of revenue generation is extremely low** and not enough to allow neo-banks to keep their heads above water.
    - Moreover, interchange is indirectly regulated in India (through merchant discount rate regulation), so unlike developed markets like the United States (where fintechs can earn revenue on interchange by partnering with small and medium banks), **fintechs in India are constrained along this dimension.**
  - **Potential Obsolescence of the Partner Bank Core Banking System:**
    - Fintechs offering neo-banking services are **constrained by product buckets the partner bank can offer within its business** and technological infrastructure.
    - Without the ability to leverage their balance sheet and their own technological stack to create "ground-up" credit products and user experiences, their potential will never be fully unlocked.
- **High Cost of Capital & No Entry Barrier:**

- **Neobanks cannot issue low-cost deposits** and are constrained to rely on expensive equity capital to fund innovation and operations.
    - The licensing framework also serves as a strategic moat for licensed entities.
    - In absence of a licensing framework, **entry barriers for fintechs to enter Neo-banking space are low.**
- This creates two negative externalities for the ecosystem.
    - First, as with any ecosystem with low barriers to entry, this **context offers opportunities for actors that are not fit-and- proper to enter the market** creating a consumer protection risk especially on the retail side.
    - Secondly, it **creates herd mentality in terms of simply replicating business models** and products already witnessed by the markets, rather than genuine innovation.

How is a Digital Bank different from a Neobank?

- A **digital bank** and a neobank are different even though they appear to be based on the mobile-first approach and emphasis on digital operating models.
- Digital banks are often the online-only subsidiary of an established and regulated player in the banking sector, a neobank, on the other hand, exists solely online without any physical branches and independently or in partnership with traditional banks.

What are the Recommendations?

- **Digital Bank Licensing:** The report recommends the following steps for a calibrated approach:
    - **Issue of a Restricted Digital Bank License:** It means the license would be restricted in terms of volume/value of customers serviced.
    - **Licensee Enlistment** in a regulatory sandbox framework enacted by the Reserve Bank of India.
    - **Issue of a 'full-scale' Digital Bank License:** The license should be contingent on satisfactory performance of the licensee in the regulatory sandbox, including salient, prudential and technological risk management.
- **Strong Technological Basis:** It is also **imperative to lay out a strong technology foundation** built on that is **cyber-proof** along with building of capacities to deal with and mitigate technological risks.
    - Given the fast-paced changing landscape of the regulatory templates, it will be **necessary for digital banks to use emerging technologies for seamless integration** with **RegTech solutions** (technology to meet regulatory requirements) of banks and regulators, along with **regulators themselves developing emerging SupTech solutions** (to enable them automate their supervisory requirements).
- **Financial Literacy as Ecosystem Enabler:** In terms of ecosystem enablers, **financial literacy** will be the key enabler in the context of a regulatory framework for digital bank licence.
    - A **National Centre for Financial Education (NCFE)** survey (2019) found that **only 27 % of adult Indians are financially literate.**
        - This is an area that will require key focus to ensure the success of digital banks in India.