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Regulation on Neobanks

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Introduction

The banking system has been continuously evolving over the hundreds of years to meet the changing the demands of environment of the financial system. With the advent of the internet, there has been a revolution in banking, offering several services to customers. Neobanks have been at the forefront of leading the revolution of new-age banking to give high customer satisfaction by operating at low cost and high operational efficiency. As every industry has been disrupted by tech in recent years, banking remained Brick and Mortar but neobanks changed that and so would the regulatory framework have to accommodate them.

Problem solved by Neobanks

In India, MSMEs rely on unofficial money lenders to pay off their debt. These borrowers cannot establish a credit history to use typical banks' lending services. It is a combination of informal and formal borrowing, even with exposure. Due diligence costs for banks rise, and their inability to take on more risk makes it unprofitable to lend to MSMEs.

There is a credit market under penetration in India because of these reasons. The primary issue facing regulated retail banking is the lack of innovation, which forces "thin file" borrowers to turn to unregulated and grey markets instead of regulated ones for their financial needs. Product customization and innovation from within the regulated ecosystem niche market for the under-served is one of the potential ways to grow organically. This is the domain where neobanks are trying to fill the gap.

Digital banks: What they hold for India

Three models of banks have come up after the global financial crisis of 2008:

•Neo-banks are established, licensed banks that provide "over-the-top" services to customers by "renting" the bank's balance sheet for deposits and loans.

- Full-Stack (Licenced) Digital Banks: These companies provide loans, accept deposits on their balance sheet, and are fully operational banks subject to banking regulation.

- (Autonomous) unit of traditional banks: These organizations are effectively independent, stand-alone neo-banks that compete with conventional banks' neo-banking operations.

Characteristic features:

- Neo-banks' banking strategy aims to serve populations that traditional banks underserve.
- They offer speed, faster technology deployment, efficient organizational design
- Superior user experience and transparency in consumer transactions.
- Reduced operating costs because of no physical locations, and because of that, they can grow their market share.
- A low barrier to entry into the neobank space is an attractive proposition.
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Evolution of Neobanking in India

Over the past four to five years, there has been a notable surge in the Indian neobanking industry. Each neobank has a distinct product offering and target consumer group that imply colossal development potential for them in the coming years, even though over 36 companies are attempting to scale up their businesses. Innovation and greater emphasis on meeting consumer expectations are all contributing to the growth of India's financial services industry. In addition, efforts by conventional banks to form strategic alliances with neobanks and the involvement of private equity firms are contributing to the growth of neobanking in India.

Services of Neobanks offers specialized services such as:

1. Neobanks have an advantage over regular banks because of their distinctive online presence. They may provide cheap fees and high interest rates on deposits since they do not need physical branches, which lowers their operating costs. This translates to more significant pocket money and a more promising financial future.
2. Neobanks allows you to handle money how you see fit with its mobile-first strategy and round-the-clock digital services. They give you the power and comfort you require by using cutting-edge technology to deliver creative solutions, fast response times, superior customer care, and simple onboarding.
3. Neobanks have streamlined loan procedures with easily accessible online applications and verification. Following the validation of their credit ratings, customers can select the loan they want and get their money immediately.
4. Using cutting-edge technology, Neobanks prioritizes security, offering safe online banking platforms with features like two-factor authentication and biometric verification. They protect your financial data and provide peace of mind by using AI and cloud analytics to thwart cyberattacks.

Existing partnership model

The prevailing Neo-bank business model in India results from a regulatory gap. Without a licensing framework for "full stack" digital banks, fintech companies in India that provide the Neo-bank concept have had to adapt and have started using the "front-end neo-banks" model. As the name suggests, this collaboration between neo-banks and traditional banks, with the former providing the "utility" layer and the latter the engagement layer.

These neo-banks have focused much more on services aimed at customers. Additional conveniences, including digital debit cards, tools for managing personal finances such as spend analytics for better budgeting, investment opportunities through its mobile application through its B2B partnerships, and possibly a credit line, are offered by a typical consumer-facing Neo-bank.

This model has several challenges:

- Limited possibility for revenue: Fintech's monetization issues are readily apparent. Wherever they serve as channel partners, they receive fee-based revenue and may receive a portion of interchange on card payments.
- Difficulty building trust: Consumers view traditional banks as safer and doubt neobanks credibility.
- High capital costs and lack of entry barriers: Neo-banks must rely on pricey equity capital to finance operations and innovation since they cannot offer low-cost deposits. Fintech entry hurdles into the neo-banking industry are minimal without a licensing structure. Two detrimental externalities result from this. First, this context presents an opportunity for unfit and improper actors to enter the market, as with any ecosystem with low barriers to entry. This creates sides risk to consumer protection, particularly on the retail side. Second, it fosters a mindset where people copy company models like a herd.

Regulatory consideration for Neo banks in India:

Even though some international national banks have Indian subsidiaries that primarily offer digital products, virtual banking licenses are still unavailable in India. In addition to emphasizing that banks emphasize having a physical presence, the RBI has recently reiterated that providers of digital banking services must also have a physical presence. Brick-and-mortar branches are crucial because they provide in-person client service and issue resolution. To comply with legal requirements, neo-banks outsource their banking operations to individuals holding banking licenses, forming strategic alliances with established banks, and enhancing services for already-existing institutions. Some neo-banks are already implementing this concept on a global scale. Neo banks work alongside traditional banks to offer consumer and business banking.

Additionally, neo-banks provide:

- Services that circumvent the jurisdiction of the RBI
- The Securities Exchange Board of India (SEBI)
- The Insurance and Regulatory Development Authority of India (IRDAI) financial authorities

Services provided by neo-banks

- Banking services: utility bill payment, credit/loan, domestic money transfers, and prepaid card services
- Investment advisory products: gold, mutual funds, stock market, initial public offering, and stock market investments
- Corporate representatives: Insurance policy, Insurance web aggregator

Opportunities:

1. Specialised services provided: Neo banks have the potential to offer a notably more comprehensive range of services, hence creating a unique value proposition. Neo banks offer an extensive range of creative and customer-focused solutions, unlike traditional banks, which only offer restricted banking services.
2. Generation tech-savvy: India's smartphone penetration grew at a 14.26% CAGR from

46.44% in 2019 to 60.63% in 2021. This could be related to the COVID-19 pandemic. Fintech has significantly benefited from the widespread increase in smartphone usage, allowing it to implement a much-needed change faster than expected. The COVID-19 epidemic further expedited Neobanks' growth in India. This gives neo-banks a great deal of promise.

3. FinTech Ecosystem: India has the third largest FinTech ecosystem globally after the US and China. However, the country still has untapped potential because financial services are less widely used in India. Given these unexplored prospects and a suitable environment, India has enormous growth potential.

What needs to be done?

- The regulatory framework does not call for the complete digitalization of the financial product offering process. Considering the digital services provided by neo-banks and their connections to financial institutions, the existing indirect restrictions need to be re-examined. It is necessary to think about a legislative framework that permits regulated entities to handle tasks like fund management and settlements. In contrast, FinTech partners handle the technological interface and user experience.

- The RBI's Branch Authorization guidelines must be changed similarly, which describes "branch" as full-fledged branches, specialized branches, remote offices, off-site ATMs, administrative offices, controlling offices, service branches, etc. This definition does not consider the digital setup of neobanks. Additionally, only banks with a physical presence can provide mobile banking services to their clientele under the RBI's mobile banking criteria.
- Minimum Paid-Up Capital: Depending on how restricted a digital business bank is, its minimum paid-up capital within a regulatory sandbox may correspond to that restriction.
- Application pool and track record: The license may require one or more controlling people of the application organization to have a proven track record in related areas, including e-commerce, payments, and technology, given the "digital-native" character of the banks operating under this license. Potential qualified candidates for application include small finance banks and other regulated businesses (such as incumbent banks that may perceive a chance to obtain a full-stack digital business bank license) or existing neo-banks looking to upgrade.
- Equitable Access to the Infrastructure Enablers: Like traditional banks, digital banks should have equal access to all the essential infrastructure enablers in the Indian financial ecosystem for their license and business model to be viable and foster competition. Access to Aadhaar eKYC and credit information companies, as well as UPI, IMPS, and central payment systems (NEFT/RTGS), are included in this.
- ATM programmes
- Deposit Insurance & Credit Guarantee Corporation (DICGC) (opposing the DICGC's determination of the appropriate premium levy). • The environment of AA.
- Phased relaxation of business limitations: When mapped, several Benchmark Jurisdictions on the Index began with business constraints (such as on the number of deposits and assets) and correspondingly lower minimum paid-up capital levels. That strategy can be replicated in the restricted Digital Business bank license. These company limitations may pertain to the number of assets and deposits handled or clients they serve. Suppose the licensee performs satisfactorily on agreed-upon measures. In that case, the regulator may gradually loosen these requirements until the licensee is prepared to leave the sandbox and function as a "full-scale Digital Business bank."
- Regulation of technological risk: Because digital business and consumer banks utilize their APLs to establish relationships with multiple counterparties from which hazards may arise, they are more sensitive to technological risks than traditional banks.
- Business Continuity Planning: Following the global financial crisis, supervisory authorities, such as the Federal Reserve, mandated that banks operating under their auspices submit "business continuity plans"

(BCPs), commonly referred to as "living wills," outlining an "exit strategy" for depositors and other creditors if the bank failed or was forced to wind down operations for various reasons.

(One of the few nations with a regulatory sandbox ecosystem, the RBI was founded in August 2019. Eligible organizations can test their innovative products or services in real time in a regulated setting within this sandbox. To promote the controlled and orderly expansion of the FinTech ecosystem in India, innovators, regulators, financial service providers, and end

users have joined together to create this initiative. The suggestions of the Financial Stability and Development Council - Sub Committee (FSDC-SC) Working Group on FinTech and Digital Banking were followed in establishing the Regulatory Sandbox. On August 13, 2019, the RBI website released the final Enabling Framework for the Regulatory Sandbox (RS) following significant stakeholder engagements. 'Retail Payments' was announced as the theme for the first batch after that. On December 16, 2020, the Enabling Framework was updated to include lessons learned from the first cohort's implementation. Furthermore, applications with the "Cross Border Payments" theme were allowed for the second cohort. Additionally, word spread that the third cohort's focus will be "MSME Lending.")

Case Analysis of Georgian Neobanks

To increase financial stability and client engagement, the National Bank of Georgia supports the development of novel technology and creative business models in the financial industry.

To do this, the National Bank of Georgia is putting open regulatory concepts and a technology-neutral risk-taking approach into practice. The National Bank's supervisory plan for 2020–2022 is based on these fundamental ideas. The National Bank of Georgia released its guidelines for digital banking licensing in July 2020 for public comment. Benefits can be utilized during the licensing procedure, and the regulations for entering the banking industry have been streamlined. Benefits could include granting a banking license if ten per cent of the required regulatory capital is obtained and the so-called banking operations for conducting business and attracting more investors. Offering a "build-up period," a streamlined form for reporting liquidity, supervisory guidance throughout the process of developing a business plan, and, when necessary, the focused use of a regulatory laboratory to assess the risk associated with specific technologies. To be granted a full banking license, A bank must prove its business plan's viability and effectively fulfil a traditional bank's standards. The National Bank of Georgia views the banking industry as a digital bank that can lower financial intermediation costs and increase access to credit.

The first digital bank in Georgia is SPACE, the country's first neo-bank, which debuted in May 2018 and is being carried out with TBC Bank's assistance. The project involves well-known and seasoned businesses in information security, which is regarded as one of the safest environments in the world. Georgian Bank values protecting security and personal data, which is essential for the client, so the company devotes many resources to this area. The company actively complies with all legal requirements, including those set forth by the National Bank, with the additional goal of safeguarding the interests of its customers.

Way Forward:

The RBI, SEBI, and IRDAI are the main regulatory bodies that oversee the Indian financial sector. These authorities have put out several programs and rules to provide financial products with more uniform, easy, safe, and digital accessibility. It is admirable that all the authorities have worked so hard to create regulations that match the rapid advancements in technology and innovations in the financial industry. Many of the products that neobanks currently offer require direct regulation. On the other hand, indirect regulation (by their affiliation with regulated firms) has guaranteed that their product offers comply with regulatory standards. As a result, these organizations have been able to win over more clients and provide a wide range of financial products to the public.

To revolutionize the financial business in a regulated area, there should be room for innovation from within the financial sector, not simply the front end. Policymakers can take inspiration from the Georgian system and amend it to suit the Indian environment to create value for the segment who were underserved in the traditional banking system.

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