Digital banks: Convergence of technology and banking

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Key takeaways:

- *A point of view on the potential limitations of having only segment-specific digital bank licenses*
- *Digital bank licenses will mark convergence of two trends: traditional banks wanting to be tech driven to keep up the innovation and improve customer experience while fintechs/Neo banks seeking licenses to operate with full range of banking.*

Niti Aayog recently came out with a discussion paper[1] on the proposal for a *separate* digital bank licensing regime in India. While this is a welcome suggestion in the right direction, the key is going to be the structure of the licensing and banking activities that a digital bank can perform, which can make it a successful business model.

Globally, digital banks have been launched across multiple geographies in various models. Digital banks are expected to have newer technological capabilities, lower operational and capital expenditure per customer to offer more affordable, and user-friendly services to underserved customers than their brick-and-mortar counterparts. Globally, bespoke digital banking licenses go by different names: 'virtual banks' in Hong Kong Special Administrative Region (SAR) China, 'internet-only banks' in Korea and Taiwan and 'digital banks' in Singapore. However, they share a few characteristics:

- **Restrictions on banks' physical presence**: Regulators have limited physical touch points in digital bank licenses to encourage distribution. For example: digital banks in Taiwan and Singapore are not allowed to establish branches, but at the same time they can participate in a shared ATM network and offer services through agents

- **Compliant with fundamental requirements for banking**: Regulators have ensured all new digital banks' licensing regime to comply with mandatory regulatory requirements, such as Anti Money Laundering (AML)/KYC, consumer protection, risk management and prudential requirements, etc.

- **Focus on Small and Medium Enterprises (SME):** Regulators have given encouragement in the licensing regime of digital banks to target underpenetrated sectors, such as micro, small and medium enterprises through innovations in digital distribution, digital underwriting, etc.

- **Ownership and controlling requirements:** Regulators have relaxed ownership norms to attract big tech companies, fintechs and other type of investors in digital banks. For example: Korea allows non-financial companies to own up to 34 per cent of digital banks.[2]

Separate digital banks license is not the only approach followed by regulators globally. Some regulators in markets such as Brazil, Germany and South Africa have licensed digital banks under their existing licensing regimes.

Overall, three key models emerge in context of digital banks:

- **Neo-banks:** These Neo-banks are platform players partnering with incumbent licensed banks to offer specific banking services, such as deposits, cards and payments, etc.

- **Separate unit of traditional banks:** These banks are essentially separate units of incumbent traditional banks functioning independently.

- **Full stack digital banks:** These are independent digital banks fully regulated by the banking regulators and operate with their own brand and balance sheets.

The first two models are already prevalent in India. However, the discussion on digital banks is revolving primarily around the third model which in turn will also allow players currently operating in first two models to convert into the third model if the digital bank licenses are available.

It is critical to clearly articulate the objectives of digital banks and the segments they will serve. While the Niti Aayog paper proposes the concept of digital business banks, restricting the licensing regime to a particular segment may not work basis the global experience of launching the digital banks mentioned in above models.

Hence, the licensing regime for digital banks should focus on broad contours such as applicant's track record, technology track record and phased approach leveraging current RBI regulatory sandbox. The use cases available in the sandbox could be leveraged to prove their business model for the segment in which the applicant wishes to operate as digital bank along with providing equal access to digital infrastructure such as Aadhaar, PAN, Payment systems (NPCI, NEFT, RTGS, UPI), AA ecosystem, CBDT access, CIC access, access to Deposit Insurance and Credit Guarantee Corporation (DICGC). At the same time, flexibility should be given to respective players to articulate their digital business model and business plan for the segments they are planning to operate in the digital bank applications.

Digital bank licenses are expected to mark convergence of two trends: traditional banks wanting to be tech driven to keep up the innovation and improve customer experience while fintechs/Neo banks seeking licenses to operate with full range of banking.

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[1] *Niti Aayog Discussion Paper: Digital Banks: A Proposal for Licensing & Regulatory Regime for India, 24 November 2021*

[2] *CGAP, accessed on 31 March 2022*