Deconstructing Digital-only Banking Models | *A Proposed Policy Roadmap for India*

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I. Setting the Context

Technology has facilitated an influx of new business models in financial services, including exclusively digital branchless banking models, either in the form of licensed digital banks or as partnerships between licensed banks and non-banks. Broadly, digital banks are "licensed deposit-taking institutions that are members of a deposit insurance scheme and deliver banking services primarily through electronic channels instead of physical branches."[1]However, in certain jurisdictions, owing to a regulatory architecture that does not permit digital banks (like India), digital-only banking models operate as partnerships between licensed banks and non-banks. In the Indian context, most of these non-banks that partner with banks to provide such digital banking services typically identify themselves as "neobanks". Countries like the United Kingdom ("**UK**") have witnessed relative success with digital banks, with such banks tripling their customer base from 2018 to 2019.[2] Countries like Hong Kong and Singapore have now introduced separate regulatory regimes for digital banks. While in 2014, India took significant steps towards boosting financial inclusion through the introduction of differentiated banks - payment banks and small finance banks - the regulatory framework does not permit fully digital banks. This report deconstructs the digital-only banking model in India and globally, assesses its value propositions, and recommends a phased policy roadmap for such models in India. Through this roadmap, the report seeks to leverage the bank-fintech partnerships in their current form and understand whether this may be scaled to full digital banks. The report notes however, that given India's unique context, with important constraints on financial literacy and internet penetration, a digital-only model must be introduced after careful consideration.

The ongoing COVID-19 pandemic has accentuated the role of contactless delivery of financial services. Going forward, as society adapts to the realities of a post-pandemic context, technology is likely to play a much larger role. In this regard, two important considerations follow.

Rising demand for digital services in the aftermath of COVID-19

The COVID-19 pandemic has catalysed the adoption of digital services across sectors. Regulators have actively encouraged shifting to contactless digital payments in light of concerns regarding the use of cash and the safety of in-person transactions.[3]The impact has been significant even within bank processes and supervision requirements highlighting the significance of digital solutions such as video know your customer which was permitted by the Reserve Bank of India ("**RBI**") before the outbreak of the pandemic.[4] Early research indicates that the conditioning of digital interactions brought about by the pandemic will facilitate the uptake of technology in banking, with the likelihood of sustained uptake from consumers given rising confidence as more services are digitised.[5] This altered paradigm only serves to underscore both the utility and the rapid pace at which the banking sector is being digitised.

Underserved market for Micro, Small and Medium Enterprises and other underserviced groups

As a sector that has been hit particularly hard by the effects of COVID-19, it is critical to provide access to banking services as well as credit products to revive the micro, small and medium enterprises ("**MSMEs**"). MSMEs have

[1] Bank for International Settlements, 'Regulating fintech financing: digital banks and fintech platforms' (2020) <https://www.bis.org/fsi/publ/insights27.htm> accessed 12 September 2020

[2] Accenture, 'U.K. Neobanks Near 20 Million Customers in 2019, but Customer and Deposit Growth Rates Slow, According to Research from Accenture' (2020) <https://newsroom.accenture.com/news/uk-neobanks-near-20-million-customers-in-2019-but-customer-and-deposit-growth-rates-slow-according-to-research-from-accenture.htm> accessed 16 September 2020

[3] See Economic Times, 'RBI pushes digital payments in the time of COVID-19' (2020) < https://bfsi.economictimes.indiatimes.com/news/policy/rbi-pushes-digital-payments-in-the-time-of-covid-19/74655639> accessed 13 July 2020. See also Bank for International Settlements, 'Covid-19: Boon and bane for digital payments and financial inclusion' (2020) < https://www.bis.org/fsi/fsibriefs9.htm> accessed 15 September 2020

[4] Reserve Bank of India, 'Master Direction - Know Your Customer (KYC) Direction, 2016 (Updated as on April 20, 2020)' (2020) < https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11566> accessed 23 July 2020

[5] Deloitte, 'Retail Banking in the Age of COVID-19' (2020) < https://www2.deloitte.com/content/dam/Deloitte/global/Documents/Financial-Services/gx-fsi-retail-banking-in-the-age-of-covid-19.pdf> accessed 13 July 2020

been traditionally underserved by the formal banking segment, which makes this sector a particularly attractive business proposition for emerging digital-only banking models. In March 2019 alone, the estimated credit gap stood at ₹20 – 25 trillion.[6] Banks have also been encouraged to increase outreach of banking services by utilising technology to lower operating costs and increase efficiency.[7] Bolstering partnership between banks and financial technology (fintech) companies in this regard can further the regulatory objective of enhancing the financial health of and supporting the MSME sector, if combined with prudent supervision from the regulator.

A well-functioning financial system will require a mix of institutions that can serve the diverse needs of the Indian population.[8] While the RBI introduced the concept of differentiated banks in the form of small finance banks and payments banks, this report goes a step further and seeks to explore the possibility of digital banks in India. Tracing the recent developments of the digital banking model in India and across selected jurisdictions, this report proposes a roadmap to leverage the existing bank-fintech partnership to provide branchless banking services and facilitate India's transition to a market for digital banks. Keeping in mind the nascent stage of the digital-only banking market in India (also referred to as "neobanking") and the current economic scenario, this report sets forth a phased roadmap to leverage the potential of such a banking model and minimise risks associated with it. In doing so, the report remains conscious of the country's unique requirements and proposes the introduction of digital banks subject to market conditions and a thorough understanding of the regulatory risks involved.

While this report seeks to leverage the digital-only banking model, the authors remain conscious and acknowledge the significance of physical branches and agent networks given that the uptake of digital technologies for financial services is not uniform across the country.

[6] Reserve Bank of India, 'Expert Committee on Micro, Small and Medium Enterprises' (2019) < https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=924> accessed 13 July 2020
[7] ibid
[8] Reserve Bank of India, 'Report of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households' (2014) <https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=727> accessed 2 June 2020

II. Understanding the Banking Sector in India

Banks are essential components of the financial system. World over, as technology increasingly permeates the world of finance, banks and markets continue to adapt. In addition to the rising use of technology-based solutions within the financial sector, over the last two decades the impact of technology has been felt in banking as well. This chapter outlines the design and development of India's banking sector, and traces regulatory initiatives to facilitate technology integration in banking. Our analysis of these developments reveals: (a) the significance of differentiated banks to meet the needs of different sectors and customer segments; (b) the increasing emphasis on technology in driving bank operations; and (c) evolution of the regulatory framework to provide banks with necessary flexibility on the choice of delivery channels from physical branches to agents. This report seeks to explore if a possible transition from this stage to a digital-only banking model for India is a feasible objective, in the form of bank-fintech partnerships or digital banks.

India's Banking Policy

Traditional Banks

Banking regulation in India is primarily guided by the Banking Regulation Act, 1949 ("**BR Act**") and the Reserve Bank of India Act, 1934 ("**RBI Act**"). The law is implemented by the RBI, India's central bank and primary regulator of all banking entities. To operate as a bank, an entity must be licensed by the RBI. The prerequisites for a license include satisfying stipulated conditions on the ability to repay depositors, capital structure and earning prospects, and public interest. Banks are typically categorised based on their ownership structure and cater to a variety of customers. Commercial banks cater to segments across the board, whereas co-operative banks and differentiated banks (such as the small finance banks and payment banks) cater predominantly to semi-urban, rural areas and small businesses. Banks are permitted to maintain agent networks to facilitate greater outreach of banking services by performing activities such as identifying borrowers, collecting and processing loan applications, and creating awareness regarding savings products.[9]

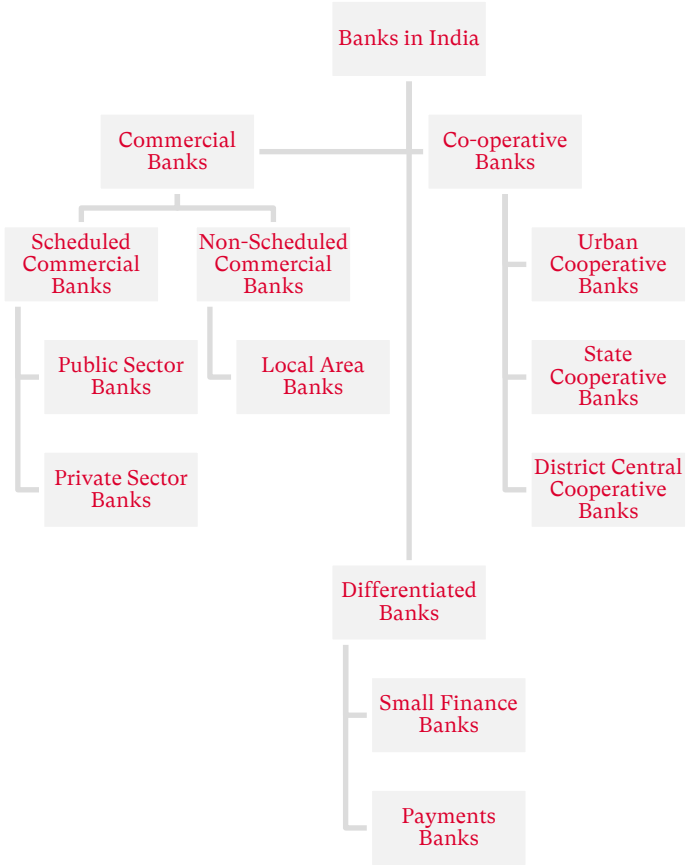


Figure 1: *Taxonomy of Banks in India. Source: RBI*

[9] See Reserve Bank of India, 'Discussion Paper on Engagement of 'for-profit' Companies as Business Correspondents' (2010) https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2234 accessed 2 June 2020. See also Reserve Bank of India, 'Financial Inclusion by Extension of Banking Services – Use of Business Correspondents' (2014) <https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=8955< accessed 2 June 2020.

Differentiated Banks

The discussion on differentiated banks stemmed from the need to increase the size and strength of the banking sector relative to the needs of the economy.[10] The concept of differentiated banks was first discussed in a 2007 RBI Technical Paper on Differentiated Bank Licenses.[11]It argued that uniform treatment of banks would lead to regulatory and compliance costs at a time when banks were moving to specialise. While the paper concluded that the time was not yet opportune for such banks, in 2008, the Committee on Financial Sector Reforms headed by Dr Raghuram G Rajan discussed differentiated banks in the context of examining the relevance of small finance banks for India to further financial inclusion.

In 2013, the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households headed by Dr Nachiket Mor ("**Nachiket Mor Committee Report**")[12] espoused the concept of differentiated banks using the functional building blocks of payments, deposits and credits. The committee recommended the licensing of payment banks whose primary role would be to provide payment services and deposit products to small businesses and low-income households. Financial inclusion was sought to be achieved by providing access to an electronic payments infrastructure, the cost of which would be significantly lower than those associated with traditional branches.

Designing a Banking System: The Nachiket Mor Committee Report

Two broad designs for the banking system were discussed:

Horizontally Differentiated Banking System

- *Full service bank that combines payments, deposit, and credit*
- *They are primarily differentiated based on size, geography or sectoral focus*
- *Possible designs: national bank with branches (public sector banks such as State Bank of India); national bank with agents (private banks such as ICICI Bank), national consumer bank (such as deposit taking non-banking financial companies ("**NBFCs**")), etc.*

Vertically Differentiated Banking System

- *Unlike a full service bank, these banks specialise in one or more of the "building blocks" of payments, deposit, and credit*
- *Possible designs: payments network operator (licensed under the Payment and Settlement Systems Act, 2007); payment banks, etc.*

The Indian banking system is designed as a combination of vertically and horizontally differentiated systems.

In 2014, the RBI released guidelines for the licensing of payments banks[13] and small finance banks.[14] The RBI also stated that it plans on introducing various categories of differentiated bank licenses to allow a wider pool of entrants into banking.[15] Payments banks are not permitted to engage in any lending activity, and their income is predominantly derived from interest earned on investments in high quality securities.[16] On the other hand, small

[10] Reserve Bank of India, 'Report of the Committee on Comprehensive Financial Services for Small Businesses and Low Income Households' (2014) <https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?UrlPage=&ID=727> accessed 2 June 2020; Reserve Bank of India, 'Banking Structure in India – The Way Forward' (2013) <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/DPBS27082013_F.pdf> accessed 24 August 2020.

[11]Reserve Bank of India, 'Technical Paper on Differentiated Banking Licenses' (2007) < https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/80798.pdf> accessed 31 May 2020

[12] Reserve Bank of India (n 10)

[13] Reserve Bank of India, 'Guidelines for Licensing of Payment Banks' (2014) <https://www.rbi.org.in/scripts/bs_viewcontent.aspx%3FId%3D2900> accessed 2 June 2020. See also Reserve Bank of India, 'Operating Guidelines for Payments Banks' (2016) < https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10635&Mode=0> accessed 3 June 2020.

[14] Reserve Bank of India, 'Press Release: RBI releases Guidelines for Licensing of Small Finance Banks in the Private Sector' (2014) < https://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=32614> accessed 2 June 2020. In 2019, the RBI updated the licensing framework for Small Finance Banks and released guidelines for the 'on tap' licensing of these entities. See Reserve Bank of India, 'Guidelines for 'on tap' Licensing of Small Finance Banks in the Private Sector' (2019) < https://www.rbi.org.in/scripts/bs_viewcontent.aspx?Id=3797> accessed 3 June 2020. See also Reserve Bank of India, ''Guidelines for Licensing of Small Finance Banks in Private Sector' dated November 27, 2014 – Modifications to existing norms' (2020) < https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11845> accessed 25 August 2020

[15] Reserve Bank of India, (n 13)

[16] Radhika Merwin, `On-tap' licensing of small finance banks: Will payments banks go for it' (2019) < https://www.thehindubusinessline.com/money-and-banking/on-tap-licensing-of-small-finance-banks-will-payments-banks-go-for-it/article29497255.ece > accessed 2 June 2020 https://www.thehindubusinessline.com/money-and-banking/on-tap-licensing-of-small-finance-banks-will-payments-banks-go-for-it/article29497255.ece

finance banks are permitted to undertake banking activities, including providing credit. The key difference between small finance banks and regular commercial banks is scale[17] - the former tend to service small business units and small and medium farmers and operate at a much smaller scale than the latter. Payments banks have not succeeded as initially hoped, due to the tension between profitability and financial inclusion objectives.[18] While the RBI initially licensed 11 entities, only 6 remain operational. High losses and operating liabilities and a limitation on the business model itself (*viz.* prohibition on providing loans, unlike commercial or small finance banks) alongside constraints on the size of the deposits, mean that such entities are compelled to offer competitive interest rates on these deposits to compete with private banks which drives down margins.[19] In contrast, stakeholders have indicated that although the record has been positive, it is early to judge the success of small finance banks.[20]

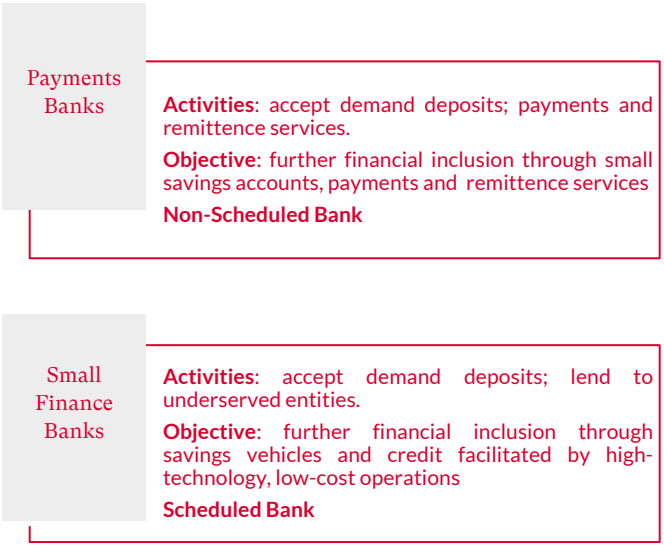


Figure 2: *Payments Banks and Small Finance Banks*

Physical Branches and Digitisation

Extant regulation requires banks (both commercial and small finance banks) to open a minimum of 25% of banking outlets in rural areas.[21]The requirement of opening at least 25% of branches in unbanked rural centres is not stipulated for payment banks. However, the payments bank will be required to have at least 25% of physical access points including business correspondents in rural centres. The emphasis on the maintenance of physical branches has been a consideration from as early as 1969 when the RBI introduced the Lead Bank Scheme to enhance the flow of funds to the priority sectors and to promote the role of banks in the rural sector.[22]The latest iteration of the Lead Bank Scheme notes the importance of brick and mortar branches as an essential element of financial inclusion. India's National Strategy on Financial Inclusion underscores the importance of physical outreach measures in the form of business correspondent or agent networks as well as physical branches in order to deepen access to and quality of financial services across the country.[23]

The meaning of a 'banking outlet' has also evolved over the years. While the older definitions of a "branch" included full-fledged branches, specialized branches, satellite offices, mobile branches, extension counters, off-site automated teller machines and administrative offices, this definition has since expanded to facilitate greater financial inclusion and provide banks with flexibility on the choice of delivery channels.[24] For instance, in 2016 a report of the RBI's internal working group recommended that all fixed point locations are brought on par with

[17] Tanya Kandelwal, 'Explained | From payments banks to neo banks -- how India's fintech ecosystem has evolved' (2019) <https://www.moneycontrol.com/news/business/companies/explained-from-payments-banks-to-neo-banks-how-indias-fintech-ecosystem-has-evolved-4700551.html> accessed 2 June 2020.
[18] Indradeep Ghosh and Ajit Ranade, 'A Trilemma and a Possible Solution Can Payments Banks Succeed?' (2020) 55 (15) Economic and Political Weekly <https://www.epw.in/journal/2020/15/special-articles/can-payments-banks-succeed.html#> accessed 2 June 2020.
[19] Radhika Merwin, 'Why five out of the 11 payments banks have shut shop' (2019) <https://www.thehindubusinessline.com/money-and-banking/five-out-of-the-11-payments-banks-have-shut-operations-why/article29381134.ece> accessed 3 June 2020.
[20] See Amulya Neelam, 'Tracking Performance of Small Finance Banks against Financial Inclusion Goals' (2019) <https://www.dvara.com/research/wp-content/uploads/2019/11/Tracking-Performance-of-Small-Finance-Banks-against-Financial-Inclusion-Goals.pdf> accessed 2 June 2020; Shailesh Menon, 'In 5 years small-finance banks have done well. The challenges ahead: scale, CASA, and managing risk' (2019) <https://prime.economictimes.indiatimes.com/news/72682529/fintech-and-bfsi/in-5-years-small-finance-banks-have-done-well-the-challenges-ahead-scale-casa-and-managing-risk-> accessed 2 June 2020.
[21] Reserve Bank of India, 'Rationalisation of Branch Authorisation Policy - Revision of Guidelines' (2017) < https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=10972&Mode=0> accessed 4 August 2020. Note that this is also applicable to small finance banks.
[22] See for example, Reserve Bank of India, 'Master Circular – Lead Bank Scheme' (2020) < https://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11926> accessed 4 August 2020
[23] Reserve Bank of India, 'National Strategy for Financial Inclusion2019-2024' (2020) < https://rbidocs.rbi.org.in/rdocs/content/pdfs/NSFIREPORT100119.pdf> accessed 4 August 2020
[24] See Reserve Bank of India, 'First Bi-monthly Monetary Policy Statement' (2016) < https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=36654 > accessed 24 August 2020

bank branches.[25] Pursuant to this recommendation, the Branch Authorisation policy was revised in 2017, incorporating a diluted definition of banking outlets which included fixed point delivery units, providing services for a minimum of four hours a day for five days a week and manned by bank staff or business correspondents[26] which provided additional leeway to banks to rely on agent networks. Indeed, the signs point to this definition expanding further – as the Governor of the RBI noted recently, "The need for brick and mortar branches is being reviewed continuously as digitisation has literally brought banking to one's fingertips, obviating the need to physically visit a bank branch for most of the banking services".[27]

Digital-Only Banks: the Next Logical Step?

These developments demonstrate active measures taken by the regulator to leverage the benefits of technology. For instance, a technology-reliant payments banks model sought to utilise digitisation to offer low cost banking solutions.[28] Similarly, the dilution of the definition of bank branches is indicative of the breadth of banking solutions technology has on offer. The RBI Annual Report 2019-2020 notes that the "use of information technology (IT) and intermediaries in the form of Information and Communication Technology (ICT) based models including BCs, ATMs and mobile vans has increased outreach, scale and depth of banking services at an affordable cost." Indeed, the latest annual report notes the emphasis on technology-enabled customer services as a specific objective.[29]

Financial technology (fintech) companies cater to niche customer market segments in India, and play a key role in both product customisation and distribution stages. Given the evolving context post the COVID-19 pandemic, it is clear that technology will play a much larger role in banking services, as social distancing norms and limits on physical contact continue. Technology adoption in the banking sector has been meaningfully facilitated through different bank-fintech partnerships. It concurrently appears that alongside scaling these bank-fintech partnerships, the introduction of digital banks may be the logical next step. Indeed, in a recent speech, the Governor of the RBI noted that technology is an essential prerequisite to boosting banks' efficiency, particularly in a post-COVID business paradigm.[30]

After the payments and lending space, one such model that is currently being witnessed in the Indian market is the digital banking model that is discussed in detail in the next chapter.

[25] Reserve Bank of India. 'Report of the Internal Working Group (IWG) on Rationalisation of Branch Authorisation Policy' (2016) < https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=38250> accessed 24 August 2020
[26] Reserve Bank of India, (n 21)
[27] Shaktikanta Das, 'Banking Landscape in the 21st Century' (2020) <https://www.rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=18821 > accessed 24 August 2020.
[28] Reserve Bank of India, 'Guidelines for Licensing of Payments Banks' (2014) < https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2900> accessed 11 September 2020
[29] Reserve Bank of India, 'Annual Report 2019-20) (2020) < https://m.rbi.org.in/Scripts/AnnualReportPublications.aspx?year=2020> accessed 15 September 2020
[30] Shaktikanta Das, 'It is Time for Banks to Look Deeply Within: Reorienting Banking Post-Covid' (2020) < https://www.rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=1099> accessed 11 September 2020

III. Unpacking the Digital-only Banking Models

As detailed in the previous chapter, the trend towards branchless banking with a focus on technology driven banking operation appears to be gathering steam in India. Catalysed by the increased emphasis on technology use in a post-COVID era, it seems certain that greater digitisation of customer service delivery channels is imminent. This is also evidenced by the emergence of the bank-fintech partnership. While India still experiments with the bank-fintech partnership as one of the forms of digital-only banking, licensed digital banks that allow end-to-end banking operations to take place digitally have emerged in certain jurisdictions. Going forward, the digital-only banking model may play an important role in providing critical banking services and contributing to the growth of a robust and competitive banking sector. This chapter analyses the growth of digital-only banking model by unpacking the models currently in play.

The Digital-only Banking Model

Digital banks are transforming the way banking is viewed by customers and the market. Unlike traditional banks, which require brick-and-mortar infrastructure or physical access points, digital banks leverage technology to provide banking services through mobile applications and internet-based platforms, providing banking services through digital channels. Globally, terms like "neobanks", "challenger banks", "digital banks" or "virtual banks" are often used interchangeably. The digital-only banking business model is determined by the regulatory architecture of a particular jurisdiction. In the Indian context, such a model involves partnership between an existing licensed bank and a non-bank (typically a fintech company), commonly referred to as a "neobank". Broadly, digital-only banking models may be categorised as follows.

Model A: Licensed Digital Banks

- These entities are licensed by the regulator to provide all banking services.
- They have a technology-enabled business model and provide services remotely with no or minimal physical point of contact.
- In some cases, these banks partner with fintech companies to provide value added services through a marketplace model (Starling Bank (UK)) or banking-as-a service model (Solaris Bank (Germany)).
- Permitted in jurisdictions such as UK, Singapore, Hong Kong, etc.

UK	monzo
China	WeBank 微众银行
South Korea	kakaobank

Model B: Digital Unit of Existing Licensed Bank

- Existing licensed bank which offers digital-only services under a different brand name or unit.
- By leveraging technological solutions, they target the tech savvy customers to deliver banking services.
- Such models can be noted in the Indian market.

DBS	digibank by DBS
SBI	yono SBI
Kotak	811 kotak Kotak Mahindra Bank

Model C: Partnership Model

- Customer facing non-banks (fintech companies) partner with licensed banks and financial institutions to provide a software overlay.
- Through such partnerships, these non-banks provide customers access to a range of financial services such as facilitating opening of current accounts, applying for loans, issuing co-branded cards and payment services.
- To differentiate their offerings, they provide value added services such as expense management, preparation of invoice, vendor payment management, etc.

ICICI Bank	open
DCB Bank, IDFC, First Bank, Yes Bank	Niyo
Bankcorp Bank (US)	chime

Figure 3: *Snapshot of the different digital-only banking models*

Model A is seen in countries that have adopted a policy on digital banks - either as a standalone framework or through existing bank licensing framework. Like traditional banks, these licensed digital banks can offer a full range of banking activities. Currently, due to the regulatory architecture in India that requires banks to have branches / banking outlets, Model A is not present in India. A discussion on how certain jurisdictions have approached Model A is set out in Chapter IV of this Report. However, in the recent past, India has witnessed the evolution of Model B and Model C. In case of Model C i.e. the Partnership Model, the non-banks through their partnership with licensed banks and financial institutions seek to provide a host of financial and value added services. In doing so, the non-bank relies on the partner bank to provide the core regulated services. For instance, while the non-bank may facilitate current account opening, the actual account is opened with a licensed bank and the deposit is accepted by such bank. Similarly for loan products, while the non-bank may facilitate a customer to apply for a loan, the actual loan is provided by a bank or an NBFC.

In this Report

- *The term 'digital-only banking model' refers to a model of banking carried out under either of these options discussed above, as may be allowed in a particular jurisdiction.*
- *The terms "digital-only banks" or "digital banks" refer to entities specifically licensed under applicable laws to operate as digital banks with no or minimal physical presence.*
- *The term 'neobanking platform' is used to describe the technology interface (website or mobile application) operated by a non-bank under the Partnership Model.*

As discussed above, both in the case of Model A and Model C, one is likely to witness bank-fintech partnerships. Two broad forms of partnership between banks and fintech companies seem to have emerged: software-as-a-service ("**SaaS**") and banking-as-a-service ("**BaaS**").[31]Broadly, in case of the SaaS model, the fintech partner provides software to the regulated bank to better serve its customers and in case of BaaS model, a bank allows access to banking or financial services to the clients of its fintech partner. Banking is a highly regulated activity and involves huge regulatory and compliance costs. A BaaS provider (that is often simply explained as a technology company with a banking license)[32] enables many fintech players to provide financial services to its customers under a partnership model without having to separately obtain a banking license. While there may be different models of BaaS, one may refer to the Solaris Bank in Germany which is one extreme example of the BaaS model. It describes itself as a "technology company with a German banking license." It is understood that the bank does not engage in direct consumer contact, and is mainly involved in allowing fintech companies to piggyback on its banking license to provide financial services to the fintech consumers.[33]Currently, we have not witnessed such a form of the BaaS model in India. Going forward, as such models evolve, with the use of application programming interfaces ("**APIs**"), the nature of a primary financial relationship may undergo transformation as consumers interact directly with companies that may not be banks but are connected to them through APIs.[34]

[31] Luca Enriques and Wolf-Georg Ringe, 'Bank-Fintech Partnerships, Outsourcing Arrangements and the Case for a Mentorship Regime' (2020) Capital Markets Law Journal < https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3625578> accessed 24 August 2020
[32] Peter Zetterli and Ivo Jenik, 'These Digital Banks Help Fintechs to Offer Banking Services' (2020) <https://www.cgap.org/blog/these-digital-banks-help-fintechs-offer-banking-services> accessed 25 August 2020
[33] Enriques and Ringe (n 31). Solaris <https://www.solarisbank.com/en/services/> accessed 26 August 2020. The website of the Solaris Bank states "Start building your own banking service" and "Choose from our API accessible services to create your own fully licensed state of the art financial solution"
[34] Nydia Remolina, 'Open Banking: Regulatory Challenges for a New Form of Financial Intermediation in a Data-Driven World' Singapore Management University Centre for AI & Data Governance Research Paper (2019) <https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3475019> accessed 10 September 2020

Assessing the Benefits and Challenges of a Licensed Digital Bank and Partnership Model

The table below is a comparative assessment of the benefits of a licensed digital bank and the Partnership Model and the issues for consideration in adopting a particular approach by a jurisdiction.

Issue		Licensed Digital Bank	Partnership Model
Regulatory perimeter	Benefit	It may boost competition and heterogeneity in the banking sector. This has been one of the primary objectives for jurisdictions with licensed digital banks.	It leverages the benefits of the bank-fintech partnerships that have so far had a positive response in the case of payments and lending. This option is suitable to assess the readiness of the market for a licensed digital bank.
	Concern	Typically, applicant for digital banks will have to meet the same prudential requirements as that of other incumbent banks. Therefore, as compared to the Partnership Model, this model will require significant investment in compliance (such as bearing costs of licensing and complying with prudential regulation) by the applicant. Hence, initially there may be few takers for such a model.	Typically structured as an outsourcing arrangement, this model may be a poor substitute for regulatory scrutiny, as the fintech entity may not be subject to direct oversight of the regulator.
Business proposition	Benefit	Such banks tend to target specific customer segments, especially those that have typically been under-serviced by incumbents, such as MSMEs or young millennials.	Reduced compliance costs for fintechs partnering with bank, since there is no requirement to obtain a full banking license.[35] It allows banks to leverage the partnership to target a wider customer segment, making it an attractive partnership proposition.
	Concern	The viability of the business proposition will be dependent on the regulatory framework. For instance, in the case of payment banks, restrictions on specific activities have adversely impacted the business proposition for such banks. Similarly, if the licensing requirement are too stringent, most new age companies may not be able to meet the same.	Scaling might be a challenge, given that fintech will be reliant on banks until the time they can acquire their own licenses.
Consumer welfare	Benefit	It opens the sector for entry of new entrants that can leverage emerging technologies to provide customer centric differentiated and niche services. This includes various value added services (business-related and account-management services, such as book keeping, tax filing, inventory management, payment services, AI-driven accounting insights) over and above traditional banking services.	Under this model also, services mentioned in the previous column can be provided. From a consumer's perspective, the partnership with a licensed bank signals a level of trust.
	Concern	For such banks, risk management relating to cyber-security and business continuity is critical. Accordingly, the existing regulatory framework must be designed keeping in mind the business models of such banks and the peculiar risks that it may pose.	If the extent of applicable regulatory perimeter is unclear, it impacts the delineation of liability between the bank and the fintech partner. This in turn adversely impacts the ability of the customer to redress her grievances. In the long term, this may lead to mistrust between consumer and the fintech companies.

[35] Organisation for Economic Cooperation and Development, 'Digital Disruption in Banking and its Impact on Competition' (2020) <http://www.oecd.org/daf/competition/digital-disruption-in-financial-markets.htm > accessed 11 June 2020

Deconstructing the Digital-only Banking Model in India

In India, the digital-only banking model is structured as a partnership between a licensed bank and non-banks such as fintech companies. For providing access to regulated activities such as operating a bank account, issuing credit, debit or prepaid card, or providing loans, these non-banks have to partner with a licensed bank. Such non-banks provide a technological platform through which access to various banking and value added services are provided. Based on a review of publicly available information, this report has identified 17 neobanking platforms[36] in India. These include platforms that provide access to different types of financial and value added services (as described in the matrix below) and platforms that specifically identify themselves as "neobanking" platforms (irrespective of the services that they provide). Some of these platforms are yet to launch their products, but have secured advanced funding. Set out below is a snapshot of some neobanking platforms in India.[37]

Entity	Customer Segment	Key Offerings (Indicative List)
Niyo	Personal	Facilitates opening of savings bank account with a licensed bank; Prepaid card in association with licensed banks Personal finance management
Instantpay	Personal, Start-ups and MSMEs	Facilitates opening of current account for MSMEs; overdraft facility or application for loan Built-in customer relationship management to onboard customers, vendors and employees; management of expenses with spend cards having real-time reporting and controls
Yelo Bank	Not specified	Website does not provide detailed description of offerings. Service offering described as "*One account for banking, credit, payment solutions and remittance*"
Finin	Personal, Business	Facilitate bank account opening Holistic view of all accounts in one place; AI-driven insights on spends and automation of savings behaviour; data-driven personalised investment plans
Hylobiz	MSME	Cost-effective payment methods and payment APIs Automated tracking of cash and cheque collections; real-time dashboard of receivables, enterprise resource planning status; integration with accounting systems; automation of purchase orders
RazorpayX	MSME	Facilitates opening and operating of current accounts Payments through a dashboard or APIs. Enables addition of contacts and initiation of customer payouts, vendor payments, and employee salaries individually or in bulk different payment modes. Dashboard gives data on real-time transactions to help businesses make better decisions Automate and execute payroll, compliance, and contractor payments
Open	Start-up, MSME	Facilitates opening and operating of current accounts Unified dashboard to connect and manage multiple bank accounts Simplified payment gateway powered Create GST compliant invoices or bills to request and send business payments Automated accounting, bookkeeping, GST and tax-filing, generation of cashflow reports, balance sheet and profit and loss, payroll management
NamasteBiz	Small businesses	Enables addition and operation of current bank account or UPI to the Biz app Generates credit eligibility report that recommends loan products for the business Report on account balance, transaction history, transaction tagging, incoming and outgoing cash flow or transaction reminders Facilitates payment through recognised payment modes Create GST invoices, digital bill book; consolidates contact details of customers and suppliers along with the transaction history, payment reminders, payment due and invoices
Jupiter	Personal	Jupiter savings account and Visa debit card in partnership with a licensed bank Spend analytics to track spending patterns Automated savings by saving money aside every day, week or month Provides access to loan offers
Nupay	Large and small businesses	Create, send, receive and reconcile invoices Create virtual accounts, collect from buyers, automate refund processing and manage multi-party seller settlements for marketplaces, aggregators, e-auctions and digital procurement Automated invoice management, reconciliations and payment platform

[36] The entities reviewed for this report: 1. Niyo; 2.InstantPay; 3.Payzello; 4.Yelo; 5.Finin; 6.Hylobiz; 7.Razorpay; 8.Open; 9.Namaste Biz; 10.Jupiter; 11.NuPay; 12.Neo Bank; 13.Epifi; 14.Wizely; 15. Walrus; 16.Vanghee; 17.Fampay. The information mentioned in the matrix is based on information available on the respective webistes of these neobanking platforms.

[37] The information mentioned in this matrix is based on information available on the website of these neobanking platforms. The authors have not independently verified the information on their website. Due to the frequent updates to these websites, please note that this report is based on information accurate up to 24 August 2020.

Key Takeaways: Indian Perspective

- Neobanking platforms in India provide a technological interface through which customers can access a suite of financial services. Given the regulatory architecture in India that does not permit digital banks, such platforms are structured as bank-fintech partnership.

- Broadly, such platforms provide access to the following types of services - (a) facilitating opening and operating savings or current account with a licensed bank; (b) access to loan offers or applying for loans; (c) issuance of co-branded cards; (d) payment gateway facilities; (e) personal finance or expense management; and (d) value added services such as invoice generation, accounting, GST compliance, payroll management, enterprise resource planning, etc.

- For providing regulated activities like opening or operating a bank account, providing loans, issuance of cards, etc., these entities have to rely on a licensed bank partner. In such cases, the obligation to follow the regulatory requirements is on the partner banks. For instance, in case of lending products, the credit risk is borne by the partner banks.

- The arrangement between a bank and the non-bank under the Partnership Model is determined by an agreement executed between them. Broadly, it may be considered as an outsourcing arrangement. While some of the domain experts consulted for this report indicated that some non-banks operating under this model appear to operate as businesses correspondents for their partner bank, this could not be independently verified.

- Non-banks usually partner with multiple bank partners to provide different banking services through the neobanking platforms.

- Such neobanking platforms typically target tech-savvy millennials, start-ups or underserved segments such as MSMEs.

- Currently, there are around 17 neobanking platforms in India. These include platforms that provide access to different types of financial services and platforms that exclusively identify themselves as neobanking platforms. The neobanking sector in India is at a nascent stage with many neobanking platforms yet to formally launch their products and services in the market.

Global Digital-only Banking Activity - A Snapshot

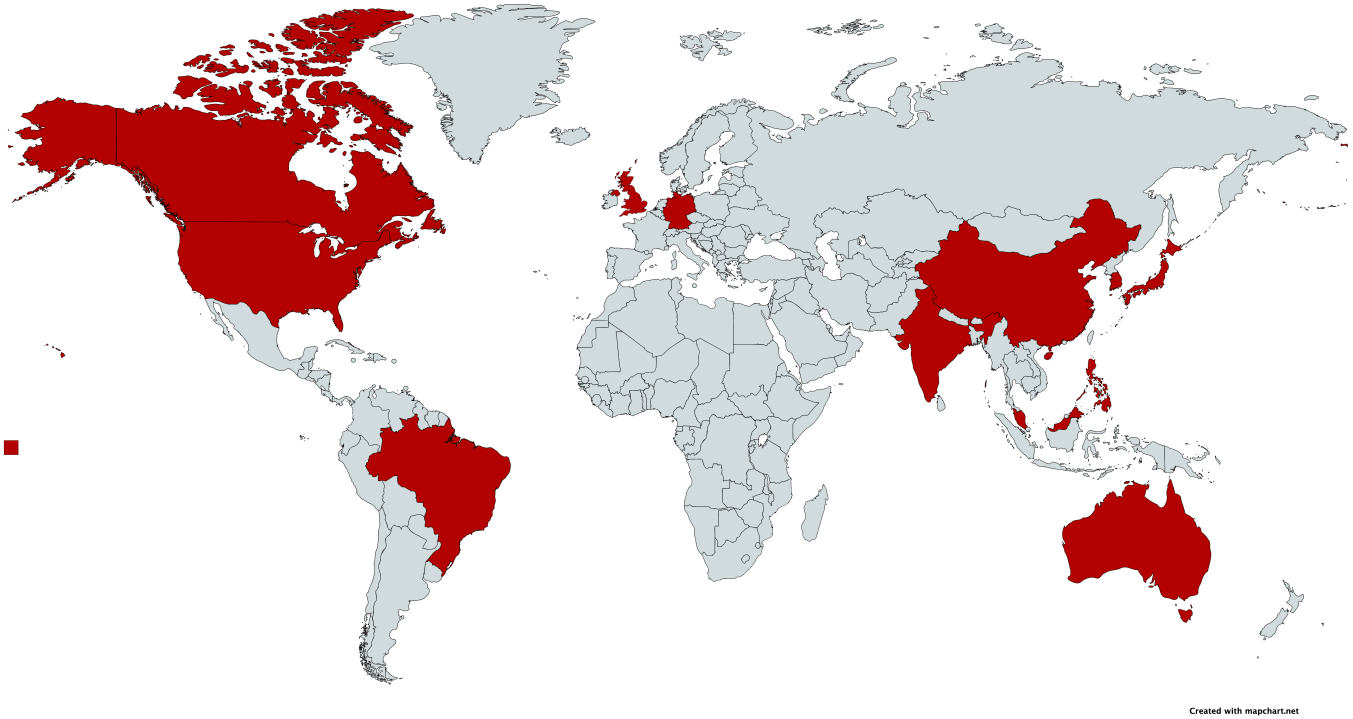
Australia

Xinja Bank Limited
86 400 Ltd
Judo Bank Pty Ltd.
Volt Bank Ltd

China

We Bank
MyBank
AiBank

Hong Kong
Airstar Bank
Ant Bank
Fusion Bank
Livi VB Limited
Mox Bank
Ping an Oneconnect
Welab Bank
Za Bank



India (Partnership Model)
Niyo
Open
Jupiter

Malaysia
Up to five licenses to be issued

Philippines
Tonik Bank

Singapore

Two Digital Full Bank and three Digital Wholesale Bank Licenses to be issued

South Korea
Kakao Bank
K Bank
Toss Bank

Thailand
ME by TMB Bank

United Kingdom
Monzo Bank
Starling Bank
Atom Bank

United States
Varo (chartered)
Chime
Square

Note: ***Figure represents indicative list of jurisdictions with both licensed digital banks and Partnership Model***

IV. International Perspective

Globally, several jurisdictions have seen the rise of digital banks. In respect of developing the market for such banks, the UK has led the pack – new entrants in the form of Monzo and Starling Bank have seen considerable success and growth in the sector.[38]The entry of these new fintech companies may be read alongside the regulator's efforts to encourage competition – in particular, the adoption of the 2015 European Union ("**EU**") Payment Services Directive II, which requires all payment account providers throughout the EU to provide access to certain regulated firms to customer's accounts, provided their explicit consent is obtained. Besides the UK, several jurisdictions in the South East Asian region have witnessed the rise of digital banks. The predominant policy considerations appear to be to promotion of innovation, competition and heterogeneity in the market for banking services and in some cases financial inclusion. This chapter provides a cross-country overview of the regulatory framework (final and draft) for digital banks in selected jurisdictions.

Regulatory Approach

The regulatory approaches discussed below provides a high-level overview of the applicable regulation, its form, and motivation. It is pertinent to note that many of these reforms are new or proposed, and therefore conclusions on the suitability of reforms are not appropriate at this stage.

In terms of regulatory architecture for digital banks, two broad approaches are notable. *First*, certain jurisdictions have issued or are in the process of issuing a specific licensing framework for virtual or digital banks. Such a framework expressly recognises digital banks, virtual banks, or internet-only banks as a category of bank and outlines specific requirements for such banks in certain aspects. However, most frameworks also require these banks to meet the prudential requirements outlined in their broader banking licensing framework. *Second*, there are jurisdictions that have integrated the digital bank licenses within their existing bank licensing framework. A 2020 survey of thirty-one jurisdictions by the Bank for International Settlements[39] found that most surveyed jurisdictions applied existing banking laws and regulations to digital banking, with the effect that new applicants must go through the same process as those with a traditional business model.

Singapore: Digital Banks
Two types of licenses are envisaged:[40] • Digital Full Bank (DFB) - It can take deposits from and provide banking services to retail and non-retail customer segments. • Digital Wholesale Bank (DWB) - It can take deposits and provide banking services to SMEs and other non-retail customer segments. Monetary Authority of Singapore ("**MAS**") has announced that it will issue up to 2 DFB licenses and 3 DWB licenses.[41]MAS has received 21 applications, comprising 7 DFB applications and 14 DWB applications.[42] Main Applicants include:[43] (a) Consortium of Grab (ride-hailing platform) and Singapore Telecommunications (telecom company); (b) Sea (internet firm); (c) Group led by Razer (gaming firm); (d) Beyond consortium, led by Osim founder Ron Sim's V3 Group (consumer firm) and

[38] The Economist, 'Neobanks are changing Britain's banking landscape' (2019) < https://www.economist.com/special-report/2019/05/02/Neobanks-are-changing-britains-banking-landscape > accessed 19 June 2020.
[39] Johannes Ehrentraud, Denise Garcia Ocampo, Lorena Garzoni and Mateo Piccolo, 'Policy responses to fintech: a cross-country overview' (2020) < https://www.bis.org/fsi/publ/insights23.htm > accessed 19 June 2020. See also Bank for International Settlements, 'Regulating fintech financing: digital banks and fintech platforms' (2020) <https://www.bis.org/fsi/publ/insights27.htm> accessed 12 September 2020
[40] Monetary Authority of Singapore, 'Digital Bank License' (2020) < https://www.mas.gov.sg/regulation/Banking/digital-bank-licence> accessed 24 June 2020. See also Monetary Authority of Singapore, 'MAS Extends Digital Bank Assessment Period in view of COVID-19 Pandemic' (2020) < https://www.mas.gov.sg/news/media-releases/2020/mas-extends-digital-bank-assessment-period-in-view-of-covid-19-pandemic> accessed 24 June 2020.
[41] ibid
[42] Monetary Authority of Singapore, '14 digital bank applicants eligible for next stage of assessment' (2020) <https://www.mas.gov.sg/news/media-releases/2020/14-digital-bank-applicants-eligible-for-next-stage-of-assessment> accessed 25 August 2020
[43] Anshuman Daga and Aradhana Aravindan, 'UPDATE 2-Grab-Singtel, Sea among 14 shortlisted for Singapore digital bank licences - sources' (2020) <https://www.reuters.com/article/singapore-banks/update-2-grab-singtel-sea-among-14-shortlisted-for-singapore-digital-bank-licences-sources-idUSL4N2DV0DB> accessed 20 August 2020; See also CNBC, 'China's Ant Financial applies for Singapore digital banking license' (2020) <https://www.cnbc.com/2020/01/02/chinas-ant-financial-applies-for-singapore-digital-banking-license.html> accessed 8 August 2020

payments company EZ-Link; (e) Consortium of MatchMove (Fintech) and Singapura Finance; (f) Consortium led by Hong Kong financial services provider AMTD Group. It includes Singapore power grid operator SP Group, Chinese tech firm Xiaomi's finance arm and crowdfunding platform Funding Societies; (f) Ant Financial (China)

Hong Kong: Virtual Banks

Separate licenses have been issued for virtual banks.[44] As of May 2020, the regulator has licensed 8 entities out of 33 applications[45]

Licensed entities are:[46](a) Airstar Bank Limited (banking entity); (b) Ant Bank (Hong Kong) Limited (offshoot of China's Ant Financial); (c) Fusion Bank Limited (Joint venture between Tencent Holdings Limited, Industrial and Commercial Bank of China (Asia) Limited, Hong Kong Exchanges and Clearing Limited, Hillhouse Capital, and Hong Kong entrepreneur Mr. Adrian Cheng); (d) Livi VB Limited (Joint venture between the Bank of China, Hong Kong, JD Digits (formerly JD Finance), and Jardines); (e) Mox Bank Limited (JV of StanChart, PCCW, HKT (telecommunications) and Trip.com); (f) Ping An Oneconnect Bank (Hong Kong) Limited (Ping an is a China-based insurance group, and Oneconnect is a technology services company); (g) Welab Bank Limited (Hong Kong-based FinTech); (h) Za Bank Limited (part of Zhong An, a Chinese insurance company)

Malaysia Digital Banks

An Exposure draft on licensing framework for digital banks has been released.[47]

The Bank Negara Malaysia has announced that up to 5 licenses will be issued to qualified applicants to establish Digital Banks to conduct either conventional or Islamic banking business

Entities which have signalled interest include:[48] (a) Technology, gaming, Airline, and telecom companies such Grab, Axiata, AirAsia, and Razer; and four banks - CIMB Group Holdings Bhd, Affin Bank Bhd, Hong Leong Bank Bhd and AMMB Holdings Bhd

South Korea: Internet-only Banks

It has enacted the Act on Special Cases Concerning the Establishment, Operation, etc. of Internet-only Banks, 2019 which sets out specific provisions for authorisation of 'internet-only banks' under the Banking Act[49]

Prior to the enactment of this law, Kakao Bank and K Bank were operating as internet banks licensed under the Banking Act

In December 2019, the Financial Services Commission ("**FSC**") granted 'Toss Bank' a preliminary license to operate internet-only. Toss Bank can begin operations within 6 months of getting a final approval from FSC.[50]

Taiwan: Internet-only Banks

Pursuant to its policy announcement in 2018, Taiwan has amended the Standards Governing the Establishment of Commercial Banks and Regulations Governing Investments in other Enterprises by Commercial Banks to issue licenses to internet-only banks[51]

Three applicants have been granted approval to set up internet-only banks

[44] Hong Kong Monetary Authority, 'A Guideline issued by the Monetary Authority under Section 16(10)' (2018) < https://www.hkma.gov.hk/media/eng/doc/key-information/press-release/2018/20180530e3a2.pdf> accessed 30 July 2020
[45] Hong Kong Monetary Authority, 'Virtual Banks' < https://www.hkma.gov.hk/eng/key-functions/banking/banking-regulatory-and-supervisory-regime/virtual-banks/> accessed 30 July 2020; See also Alun John, 'Factbox: Developments in online-only bank licensing in Asia' (2020) < https://www.reuters.com/article/us-asia-banks-digital-factbox/factbox-developments-in-online-only-bank-licensing-in-asia-idUSKBN1ZL0T3 > accessed 13 July 2020
[46] Hong Kong Monetary Authority, 'Granting of virtual banking licences' (2019) <https://www.hkma.gov.hk/eng/news-and-media/press-releases/2019/05/20190509-3/> accessed 9 August 2020. See also Hong Kong Monetary Authority, 'Fusion Bank' < https://www.hkma.gov.hk/media/eng/doc/key-functions/ifc/fintech/FCAS_2020_21_JD_FusionBank.pdf> accessed 9 August 2020; Sumeet Chatterjee and Alun John, 'Hong Kong digital banks launch faces delay due to protests - sources' (2019) < https://www.reuters.com/article/hongkong-protests-banks/hong-kong-digital-banks-launch-faces-delay-due-to-protests-sources-idUSL3N2670UH > accessed 9 August 2020; Mox Bank, 'About Us' < https://mox.com/about-us/> accessed 9 August 2020
[47] Bank Negara Malaysia, 'Regulatory Framework for Digital Banks' (2020) <https://www.bnm.gov.my/index.php?ch=en_press&pg=en_press&ac=5005> accessed 20 August 2020
[48] Adeline Paul Raj, 'Interest in Digital Bank License Picks Up' (2020) <https://www.pwc.com/my/en/assets/media/pwc-in-the-news/2020/200622-theedge-interest-in-digital-bank-licences-picks-up-kelvin-lee.pdf> accessed 9 August 2020; Reuters, 'Malaysia's Axiata in talks with 11 to partner up for bid on digital bank license' (2020) <https://www.reuters.com/article/us-malaysia-axiata/malaysias-axiata-in-talks-with-11-to-partner-up-for-bid-on-digital-bank-license-idUSKBN20F19R> accessed 9 August 2020; Anshuman Daga and Liz Lee, 'Exclusive: Grab, Razer, AirAsia exploring bids for Malaysia digital bank licence: sources' (2020) <https://www.reuters.com/article/us-malaysia-banks-exclusive/exclusive-grab-razer-airasia-among-firms-exploring-bids-for-malaysia-digital-bank-license-sources-idUSKBN1ZL0SE> accessed 9 August 2020; Joyce Goh and Adeline Paul Raj, 'Grab and four banks keen on digital banking licence' (2019) <https://www.theedgemarkets.com/article/cover-story-grab-and-four-banks-keen-digital-banking-licence> accessed 9 August 2020
[49] Act On Special Cases Concerning Establishment And Operation Of Internet-Only Banks (2018) <https://elaw.klri.re.kr/eng_mobile/viewer.do?hseq=49704&type=sogan&key=40> accessed 25 August 2020
[50] FSC, Press Release on 'FSC Approves Internet-only Bank License for Toss Bank', 16 December 2019 <http://meng.fsc.go.kr/common/pdfjs/web/viewer.html?file=/upload/press1/20191217092953_89256891.pdf> accessed 25 August 2020
[51] Financial Supervisory Commission, 'FSC announced related regulations regarding internet-only banks establishment and started to accept applications' <https://www.fsc.gov.tw/en/home.jsp?id=476&parentpath=0%2C4> accessed 25 August 2020

- Line Financial Taiwan - a consortium consisting of South Korea's Line Corp (operator of a messaging app and virtual network operator), Taipei Fubon Commercial Bank, CTBC Bank, Standard Chartered Bank, Union Bank of Taiwan, and telecoms operators FarEasTone and Taiwan Mobile

- Rakuten International Commercial Bank - a partnership between Japanese tech major Rakuten (operates an e-commerce in Taiwan), and IBF Financial Holdings

- Next Commercial Bank - a consortium led by incumbent Taiwanese telco Chunghwa Telecom. Shareholders include KGI Bank, Shin Kong Life Insurance, Mega International Commercial Bank, supermarket chain operator PX Mart and logistics company TradeVan[52]

Philippines: Digital Banks

It has released draft guidelines for the setting up of Digital Bank issued for public consultation.[53] It proposes to amend the Manual of Regulations for Banks to introduce a new category of Digital Banks

Two types of Digital Banks envisaged under the draft guidelines

- Basic Digital Bank - They can accept deposits, grant unsecured loans, collect and pay for the account of others, provide remittance and bill payment services and/or issue electronic money products. They perform these services for retail customers and MSMEs.

- Advance Digital Banks - In addition to the aforesaid activities, they can grant secured loans, issue credit cards and perform other activities as may be allowed. They can serve retail customers, MSMEs and large enterprises

Under the existing framework, there are some banks that provide digital banking services (with minimal or no physical branches) such as Tonik Digital Bank[54]

UK: Integrated into existing banking license framework

A bank must obtain a Part 4A permission under the Financial Services and Markets Act 2000 to carry on the regulated activity of accepting deposits by the Prudential Regulation Authority.

No specific licensing framework for Digital Banks. They go through the same process as other applicants for a Part 4A permission

Two notable digital banks have been granted a Part 4A permission to operate as full-fledged banks - Starling Bank and Monzo Bank

In addition to these banks, the European Commercial Bank has granted licenses to N26 and Revolut to operate as banks.[55]

Australia - Integrated into existing banking framework for authorised deposit taking institutions

Australian Prudential Regulatory Authority has issued licenses to digital banks under the Banking Act 1959.[56] Two licenses available:

- Direct route, available to applicants with adequate resources and capabilities; and

- Restricted route, aimed at new players. It allows entities to conduct limited banking business for a maximum period of 2 years before meeting the full prudential framework

1 restricted license and 4 full authorised deposit-taking institution (ADI) licenses under the direct route have been issued to digital banks.[57] Digital Banks under Restricted Route include IN1Bank and Volt Bank. Digital banks under the Direct Route include Xinja Bank Limited; 86 400 Ltd; Judo Bank Pty Ltd. and Volt Bank Ltd.

[52] Fitch Solutions, 'Taiwan Fintech: Regulation Increasingly Supportive Of Digital Players' (2020) < https://www.fitchsolutions.com/corporates/telecoms-media-technology/taiwan-fintech-regulation-increasingly-supportive-digital-players-02-01-2020> accessed 25 August 2020

[53] Guidelines on the Establishment of Digital Banks (2020) <http://www.bsp.gov.ph/downloads/regulations/pexd/pexd1.pdf> accessed 25 August 2020

[54] It is understood that Tonik Digital Bank has been issued a rural banking license, while CIMB Bank and ING Bank have commercial banking licenses. They have a digital platform business model with minimal physical touch points through partner merchants. Once the virtual banking regulations have been released, the current digital banks will be given one year as a transitional period to comply with the regulations in order to get the virtual banking licence. See Asian Banker, 'Are central banks issuing digital banking licences to counter the threat of fintechs and big techs?' (2020) < https://www.theasianbanker.com/updates-and-articles/are-central-banks-issuing-digital-banking-licences-to-counter-the-threat-of-fintechs-and-big-techs > accessed 28 August 2020

[55] Bryan Lee, 'What is a banking license anyway?' (2017) < https://mag.n26.com/what-is-a-banking-license-anyway-3316da3b9d1e> accessed 29 July 2020; Revolut, 'We got a banking licence' (2018) <https://blog.revolut.com/we-got-a-banking-licence/> accessed 29 July 2020

[56] Banking Act 1959 < https://www.legislation.gov.au/Series/C1959A00006> accessed 19 June 2020.

[57] Australian Prudential Regulatory Authority, 'Register of authorised deposit-taking institutions' (2020) < https://www.apra.gov.au/register-of-authorised-deposit-taking-institutions> accessed 25 August 2020s

Key Takeaways: International Perspective

- Globally, broadly, two approaches are adopted by jurisdictions for licensing digital banks - (a) application of existing banking license framework to digital banks; and (b) separate licenses for digital banks. A BIS study notes that most jurisdictions seems to have adopted the integrated approach discussed in (a). Specific licensing framework for digital banks can be seen in several Asian jurisdictions.

- While jurisdictions like Singapore, Hong Kong, South Korea and Taiwan have finalised their frameworks, Malaysia and Philippines are in the process of issuing their frameworks.

- In the international jurisdictions reviewed for this Report ("**Reviewed Jurisdictions**"), primary considerations for issuance of digital bank license are - promotion of innovation in the financial sector, promotion of competition and financial inclusion.

- In certain jurisdictions, applicants include joint venture or consortiums of banks or financial institutions and telecommunication companies, e-commerce / technology / fintech companies. Such consortium consisting of players with expertise in finance and technology indicate that applicants seek to combine their individual strengths to enhance the digital bank's value proposition.

- In most of the Reviewed Jurisdictions, digital banks can carry normal banking activities. In some jurisdictions, such banks are expected to serve small businesses.

- The Reviewed Jurisdictions mostly permit one physical place of presence for the licensed digital banks, without any expectations to set up local branches. In some cases, there is a prohibition on setting up physical branches.

- While the aforesaid discussion highlights the entities licensed by the concerned regulators to operate as a full-fledged digital bank, many jurisdictions also witness digital-only banking models that operate as partnership between licensed banks. For instance, Chime – a leading fintech providing banking services in the US – partners with Bancorp Bank. Similarly, in Canada, players such as Koho and Brightside adopt a partnership model.

- It is pertinent to note that many of the reforms in the digital banks licensing regimes across jurisdictions are relatively new, and it is therefore difficult to comment on the relative success or failure of these various approaches at this stage.

Key Features of Digital Bank Licensing Frameworks - A Cross Country Snapshot

Hong Kong	Singapore	South Korea	Taiwan	Malaysia (Draft Stage)	Philippines (Draft Stage)
Policy Objective					
Promote fintech and innovation and offer a new kind of customer experience and to help promote financial inclusion	Ensure that Singapore's banking sector continues to be resilient, competitive and vibrant	Promote financial innovation and sound competition in the banking business and enhance convenience of financial consumers	To keep up with development trend of digitisation and business opportunities and to encourage financial innovation and deepen financial inclusion	Enable innovative application of technology in the financial sector and allow entry of digital banks with innovate business models that target underserved and unserved market segments	Promote responsible innovation and the digitisation of the financial industry
Specific eligibility requirements relating to technology					
Both financial firms (including existing banks in Hong Kong) and non-financial firms (including technology companies) may apply	One entity in the applicant group has three or more years of track record in technology or e-commerce business	For assessing the shareholding of the non-financial investor in certain cases, the regulator may take into account the contribution plan for promotion of convergence between finance and information and communications technology, microfinance support, etc.	At least one of the founders shall be a bank or a financial holding company Non-financial founder who has the financial technology, e-commerce or telecommunication capabilities may subscribe more than 10% of the paid-in capital	Applicant must demonstrate risk management and compliance capabilities through a track record of operating in a regulated environment as well as application of technology in financial services. Applicant must also demonstrate a commitment to financial inclusion.	
Scope of business					
Can carry normal banking activities Virtual banks should not impose any minimum account balance requirement or low-balance fees on their customers Can target retail and SMEs	Digital Full Bank - Take deposits and provide banking services to retail and non-retail customers. Commences operations as a restricted DFB (with restrictions on deposit size) and gradually progress to become a full DFB Digital Wholesale Bank - Take deposits from and provide banking services to SMEs and other non-retail customer segments. Offer interest bearing current accounts for businesses, restriction on providing financial advice to retail customers and prohibition on providing unsecured credit to retail customers	Not permitted to grant credit to corporations. However, internet-only banks are permitted to provide credit to small and medium businesses.	Same as conventional commercial bank	Regular banking activities, but is expected to target underserved and unserved market segments. However, for up to five years from commencement of its operations, a Digital Bank shall ensure that the total size of its assets do not exceed RM 2 billion	Basic Digital Bank (BDB): permitted to perform banking activities for retail and MSME customers. This includes accepting deposits, granting loans, and providing payment services. Advance Digital Bank: permitted to perform banking activities for retail and MSMEs in addition to large enterprises and other corporate clients. This includes all activities a BDB may perform as well as granting secured loans and issuing credit cards.

Number of licenses					
8 licenses issued	2 DFB and 3 DWB licenses will be issued	3 licenses issued	3 licenses issued	Reports indicate that up to 5 licenses will be issued	
Shareholding Structure					
A person who holds more than 50% of the share capital the bank should be a bank or a financial institution supervised by a recognised authority in Hong Kong or elsewhere. Failing this, the applicant must be held through an intermediate holding company incorporated in Hong Kong, subject to supervisory purview	DFBs limited to applicants anchored and headquartered and controlled by Singaporeans. DWB's are open to foreign companies as long as they are locally incorporated	Non-financial investor may not hold more than 34% of the voting stock, which may be exceeded subject to approval from the regulator.	More than 40% of the paid-in capital shall be subscribed by the professional founders and shareholders such as financial holding companies, banks, insurance companies or securities firms, and at least one of the founders shall be a bank or a financial holding company whose minimum shareholding of the subscribed paid-in capital should exceed 25%	The regulator may require a shareholder who holds more than 50% aggregate interest of the bank to organize all its financial and financial related subsidiaries under a single apex financial entity, which would either be a licensed institution or a financial holding company.	A foreign individual or non-bank cannot own or control more than 40% of the voting stock. However, qualified foreign banks may own or control 100% of the voting stock
Minimum paid-up capital					
HKD 300 million (same as other licensed banks)	DFB - SGD 15 million with progressive increase to SGD 1.5 billion DWB - SGD 100 million	At least 25 billion won	NT$10 billion (same as setting up a conventional commercial bank)	For up to five years after the commencement of its operations, minimum capital funds of RM 100 million. After the end of the foundational phase, RM 300 million (same as licensed bank and licensed Islamic bank)	Basic Digital Bank: P400 million Advance Digital Bank: P900 million
Necessity of Physical Presence					
Must maintain a physical presence in Hong Kong, which will be its principal place of business Not expected to establish local branches	One physical place of business		Apart from the head office and a customer service centre to take care of customers' needs face to face, an internet-only bank may not establish physical branches	Required to establish a registered office in Malaysia, which may also serve as a center for face-to-face customer complaints. Not permitted to establish any physical branches	Permitted one office to receive customer complaints. Not permitted to establish any other physical branches

V. Value Proposition of Digital-only Banking Models

While the Indian neobanking sector is at a nascent stage, globally there has been a steady growth in digital-only banking models. As discussed above, many jurisdictions in the Asian region have issued licenses or are in the process of issuing licenses for digital banks or virtual banks. To assess the rise of these digital-only banking models, it may be useful to study their value proposition from the perspective of policymakers, consumers and businesses i.e. fintech and banks.

Supporting small businesses and start-ups

The digital-only banking model is challenging the traditional banking model that relied on a one-size-fits-all approach. A review of the business models and product offerings by such digital-only banking models, both globally and in India indicate that such platforms target customer segments, such MSMEs, start-ups and young professionals that have been traditionally underserved by incumbent banks.

The MSME sector has emerged as an important customer segment for digital-only banking models. Despite their significant role in the economic growth of the country (as highlighted in the box), the sector has remained underserved by traditional banks for several reasons. First, due to barriers that include high costs to serve, informal organisation, and lender coverage, several MSMEs lack access to credit and capital supply is constrained, with limited available avenues in the formal sector.[58] This has resulted in an estimated credit gap of ₹20 – 25 trillion for MSMEs.[59] Second, long assessment processes and a relative lack of diversity in the availability of products tailored to MSMEs compound existing challenges in accessing finance.[60] Third, our discussions with domain experts indicate that traditional banks lack the incentive to invest in tailoring products to MSMEs, given that any such customised product would require changes to the core banking infrastructure that is aimed to serve a large, general population rather than a specific market segment. With the digital transformation of the financial sector, more cost efficient models for serving MSMEs are emerging, including digital-only banking models. Since most digital banking models target a niche customer segment, they are able to dedicate all their resources in understanding the financial and business needs of that particular segment.

MSMEs and Start-ups: A Growth Opportunity

MSMEs

- *Spread across 63.8 million enterprises, MSMEs contribute over 28% to India's GDP. Despite their significance for inclusive economic growth, the sector is currently faced with several well-documented challenges. Financial products and services that are critical to their growth remain in short supply.*

Start-ups

- *As per the Start-up India initiative, India has the third largest start-up ecosystem in the world with 50,000 start-ups in 2018. As per industry estimates, around 1300 start-ups added in 2019.*

Source: International Finance Corporation, Press Trust of India

Existing research suggests that the needs of entrepreneurs of small businesses can be categorised as core business activities and administrative activities.[61] The core businesses activities such as finding clients, maintaining client

[58] See International Financial Corporation and Intellecap, 'Financing India's MSMEs' (2018) <https://www.intellecap.com/wp-content/uploads/2019/04/Financing-Indias-MSMEs-Estimation-of-Debt-Requireme-nt-of-MSMEs-in_India.pdf> accessed 30 July 2020
[59] See Reserve Bank of India, 'Expert Committee on Micro, Small and Medium Enterprises' (2019) < https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=47331> accessed 30 July 2020
[60] See Reserve Bank of India, 'Expert Committee on Micro, Small and Medium Enterprises' (2019) < https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=47331> accessed 30 July 2020
[61] McKinsey, 'Beyond banking: How banks can use ecosystems to win in the SME market' (2019) <https://www.mckinsey.com/~/media/McKinsey/Industries/Financial%20Services/Our%20Insights/How%20banks%20can%20use%20ecosystems%20to%20win%20in%20the%20SME%20market/How-banks-can-use-ecosystems-to-win-in-the-SME-market-vF.pdf> accessed 17 September 2020

relationship, managing orders, etc. are the drivers of growth and profit for such businesses. On the other hand, administrative tasks such as accounting, book-keeping, following up on payables and receivables, taxation related issues, and managing payments and bank accounts are essential functions for proper functioning of a business, but which may not necessarily lead to its growth.[62] It has been pointed out that these are some common challenges facing such businesses.[63] The digital-only banking model has the potential to offer a broad range of services to meet the needs of MSMEs, including but not limited to banking, in a single integrated platform. To deal with these issues, digital-only banking platforms provide such businesses with access to various services and functionalities such as opening and managing current account, payment gateway, automated accounting, invoice preparation, etc. Through APIs and advanced data analytics, such platforms can provide access to several services to meet the business needs of such small businesses and start-ups and automate simple tasks such as cash collection, preparing accounts and tax returns.

Our study of the neobanking platforms in India indicates that several entities such as Open, RazorpayX, Hylobiz, NamasteBiz, and Jupiter seek to service the MSME and start-up segments and focus on the activities mentioned above.

Case Study

A Bengaluru-based fintech company, through its partnership with a licensed bank, provides business banking services to entrepreneurs and small and medium enterprises.

Servicing over 400,000 businesses through its platform and processing $5 billion in transactions each year, it helps businesses by allowing them to maintain multiple bank accounts, provides payroll management services for salaries, automatically tracks customer payments and bank statements thereby eliminating the need for manual reconciliation, in addition to providing API support and third party plugins to integrate business workflows and banking.

As part of its automated bookkeeping services, it allows its customers to prepare GST tax filings, analyse cash flow patterns through spending reports, as well as auto-categorise income and expense categories.

The start-up is backed by established investors such as Tiger Global Management, 3one4 Capital and Speedinvest and has raised over $35 million in funding according to news reports.

Source: Economic Times, Bank Open

[62] Ibid
[63] Medici, 'Setting Up a Neobank From Scratch' (2020) <https://gomedici.com/setting-up-Neobank-from-scratch> accessed 25 August 2020

Globally, there has been a steady growth in the number of digital banks globally catering specifically to MSMEs / small businesses. The number of customers served by these banks and the investment in these banks also indicate the growing popularity of such baking models and the value proposition for small businesses as is evident from the matrix below.

Name and Country of Origin	Customer Segment	Key Highlights
Monzo (UK)	Personal, small businesses	3.9M retail customers; 2,500 small businesses[64] (Financial Year 2020); £384.7M in funding over 16 rounds[65]
N26 (Germany)	Personal, Free lancers, Self-employed	5M customers as of January 2020;[66] $782.8M raised in 8 rounds[67]
Revolut (UK)	Personal and business	12M+ personal customers;500k business customers;[68] $917M raised in 13 rounds [69]
Oaknorth (UK)	SME	£3.1 bn loan facilities; £65.9m in profit before tax (2019) [70]
Judo Bank (Australia)	SME	650 customers; Valuation of $ 1 B[71] (licensed in 2019)
Starling Bank (UK)	Personal and small businesses[72]	1.5 million accounts in total, with almost 200,000 SME accounts and 1.25 million retail accounts;[73]363M raised.[74]
Atom Bank (UK)	Personal and small business	65,000 customers;[75] £429M raised.[76]

Promoting Innovation, Competition, and Heterogeneity in the Banking Sector

Research indicates that with the expanding role of fintech within the banking system, competition amongst incumbents and new entrants will turn on the ownership of the customer relationship.[77] Digital banks in particular, may compete with incumbent licensed bank in the retail segment, due to the lower cost of their internet-only operations.[78] It is in this context that licensing new players to provide fintech-enabled banking services may promote competition in the banking sector. Technology has lowered the participation barrier for new players and regulation may leverage this while managing attendant risks through a tailored supervision and oversight framework. Indeed, jurisdictions such as the UK, Singapore, and Hong Kong have issued virtual bank licenses with the specific objective of promoting competition and innovation by facilitating the entry of new players.

The RBI is responsible for promoting competition and heterogeneity in the banking sector, alongside fulfilling its mandate of managing systemic risk in the financial system. Licensing new banking companies serves the purpose of promoting heterogeneity by facilitating the entry of new types of players that can focus on niche services and

[64] Monzo Bank, 'Annual Report& Group Financial Statements' (2020) <https://monzo.com/static/docs/monzo-annual-report-2020.pdf> accessed 17 September 2020
[65] Crunchbase, 'Monzo - Financials' (2020) <https://www.crunchbase.com/organization/monzo/company_financials> accessed 29 July 2020
[66] N 26, '5 million customers in 5 years—N26 celebrates another record-breaking milestone' <https://n26.com/en-de/blog/5-million-announcement>accessed 27 July 2020.
[67] Crunchbase, 'N 26- Financials'<https://www.crunchbase.com/organization/n26/company_financials>accessed 27 July 2020.
[68] Revolut, 'About' (2020) <https://www.revolut.com/about-revolut> accessed 27 July 2020.
[69] Crunchbase, 'Revolut- Funding Rounds' (2020) < https://www.crunchbase.com/organization/revolut#section-funding-rounds> accessed 27 July 2020.
[70] Oaknorth Bank, 'Annual Report 2019' < https://www.oaknorth.co.uk/download/annual/> accessed 17 September 2020.
[71] Financial Review, 'Judo Bank is now Unicorn' () <https://www.afr.com/companies/financial-services/judo-bank-is-a-now-a-unicorn-20200506-p54qa0> accessed 17 September 2020
[72] TechCrunch, 'Atom is the first of the new UK challenger banks out the gate — sort of' (2016) < https://techcrunch.com/2016/04/06/atom-bank-launches/> accessed 3 August 2020. See also Atom, 'Transforming banking for small businesses' (2019) < https://www.atombank.co.uk/blog/2019/transforming-banking-for-small-businesses > accessed 3 August 2020
[73] Starling, 'Trading Update - July 2020' (2020) < https://www.starlingbank.com/investors/2020/trading-update-2020/> accessed 17 September 2020
[74] Crunchbase, 'Starling Bank' (2020) <https://www.crunchbase.com/organization/starling-3> accessed 3 August 2020
[75] Statista, 'Key Figures' (2019) < https://www.statista.com/statistics/1112127/key-figures-for-atom-bank-united-kingdom/> accessed 3 August 2020
[76] Crunchbase, 'Atom Bank' (2020) <https://www.crunchbase.com/organization/atom-bank> accessed 3 August 2020
[77] Bank for International Settlements, 'Implications of fintech developments for banks and bank supervisors' (2018) < https://www.bis.org/bcbs/publ/d431.pdf> accessed 5 August 2020
[78] ibid

underserved customer segments. The RBI-appointed Inter-Regulatory Working Group on FinTech and Digital Banking noted in its report that a more diverse financial sector reduces systemic risk and fintech may provide a boost to competition and efficiency in the financial sector. Pertinently, the report notes that innovation in digital financial services is essential to cater to changing consumer expectations.[79]

New Business Models and Untapped Markets

For businesses, the market for neobanking is an attractive proposition for three reasons: *one*, it allows them to leverage new digital-only business models which rely on new revenue streams; *two*, there is an existing incentive to tap-into underserved market segments; *three*, the participation barriers have been lowered due to technology.

Technology has reduced barriers to entry for new players, given that a digital-only bank would rely primarily on digital infrastructure, as opposed to physical cash points and brick-and-mortar branch operations which may be relatively more expensive to operate and maintain.[80] These entities would rely more on customer relationships and apply technology in an innovative and cost-effective manner. For nascent entities that are looking to partner with existing licensed banks, the neobanking model allows non-banks to retain customer relationships while also providing access to a new consumer segment for the partner banking entity. There is a strong incentive to serve market segments that the traditional banking sector has failed to service. For instance, a credit gap of ₹20 – 25 trillion signals a large market for underserved MSMEs credit in India[81] and as preliminary evidence from the Indian and global neobanking market shows, there is a marked emphasis on business banking and accounting products that are tailored to entrepreneurs and small businesses. Businesses are therefore incentivised to tap into new customer segments, leverage technology-enabled efficiencies to lower operating costs and leverage new business models, as well as develop consumer-oriented solutions. Indeed, 2019 marked a new high for fintech investment in India, with a total of $2.3 billion invested[82] and market studies indicate that investment in digital banking will likely grow in the Asia Pacific area, given that several jurisdictions in the region have taken steps towards issuing digital bank licenses.[83]

[79] Reserve Bank of India, 'Inter-Regulatory Working Group on FinTech and Digital Banking' (2018) < https://www.rbi.org.in/scripts/PublicationReportDetails.aspx?ID=892 > accessed 5 August 2020
[80] Bank for International Settlements, 'Implications of fintech developments for banks and bank supervisors' (2018) < https://www.bis.org/bcbs/publ/d431.pdf> accessed 5 August 2020
[81] See Reserve Bank of India, 'Expert Committee on Micro, Small and Medium Enterprises' (2019) < https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=47331> accessed 30 July 2020
[82] KPMG, 'Pulse of Fintech H2 2019' (2020) <https://home.kpmg/xx/en/home/campaigns/2020/02/pulse-of-fintech-h2-19-asia-pacific.html> accessed 5 August 2020
[83] ibid

Key Takeaways

- Globally, many jurisdictions are witnessing the rise of different forms of digital-only banking models. A review of some of the digital banks across different jurisdictions indicate that they focus on serving specific customer segments that have traditionally not been a priority for traditional banks, such as millennials, entrepreneurs and small businesses.

- Globally, such digital banks offer a diverse range of digital-only services with a heavy emphasis on improving the customer relationship. These include instant account opening, instant money transfer and expense management services. The products and services are tailored based on the customer segment serviced – for instance, while MSME-focused entities may provide innovative cash-flow based credit products in the form of equipment leases, millennial-focused digital banks place reliance on the digital nature of services, providing expense management and transfer services instead.

- One common customer segment that seems to have gained popularity with such digital-only banking models (both in India and globally) banks is the MSME segment. Through their technology focused operations, these banks are able to offer a range of services to meet the varied banking and business needs of such businesses. These includes, facilitating account opening, customised lending products based on smart contract and machine learning technology, accounting tools and in-app invoicing services for business accounts and an emphasis on strong customer support.

- This holds significance for the MSME sector and the start-ups in India that has not been the focus of traditional banks in India. By providing a larger suite of digital banking services, such digital-banking models may enhance MSMEs' ability to digitise and consequently formalise their own operations, thereby addressing what has often been the biggest impediment that MSMEs face in accessing formal credit.

- For regulators, the value proposition of these digital-only banking models, more particularly digital banks, seems to be in its potential to promoting competition, heterogeneity and innovation in the market for banking services. This seems to be the primary policy objectives for regulators issuing digital bank licenses.

- Technology has lowered the barriers to entry. This means that there is a stronger case for challengers to break into the banking sector. Moreover, this allows them to cater to market demand that has been traditionally underserved or untapped. A good example is the market for credit for small businesses in India, which has remained underserved by large institutions. New entities seeking to tread this ground have a large and ready market to leverage, which is possible now because of technological innovations in this space. For banks, a digital-only banking model enables them to tap into newer customer segments with a low-cost business model. From a fintech companies' perspective, such partnership with licensed banks enable to get them access to develop products and brings them to the market without having to apply for a separate banking license. They can depend on the reputation of their banking partner to reach a client base without having to start from scratch.

VI. Assessing the Case for Regulatory Intervention

The neobanking sector in India is still at a nascent stage, although it appears to be growing at a steady pace with the backing of established and experienced funders. Importantly, despite the entry of these non-banks which have grown to offer a bouquet of financial services, there is not much clarity on the regulatory framework applicable to the activities of these neobanking platforms. For the reasons discussed below, we argue that it is necessary for policymakers in India to design and consider policy interventions to harness the potential of the emerging digital-only banking models for furthering the promotion of fintech innovation, competition and supporting the underserved segments such as MSMEs. In designing regulatory interventions, it is also significant that policymakers also consider the limitations of the digital-only banking model, which presume that customers have some level of comfort or knowledge about digital transactions. This is evident from the specific customer segments targeted by such digital-only banking models, such as small businesses and tech savvy young millennials. Further, currently customers using such services will require access to necessary infrastructure (such as a smartphone, good internet connectivity) for accessing these services, which may not be the case for many base of the pyramid customers in India.

Growth of the Neobanking Market in India

Over the last few years, the number of neobanking platforms as well as the investment in the sector has risen consistently. In 2018 alone, the estimated value of the global digital banking market was USD 18.6 billion.[84]Furthermore, it is reported that the neobanking sector in India had raised $116 million in 2019, representing a seven-fold jump year-on-year,[85] demonstrating a healthy appetite for market entrants in this segment. Individual players have also succeeded in attracting capital from established funders, with entities such as Epifi attracting seed funding of $13.2 million, valuing the start up at $50 million in 2019.[86] Similarly, Jupiter (as Amica financial) raised $24 million in its maiden round of funding in 2019.[87] Moreover, despite the capital constraints in light of COVID-19, reports indicate that neobanking continue to attract capital.[88] Established fintech players have also forayed into

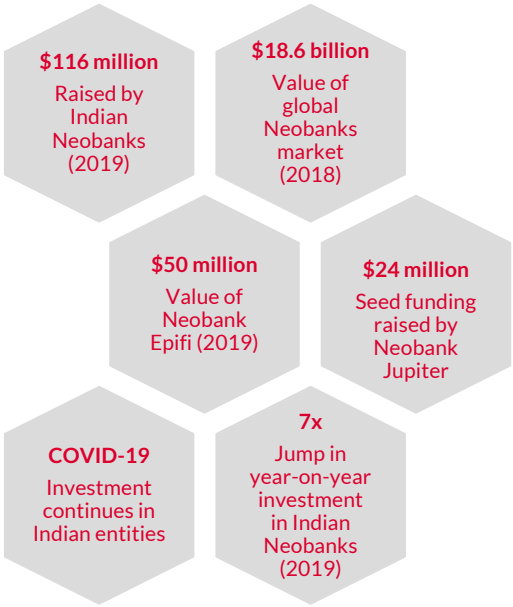


Figure 4: Market Snapshot

[84] PwC, 'Neobanks and the next banking revolution ' https://www.pwc.in/consulting/financial-services/fintech/fintech-insights/Neobanks-and-the-next-banking-revolution.html#sources accessed 13 July 2020

[85] Mihir Dalal and M Sriram, 'How savvy startups are rebooting banking ' (2020) <https://www.livemint.com/companies/start-ups/how-savvy-startups-are-rebooting-banking-11581611838546.html> accessed 13 July 2020

[86] Biswarup Gooptu, 'Neobank EpiFi raises $13.2M seed funding led by Sequoia, Ribbit & others' (2020) < https://tech.economictimes.indiatimes.com/news/startups/neo-bank-epifi-raises-13-2-million-in-seed-funding-roung/73217550 > accessed 13 July 2020

[87] Biswarup Gooptu, 'Amica Financial Technologies raises $24 million in funding' (2019) < https://tech.economictimes.indiatimes.com/news/startups/amica-financial-technologies-raises-24-million-in-funding/71882011 > accessed 13 July 2020

[88] Economic Times, 'Walrus raises funding from Better Capital, others' (2020) <https://economictimes.indiatimes.com/small-biz/startups/newsbuzz/walrus-raises-funding-from-better-capital-others/articleshow/76977782.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst> accessed 13 July 2020

the neobanking sector. For instance, the fintech firm Razorpay has also announced its foray into the sector.

Tapping into the value proposition of Digital-only Banking Models

The preceding chapter sets out in detail the value proposition of digital-only banking models for policymakers, customers and banks and fintech companies. Targeted policy interventions for facilitating the growth of the digital-only banking sector will be instrumental to harness the potential of such models *viz.* - address the underserved market for MSMEs, promote competition and heterogeneity in the banking sector and promoting innovation in the financial sector through leveraging bank-fintech partnership.

Regulatory Risks

Despite the fact that the neobanking market in India has witnessed a healthy growth and investment over the last few years, their partnerships with banks merits regulatory consideration. Based on a review of the business proposition of some of the neobanking platforms in India as publicly available, it is likely that most of these bank-fintech partnerships are structured as an outsourcing arrangement.[89] However, in certain cases where such non-banks are selling third party products or are verifying data for credit requests or undertaking the preliminary work for opening current accounts, it is arguable that such entities carry out activities authorised for business correspondents.[90] Business correspondents are retail agents engaged by banks for providing banking services at locations other than a bank branch/ATM.[91] During the stakeholder discussion for the purposes of this report, some stakeholders indicated that in certain cases, neobanking platforms act as business correspondents for banks. However, this information could not be independently verified by us. Currently, RBI regulates outsourcing of financial services to third parties under specific outsourcing guidelines. Similarly, business correspondents are regulated by RBI under specific guidelines.[92] Notably, in determining their arrangements with business correspondents, banks are mandated to follow the outsourcing guidelines. A snapshot of both guidelines is provided.

Outsourcing Guidelines - A Snapshot

Outsourcing Guidelines

- *The RBI regulates the outsourcing of financial services to third parties by banks under the Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks ("**Outsourcing Guidelines**").*
- *Broadly, outsourced financial services include applications processing (loan origination, credit card), document processing, marketing and research, supervision of loans, data processing and back office related activities, etc.*
- *Under these guidelines banks: (a) continue to be liable for the outsourced activity; and (b) cannot outsource core management functions such as internal audit, determining compliance with KYC norms for opening deposit accounts, according sanction for loans and management of investment portfolio.*
- *These guidelines outline necessary safeguards that banks must adhere to for addressing the risks inherent in such outsourcing should be put in place. These safeguards pertain to delineation of the banks obligations for outsourcing its activities, contents of the outsourcing agreement, requirements relating to confidentiality and security of customer information, monitoring of such outsourced activities, grievance redressal framework, business continuity plans, etc.*

[89] Reserve Bank of India, 'Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by banks, 2006' (2006) < https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=3148&Mode=0> accessed 10 September 2020
[90] Advait Rao Palepu, 'India's Neo-Banks: What's So 'Neo' About Them?' (2019) < https://www.bloombergquint.com/business/fintech-news-indias-neo-banks-whats-so-neo-about-them > accessed 11 June 2020; https://www.lexology.com/library/detail.aspx?g=cf36beb3-f11c-4c43-99b1-2d85cb34fef1
[91] Reserve Bank of India, 'Discussion Paper on Engagement of 'for-profit' Companies as Business Correspondents' (2010) https://www.rbi.org.in/Scripts/bs_viewcontent.aspx?Id=2234 accessed 2 June 2020.
[92] Reserve Bank of India, 'Master Circular on Branch Authorisation' (2014) <https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9014> accessed 26 August 2020

To assess the regulatory issues that the Partnership Model in India presents, it is imperative to understand the activities provided by such neobanking platforms, the entities involved and the extent of RBI supervision. ***For the purposes of studying the Partnership Model in India for this Report, the authors have reviewed publicly available information on the websites of 17 neobanking platforms operated by non-banks ("Surveyed Platforms") in India. Neobanking platforms include platforms that provide different types of banking services (as described in the matrix below) or such platforms that exclusively identify themselves as neobanking platforms. Please note that some of these Surveyed Platforms are yet to launch their products, but have secured advance.***[93]

Business Correspondent Guidelines - A Snapshot

Guidelines for Business Correspondents

- *To ensure greater financial inclusion and increasing the outreach of the banking sector, banks have been permitted to use the services of intermediaries in providing financial and banking services through the use of business facilitator or business correspondent model as per RBI guidelines.*

- *Entities eligible to be appointed as business correspondents include, NGOs or micro finance institutions set up as Section 8 company, trust or society, post offices, cooperative societies, NBFCs and companies with large and widespread outlets.*

- *They may carry out the following activities - identification of borrowers; collection and preliminary processing of loan applications including verification of primary information; advice on managing money and debt counselling; processing and submission of applications to banks; post-sanction monitoring; disbursal of small value credit; recovery of principal / collection of interest; collection of small value deposits; sale of micro insurance/ mutual fund products/ pension products/ other third party products; and receipt and delivery of small value remittances, etc. They are also allowed to operate and man fixed point service delivery units for Domestic Scheduled Commercial Banks, Payment Banks, and Small Finance Banks where loans, deposit services, and cheque services are provided.*

- *A business correspondent can act as a business correspondent for multiple banks. Due to reputational, legal and operational risks associated with the engagement of a business correspondent, RBI requires banks to adhere to specific safeguards while engaging them. This includes, adherence to Outsourcing Guidelines, measures relating to protection of customer confidentiality, consumer protection, including grievance redressal mechanism and prohibition on charging fees to customers for services being performed on behalf of a bank.*

[93] The websites reviewed for this purpose: Niyo <https://www.goniyo.com/> accessed 11 June 2020; InstantPay (2020) < https://www.instantpay.in/> accessed 18 June 2020; Payzello < https://www.payzello.com/faqs > accessed 18 June 2020; Yelo < https://www.yelobank.in/ > accessed 18 June 2020; Finin < https://www.finin.in/ > accessed 18 June 2020; Hylobiz < https://hylo.biz/ > accessed 18 June 2020; Razorpay, 'RazorpayX – How We Built a Startup in a Startup' (2020) < https://razorpay.com/blog/razorpayx-a-startup-in-a-startup-Neobank/ > accessed 11 June 2020; Open, 'Get Started' (2020) <https://www.bankopen.co/#lp-pom-block-1086> accessed 17 June 2020; Namaste Biz, 'NamasteBiz about' (2020) <https://www.namastebiz.com/biz_about/> accessed 18 June 2020; Jupiter < https://jupiter.money/> accessed 18 June 2020; NuPay < https://www.nupay.co.in/# > accessed 18 June 2020. Neo Bank < https://neo-bank.com/> accessed 14 September 2020; Epifi < https://epifi.com/> accessed 14 September 2020; Wizely < https://wizely.in/> accessed 14 September 2020; Club Walrus < https://clubwalrus.com/ > accessed 18 June 2020; NuPay < https://www.nupay.co.in/# > accessed 18 June 2020. Vanghee <https://www.vanghee.com/#/home> accessed 14 September 2020; Fampay < https://fampay.in/> accessed 14 September 2020. Please also note that during our research, we learned that Open, which uses the URL 'bankopen.co' is migrating to a new URL 'open.money'. We have extracted data on 'bankopen.co' for this report.

Neobank Activity	Description	Entities Involved
Account opening	Customers can open current account with a bank through the platform. For instance, Open (a neobanking platform) provides its customers with the option to open a current account with ICICI Bank. It also lets customers connect their existing banks accounts from other Indian banks to view, reconcile and manage banking in one unified dashboard	Non-banks and partner bank(s)
Loan offers	Customers can have access to loan offers. For instance, NamasteBiz claims[94] that linking the app with the ICICI current account will give the customer access to "pre-approved loan offers from 70+ banks and NBFCs".	Non-bank, bank and NBFCs
Card services	It issues cards in partnership with existing banks. For instance, Niyo offers Niyo prepaid cards in partnership with DCB Bank and Yes Bank. Niyo also offers the DCB Niyo Global Card which is a debit card powered by Visa and issued with DCB Niyo Current Account..	Non-bank; partner bank(s); NBFC; PPI Issuer; Card network
Payment Services	It provides facilities to businesses to collect payments through payment gateway, IMPS/NEFT/RTGS and make API based bank payouts. For instance, the neobanking platform Open enables businesses to accept such payments through payment gateway facilities provided by Stripe, a technology company.[95]	Non-bank, regulated payment service providers and fintech companies
Value added services	In addition to the aforesaid banking and financial services, many neobanking platforms provide other services for meeting the business requirements of small businesses. This includes accounting, bookkeeping, tax filing, etc. For instance, RazorpayX partners with Opfin, a payroll and HR management software for automating the payroll process of a business.	Non-bank; technology companies

The following points emerge from a review of the neobanking platforms under the Partnership Model in India. *First*, non-banks partner with regulated entities (such as banks, NBFCs or payment system operators) to provide access to financial services to customers. *Second*, these non-banks partner with multiple regulated entities for providing the services referred to above. *Third*, they also partner with technology companies to offer value added services. *Fourth*, RBI supervision is limited to those activities that have been outsourced by banks / regulated entities to the concerned non-bank. Therefore, existing arrangements between banks and non-bank under the Partnership Model is likely to be subject to indirect supervision of RBI under the outsourcing and business correspondent guidelines. However, unlike many technology service providers which support back end services of banks, neobanking platforms are customer facing entities. This requires that regulatory protections are robust and comprehensive. In the absence of a regulatory framework, ambiguity regarding the role of such neobanking platforms may arise when contracts do not clearly demarcate responsibilities between various actors.

Based on a review of publicly available information on the Surveyed Platforms, this report highlights certain findings that merit regulatory consideration.[96]

Usage of the terms 'bank', 'banking' or 'neobanking'

Under the BR Act, usage of the terms like 'bank', 'banker', 'banking' and 'banking company' are limited to licensed banks alone, in order to avoid misleading the public.[97] Non-bank entities are prohibited from using these terms as a part of its name or "in connection with its businesses". Although several Surveyed Platforms clarify that they are not banks, some employ the term 'bank' on their website addresses or use the term 'banking' in describing their services. The usage of these terms risks violating the spirit of the provisions of the BR Act, as consumers may be misled into thinking that these non-banks are authorised and are regulated as licensed banks, when in fact their operations are carried out only through partnership with licensed banks. In certain cases, the Surveyed Platforms also use the terms like 'neobank' or 'neobanking platform' to describe themselves. Given that such terms do not have any standard definition recognised by any regulator, it may be misleading for consumers. This is more concerning when such platforms do not disclose their partnership with banks upfront.

[94] Namaste Biz, 'NamasteBiz about' (2020) <https://www.namastebiz.com/biz_about/> accessed 18 June 2020
[95] Open, 'Get Started' (2020) <https://www.bankopen.co/#lp-pom-block-1086> accessed 17 June 2020
[96] Please note that this data was sourced from the websites of these entities, which along with their terms and conditions, are subject to constant updates and revisions. Some of these entities are yet to launch their products.
[97] Section 7, Banking Regulation Act, 1949

Use of the terms 'Bank' and 'Banking'
*Out of the **17 Surveyed Platforms**:*
1. ***3 platforms** include the term 'bank' in the website URL.* [98]
2. ***Around 12 platforms** utilise the term 'banking' to as a part of their taglines or as part of key marketing material to describe their services.*
(a) *Some descriptions used by these non-banks are: 'Banking for the New India', "A new approach to banking", "Xperience The Future of Banking", "Bank of the Future", "Banking made awesome", "smart banking application".*
(b) *In all the aforesaid instances, the platform has not disclosed the name of the partner bank upfront.*
(c) *Out of 12 platforms that utilise the term 'banking', 5 fully disclose their banking partners upfront.*
(d) *In case of the remaining 7 platforms that do not disclose their partner banks, few are yet in the process of launching their products and hence may have not disclosed their partners.*
3. *In certain cases (6), the platforms describe themselves as 'neobanks' or neobanking platforms either on their home page or in the terms and conditions.*
4. *Some Surveyed Platforms also use the term 'neobanking' even when they are not providing any specific banking related services. For instance, in a particular case, a platform which only provides wallet services under a co-branding arrangement with a licensed bank,*

Details of Partner Banks

The aforesaid issue is further aggravated when non-banks fail to disclose their partner banks on their website. Several activities such as opening business current accounts, issuance of debit cards, provision of loan offers, etc. are undertaken by neobanking platforms through their partnership with licensed banks. In certain cases, non-banks partner with multiple commercial banks and other financial institutions to offer a bouquet of financial products and services. While certain entities clearly list details of their partner banks, several others fail to disclose this information entirely on their websites. For customers who avail of these services or purchase products offered by these entities, the absence of information relating to partner banks may adversely impact access to grievance redressal mechanisms by such consumers.

Disclosure about partner banks
Out of the 17 Surveyed Platforms,
1. ***7 platforms** clearly state upfront that their services and products are backed by regulated banks.* [99]
2. ***5 platforms** clarify the association with banks either in the terms and conditions or in some other part of the website*
3. ***5 platforms** do not mention anything about their banking partners. It must be noted here in most cases, such platforms are currently in the process of launching their services and hence may have not mentioned their partner banks.*

[98] Please note that during our research, we noted that Open, which uses the URL 'bankopen.co' also has another URL 'open.money'. Since 'bankopen.co' is still active, we have included it as one of the two entities using the term "bank" in the URL.
[99] Please note that during our research, we noted that Open, which uses the URL 'bankopen.co' also has another URL 'open.money'. '. While 'bankopen.co' lists the partner banks, the open.money 'does not include details of partner banks. Since, both these websites are live, we have taken into account both these websites for our analysis.

Consumer Protection and Grievance Redressal Framework

In the case of banks, the RBI has established a clear grievance redressal framework for customers.[100]This includes detailed procedures in respect of customer service as well as a Banking Ombudsman. In the case of business correspondents as well as service providers who fall under the Outsourcing Guidelines, the RBI has mandated a multi-tiered grievance redressal machinery, with recourse to the Banking Ombudsman. However, with regards to consumer grievances in respect of the products or services offered on neobanking platforms, there are certain issues which merit consideration. *First*, in cases where such platforms do not clearly advertise their banking partners, consumers have little awareness of the grievance redressal machinery available to them through the bank. *Second*, in most cases, the website of the neobanking platform do not clearly set out the grievance redressal mechanism. *Third*, the access to grievance redressal mechanism is typically available for services that the bank has outsourced to the service provider or the services provided by the business correspondent on behalf of the bank. However, in certain cases, neobanking platform may also partner with third party service providers for providing certain services, especially the value-added services. In such cases, the availability of the grievance redressal against such services must be clearly spelt out for consumers - i.e. whether they will be covered under the bank's grievance redressal mechanism as envisaged under the Outsourcing Guidelines or there will be a separate grievance redressal framework for the same. The issue that may arise in case such

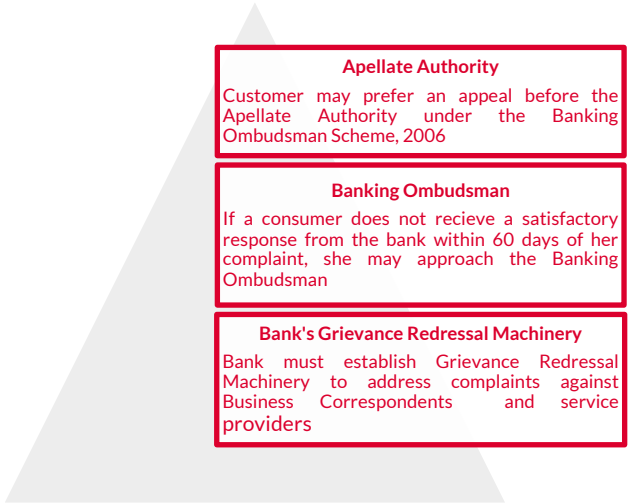


Figure 5: *Grievance Redressal under the Business Correspondent and the Outsourcing Guidelines*

Disclosure about Dispute Resolution
Customer X opens a business current account with a neobanking platform N. The current account is owned and operated by regulated bank B, however, the customer may be unaware of this fact since N has not clearly disclosed this information on its website. Along with the current account, N also provides an automated accounting service to X. This accounting service is powered by technology company A. In the absence of a disclosure on the grievance redressal mechanism, Customer X will be unaware of the recourse available to her *Out of the 17 Surveyed Platforms, only 6 had disclosed terms and conditions relating to dispute resolution on their website. Even in such disclosures, in certain cases, it is not very clear if the same pertains to grievances relating to the account on the neobanking platform or the underlying financial service. Many platforms may have not issued such policy as they are yet to launch their services.*

The adverse impact of some of these issues was recently witnessed in the case of loans secured by digital lending platforms, where these platforms were portraying themselves as lenders without disclosing the names of the bank / NBFC. Consequently, customers were not able to access grievance redressal mechanisms available under the regulatory framework. Accordingly, RBI issued a set of instructions for banks and NBFCs engaging such services of digital lending platforms.

Balancing promotion of innovation with prudential risk management

From a regulatory perspective, the bank-fintech partnership under the Partnership Model presents a fintech-driven risk, which requires a careful balance to be maintained between the policy objective of promoting innovation and managing prudential risks associated with contractual arrangements between banks and non-banks. While such partnerships between a bank and fintech, typically structured as an outsourcing arrangement may be relevant for a nascent industry, going forward there are certain policy considerations which will be relevant to design the regulatory framework governing digital-only banking models in India. *First*, one of the

[100] See Reserve Bank of India, 'Master Circular on Customer Service in Banks' (2015) < https://www.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9862#42> accessed 23 July 2020. See Reserve Bank of India, 'Banking Ombudsman Scheme 2006' (2006) < https://rbidocs.rbi.org.in/rdocs/Content/PDFs/BOS2006_2302017.pdf> accessed 23 July 2020

biggest challenges with such contractual arrangements under the Partnership Model is the absence of effective regulatory oversight. The absence of effective supervision of the fintech by the regulator may lead to regulatory arbitrage and enforcement issues, which may ultimately impact financial stability. The Financial Stability Board ("**FSB**")[101] takes note of the third party dependencies of financial institutions, interdependencies which are slowly emerging and its implications on financial stability. While financial institutions often outsource functions like customer relationship management, financial accounting, to third parties, such third party service providers may themselves depend on cloud services. The FSB notes that this can make identification of concentration risks even more opaque and the failure of a key third-party provider could in theory trigger financial instability, particularly if risks are not appropriately managed at the provider level. In case where a single non-bank partners with multiple entities, this risk is amplified due to interconnectedness. *Second*, it has been pointed out[102] that such contractual relationships may not be conducive for fintechs to scale up their businesses as such arrangements may often become pervasive, leading many fintechs to apply for regulatory licenses. *Third*, since neobanking platforms serve as front end service providers, there is a possibility that such platforms soon become the key distributors of core financial services. This combined with the possibility of certain services being dominated by a smaller number of service providers (especially big technology companies) may lead to concentration of risks relating to crucial functions. [103] Therefore, the regulatory framework needs to take into account the evolution of bank-fintech partnerships and the complexities surrounding the same.

The risks identified above are focused on the bank-fintech partnerships as currently in use in India.

[101] Financial Stability Board, 'Third-party dependencies in cloud services: Considerations on financial stability implications' (2019) <https://www.fsb.org/2019/12/third-party-dependencies-in-cloud-services-considerations-on-financial-stability-implications/> accessed 26 August 2020
[102] Luca Enriques and Wolf-Georg Ringe, (n 31)
[103] ibid

VII. Proposed Roadmap for Digital-only Banking Adoption

This part of the report draws on analyses of the regulatory framework, market conditions, as well as insights from developments in other jurisdictions to recommend a roadmap for policy action on digital-only banking in India. Given that the neobanking sector in India is at a nascent stage, this report recommends a phased and proportionate regulatory response in terms of short term, medium term and long term recommendations. This will be relevant to address two objectives: (a) harness the potential of bank-fintech partnership in the banking sector under the Partnership Model; and (b) assess the readiness of the Indian market for digital-only banks. It is worth noting that India does not currently have a data protection law. While the digitised nature of banking activities necessarily entails implications for data protection, these are not discussed in the recommendations below, given that specific recommendations may lead to disparate protections, particularly when the need for strong data protection is for the financial sector as a whole and not specific to digital banking as an activity.

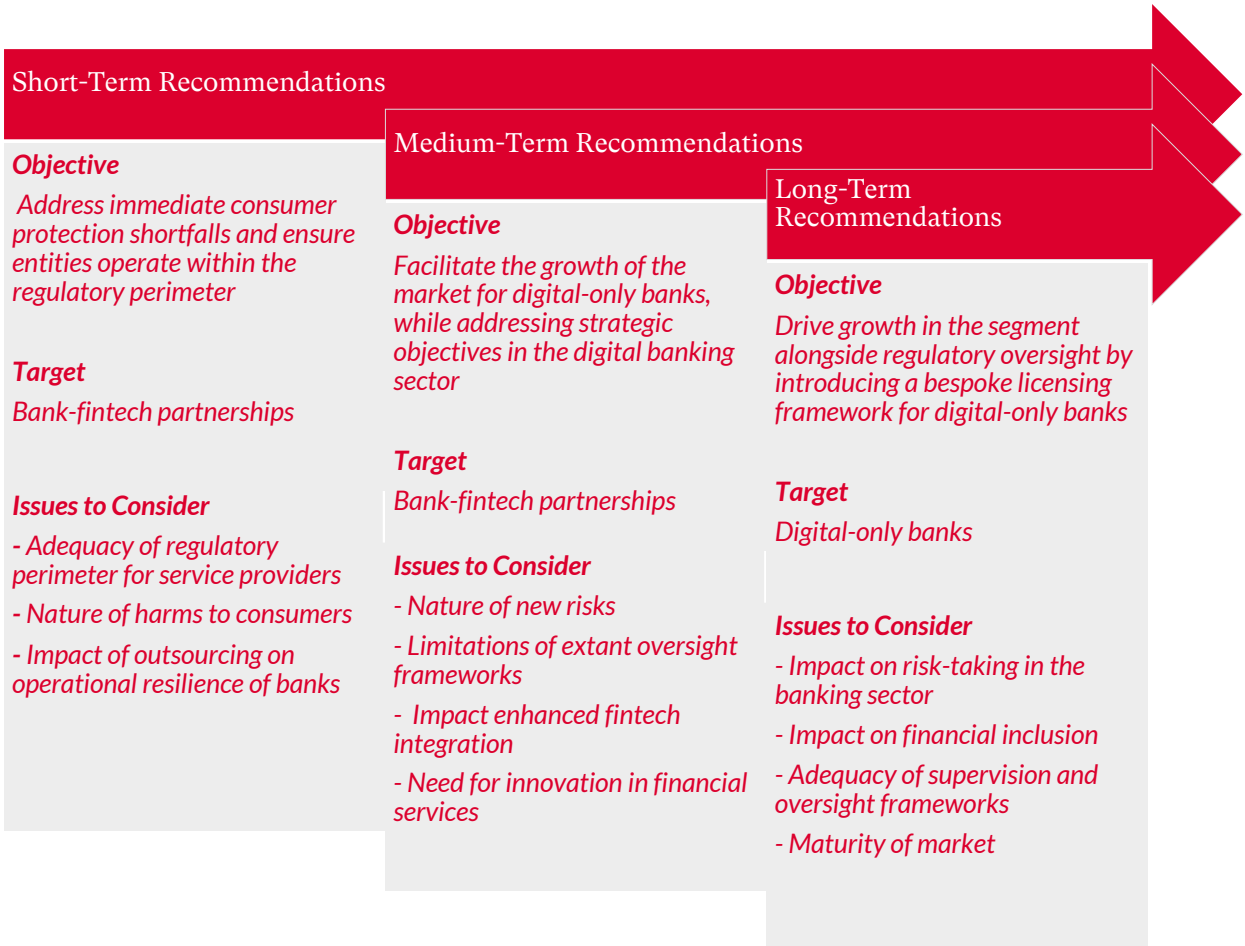


Figure 6: *A Roadmap for Implementation*

Short-term Recommendations

Objective

The short-term recommendations seek to address the lacunae in the neobanking sector that have an immediate impact on consumers. The solutions below are structured as light-touch regulation keeping in mind regulatory capacity as well as the objective of tackling consumer harms without unduly slowing down the growth of the emerging sector, which is still at a nascent stage.

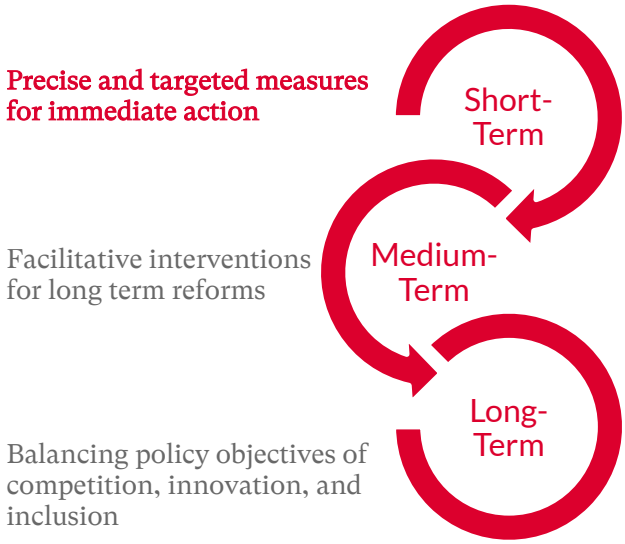


Figure 7: *A Roadmap for Reform: Short-term*

Issue directions to clarify the regulatory framework applicable to neobanking platforms

The RBI must issue directions ("**Proposed RBI Directions**") to clarify the regulatory framework that will be applicable to partnerships between banks and non-banks operating a neobanking platform. Regardless of how such partnerships are structured under the Partnership Model, broadly from a regulatory perspective, these arrangements are likely to fall under the outsourcing arrangement.[104] Based on the nascent stage of the neobanking market in India and the business models which are still evolving, this report advocates for a light touch regulatory framework and bringing these neobanking platforms within the existing Outsourcing Guidelines framework. Therefore, the Proposed RBI Directions should direct that banks and NBFCs partnering with such platforms should comply with all the provisions of the Outsourcing Guidelines. Currently, such guidelines may be issued by RBI by exercising its powers under section 35A of the BR Act and section 45JA of the RBI Act.[105] A similar framework was recently issued by RBI for loans sourced by banks and NBFCs over digital lending platforms. In certain cases, neobanking platforms also partner with banks to provide co-branded cards (such as credit, debit and prepaid cards). In such cases, adherence to directions to such co-branding guidelines issued by RBI should also be stressed.

Given the customer facing nature of such platforms, this report recommends that the Proposed RBI Directions should specifically address the concerns raised by the issues discussed above. Notably, since non-banks under the Partnership Model do not come under the direct supervision of the RBI, the proposed directions will be enforced through regulated entities such as banks and NBFCs.

Clarify the usage of the terms 'bank' and 'banking'

The Proposed RBI Directions should expressly prohibit the usage of the terms 'bank' and 'banking' by neobanking platforms either as a part of their names or URL. In particular, the RBI must stress that new technology and finance companies operating such platforms in consumer-facing segments must be particularly mindful of using potentially misleading terms. For instance, in cases where such platforms seek to use the term banking or neobanking as a part of the description of their services, adequate care must be taken to ensure that they do not portray themselves as banks or as carrying out banking functions to customers. Accordingly, necessary disclaimers should be conspicuously provided.

Mandate clear publicity of details of regulated partner banks

As discussed above, some neobanking platforms do not currently disclose the names of their partner banks upfront. Since these are consumer-facing entities, the report highlights how the non-disclosure of partner banks may be misleading and have serious consumer protection risks. The disclosure of partner banks also becomes

[104] Luca Enriques and Wolf-Georg Ringe, (n 31)

[105] Section 35 of the BR Act empowers the RBI to issue directions in public interest or in the interest of banking policy, among other grounds. Section 45JA of the RBI Act empowers the RBI to determine policy and issue directions in public interest or to regulate the financial system of the country, among other grounds, to non-banking financial companies.

critical to ensure that customers have access to grievance redressal mechanisms that banks are mandated to maintain for such outsourcing arrangements under the regulatory framework. The Proposed RBI Directions must therefore require banks and NBFCs partnering with neobanking platforms to ensure that must visibly and clearly disclose the details of the regulated partner bank and NBFCs on their website, mobile application, and all printed promotional material.

Clarify the consumer redressal framework

For addressing grievances under an outsourcing arrangement, banks are mandated to set up a grievance redressal mechanism. Accordingly, the Proposed RBI Directions must require banks to ensure that consumers interacting with a neobanking platform have been notified of the applicable grievance redressal mechanism along with the contact details of relevant person(s) to be approached for such grievances. In certain cases, a consumer grievance may pertain not just to the services underlying a bank account, but to allied value added services. Whether such services fall within the outsourcing arrangement between the bank and the neobanking platform will be determined by the contractual arrangement between them. Banks should ensure that consumers have been adequately informed about the grievance redressal mechanism that is applicable for grievances relating to any of the services being provided by a neobanking platform.

Important Terms and Conditions

The Proposed RBI Directions should re-emphasise that any arrangement between a bank and neobanking platform should expressly reflect the terms and conditions set out in the Outsourcing Guidelines. Particularly, these directions should emphasise that banks should ensure that: (a) the terms and conditions governing various banking and financial services are made available to consumers on the neobanking platform; (b) there is transparency regarding the fee charged by neobanking platforms; and (c) neobanking platforms partnering with multiple banks and regulated entities ensure they do not co-mingle customer data.

Medium Term Recommendations

Objectives

In the preceding chapter, this report highlighted certain policy concerns that may emerge when the bank-fintech partnership is lightly regulated. Yet, this Report is also conscious of the stifling impact of stringent regulation on promoting innovation. The medium term recommendations focus on creating a facilitative framework that will enable the regulator to assess the market for entry of digital banks in India, design proportionate regulations for such banks and enable easy transition of fintech companies from non-regulated entities to fully licensed entities, either on its own or through partnership. Subject to sustained growth in the neobanking sector, in the medium-term the complementarities that are inherent in a bank-fintech partnership may be leveraged strategically to address key issues in the Indian financial sector, including promoting competition, innovation and supporting small businesses.

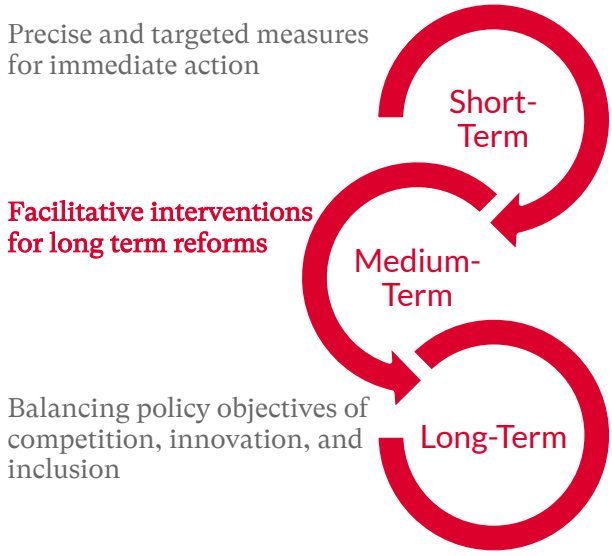


Figure 8: *A Roadmap for Reform: Medium-term*

Recommendations

Leverage the Regulatory Sandbox

Given the relatively large focus of digital-only banking model on the MSME sector, leveraging the bank-fintech partnership may prove an additional boost to existing initiatives targeting MSMEs. In 2019, the RBI launched a regulatory sandbox – a controlled and supervised testing space that relaxes certain regulation for a limited time period - with a view to enhance consumer welfare and provide guidance to new entities in the financial sector.[106] The sandbox operates on thematic cohorts, with 'Retail Payments' being the first cohort that RBI has opened under the sandbox framework. It is therefore recommended that the RBI leverages the sandbox and runs a cohort that is dedicated to digital-only banking models, and more specifically digital-only banking models are specifically targeted towards MSMEs. The RBI must utilise the evidence gained from the sandbox experimentation, to understand the readiness of the Indian market to operate digital banks, their value proposition for financial inclusion, especially their role in supporting small businesses and assess consumer harms, operational risks, and cyber risks that emanate from such form of banking. This will allow the regulator to observe first-hand: (a) the risks and scalability of fintech entities operating as service providers in bank-fintech partnerships; (b) understand the adequacy of extant supervisory frameworks governing such partnerships (such as Outsourcing Guidelines and Business Correspondent Guidelines); and (c) the viability of a digital bank license in India.

Code of Conduct for Neobanking Platforms

If the market for third party service providers, in the form of neobanking platforms, continues to expand then it is likely that the breadth and depth of bank and fintech partnerships will grow in tandem. In this regard, such partnership might well offer complementarities, to the extent that it facilitates banks' foray into underserved markets such as in supplying personalised products, services and credit to MSMEs. Given both the wide range of activities that these neobanking platforms undertake, which include account opening services, business accounting features, and cards and payment facilities, as well as the nature of their operations, which are predominantly through digital modes and are directly customer-facing, it may be necessary to have a code of conduct for such entities that sets out best standards and practices that must be adhered by such entities. This is also particularly important since neobanking platforms partner with different banks and financial institutions,

[106] Reserve Bank of India, 'Enabling Framework for Regulatory Sandbox' (2019) < https://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=938> accessed 30 July 2020

which may give rise to concerns relating to mis-selling, cross-selling and co-mingling of customer data. Given that the neobanking platforms are not within the direct supervision of the RBI, this code of conduct is envisaged to be industry wide acceptable minimum standards on specific key issues, as explained in detail below.

	Key Features of the Code
What is the purpose of a Code of Conduct?	• *The proposed code is envisaged to be an industry-led initiative. It will set out a minimum standard of transparency and fair practices for neobanking platforms who operate as banks' outsourcees. It will lay standards in respect of fair marketing practices, transparency, requisite data confidentiality measures, consumer dispute redressal, and the manner in which products are marketed and sold.*
How is a Code of Conduct different from the Outsourcing Guidelines?	• *The proposed code of conduct supplements the guidance outlined in the Outsourcing Guidelines, similar to the Code of Conduct for Direct Sales Agents.* • *Unlike the Outsourcing Guidelines, which lays down standards for banks by RBI, the proposed code of conduct will be drawn up and approved by the bank and it will lay down standards that must be followed by the non-bank partners.*
How will the code be issued?	• *The RBI must issue directions under Sections 35A of the BR Act and Sections 45JA of the RBI Act requiring all banks and NBFCs respectively that have entered into partnership agreements with neobanking platforms to strictly put in place a board approved code of conduct for such partners.*

Long Term Recommendations

Objective

The long term recommendations set out below are framed keeping in mind the RBI's objective to promote competition and financial stability through its statutory mandate of regulating the banking sector. The implementation of these recommendations are integrally tied to the findings of the medium term recommendations and the growth of the neobanking market in India.

Globally, reforms in the digital banking space have been targeted towards enabling greater competition and heterogeneity in the banking sector by leveraging technology. In this regard, technology's contribution has been significant: barriers to entry for newer firms have been lowered, due to the fact that digitally dependent business models have lower operating costs. Additionally, firms have a valuable business proposition as these business models may rely on different sources of revenue, such as catering to underserved market segments or developing new financial products, with a focus on customer experience.

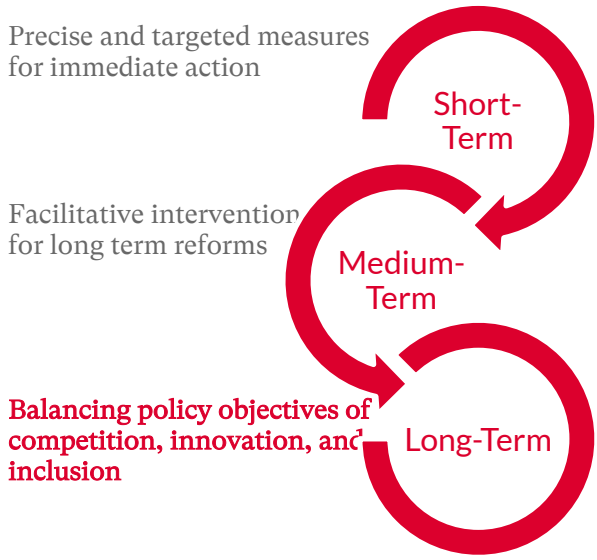


Figure 9: *A Roadmap for Reform: Long-term*

Therefore, facilitating the growth of digital banks may serve to boost competition, innovation, and heterogeneity in the banking sector by permitting the entry of new players. Insofar as fulfilling objectives such as financial inclusion are concerned, it is necessary to recognise that digital-only banks, can only act as one of the many options to further the financial inclusion agenda for supporting small businesses and entrepreneurs. However, in doing so this Report acknowledges the important limitations of this intervention given the status of financial literacy, and mobile and internet penetration in geographically excluded segments.

Recommendations

Issue Licensing Framework for Digital Banks

Subject to the findings of the sandbox testing under the medium term recommendations, the RBI may consider issuing a separate licensing framework for digital banks. The RBI is empowered by Section 22 of the BR Act to issue banking licenses to entities intending to undertake the business of banking as defined under Section 5 of the Act. In line with the guidelines issued for differentiated banks such as payment banks and small finance banks, the RBI may publish Guidelines for the licensing of digital banks, incorporating licensing conditions.

The licensing framework may impose prudential requirements and licensing pre-conditions that are in line with existing commercial bank requirements[107]with modifications where necessary to address data protection, operational, and technology risks that emanate from the digital nature of such banks. This must be issued keeping in mind market conditions, the impact of the introduction of new entities on risk-taking in the banking sector, as well as the overarching financial stability implications. Key issues that must be addressed by the proposed licensing guidelines along with possible approaches for the same is set out below.

[107] Reserve Bank of India, 'Guidelines for Licensing of New Banks in the Private Sector' (2013) <https://m.rbi.org.in/scripts/bs_viewcontent.aspx?Id=2651> accessed 2 June 2020

Designing a Digital Bank Licensing Framework for India	
Issue	**Possible Approaches**
Policy Objective	Regulation may fulfil any or all of the following objectives: • Promote competition in the banking sector (UK, Singapore, South Korea); • Enable innovative application of technology in the financial sector (Hong Kong, South Korea, Malaysia); and / or • Further the financial inclusion agenda by targeting underserved and unserved segments, especially small businesses (Hong Kong, Taiwan, Malaysia)
Specific Eligibility Conditions	• A requirement for a track record in the technology business may be considered for the applicant or the promoter group (Singapore, Malaysia) if the policy objective is to open the sector for entry of technology-based businesses; and / or • In certain jurisdictions (Singapore, Hong Kong), a consortium model is envisaged where a consortium consisting of financial firms and non-financial firms (such as technology, e-commerce companies, telephone companies) is allowed to apply for the license; and / or • Possibility of allowing existing small finance banks and payment banks to convert to digital banks may be considered.
Scope of Business	• Most Reviewed Jurisdictions allow digital banks to carry out normal banking activities. Certain jurisdictions (Hong Kong, Singapore, Malaysia, Philippines) envisage such businesses to specifically cater to MSMEs. Singapore has a separate license for MSME focused digital banks. • Given the experience with payment banks, the core design for digital banks should account for the business viability of entities in order to meaningfully meet the very motivation for its introduction. Accordingly, the approach referred to above where digital banks have been primarily allowed to carry out normal banking activities, with an expectation to serve underserved segments such as small businesses may be considered.
Licensing Process	The licensing process may consider a phased approach adopted in jurisdictions like Australia and Singapore. Two possible approaches: • Mandatory phased approach (Singapore): A digital bank can commence operations as a restricted bank before functioning as a full-fledged bank. Broadly, the restricted phase starts with a lower minimum paid-up capital requirement, a cap on deposit and certain restriction on permissible activities. The bank is expected to focus on "deploying its technology and risk management systems and establish its business model." The paid-up capital and the deposit size gradually increases till the bank is finally approved by the regulator to carry out full-fledged banking activities with no cap on deposits and increased paid-up capital. • Optional phased approach (Australia): This option allows applicants to apply for a license and directly commence banking operations. Alternatively, it may allow applicants to apply for a restricted license before they meet all the prudential requirements in full. It allows them to conduct limited baking activities while developing their capabilities and resources. An entity can be allowed to operate under a restricted license for a specified period. Notably, this framework is applicable to all authorised deposit institutions and not restricted to digital banks.
Physical branches	• In line with most Reviewed Jurisdictions, digital banks should be required to have one physical place of presence. • The requirement to maintain physical branches or points should be dispensed or may be capped to ensure that the delivery of banking service is primarily through digital means.

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