Why Digital Banks aren't a Good Idea yet

What is the issue?

NITI Aayog, in a recent discussion paper titled Digital Banks: A Proposal for Licensing & Regulatory Regime for India, floated the idea of setting up full-stack digital banks.

What are digital banks?

- Digital banks or DBs are defined in the **Banking Regulation Act, 1949**.
- These entities will issue deposits, make loans and offer the full suite of services that the Banking Regulation Act empowers them to.
- DBs will principally rely on the internet and other proximate channels to offer their services and not physical branches
- Niti Aayog has floated the idea of setting up full-stack digital banks.

What is the need for digital banks?

- To help overcome financial inclusion challenges in the country
- To reduce cost of transactions
- To gain access to technology
- For utilisation of the JAM trinity
- To reduce banking-inequality
- To place India as the global leader in Fintech

What is the status of banking sector in India?

- Over the past few decades, banking-licence categories have grown in number.
- Today, the banking sector includes
    - Public sector banks,
    - Private sector banks (21),
    - Small finance banks (12),
    - Payments banks (6),
    - Regional rural banks (43),
    - Foreign banks (44),
    - Local area banks (3),
    - Financial institutions (4),
    - Urban cooperative banks (1,531),
    - Multi-state cooperative societies & banks (1,130)

Problems for the regulator

- Issues of poor governance
- Capital constraints
- Weak management

- Unaddressed consumer grievances

What is the suggestion of Niti Aayog?

- The paper also suggests a two-stage approach :
    1. Granting of a digital business bank license
    2. Granting of a digital (universal) bank licence after gaining experience as the former
- Even with the Digital Business Bank license, it recommends a carefully calibrated approach comprising of issue of a restricted digital business bank license (in terms of volume/ value of customers serviced and the like).
- It recommends the enlistment of the licensee in a regulatory sandbox framework enacted by the RBI.
- It also suggests the issuance of a "full-stack" Digital Business Bank license based upon the satisfactory performance of the licensee in the regulatory sandbox.
- It further suggested that minimum paid-up capital for a restricted digital business bank operating in a regulatory sandbox may be proportionate to its status as restricted.
- As per the illustration, upon progression from the sandbox into the final stage, a full-stack digital business bank will be required to bring in Rs. 200 crore (equivalent to that required of the Small Finance bank).

What are the challenges?

- **Granting license**- RBI’s experience with private sector banks licensing over the past won’t make it rush to give out newer licences as RBI had to step in to contain damage in the case of private sector banks like Yes Bank and LVB.
- While RBI has a “bank under repair” sign-board in its PCA framework, it has not said anything about the efficacy of the various other banking categories such as payments banks or SFBs.
- Some of these banking categories as well as the older licence categories seem to have no visibility of viability and have not been able to showcase their significance in terms of the intended objective.
- Until legislation catches up, regulation has to adapt to ensure that the financial system absorbs digital innovation in a non-disruptive manner.
- **Ownership of banks**- Global regulators have worries about the ultimate ownership of banks preferring resident in their jurisdiction which could be a challenge for many aspirants of digital-only bank licences.
- **Raising liability pool**- The challenge for digital banks will be to show that they can raise a liability pool, instead of just using large equity capital as a debt-funding source.
- **Cyber security**- In terms of consumer protection, everything related to cyber security or digital data security or privacy rights is a concern.
- **Neo bank**- Even stable NBFCs with large capital bases are not allowed to use the word “bank” in describing themselves in any consumer communication, whereas many new-age fintech platform has named itself a neo bank.

*Neo-banks are **online-only** financial technology (fin-tech) companies that operate solely digitally or via mobile apps.Neo-banks are digital banks without any physical branches offering services that traditional banks don’t.*

References

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