Credit to Digital Banks

-By Amitabh Kant

India's financial technology sector has been a global bellwether. It attracted $5.7 billion in funding in CY 2022 alone; over 550 start-ups received $25 billion in funding. This capital base and the policy and technology catalysts in the form of J-A-M trinity have enabled solving major social public policy challenges including financial inclusion and formalization of the economy. The PMJDY has seen 420 million new bank accounts being opened since 2014; Aadhaar e-KYC has enabled more than 55 trillion authentications; UPI transferred ~ INR 126 lakh crores in value across 7400 crores transactions in CY 22.

Having solved for the first layer of the financial inclusion agenda through the J-A-M trinity, the next big challenge that awaits India is facilitating credit deepening, especially on the micro and small business end of the business spectrum. Data suggests that India has ~79 lakhs MSMEs. ~ 95% of these 79 lakhs are micro enterprises that remain largely outside the ambit of bank-based finance. The UK Sinha Committee Committee, established by RBI reported that the addressable credit gap in the MSME space was INR 25 trillion in 2019. What should concern us even more is that the addressable credit gap is growing at ~35 % on a compounded annual basis.

Just as J-A-M trinity solved the breadth problem by expanding the coverage of bank accounts to 42 crore new people, regulatory innovations

in the form of Digital Banks offer the promise of mitigating the credit deepening challenges India faces.

The existing constituents of the financial marketplace, banks and NBFCs are structurally constrained in serving the micro and small segments of the MSME ecosystem. While banks incur significant costs to serve-flowing from lack of formal documentation and absence of transparency around credit history of potential borrowers, NBFCs are hamstrung by the high cost of funds ("**CoF**") they have to deal with. (Illustratively, the largest well-capitalised NBFC in India incurs a CoF of 7.5 %. Compare that with CoF of a well capitalised bank- ranges from 3.8 %- 4.5%).

While the RBI has enacted reform measures like TReDS to solve for working capital constraints in the micro and small enterprises credit space, TrEDS relies on corporate buyers to on-board their seller ecosystem on to the platform. It has been a challenge for the TReDS operator platforms to on-board private sector buyers. Moreover, buyers themselves can run invoice discounting programs with their partner commercial banks for their vendors. So, they appear to lack incentives to utilise platforms like TrEDS to save on some percentage points in procurement costs.

Digital Banks are banks as defined in the Banking Regulation Act. They will issue deposits, make loans and offer a fuller suite of services that the Banking Regulation Act empowers them to. Digital Banks are efficient along both the cost-to-serve, and cost-of-funds dimensions. These benefits are especially important in grey swan contexts like the Coronavirus

pandemic and have been empirically found to be so, as the Niti Aayog Report on Digital Banks released in June 2022, highlighted.

Researchers at the IMF used the pandemic opportunity to test the correlation between digital lending and firm performance. The pandemic offered a good context to test the public policy utility of digital banking especially because "high touch" due diligence was ruled out. These researchers found that lending to a random sample of 40,000 micro and small enterprises ("MSEs") by a Digital bank (MyBank) was positively associated with sales growth at borrowers. They further established a possible causal relationship between lending by a Digital bank and the MSE's higher sales growth during the pandemic.

Banking and financial sector has shifted to market-based credit allocation, and the RBI no longer sets interest rates on individual loan categories. However, priority sector lending (PSL) remains subject to outdated laws, including administered interest rates. This results in a dual regulatory architecture that requires reform. The PSL regulatory framework needs to be mordernised. An upgraded framework aligned with market-based principles can promote greater efficiency and flexibility in lending to priority sectors.

Since specialized Bank licences including the Digital Bank licences (as and when they are enabled) are aimed at enabling provision of banking services to a targeted demographic (eg, MSEs), a case-by-case approach to determining respective PSL obligations will ensure effective service delivery to their target market while fulfilling their social obligation towards priority sector lending. Because the PSL obligations are tailored to the particular

Bank concerned, this reform will also promote greater on-balance-sheet lending rather than fulfilling PSL obligations through secondary markets.

Presently, a universal bank licence requires INR 500 crores as minimum capital to be brought in by the applicant. It is a one-size-fits-all requirement. Such one-size-fits-all mandates are inefficient because they lock in disproportionate capital. Moreover, empirical research has shown that disproportionately high minimum capital requirements operate as market barriers entrenching incumbents and inhibit ease of doing business.

Global Regulatory practice has evolved to offer tailored regimes. ~85 % of the jurisdictions surveyed for the Niti Aayog Report on Digital Banks offer proportionate minimum capital requirements. Accordingly, the Digital Bank licensing framework should bring India's banking regime lockstep with the world and offer proportionate minimum capital norms to the applicants.

The policy and technology catalysts in the form of J-A-M trinity have enabled solving social public policy problems including financial inclusion and formalization of the economy. The next big opportunity lies in enabling credit to India's 79 lakh MSMEs. A well-crafted Digital Bank regime powered by India stack is the catalyst for the next credit revolution.

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