Full-Stack Digital Bank: An Idea Whose Time Has Come

--Amitabh Kant

It would be a truism to suggest that India is a global leader when it comes to fintech innovation. Following the IndiaStack and related developments the domestic fintech industry recorded impressive growth. The sector attracted INR 19,980 Crores in investments in 2020 and INR 14800 Crores in 2021 (H1); more than 42 Crores new bank accounts have been opened under PMJDY since 2014; Aadhaar e-KYC has enabled more than 55 lakh Crores authentications; UPI transferred ₹ 6 lakh Crores in value across 365 Crores transactions in September 2021; and India has given the world its own version of "open banking", the account aggregator framework that recently went live enabling consent-based transfer of data between regulated intermediaries. The Discussion Paper on licensing and regulatory regime for Digital Banks released by Niti Aayog is aimed at cementing India's place as a trailblazer in fintech. As the Hon'ble Prime Minister observed in his recent address, fully digital banks are already a reality and it is just a matter of time for them to become commonplace. As the Niti Aayog's Discussion Paper highlights, full-stack Digital banks may also hold the promise as a potential solution for the persistent policy challenge of credit deepening. It is the next stage of financial inclusion.

Despite India's impressive strides in financial inclusion leveraging a slew of digital public goods infrastructure there remains major gaps. As on date, a significant fraction of India's approximately 640 lakhs MSMEs remain under-served or unserved in terms of their credit needs by the formal financial sector. In a widely cited report, the IFC estimates the total credit gap to be ₹ 25 lakh Crores and growing. Despite several proactive regulatory and policy initiatives, existing supplier constructs (eg, banks / NBFCs / TReDS) have structural or business constraints requiring targeted interventions to overcome this gap.

For example, given the scale and overheads involved, a minimum ticket size may be required for banks to service micro or small business owner, despite formal digital financial footprint. These friction points translate into high cost-to-serve for banks. While the NBFCs have innovated around product and distribution channels using technology, lacking the ability to issue low-cost deposits, they confront a cost-of-funds constraint in servicing MSMEs. Illustratively, even the largest (deposit-taking) NBFCs in India raise funds at as high as 7.5% . It is easy to infer that NBFCs lower down the order face higher funding costs. Finally, as the U K Sinha Committee has observed in its report, despite best efforts, the TrEDS platforms have had limited success in terms of onboarding corporate (and PSU) buyers thus limiting their ability to finance MSME suppliers.

Having prepared the bedrock of financial innovation and inclusion, it is time to look towards the next steps in the direction of digitalisation in the banking, financial services and insurance sector- with the advent of a "full-stack" digital bank – entities that will issue deposits, make loans and offer the full suite of services under the existing regulatory regime.

To their credit, fintechs (known in industry parlance as “neo-banks”) are working with scheduled commercial banks to enable greater access to credit along with offering other adjacent value-added services. Typically, this partnership model involves fintechs operating at the engagement layer (“front-end”) and relying on bank balance sheets to issue current accounts, credit lines, loans, credit cards and such. However, this partnership model is sub-optimal for several reasons.

Firstly, it prevents ground-up product innovation because the fintech partner is constrained by the limitations of the core banking system of the partner bank. This constrains their ability to serve some emerging sub-sets of entrepreneurs. A typical example in this regard is a bakery (typically incorporated as a privately held company) in an urban centre like Bangalore that relies on subscription-based software-as-a-service vendors for its office operations. It needs a credit line *tailored to its billing and payment cycle* to manage its working capital cycle better. Traditional banks may not be able to make necessary technological changes on their core banking system on the fly for this client.

Secondly, regulators lack a direct line of sight into this these partner fintechs creating potential for risks borne from the opacity. A digital bank license framework solves for both cost-to-serve constraint (through exploiting their stack) and cost-of-fund constraint (through issuance of low-cost deposits). Furthermore, it enables greater transparency from a regulatory vantage point.

Based on a detailed review of the global regulatory developments especially in South East Asia, towards recognizing digital banks, a systematic Digital Bank regulatory Index was created in the Discussion Paper to distil regulatory best practices in designing a Digital bank licensing template for India. The licensing framework proposed is fully compatible with novel use-cases witnessed globally; eg, “Banking-As-A-Service” to cite one salient example. The sequence of reform proposed envisages a Digital Business bank license in the first stage. It suggests scaling up to a Digital “universal” bank license basis public policy experience gathered in regulating and supervising this set of differentiated banking licensees.

Technology and increased digitalisation is bound to be disruptive for the incumbents and care needs to be taken that the sector grows in a holistic manner with level playing field between different segments of business entities. In past the regulator has been conscious of this aspect while expanding the gamut of new licensed entities in this space. Digital Business banks need to be incubated under the extant RBI regulatory sandbox regime before they achieve the size and scale to operate as full-fledged banks. There needs to be regulatory parity between incumbent commercial banks and proposed Digital Banks from a prudential and consumer protection standpoint. Equally, digital literacy initiatives (so that customers engage with Digital Banks in an empowered way) and cyber-security /potential frauds emanating from social engineering need to be focussed on. The regulatory framework the Discussion Paper has proposed has accounted for these factors.

With the digital public infrastructure at its disposal, India has the opportunity to become the global trailblazer in one more area of fintech. MSMEs are catalyst for India's growth engine contributing 28 % of its GDP, employing 11 Crores of its population, 45 % of its manufacturing output and 40 % of its exports. Digital Banks offer the promise of giving them wings to fly high.

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