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Licensing Digital Banks & Proposing a Regulatory Regime for them in India

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ABSTRACT

Following demonetization, India experienced a significant increase in cashless transactions, propelled by initiatives such as PMJDY and the digital revolution driven by e-KYC and UPI. PMJDY, launched in 2014, facilitated the opening of a remarkable 420 million bank accounts, while UPI, introduced in 2016, emerged as a leading platform for real-time payments processing, handling transactions valued at 4 trillion rupees. Additionally, the Reserve Bank of India (RBI) introduced Payments Banks, a pioneering banking model primarily focused on deposit acceptance, with offerings including checking and savings accounts, ATM or debit card issuance, and online or mobile banking services. Concurrently, the rise of Neo Banks has enriched India's banking landscape, catering to underserved demographics with frictionless, user-centric experiences and leveraging innovative technologies to address the evolving needs of small businesses, migrants, gig workers, and budget-conscious consumers. Moreover, the integration of initiatives such as India Stack, Aadhaar, and UPI Rail has ignited a payments revolution, positioning India as a global benchmark in digital banking innovation. This policy paper on NITI Aayog report [2] titled "Digital Banks - A Proposal for Licensing & Regulatory Regime for India" delves into the licensing and regulatory frameworks governing Digital and Neo banks, highlighting their transformative potential in advancing financial inclusion, fostering innovation, and enhancing India's global competitiveness in the digital banking landscape. Effective implementation and ongoing monitoring of these initiatives are crucial to realizing their full scope and ensuring sustainable growth and inclusivity in the digital banking ecosystem.

Keywords: Digital Banks (DB), Account Aggregator (AA), UPI, Banking as a Service (BaaS), Small Finance Bank (SFB), Payments Bank (PB)

JEL classification: M13, M15, M38, M48, N20, N40, O16, O32, O33, O35, O36, O38

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1. Background

The release of the Nachiket Mor Commission[1] report in 2014 marked a significant step forward in promoting financial inclusion with a focused approach. One notable recommendation from the commission was the implementation of a differentiated banking policy, which involved issuing specialized bank licenses. This approach aimed to leverage narrow specialization rather than having every bank engage in all banking activities across its balance sheet.

In line with the commission's suggestions, the Reserve Bank of India (RBI) introduced guidelines for Payments Banks (PB) and Small Finance Banks (SFB) in 2014. A PB functions as a 'narrow bank' by collecting deposits, providing payment services, and refraining from issuing credit, thus having no assets on its balance sheet. On the other hand, an SFB operates as a full-fledged bank with a primary focus on lending to small and medium enterprises (SMEs), utilizing low-cost deposits for financial deepening.

India is also progressing towards the implementation of "Open Banking" through the Account Aggregator (AA) framework established by the RBI. This framework aims to facilitate credit expansion among previously underserved groups once it is fully operationalized commercially.

However, despite advancements in regulatory innovation, traditional banking principles of providing credit and issuing demand deposits remain largely unchanged, leaving incumbent banks unaffected. While these reforms have enhanced user experience, particularly in payments, they have shown minimal improvement in the core banking benefits layer. Consequently, there are still significant portions of the country that have not fully embraced the digital revolution in banking due to inertia and other factors.

2. Challenges with existing "Partnership based" Neo-Bank Model

i. Limited Revenue potential:

While the fintech companies earn fees in specific situations, their model heavily relies on third-party income and lacks diverse revenue streams. Furthermore, regulations restrict access to lucrative interchange fees common in other markets, hindering their ability to monetize effectively. This "viability challenge" threatens the long-term sustainability of the sector despite its initial growth. The viability challenge refers to the difficulty Indian fintech companies face in achieving long-term financial sustainability due to limitations in their revenue generation models.

ii. Core banking system of the partner bank's possible obsolescence:

Neo-banking Fintechs offering services are constrained by the product offerings available through partner banks' business and technological infrastructure. Their full

potential cannot be realized unless they have the ability to create credit products and customer experiences from scratch using their own balance sheet and technological capabilities. The existing partnership model between neo-banking Fintechs and traditional banks acts as a bottleneck, as traditional banks' outdated core systems and limited product range hinder the innovative potential of neo-banking. Neo-banks lack the independence to utilize their own balance sheets and technology stacks to deliver truly innovative credit products and customer experiences.

iii. High capital costs and no entry barrier:

Moreover, due to the lack of a licensing framework, Neo banks face challenges in issuing low-cost deposits and must instead rely on expensive equity capital to support their innovation and operations. However, there are concerns that hastily designed licensing regulations could unintentionally create barriers for legitimate players while failing to deter malicious actors who exploit loopholes. In the absence of a licensing framework, entry barriers for fintech companies to enter the Neo-banking sector are minimal. This situation leads to two negative consequences within the ecosystem. Firstly, it opens opportunities for unfit actors to enter the market, posing risks to consumer protection, especially on the retail side. Secondly, it encourages a herd mentality where businesses simply replicate existing models and products rather than focusing on genuine innovation.

3. Need of Digital Banks

According to the NITI Aayog report [2], there are 63.88 million unincorporated micro, small and medium enterprises (MSMEs) in India and a significant portion of these enterprises remain outside the realm of formal finance. Even with best practices, traditional banks struggle to reach smaller MSMEs due to challenges in assessing creditworthiness for low-value loans. Digital banks, with their data-driven and AI-powered models, can bridge this gap and provide crucial financial access to these businesses. The International Finance Corporation (IFC) estimates the total addressable credit gap in the MSME segment at US$25.8 trillion, growing at a compound annual growth rate (CAGR) of 37%[2]. Traditional brick-and-mortar banks, even using best-practice guidelines for priority sectors, remain underperforming in assessing credit risk for small ticket sizes (approximately ₹100,000 to ₹1,000,000)[2].

The need for licensed entities to utilize technology and provide affordable credit to meet the changing needs of modern digital businesses, such as subscription-based SaaS (software as a service) ventures, is evident due to the drawbacks of conventional loan options like high costs and operational inefficiencies.

4. Digital Bank Regulatory Framework - Global View [4]

There are 4 factors in this framework:

i. **Entry barriers -** This aspect will determine whether the entry barriers for fintechs and related entities in obtaining Digital Banking (DB) licenses are high or low. For instance, if a jurisdiction imposes a uniform minimum capital requirement for eligibility without considering the diverse business models of applicants, it will receive a negative rating in this regard.

Conversely, regulatory frameworks that tailor eligibility criteria to differentiate between traditional banks and digital banks will be viewed positively. Regulators may also introduce eligibility conditions based on the track record of applicants to ensure that only entities with a proven history apply. The appropriateness of such eligibility conditions depends on the specific context.

ii. **Competition -** This factor assesses the level of competitiveness within a regulatory regime. In the banking services market, competition occurs between traditional brick-and-mortar commercial banks and digital banks. Regulatory regimes that do not unfairly favour traditional banks over digital banks will receive a positive score in this regard. Conversely, regimes that disadvantage digital banks by denying them access to privileges enjoyed by traditional banks will receive a negative score. For example, if a jurisdiction grants traditional banks access to Central Bank payment systems but not digital banks, or if there is unequal access to the deposit insurance system, it would be considered as discriminatory against digital banks.

iii. **Business Restrictions -** Digital banks (DBs) face a delicate balancing act. While they require operational freedom to innovate and serve customers effectively, their primary function of managing finances demands safeguards for financial stability. This factor evaluates the level of independence granted by various regulatory regimes, taking into account the necessity of prudential measures while also examining their transparency, rationale, and proportionality. For instance, imposing limits on initial business expansion based on asset or deposit thresholds may be deemed acceptable if there exists a transparent and clear pathway for DBs to surpass these restrictions as they demonstrate stability and operational maturity. The key lies in ensuring that restrictions are clearly defined, justified, and do not unnecessarily hinder innovation.

iv. **Technological neutrality -** Regulation in the fintech sector tends to have a limited lifespan due to the ever-evolving nature of the technologies utilized by regulated entities. This continuous flux in technology can be mitigated if a regulatory framework shows preference towards certain technologies or sets of standards over others. However, such regulatory bias runs the risk of impeding innovation. Therefore, technological neutrality serves as a crucial criterion for assessing a regulatory framework. Regulatory regimes that mandate or exhibit bias towards specific technologies by incorporating them into legislation receive a negative rating in terms of this attribute, while those that maintain neutrality towards technology choices receive a positive rating.

The table I below compares the factors mentioned with those of different global economies, offering a clear view of how digital banking and financial inclusion vary across countries.

[Table I]

The table II below compares the regulatory regimes of digital banks across 4 countries in the Asia Pacific region considering License Type, Number of licenses, Policy Objectives & Business Locations:

[Table II]

5. Digital Bank Regulatory Framework for India

5.1. Rationale for the NITI Aayog Regulatory Framework for Digital Banks

Banks are not just financial entities; they are the pillars of commerce and national economies, capable of either fostering growth or causing severe disruptions. Their primary role is to facilitate economic progress rather than hinder it. In this digital age, the concept of banking has transcended physical branches to encompass a vast digital landscape. This transformation has brought about various innovations and challenges that reshape the banking sector's dynamics globally.

In India, the journey towards digital banking began with significant initiatives like the Pradhan Mantri Jan Dhan Yojna (PMJDY) and the introduction of the Unified Payments Interface (UPI) post-demonetization. PMJDY, initiated in 2014, aimed to provide financial inclusion by opening bank accounts for millions of unbanked individuals. UPI, introduced in 2016, revolutionized digital payments, becoming a leading platform for real-time transactions. These initiatives, along with others like e-KYC, propelled India towards a cashless economy, fostering financial inclusion and digitization.

The emergence of digital-only banks, known as Neo Banks, further transformed India's banking landscape. These banks cater to underserved demographics and offer frictionless, user-centric experiences leveraging innovative technologies. While Neo Banks complement traditional banking services, they also address the evolving needs of small businesses, migrants, gig workers, and budget-conscious consumers.

In response to the evolving digital banking ecosystem, the Indian government proposed the establishment of Digital Banking Units (DBUs) in 75 districts to ensure widespread access to digital financial services. The Reserve Bank of India (RBI) subsequently released guidelines on DBUs, aiming to integrate advancements in digital payments, banking, and fintech into accessible solutions for all segments of society.

Despite notable advancements in promoting financial inclusion, challenges persist, especially in small business lending. The Micro, Small, and Medium Enterprises (MSME) sector, comprising a vast number of unincorporated businesses, plays a crucial role in employment generation and economic expansion. However, many MSMEs still rely on informal financial channels due to the speedy disbursal process and lack of documentation requirements.

To address the funding gap for MSMEs, the RBI has undertaken efforts to expand credit access. However, the International Finance Corporation (IFC) estimates a substantial shortfall in credit availability, highlighting the need for further reforms to improve funding accessibility for small businesses.

The banking industry is witnessing a notable transformation driven by the rise of Banking-as-a-Service (BaaS). BaaS represents a shift from integrated to modular banking, breaking down traditional bank processes into independent apps and APIs for easier access and integration. While BaaS promises modularity and flexibility for faster innovation, concerns regarding security and scalability persist.

Digital Banks (DBs), defined under the Banking Regulation Act of 1949, primarily operate through internet and remote channels, offering a complete range of banking services authorized by the law. Despite their digital focus, DBs are subjected to the same prudential and liquidity standards as traditional commercial banks, ensuring regulatory compliance and risk management.

The banking industry's evolution extends beyond traditional players to include non-bank entities like PayPal, Amazon, and Apple. These companies are innovating in financial services, offering seamless payment solutions and digital wallets, potentially disrupting traditional banking models[3].

In conclusion, the banking landscape is evolving rapidly, driven by digital innovations and regulatory reforms. While traditional banks continue to play a significant role, the emergence of digital-only banks and non-bank entities signals a shift towards a more inclusive and accessible banking ecosystem. However, challenges such as financial inclusion and profitability persist, requiring continued efforts from policymakers, regulators, and industry players to navigate the evolving dynamics of the banking sector.

5.2. Proposed Regulatory Frameworks for India by NITI Aayog

The proposed regulatory framework aims to balance innovation with stability, enabling digital banks to thrive while safeguarding consumer interests and financial integrity.

i. Introduction of New Licenses

   Limited licenses for Digital Business Banks and Digital Consumer Banks to foster innovation and accessibility.

ii. Sandbox Testing

   Applicants with restricted licenses undergo controlled testing in regulatory sandboxes to assess viability.

iii. Transition to Full-Fledged Banks

   Based on satisfactory sandbox performance, restrictions are eased upon exiting, transforming into full-scale digital banks.

iv. Legal Mechanics

A two-step process involves granting licenses under the Banking Regulation Act and notification by the central government designating additional permissible business lines.

v. Key Features

- Minimum Paid-up Capital: Graduated capital requirements tailored to sandbox phases and full-scale operations.
- Equal Access: Digital banks to have equal access to financial infrastructure.
- Business Restrictions: Phased relaxation based on asset, deposit size, or customer base.
- Regulatory Oversight: Compliance with prudential, liquidity, and technological risk regulations, ensuring stability and security.
- Technological Neutrality: Licensing remains technology-neutral, fostering innovation.
- Product Offerings: Varied banking services during sandbox phases, expanding upon successful completion.

vi. Value-added Services

Integration of non-financial services like payroll management and tax compliance, enhancing customer experience and utility.

5.3. Priority Sector Lending in the Context of Digital Banks

Priority Sector Lending (PSL) guidelines, established by the Reserve Bank of India, mandate that banks allocate a certain proportion of their lending to specific sectors of the economy that may face challenges in accessing timely and adequate credit. The report [2] suggests that applying PSL obligations to innovative bank licensing frameworks requires a nuanced approach rather than a mechanistic "checklist" approach.

- *Digital Business Banks*

While the RBI's master directions include "MSMEs" as eligible for PSL obligations, Digital Business banks focus on facilitating credit access for underserved small businesses. Hence, there's a proposal to narrow down their PSL obligations in terms of the percentage of total book size. It is suggested that the RBI determines PSL obligations for Digital Business bank licensees on a case-by-case basis when they are ready for full-scale banking operations. This approach allows for nuanced deliberations by stakeholders rather than imposing rigid mandates. Additionally, as fully licensed banks under the Banking Regulation (BR) Act, they can engage in the market for PSL certificates and invest in security receipts backed by priority sector assets to fulfill PSL targets, as proposed during consultations.

- *Digital Consumer Banks*

Under current guidelines, loans to SC/ST communities, women, individuals pursuing vocational courses, and persons with disabilities are considered PSL. Since these categories represent retail consumers, they are a natural target group for Digital Consumer banks. Consequently, the report [2] suggests that once fully operational, Digital Consumer banks may be deemed compliant with their PSL obligations if a defined percentage of their asset book comprises credit to these borrower categories.

6. Implications for the BFSI Sector

i. Enhanced Financial Inclusion: The introduction of digital banks, with a focus on leveraging technology to reach underserved populations such as MSMEs and individuals in remote areas, could significantly enhance financial inclusion in India. By providing frictionless, user-centric experiences and innovative financial products, digital banks have the potential to bring a larger portion of the population into the formal banking system.

ii. Increased Competition and Innovation: The proposal for licensing digital banks introduces more players into the banking sector, fostering increased competition. This competition can drive innovation as digital banks strive to differentiate themselves by offering unique services, better user experiences, and more efficient processes. Traditional banks may also need to innovate to compete effectively with these new entrants.

iii. Regulatory Challenges and Oversight: Establishing a regulatory framework for digital banks presents challenges in balancing innovation with stability and consumer protection. Regulators need to ensure that digital banks comply with prudential and liquidity standards while also allowing them the flexibility to innovate. Effective regulatory oversight is crucial to prevent risks such as cybersecurity threats, money laundering, and consumer exploitation.

iv. Technological Neutrality and Infrastructure Access: The proposal emphasizes technological neutrality, ensuring that regulatory frameworks do not favour specific technologies over others. This approach fosters innovation by allowing digital banks to choose the most suitable technologies for their operations. Additionally, equal access to financial infrastructure is essential to prevent market distortions and ensure a level playing field for all players in the BFSI sector.

v. Impact on Traditional Banks: The emergence of digital banks may disrupt traditional banking models, particularly in areas such as customer acquisition and service delivery. Traditional banks may need to adapt their strategies and operations to remain competitive in the evolving landscape. Collaboration between traditional banks and fintech companies can facilitate knowledge exchange and enable both parties to leverage each other's strengths.

vi. Focus on Financial Literacy and Education: As digital banking becomes more prevalent, there is a need to enhance financial literacy and digital skills among consumers, particularly those from underserved communities. Initiatives to promote financial literacy can empower individuals to make informed decisions about banking products and services, reducing the risk of financial exclusion and exploitation.

vii. Monitoring and Evaluation: Continuous monitoring and evaluation of the impact of digital banks on financial inclusion, small business lending, and overall economic development are essential. Regulators need to assess whether digital banks are achieving their intended objectives and adjust regulations accordingly to optimize outcomes for all stakeholders.

7. Conclusion

The evolution of digital banking, spurred by technological advancements and changing consumer preferences, presents a significant opportunity to address longstanding challenges in financial inclusion and small business lending. The recommendations outlined in the NITI Aayog report [2] offer a comprehensive framework for the establishment and regulation of Digital Business banks and Digital Consumer banks in India.

Firstly, the proposal by Nachiket Mor Committee emphasizes the need for differentiated banking policies, as advocated by the Nachiket Mor Commission report[1], to enable specialized bank licenses catering to specific segments of the market. This approach, exemplified by the creation of Payments Banks and Small Finance Banks, allows for targeted interventions to enhance financial access and deepen credit penetration among underserved populations.

Secondly, the report[2] underscores the imperative of regulatory innovation to facilitate the entry and operation of Digital Business banks and Digital Consumer banks. Sandbox testing, phased relaxation of business restrictions, and technological neutrality are key principles to ensure a conducive environment for innovation while safeguarding financial stability and consumer protection.

Furthermore, the recommendations of Nachiket Mor Committee highlight the importance of addressing key challenges facing the digital banking ecosystem, such as limited revenue potential, legacy infrastructure constraints, and high capital costs. By providing equal access to infrastructure enablers, relaxing entry barriers, and implementing prudent risk regulation, policymakers can foster a vibrant ecosystem conducive to sustainable growth and innovation.

Additionally, the report[2] emphasizes the role of Digital Business banks and Digital Consumer banks in advancing priority sector lending objectives. Through nuanced application of PSL obligations and leveraging innovative financing mechanisms like PSL certificates and security receipts, these banks can effectively channel credit to underserved segments while ensuring regulatory compliance.

In conclusion, the establishment of Digital Business banks and Digital Consumer banks represents a significant step towards realizing India's vision of inclusive and

sustainable economic growth. By embracing regulatory innovation, promoting technological neutrality, and fostering collaboration between traditional banks and fintechs, policymakers can unlock the full potential of digital banking to drive financial inclusion, foster entrepreneurship, and fuel economic development.

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Table I: Mapping of Benchmark Jurisdictions against the Factors [2]

Factors	*Looking Under the Hood*	*Singapore*	*United Kingdom*	*Hong Kong*	*Malaysia*	*Australia*	*South Korea*
Entry barriers	Are minimum capital requirements proportionate?	Yes	Yes	No	Yes	Yes	Yes
	Is the track record eligibility criterion proportionate?	Yes	N/A	N/A	N/A	N/A	N/A
	Are other eligibility conditions imposed proportionate?	N/A	Yes	N/A	N/A	Yes	N/A
Competition	Do Digital banks have equal access to deposit insurance system	Yes	Yes	Yes	Yes	Yes	Yes
	Do Digital banks have equal access to all payments systems & schemes	No	Yes	Yes	Yes	Yes	Yes
	Equal access to revenue sources at par with incumbents	No	Yes	No	Yes	Yes	No
Business restrictions (NOT adjusted for prudential reasons)	Are there any restrictions on minimum balance fees	Yes	N/A	Yes	N/A	N/A	N/A
	Are there any physical presence mandates NOT Justified by prudence?	No	N/A	No	No	N/A	N/A
	Are there any asset / deposit caps NOT justified by prudence?	No	No	No	No	No	No
Technological Neutrality	Are there any restrictions against or a preference for a particular technology?	No	No	No	No	No	No

Note: N/A – Not available

Source: NITI Aayog (2022). Digital Banks - A Proposal for Licensing & Regulatory Regime for India

Table II: Comparison of Regulatory regimes of digital banks in Asia-Pacific region [4]

	Singapore	*Hong Kong*	*Taiwan*	*Malaysia*
License Type	2 types-digital full bank (DFB) and digital wholesale bank (DWB)	Only 1 type of license	Only 1 type of license	Only 1 type of license
Number of licenses	Limited Number-up to 2 DFB licenses and up to 3 DWB licenses	No specified limit. 8 licenses granted.	Initially, only 2 licenses were available, but 3 licenses were eventually granted	Up to 5 licenses to be granted
Policy Objectives	• Financing growth enterprises and SMEs • Reducing costs and improving convenience for consumers • Helping people to plan early and achieve financial security in their later years	• Promote the application of fintech and innovation • Promote financial inclusion, covering retail and SME segments	• Increase customer convenience and meet customer needs • Promote financial innovation and fintech • Promote financial inclusion	• Financial inclusion, including ensuring quality access and responsible usage of financial services • Focus on reaching underserved and hard-to-reach segments which includes retail as well as MSMEs
Business Location	One physical place of business. No ATM or cash deposit machines	Must maintain a physical place of business in Hong Kong to deal with customer queries, but not expected to establish physical branches	Can have a head office and customer service centre but no branches	A licensed digital bank is required to establish a registered office in Malaysia but cannot establish physical branches.

Source: Deloitte (2020). Digital Banks in Asia Pacific: Adding value to financial services? (2020)