CUTS COMMENTS

On NITI Aayog's Discussion Paper on

DIGITAL BANKS: A Proposal for Licensing & Regulatory Regime for India

Background

Consumer Unity & Trust Society (CUTS) expresses its gratitude to the NITI Aayog for inviting comments on the Discussion Paper on Digital Banks: A Proposal for Licencing and Regulatory Regime for India.[1]

About CUTS

In its 37 years of existence, CUTS has come a long way from being a grassroots consumer-centric organisation based in Jaipur to opening overseas Resource Centres in Vietnam,[2] Africa,[3] Switzerland,[4] and most recently in the United States of America.[5] It continues to remain an independent, nonpartisan, and non-profit economic policy think tank while opening various programme centres, namely: Centre for International Trade, Economics & Environment (CITEE);[6] Centre for Consumer Action, Research & Training (CART);[7] Centre for Human Development (CHD);[8] and Centre for Competition, Investment & Economic Regulation (CCIER).[9] It has been enhancing the regulatory environment through evidence-based policy and governance-related interventions across various sectors and national boundaries. Further details about CUTS are available here. Having conducted various studies and events about e-commerce (such as Internationalisation of Micro and Small Enterprises through e-commerce and e-

[1] Discussion Paper: Digital Banks: A Proposal for Licensing & Regulatory Regime for India, *available at* DIGITAL BANKS
[2] http://cuts-hrc.org/en/
[3] http://www.cuts-international.org/ARC/
[4] http://www.cuts-geneva.org/
[5] http://www.cuts-wdc.org/
[6] https://cuts-citee.org/
[7] https://cuts-cart.org/
[8] https://cuts-chd.org/
[9] https://cuts-ccier.org/

commerce in the Context of Trade, Competition and Consumer Protection in India),[10] as well as on Data Protection (such as: Consumer Impact Assessment of Data Localisation,[11] and Understanding the Impact of Data Localisation on Digital Trade),[12] Data Sharing,[13] and Encryption[14] CUTS has observed a few critical issues in the draft architecture. These have been discussed in subsequent sections and a few recommendations to address them.

INTRODUCTION

In November 2021, NITI Aayog released a discussion paper proposing licensing and regulation of Digital Banks: The New Kid on the Block. The paper ran in a crisp and technical language in 50 pages inviting comments and suggestions from citizens, organisations, and persons interested.

The discussion paper explores the new age concept of digital banks, their potential in the financial landscape of India and obstacles on the road of digital banks in reaching their full potential. According to NITI Aayog, a significant degree of innovation has taken place in the financial landscape with the advent of fin-tech companies, specialised banks, India stack, Unified Payments Interface (UPI) and other initiatives. These innovations have had no significant impact on larger incumbent traditional banks, and the pockets of users and micro, small and medium enterprises (MSMEs) remain un-served. They are then exposed to the informal money markets where interest rates are usurious.

There is a regulatory gap due to which the front-end Neo-banks have found space to exist and conduct operations in partnership with incumbents such as SBI and Kotak. None of the Neo-banks in India are regulated directly. However, they are subject to indirect regulations (through

[10] https://cuts-ccier.org/e-commerce/
[11] Objective: Assessing the impact of restriction of cross-border data flows on consumers, among other stakeholders, on parameters, such as quality of service, innovation, data privacy, data security etc.
Expected Outcome: presenting an evidence-based impact of data localisation, to the government and other stakeholders. *Available at* https://cuts-ccier.org/consumer-impact-assessment-oncross-border-data-flow/
[12] Objective: Understand and analyse the importance of digital exports for India's GDP and economy, along with the possible impact of data localisation barriers on Indian exports of digital goods and services.
Expected Outcome: build detailed and holistic understanding of the economic implications of existing and/or proposed data localisation barriers on India's digital exports, while producing evidence to study alternatives to data localisation measures which are prohibitors to free data flows, in order to help policy makers in India and around the world to take an informed and appropriates and on data localisation.
Available at https://cutsccier.org/pdf/projectbrief-dtdl.pdf
[13] Examining the Rationale, Assumptions and Approaches to Non-Personal Data Sharing | ccier
[14] Understanding Consumers' Perspective on Encryption | ccier

their partnerships with regulated entities), ensuring that their product offerings adhere to the regulatory norms.[15]

The concept of Digital Banks is new and shiny and an effort to ride on the success of the Digital India[16] campaign. However, the success of the Digital India campaign is also a point of contemplation for many due to implementation challenges, poor planning and falling short in the accessibility of digital infrastructure.[17]

NITI Aayog released the discussion paper to establish the full-stack digital bank to bridge the ₹ 25 trillion credit gap for the MSME sector.[18]

PRELIMINARY COMMENTS

The discussion paper uses heavy technical language, which excludes readers who do not frequent the banking, fin-tech landscape. This demographic includes the people whom the regulator aims to benefit. *It is recommended that after incorporating the comments received by NITI Aayog, a simplified version of the discussion paper should be released for general public consumption.*

The discussion paper uses the under-served groups and MSME's for making a case for public policy needs of licensing of digital banks. However, the under-served groups mentioned are neither expanded upon nor addressed throughout the paper. This assumes that this welcome move is only directed towards one part of the group that remains unbanked. India has the second-highest population of unbanked people and the majority of them are women.[19]

It is thus recommended that the scope of the discussion paper and, in extension, digital banks be expanded to include all unbanked groups. Improving access, usage, and quality of services for

[15] The evolution of neobanks in India: Impact on the financial ecosystem, September 2021 *available at* The evolution of neobanks in India: Impact on the financial ecosystem
[16] Digital India is a flagship programme of the Government of India with a vision to transform India into a digitally empowered society and knowledge economy. The website for the same is accessible from this link. Digital India
[17] 6 Years of Digital India: How successful has PM Modi's plan been? Available at 6 Years of Digital India: How successful has PM Modi's plan been? | ORF
[18] Discussion Paper: Digital Banks: A Proposal for Licensing & Regulatory Regime for India Pg. 27, *available at* DIGITAL BANKS
[19] RBI Report: India's 'Financial Inclusion Index' is 53.9 by the end of March 2021, 28.08.2021 *available at* India's 'Financial Inclusion Index' is 53.9 by the end of March 2021

vulnerable sectors like gig workers, women, and MSMEs will increase the financial-inclusion Index (FI-Index)[20] by the Reserve Bank of India (RBI).[21]

One of the key requirements for having full-stacked digital licensed banks is internet connectivity. With India's growing digital infrastructure, one can assume that it is widely available, but one has to account for the consumers who do not use or are familiar with smartphones. In India, it is estimated that smartphone users will only go up to 887.4 million by 2030.[22] However, in 2021 a study found that India has a gender divide in terms of smartphone users as compared to 41 percent of men, only 23 percent of women have access to smartphones.[23] This divide in digital access also exists in rural and urban demographics, where broadband penetration is only 19 percent against the national average of 51 percent.[24]

It is thus recommended that the regulators focus on increasing access to digital infrastructure and reducing the digital divide while introducing a service to facilitate credit for the MSMEs.

The concept of Digital Only banks catering to the unbanked sector of Micro, Small and Medium Enterprises (MSMEs) is the exploratory desire of the regulator. The paper quotes that many MSMEs remain unbanked and have to rely on informal money lenders for their credit requirements. The third section of the paper states that it is beyond the scope of the discussion paper to do an exhaustive review of the reasons underlying the financing gap for the MSME sector.

However, the gap for MSMEs credit was an issue that RBI intended to solve by creating Small Finance Banks (SFBs) and MUDRA Yojana.[25] The SFBs do not need to have any physical presence but operate in a hybrid model for a reason. The banking that is only digital when pushed into remote country locations does not work as the consumers want both a physical and

[20] The FI-Index comprises three broad parameters (weights indicated in brackets) viz., Access (35%), Usage (45%), and Quality (20%).
[21] RBI unveils financial inclusion index, 17.08.2021
available at RBI unveils financial inclusion index - The Hindu
[22] India may not reach a billion smartphone users by 2030: Report
[23] Nikore, Mitali; Uppadhyaya, Ishita; India's gendered digital divide; 'How the absence of digital access is leaving women behind' , August 2021; *available at*
India's gendered digital divide: How the absence of digital access is leaving women behind | ORF
[24] Ibid.
[25] Financing India's MSMEs: Estimation of Debt Requirement of MSMEs in India; November 2018 *available at*
IFC Report (Financing India's MSMEs).cdr

digital mode where they can take their grievances.[26] One more emerging trend is that of fin-tech lenders, commonly known as NBFCs which rely on technology and use non-traditional sources for credit underwriting and disbursal.[27] Both SFBs and NBFCs were steps towards moving these small businesses towards formal sector lending.

It is thus recommended that regulators put efforts into understanding the challenges that already existing lenders face and try to resolve them to ensure optimum usage of those channels. The new category of lenders might eventually end up facing similar challenges.

When traditional banks limited branch hours and needed ATMs for currency withdrawal during the pandemic, people relied on digital payments. However, the idea behind digital facilities is to ease the life of a day-to-day customer. As per a recent report by the Securities and Exchange Board of India (SEBI), only 27 percent of the country's population is financially literate.[28] There is a need for measures to ensure this literacy across the country, focusing on deprived geographical locations.

It is thus recommended that while introducing Digital Banks to India's population, measures to increase digital and financial literacy be taken by the regulator, which is different from traditional methods to withstand the effects of the pandemic.

SECTIONAL COMMENTS

Section IV: Digital Banks: New Kid in Town

The name of Digital Bank suggests that they will rely principally on the internet and other proximate channels to offer their services and not physical branches. The proximate channels mean technology like Near -Field Communication (NFC), as has been explained in the paper.

Comments: There are two issues with this premise. *First*, banking is made accessible to those with access to the internet, which is not possible consistently in remote areas, areas with less options for Internet service providers, etc. *Second* is the use of NFC as an option for banking. The NFC is highly successful for e-payments and banking services. Still, NFC technology may

[26] Digital Banks: Will The Idea Work In India?
[27] IFC Report (Financing India's MSMEs).cdr
[28] The growing significance of financial literacy in India – Gaps and opportunities - The Financial Express

be too expensive for some companies, as it usually involves a suite of related devices, equipment, and upgrade-dependent standards.[29] The cost of installing the hardware and software and hiring technicians to maintain it can compound quickly. It is unclear who would be bearing the cost of this technology and is it even necessary to bear this cost as there are unexplored areas of SFBs and NBFCs that are open.

It is thus recommended that innovations other than NFCs such as WiFi, ZigBee, QR Codes, and others be explored by the regulators for proximate channels for Digital Banks.

The proposed digital banks will cater to small businesses towards formal sector lending. Neo-banks that have come up to fill gaps have a business proposition to provide niche products for the under catered (eg. small businesses, migrants, paycheck-to-paychecks retail consumers, gig economy workers and millennials).

It is thus recommended that regulators should find measures to increase financial inclusion in the Digital Banks model while catering to small businesses. The Neo Bank Model, while its own challenges caters to marginalised communities. Appropriate effort to incorporate the principles of catering to said marginalised communities by the Digital Banks frameworks should be made.

The section further details that to successfully establish the Digital Banks framework, a collaboration between other players of the ecosystem will be made. The digital banks' framework will also leverage the Banking-as-a-Service (BAAS) model to launch Digital Banks successfully.

Comments: BAAS is not a full-stack digital bank and collaborates with traditional banks. In partnership with traditional banks, the BAAS provides a digital experience to users while relying on the reputation of traditional banks.[30] BAAs does not offer complete suite services and when partnered with Digital Banks, the entire ecosystem becomes digital. There needs to be more clarity on accountability, transparency and grievance redressal mechanisms undertaken by Digital Banks as supported by BAAS.

It is thus recommended that before moving forward with this partnership model, the regulator prescribes a clear grievance redressal mechanism. Also, the framework needs to be clearer on risks posed and on whom the accountability of those risks will lie.

[29] Near Field Communication: Pros and Cons
[30] The risks in BaaS models | RFI Global

Section VI: A Digital Bank Global Regulatory Index

This section states that other jurisdictions like Singapore, Hong Kong, and Malaysia have issued regulatory special digital banks. And in the United Kingdom, regulators have recognized the digital banks' business model by issuing banking licences to banks offering “digital-first”/ “digital-only” propositions. In this section, the regulator has set up an index on four factors: entry Barriers, Competition, business restrictions and technological neutrality. The section also lays down the scoring methodology adopted for the benchmark jurisdictions against the Index to draw lessons for the proposed Indian framework. The benchmark jurisdictions chosen for this Discussion Paper were Singapore, the UK, Hong Kong, Malaysia, Australia and South Korea.

Comments: It is important to note that these four-factor variables do not address the concern of accountability and grievance redressal. The Index seems non-exhaustive as there should be criteria adjudging other jurisdictions on the accountability of these banks and the regulations necessary to allot accountability in the case of foreign banking agencies. Also, the digital banks that are not in partnership with incumbent banks or owned by large non- financial firms with an existing customer base can increase competition and financial inclusions and mean exposure to certain risks to the consumers.

It is thus recommended that the regulator considers accountability and grievance redressal as a factor to judge other benchmarks. Also, the maturity of the market, consumers and digital finance ecosystem and the capacity of the regulatory and supervisory systems should be factors that lead this new category's framework.[31]

Comments: A Digital Bank provides Banking as a Service and Banking as a Platform as facilities. This Opens the consumers and their financial and personal data to more risks than the incumbent and partnership banks do in the form of digital frauds, platform collapses, etc. Such issues can be solved through data privacy laws and laws that govern data transfer. The draft Data Protection Bill, 2021 (DP Bill, 2021) provides for restrictions on data transfer across borders and regulates access to data by fiduciaries and persons.[32] RBI and data restrictions govern all

[31] POLICY FRAMEWORK ON THE REGULATION, LICENSING AND SUPERVISION OF DIGITAL BANKS
[32] Draft Data Protection Bill 2021 *available at* http://164.100.47.193/lsscommittee/Joint%20Committee%20on%20the%20Personal%20Data%20Protection%20Bill,%202019/17_Joint_Committee_on_the_Personal_Data_Protection_Bill_2019_1.pdf

financial institutions are covered under its mandates. Thus, whether digital banks will be treated as platforms and governed as companies or banks.

It is thus recommended that individual regulators collaborate to create a safer space for consumers and the entities that deal with data. It is a welcome step that regulators research global frameworks for adopting best practices. However, a level playing field for traditional incumbent and digital banks must be one of the agendas of the regulator, and no framework should favour one category of institution more.[33]

Section VII: Digital Bank Regulatory Framework for India: A template

The paper highlights that a three-step sequence will be implemented to find out the highs and lows of the Digital Bank Regulatory Index. The Digital Banks will be allotted a restricted licence based on legal and other dimensions on the first step. Then on the second step, the banks will enter a regulatory sandbox with a minimum paid-up capital of Rs. 20 crore (10 percent of SFBs) and in case of satisfactory performance on the third step, the restrictions will be relaxed and digital banks can be full-stack licensee.

Comments: Though useful and successful, the regulatory sandbox concept should not become the last resort for all activities and not discourage innovation of other mechanisms to test regulations. Regulatory sandboxes are not a one-size-fits-all solution. Other approaches may be more efficient, nimble, responsive to the market, and appropriate to the specific circumstances of an individual country and/or market.[34]

It is thus recommended that regulators should consider reaching out to the stakeholders for understanding the challenges and consider alternatives to the sandbox as it is not the end-all solution. For example, ***the test-and-learn*** *approach enables a regulator to craft an ad hoc framework. An innovator tests a new idea in a live environment, with safeguards and key performance indicators in place.*[35] *A* ***wait-and-see approach*** *allows a regulator to observe how innovation evolves before intervening (e.g., person-to-person lending in China).*[36]

[33] OECD (2020), Digital Disruption in Banking and its Impact on Competition *available at* Digital disruption in financial markets - OECD
[34] Regulatory Sandboxes and Financial Inclusion
[35] One Thing Regulators Should Do Before Launching a Sandbox
[36] Regulatory Sandboxes: Potential for Financial Inclusion?

Suppose the regulator decides to go with the sandbox approach after stakeholder consultation. In that case, the regulatory sandbox conditions should imitate the real scenarios and activities discouraged outside the sandbox should not be allowed to check the limits of potential of an innovation.

In section VI, the paper accepts that there should be a differentiated minimum capital requirement as one size fits requirements only favours incumbents over new challengers. However, in section VII, the minimum capital requirement to enter the regulatory sandbox is INR 20 crores. This entry barrier rises to INR 200 crore when becoming a full stack digital bank licensee as much as the small finance banks requirements. The paper accepts that SFBs and neo-banks seeking to upgrade are eligible candidates.

Comments: We appreciate the regulator's effort in creating an entry requirement of capital, which will protect consumers' rights and ensure security. It is to be noted that the amount can act as an entry barrier to new players and favours established entities.[37] Though the mandate of strict requirements will protect consumers' interest,[38] it will also take out the smaller players in favour of large players.This will discourage smaller innovators from entering the ecosystem.[39] The digital bank licence applicants are being subjected to entry barriers of cost. Still, they lack an application prescription of how potential candidates intend to cater to the financial needs of uncatered.

It is thus recommended that sufficient measures to ensure the security of consumers and encourage innovations are taken by regulators. The findings from the global regulatory framework should be implemented in practice. This would mean that there must be differentiated entry barriers for different candidates, and this would require the prescription of categories of potential candidates in the revised framework. It should be a requirement for digital bank licence applicants to provide a clear proposal on how it can cater to the unmet financial needs of underserved segments of the market through an innovative and sustainable digital banking business model.[40]

[37] Competition Assessment Toolkit
[38] Maintaining competitive conditions in the era of digitalisation
[39] Competition Assessment Toolkit
[40] Digital Full Bank Framework, Monetary Authority of Singapore; *available at*

The paper encourages equal access to infrastructure enablers[41] to keep the business of the Digital Bank viable and pro-competition. In Section VI of this paper, the regulator speaks about the necessity to have a clear exit plan and how Digital banks will be fully digital. The paper recognises that the policies for Digital banks should be technologically neutral.

Comments: The paper fails to discuss consumers' privacy and data protection on the offset. The regulator should address data protection concerns without giving open access to all data stored with infrastructure enablers. These infrastructure enablers have a single point of central agency through which everything passes. Thus, there is a single point of failure that exists. The paper also does not distinguish between big tech firms, big investors and new and small firms. The paper has posed a clear problem that the digital banks' framework will address, but the timeline restriction on such a solution is not prescribed. SFBs and NBFCs were licensed to solve the credit gap for MSMEs, but the same has not been achieved to date.[42]

It is thus recommended that to have a pro-competition ecosystem, the regulator must install procedural safeguards for maximum protection awarded to consumers and the financial firms holding financial data. The regulator must discourage aggressive growth path business strategies and accelerated introduction of novel products.[43] The regulator must ensure that the potential candidates in their applications must include a clause that portrays the number of beneficiaries they attempt to cater to in a definite period without strict prescriptions. The digital banks should be subject to performance indicators, including catering to under-catered sectors. This would include formulating a product that leads to the customer's overall financial well-being.

Comments: If the digital bank can showcase and justify the need for a hybrid model with a limited physical presence, then arrangements allowing the regulator should make the same. Fully licensed Digital Banks must engage in the same range of activities as traditional banks. If the digital bank deems it necessary, it should open a physical office, but it would blur the line between digital banks and existing incumbent banks.

ANNEX A DIGITAL FULL BANK FRAMEWORK Eligibility Criteria Application for a digital full bank licence.

[41] Infrastructure enablers include Aadhar e-KYC/Credit information companies, UPI (NPCI)/ Central Payments Systems (NEFT/RTGS), ATM Schemes, Deposit insurance and credit guarantee corporation (DICGC) and AA Ecosystem.

[42] BRICS - Digital Financial Inclusion Report

[43] POLICY FRAMEWORK ON THE REGULATION, LICENSING AND SUPERVISION OF DIGITAL BANKS

It is thus recommended that no restrictions should be placed on the physical presence of digital banks; however, adequate supervision, monitoring and evaluation mechanisms should be prescribed in the law.

Comments: Policies on Digital Banks should be technology-neutral to allow lasting innovations subject to the overarching goals of protecting customers and the financial system's resilience. The regulator should set up an exit plan if the digital banks do not achieve the desired results. The need for the same is also demonstrated in the paper in the global regulatory section, termed as 'living wills'.

It is thus recommended that to have a technologically neutral framework, a principle-based model is set up where regulators can test licensee on the scale, reliability, privacy, security, etc. Also, while calling for potential candidates' applications, the regulator can specify an exit strategy in regulation. Another solution can be that applicants should be required to submit an exit plan and their business models.

Comments: The discussion paper lacks the need for digital bank licensing from the consumer perspective and their protection. The main goal of digital banks is to increase financial inclusion for the underbanked sectors. The majority of consumer protection requirements for any entity handling consumer's data should also apply to digital banks. Digital Banks have various services and require partnerships to distribute their products and services. Thus, having significantly larger entry points of criminal activity, technical failures lead to consumers suffering financial losses and data loss when someone handles their business in a manner unknown to them. Digital banks are at a higher risk of criminal activity than incumbent banks.[44]

It is thus recommended that the regulator addresses the issue of these securities and the safeguards it intends to place. The draft DP Bill 2021 has been formulated to prevent data breaches and protect all data privacy. A collaborative effort on the part of multiple regulators will be required to ensure risk management. Also, the role of digital banks to manage risks related to consumer's data while remaining profitable will be essential. An easy access grievance redressal mechanism should be established to ensure maximum benefit to the

[44] Two reasons digital banks face AML 'challenges' - AltFi

consumer. Also, the participation of digital banks to increase awareness on financial and digital literacy can be prescribed.

Section VIII: Conclusion

In conclusion of the discussion paper, India's public digital infrastructure, especially UPI, has successfully demonstrated how to challenge established incumbents while solving the several public policy challenges India faces.

Comments: The regulator should focus on bettering the delivery of lending services by incumbent banks and existing SFBs and NBFCs to the underbanked sector while introducing a new category of lenders that requires more resources to function effectively than it aims to provide.[45]

It is thus recommended that regulators should address challenges that existing banking frameworks face while allowing for innovation and new players to emerge. India is at the cusp of becoming a digital-first economy and is ready for its open banking framework. However, procedural safeguards to ensure a consumer-first approach is necessary. In this new proposal, consumer issues of financial inclusion, literacy, and data privacy should be considered key indicators of the framework's success.

CUTS International extends its wishes to NITI Aayog for this initiative while looking forwards to the next steps taken by the regulator in this endeavour.

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CUTS International looks forward to NITI Aayog's acceptance of the comments and recommendations given above and assisting NITI Aayog in its endeavours of empowering consumers and individuals. For any clarifications/further details, please feel free to contact Neelanjana Sharma (njs@cuts.org).

[45] Rising challenges for Indian neo-banks