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NITI Aayog's Discussion Paper *Digital Banks: A Proposal for a Licensing & Regulatory Regime for India* ORF RESPONSE

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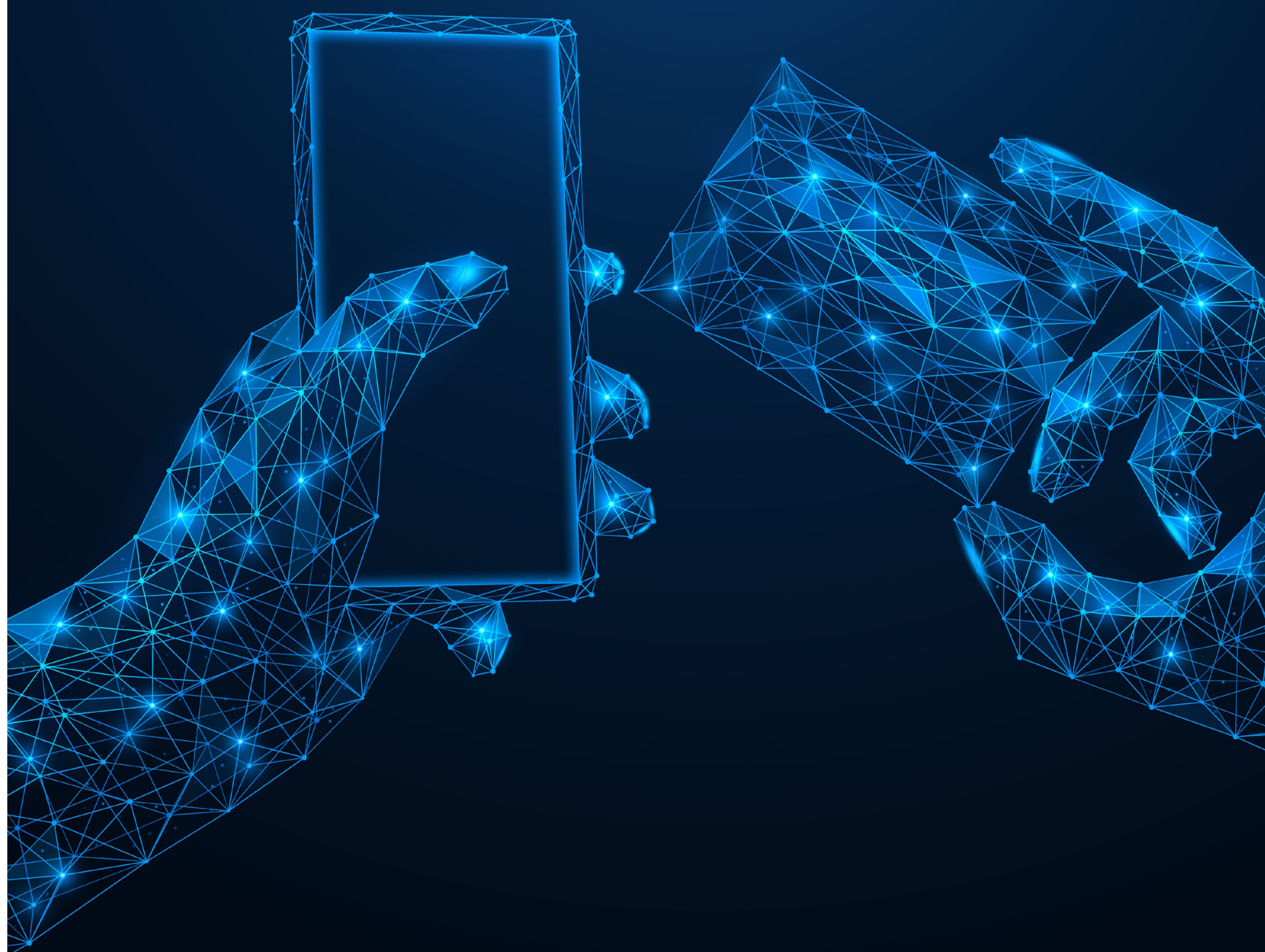

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Introduction

On 9 December 2021, ORF, in collaboration with Sequoia India, convened a non-partisan, multi-stakeholder Roundtable to solicit views on NITI Aayog's Discussion Paper, "Digital Banks: A proposal for licensing & regulatory regime for India" (referred to as 'Paper' for the rest of this document).[1] The Roundtable focused on the various elements of the Paper to determine the parameters of a properly constructed digital banking sector that would leverage technological innovation to create low-cost efficient banking to bolster legacy infrastructure. Based on the discussions at the Roundtable, this report outlines the following recommendations for NITI Aayog.

Disclaimer

The contents of this response are based on a stakeholder consultation organised by the Observer Research Foundation (ORF) on 9 December 2021. ORF has exerted its best efforts to give voice to the concerns of various stakeholder groups. However, this response should not be treated as a consensus document and does not attribute comments to, or claim to represent, the positions of any individual or organisation. All statements, assertions, or factual errors are the responsibility of ORF.

Definition of “Digital Banks”

The Paper defines “Digital Banks” using the Banking Regulation Act, 1949 (B R Act): They will issue deposits, extend loans, and offer the full suite of services that the B R Act empowers them to and will principally rely on the internet and other proximate channels to offer their services, and not physical branches.

Our Comments

While Digital Banks will rely principally on the internet and other proximate channels for offering services, the question is whether they should be allowed to open any/ limited physical branches/ correspondence. Due to low financial literacy in semi-urban and rural areas in India, there is a need to impart financial education on even the most basic banking services. “Financial literacy” represents the ability to use the knowledge and skills necessary for the useful management of human resources for achieving financial benefits, and “financial education” is a process by which people improve their understanding of financial products and services, so that they are able to make the best business decisions through such information.[2] Financial literacy and its importance for citizens, financial institutions, and society as a whole, is one of the most important preconditions for a successful process of digitisation of the banking sector, and the financial industry, overall.[3]

Imparting financial education becomes a challenge without offline presence. Studies have found that effective in-branch communication between branch staff and customers may significantly influence customers’ attitudes and intentions to use digital banking channels.

Once customers are informed personally about the usefulness, convenience, and ease of using digital banking channels, they could decide to perform all their future banking transactions online.[4] Since the uptake of digital technologies for financial services varies across the country, the significance of physical branches and agent networks should not be underestimated.[5] Thus, offline presence may be necessary for educating and driving customers to online mode. At the same time, if the Digital Banks are allowed to operate physical branches, the lines between Digital Banks and incumbent Traditional Banks tend to blur. It is important to mention here that most international regimes require that a Digital Bank have at least one physical place of business (usually a head office or a means to deal with customer complaints or queries).[6]

As for financial literacy, it is important to point out that COVID-19-related nationwide lockdowns and restrictions on mass public gatherings had disrupted the conduct of conventional financial literacy camps. Thus, alternative platforms including social media, TV and radio, and outreach through local school education boards and self-help groups are being explored.[7] Similarly, the 5Cs strategy can be modified for digital modes: development of relevant *Content*; *Capacity* of the intermediaries who provide financial services and education; leveraging on the positive effect of *Community*-led model for financial literacy through appropriate *Communication* Strategy; and enhancing *Collaboration* among various stakeholders.

Digital Bank Global Regulatory Index

The Paper proposes a Digital Bank Global Regulatory Index to map these global regulatory responses. The index is based on four factors: entry barrier; competition; business restrictions; and technological neutrality.

Our Comments

The participants in ORF's Roundtable agreed that evaluation of competition is a welcome step in the digitalisation of banking in India. However, it is essential to determine whether the regulations aim to create a level playing field or if they favour certain entrants.[8] It is also important to note that the overall competition in the Indian banking sector is strong, although it varies across the different types of bank ownership.[9] The regulations must therefore focus on establishing a fair level playing field and not favour digital banks over incumbent traditional ones. While preparing the index, it is necessary to see if there are regulatory discriminations against incumbent traditional banks.

Technological Neutrality

The Paper advocates for technological neutrality. It suggests that while prescribing technology promotes standardisation, such approach may have a chilling effect on innovation. Further, the Paper recommends that the process for acquiring a Digital Business bank license and the ambient regulations should be technologically agnostic and should neither express a preference for, nor bar a Digital Business bank from using/ not using any technology.

Our Comments

Most of ORF's participants agreed that technological neutrality is indeed necessary. The desirability of technology-neutral regulation has become part of general wisdom and is rarely questioned.[10] For Digital Banks, there is a need to establish minimum technology standards and framework which will act as guiding principles. Freedom on the technological front should be given to licensees—this will allow leveraging of technology for better customer experience. A principle-based approach must be taken where the regulator sets out the objectives, and the licensees figure out the mode of meeting those objectives. Such principles could relate to issues of reliability, scalability, security, and data privacy.

At the same time, however, technological neutrality poses a challenge in developing standards that will favour market integration without imposing a specific technology.[11] On one hand, the competition that emerges between technologies as a result of a technology-neutral approach can lead to innovative approaches to solving broader socio-economic objectives; on the other hand, favouring a particular technology helps in economies of scale and scope, and lowering costs to achieve universal service.[12]

A 2011 study[13] on mobile banking services suggests that a lack of standardisation of these services in the country has resulted in increased complexity while using mobile banking services for customers. Another study,[14] this one in 2012, suggests that the standardisation of e-banking processes is an important aspect for customers' satisfaction. The study also suggests that banks should have the same type of validation checking and form format for receiving input from its customers or prospects. Thus, while any specific technology should not be prescribed, attempts must be made to ensure that the end experience for customers is standardised.

Metrics for Monitoring During Sandbox

The Paper suggests that the Reserve Bank of India (RBI) and the applicant identify a set of metrics for which the Licensee will be progressively monitored in Step 2 in the sandbox. It suggests that certain parameters may be used, such as cost to acquire a customer, volume/value of credit disbursed to MSMEs, and technological preparedness.

Our Comments

The Regulatory Sandbox (RS), at its core, is a formal regulatory programme for market participants to test new products, services or business models with customers in a live environment, subject to certain safeguards and oversight.[15] While the Paper suggests that the RBI and the applicant can identify a set of metrics that would be progressively monitored to assess the performance, it is important that both qualitative and quantitative indicators be considered. Metrics must also be developed to assess the sandbox's impact on the market and market players.[16] It is further suggested that the metrics should be in line with the problems that are intended to be solved with digital banking licenses. While determining the metrics, frameworks by other regulators such as SEBI can be considered.

It is also suggested that the weightage given to the different metrics must be carefully crafted and there cannot be one "hero" metric. As Goodhart's law suggests, "When a measure becomes a target, it ceases to be a good measure." If one metric is made primary, it might be easy to gain this single metric at the cost of other factors.

Relaxations in Regulatory Sandbox

The Paper recommends that certain relaxations for Digital Business banks for the duration of the time they will be operating in the RS. For instance, the Paper suggests that minimum Paid-up Capital for a restricted Digital Business bank operating in a RS may be proportionate to its status as restricted.

Our Comments

The idea behind the RS is that relaxations are allowed to facilitate innovation and the requirement will increase gradually, in terms of liquidity input, management, and financial soundness. It is important for the RS to be framed in a manner that advantages are made meaningful. Generally, in an RS, the benefit that is given is for a younger startup not meeting the net worth criteria where specific regulatory requirements are relaxed, and various technical obligations are cast on the entities in the sandbox. However, for a Digital Banking license, we need to realise that the FinTechs/ companies that may be participating in digital banking would probably not need an advantage on the net worth criteria because they will likely be well-funded startups that are entering the digital banking space. There is a need to frame the sandbox more carefully, where concentration is on experimentation with technology.

The timeline for the sandbox will have to be defined at a cohort level. RBI's enabling framework for Sandbox suggests that the cohorts may run for varying time periods but should ordinarily be completed within six months.[17] The cohort for Digital Banks may also be similar to the recommended five stages as suggested in RBI's enabling framework.

Constraints on Applicants/ Minimum Criteria

The Paper suggests that obtaining a license may require one or more controlling persons of the applicant entity to have an established track record in adjacent industries such as e-commerce and payments technology. The Paper also suggests that existing neo-banks seeking to upgrade or small finance banks/other regulated entities (e.g. existing incumbent banks that may see the opportunity in full-stack Digital Business bank license) are also potential eligible candidates.

Our Comments

The imposition of a minimum criteria restricts entry to the industry, as well as the number of competitors. It also leads to protection of incumbents against entry and acts as an obstacle for worthy entrants. Such requirements, if too stringent, can reduce consumer choice and create artificial scarcity in the market. Such requirements often benefit large players over small ones.[18] Creating minimum requirements may limit the participation of existing FinTech or IT enterprises in Digital Banking. Such requirements, if not carefully crafted, could act as barrier to entry and affect the competitive landscape in the long run. However, some of these requirements may be justified as a measure to protect consumers.[19] There is a need for clarity in "fit and proper" criteria that RBI might want the applicants for Digital Banking licenses to qualify. It will be essential to ensure that the "fit and proper" guidelines are appropriate to the current state of the market, and not overdefined by concerns borne of legacy banking.

Non-Financial Businesses (NFB) and Digital Banks

The paper recommends that the RBI can define clear no-go areas which shall remain outside the scope of permissible NFBs for Digital Business banks.

Our Comments

Principle 4 of the Core Principles for Effective Banking Supervision suggests that the permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined either by supervisors, or in laws or regulations.[20] Thus, it may be prudent initially to have clearly defined areas of NFBs for Digital Banks that can be expanded on a regular basis. A "negative list" can evolve over time if it is found to be more effective.

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Digital Banks and Retail Banking

The paper suggests that Digital Banks can become a potentially effective channel through which policymakers can achieve social goals like empowering the hitherto under-banked small businesses, and enhancing trust among retail consumers.

Our Comments

It is essential to clearly prioritise the aims of Digital Banks, since segments of consumers will have to be targeted differently and a "one size fits all" approach will not be feasible. It is important to note here that Banks are supposed to have a fiduciary relationship with the users; given the relatively recent spread of financial inclusion, Indian users in other jurisdictions may be less financially aware. Another complication is that measures of consumer trust and security in traditional banks may not be easily applicable to Digital Banking.

While there is a massive need to take credit and other financial products to underserved populations, the regulation of Retail banking by digital banks will require more careful design. It is possible that Digital Banks should be encouraged to lend first to the MSME sector and businesses.

It is also possible that two tracks through the regulatory sandbox could be created: one for MSME-targeting Digital Banks, and a second for those with broader retail banking. What is most important is that innovation be put to work to increase the access of underserved populations to retail banking through digital technology.

Other Regulatory Requirements

The paper suggests that Prudential / Liquidity risk regulation for both Digital Business banks that have progressed to full license, and the incumbent commercial banks will remain the same and that Digital Banks will be required to be compliant with regulatory touchpoints like capital adequacy, risk weights, liquidity coverage ratio will be included under this head.

Our Comments

It is also important to consider all statutory and regulatory requirements such as Priority Sector Lending (PSL) and how such requirements can be incorporated in the Digital Banking infrastructure primarily since such banks do not have physical branches. It is also important to note that light regulation of entrants into the industry may foster competition, but at the potential cost of destabilising incumbents by decreasing their profitability. Thus, any relaxation of regulatory requirements has the potential to hurt the existing market. The RBI should be encouraged to demonstrate a clear and modelled link between additional or lighter statutory requirements, particularly capital requirements, and the risk posed to the financial system by Digital Banks that are subject to those requirements. If transparent modelling suggests that Digital Banks pose a different or smaller systemic risk than legacy banks, that should be reflected in the prudential norms that they must follow.

Operational/Cyber Risks

The Paper states that technology risks assume greater importance for Digital Business Banks/ Digital Banks relative to the traditional banks and that the license should require conditions for *ex ante* technological preparedness and *ex post* business continuity planning, and recommends some measures for *ex ante* technological preparedness.

Our Comments

Even with traditional E-Banking, many people have their account details compromised.[21] For digital banks, such operational or cyber risk may be accentuated due to the nature of their operation.[22] We agree that such risks must also be considered while finalising the regulations. However, while digital banks tout the advantages of their technology-first approach, serious questions remain about the ability of these lean organisations to both manage their risks and maintain profitability as regulators provide little leeway in meeting regulatory requirements.[23] It is essential that an adaptive, flexible, and evidence-based approach be taken to risk management for Digital Banks. The broader costs of regulation biased towards risk mitigation over innovation have been amply proved in the past in India, and should not be repeated.

Ownership of Digital Banks and FDI

Our Comments

It is important to discuss the ownership patterns and FDI in ownership of Digital Banks while framing regulations for Digital Banks. The Basel Committee on Banking Supervision[24] suggests that the licensing authority has the power to set criteria and reject applications for establishments that do not meet the criteria. At a minimum, the licensing process consists of an assessment of the ownership structure and governance of the bank and its wider group, and its strategic and operating plan, internal controls, risk management and projected financial condition.

It is important to note here that most leading fintechs have highly diversified holdings due to multiple rounds of fund raising. Sometimes, the Indian founders are not in controlling position of the board and are no longer owning substantial stakes in the company. Sometimes, the foreign ownership may be individually or cumulatively higher than the share of Indian promoters. Such ownership patterns are in conflict with RBI's current preference for Indian-owned or controlled banks. The RBI may also be concerned that the time horizons preferred by investors in these banks, including private equity, are not in keeping with its preference for ownership by long-term patient capital. Equally, it has a mandate to increase the overall capital invested in the banking sector. Rather than sticking to instincts forged offline, fintech's nature requires the regulator to re-examine its assumptions behind its ownership preferences. What structures will ensure stability, sovereignty, and the prevention of conflict of interest in the 21st century?

Other Comments

If the digital banks have to survive, it is critical to widen the domestic debt markets. As has been seen, the long-term liabilities pool (like FDs) do not generally go towards newer banks. Thus, there is a need to develop a pragmatic business plan that would allow for widening of the debt market. Otherwise, we will have the same stalemate as that experienced by Payments banks and SFBs.

Annex

List of Participants

Allish Jain (Cred)
Bipin Preet Singh (MobiKwik)
Biswarup Gooptu (Jupiter Money)
Geetika Singh (Pine Labs)
Hardeep Singh (Cred)
Harsh Jain (Groww)
Mandar Kagade (Black Dot Public Policy Advisors)
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Sambhav Jain (Fampay)
Shalini Saxena (Pine Labs)
Shashank Mehta (Razorpay)
Srinath Sridharan (FinTech Association for Consumer Empowerment)
Sumeet Singh (BharatPe)
Suresh Ganapathy (Macquarie Capital Securities)
Tanya Mohan Naik (Pine Labs)
Vinay Kesari (Setu)

Endnotes

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