PAYMENTS BANKS' ROLE IN DIGITAL FINANCIAL INCLUSION IN INDIA: OPPORTUNITIES AND CHALLENGES

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Abstract: Drive for "digital financial inclusion" has been a key policy factor in India for the last decade. Payments Bank is one of the recent most important strategy factors to fulfill this objective. This paper briefly discusses the structure and functions of payments banks as conceptualized and implemented. The primary goal of payments bank was enhancing the range of digital financial inclusion by leveraging the user-friendly app-based financial service platform to provide effective services in a more accessible form for low-income households and small business firms. This study attempts to understand the expectations of the policy makers regarding the role of these new financial entities and their opportunities and challenges. In the last few years after their introduction, payments banks have not been able to perform satisfactorily in the profitability front probably due to their huge initial infrastructural costs. However, it is expected that in the years ahead, payments banks are going to play a larger role in achieving financial inclusion in India. In this paper, we have discussed the performance of the payments banks in the last few years and the opportunities and challenges they are likely to face in the future years.

Keywords: Indian banking, Digital banking, Financial inclusion, Payments banks

Introduction

India stepped into the era of digital banking system with Rangarajan Committee's two reports – one submitted in 1984 and another in 1989. These reports strongly recommended for computerization of general banking operations in India at various levels. The entire landscape of banking business in this country was radically transformed with the advent of the New Economic Policies adopted by the Government of India in the early 1990s, aiming at more market-oriented, liberalized and globalized Indian economy. The Committee on the Financial System (Narasimham Committee I), which submitted its report in 1991, recommended policy changes in all aspects relating to the structure, organisation, functions and procedures of the financial system for improvements in their efficiency and productivity. The

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Committee on the Banking Sector Reform (Narasimham Committee II) which submitted its report in 1998, reviewed the progress in the banking sector and suggested policy reforms those aimed at a more efficient and internationally competitive financial sector. Implementation of these recommendations brought revolutionary changes in the Indian banking sector as India entered into the phase of financial globalization and liberalization. These policy changes brought foreign and private players to the field of Indian banking business, with their technologically advanced banking products, world-class customer service and innovative ideas such as Automated Teller Machines (ATM), credit cards and internet banking. Indian public sector banks had no other way but to upgrade themselves with modern banking technology, for their survival in the market. In this scenario, a committee on "Technology Upgradation in the Payment Systems" was constituted in 1994. This committee recommended setting up of an Information Technology Institute for Research and Development as well as for consultancy in the application of technology to the banking and financial sector of the country. This directed towards formation of the Institute for Development and Research in Banking Technology (IDRBT) in 1996, which is focused exclusively on the niche area of Banking Technology. With the guidance and support of Reserve Bank of India (RBI) and Indian Banks Association (IBA), National Payments Corporation of India (NPCI) was set up in 2008, whose primary objective is enabling digital payments and settlement system in India. NPCI is successfully working towards the aim of empowering every Indian citizen with access to a "bouquet of e-payment options that is safe, secure, convenient, quick and affordable". Nevertheless, in India, the Reserve Bank of India has always been the primary enabler of digital payments. From designing of strategy plans, performing research and development for new ideas to the implementation of the action plan for development of large-scale digital payment system in India, RBI has always performed the most critical part.

Over the past decade, the process of digitalization of the banking system in India experienced an incredible progress, primarily on account of these three factors - phenomenal growth of digital infrastructure in the country, advancement of cellular network and introduction of high-speed internet in the recent years. The increasing mobile phone density and growing usage of smart phones, leveraged upon fintech and digital payment service providers, empowered banking services to be available through mobile phones and opened the enormous possibility of digital finance. This is now a widely known perception that digital finance has the potential to offer low-cost, high-speed, transparent and secure financial services even to the low-income households of the country. Along with internet banking, banks have been offering mobile banking services through all three channels - short message service (SMS), Unstructured Supplementary Services Data (USSD) and mobile applications. Moreover, the "Digital India" movement introduced by the Government of India in 2015 along with Unified Payments Interface (UPI) launched in 2016 by NPCI also played significant role in the overall digitalization process of Indian banking. The "Digital India" movement was launched in order to set up a mechanism to ensure availability of government services to its citizens electronically through digital platform. The key government services, like income tax returns (ITR) filing, tax deducted at source (TDS) compliance and refund delivery mechanism, have been made online.

"Financial Inclusion" had been one of the most important developmental agendas of Indian banking policy makers since the last couple of decades. Numerous strategies, action plans, committee recommendations and policy measures have been initiated to bring the huge section of unbanked population of the country under the purview of formal financial system. India's financial inclusion drive got a new impetus in the early years of this new millennium on account of the rapid growth in internet connectivity even in the remote and rural places of the country, ubiquity of usage of cellular phones and remarkable advancement in the field of digital technology, especially emergence of fintech companies. All these helped the policy makers to contemplate a new strategy to accelerate the progress of financial inclusion in India – the strategy of digital financial inclusion. Since then, the RBI has taken several initiatives to leverage upon the advancement in digital technology for bringing the financially excluded people into the ambit of formal financial system. However, the greatest fillip in the field of digital financial inclusion in recent years has come from the J-A-M trinity or the Jan Dhan account-Aadhar-Mobile phone trinity. Under the Pradhan Mantri Jan-Dhan Yojana (PMJDY) scheme, launched in 2014, the aim was to open no-frill savings accounts for every adult Indian, so that all the government payments and subsidies of various welfare schemes are delivered directly to its beneficiaries only through these accounts. After opening the bank accounts, the government seeded those with Aadhaar, linked it with mobile numbers and started sending financial entitlements to the beneficiaries directly into their bank accounts. This Direct Benefit Transfer (DBT) scheme along with the PMJDY relied largely upon growing internet coverage and smartphone penetration in India. J-A-M trinity turned out to be immensely successful to dramatically enhance digital financial inclusion in India. As per government estimate, as on May, 2021, the total number of accounts opened under PMJDY scheme is 45.55 crores (Ministry of Finance 2021). However, the aim of financial inclusion is not only to make formal financial services available to the unbanked people, but also to ensure that they properly utilize these services to improve their financial well-being. Evidently that is not happening in India. There are some barriers in both the demand and supply sides. Barriers of digital financial inclusion from the supply side are non-availability of suitable financial products, inadequate technological infrastructure or problem of poor internet connectivity. In the last few years, problems of many of these supply side barriers have been addressed. But some serious difficulties remain on the demand side, such as lack of financial and digital literacy, inadequacy of information and knowledge regarding existing financial products, insufficient skill among the stakeholders to use digital infrastructure etc. These demand side barriers are even more difficult to overcome. As a result, in spite of the initiatives taken towards opening no-frill bank accounts for the excluded section of the society, a large section of Indian adult population is deprived of the formal financial services due to demand-side bottleneck. For instance, in August 2021, out of total 43.04 crore PMJDY accounts, only 36.86 crore (85.6%) were operative (Ministry of Finance 2021) causing to huge operating costs on the financial institutions providing the accounts, but not serving its very purpose. Even for the most of the operative bank accounts, usage is primarily limited to money transfers and benefit withdrawals. Clearly, the broader objectives of financial inclusion such as access to formal credit delivery system, safe and simple insurance and micro-investment products etc. are not yet satisfied. RBI realized while the financial inclusion efforts through the existing system of traditional universal banking had to continue, it may not be adequate to speed up the process and achieve the goal within the stipulated time period.

The committee report by Dr. Raghuram Rajan, titled "A Hundred Small Steps" (2008) recommended that "emphasis should be shifted from large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focussed strategy". This committee also suggested that private, well-governed and deposit taking small finance banks be allowed to speed up the financial inclusion process. Even though, the RBI had followed "go slow" approach in licensing of branch expansion of foreign and private players in the banking business. The Concept of a new banking model called the "differentiated banking model" was conceived in 2013. In September 2013, the Reserve Bank of India constituted a committee headed by Dr Nachiket Mor, to study 'Comprehensive financial services for small businesses and low-income households'. The committee submitted its report in 2014. It was observed that India had all the elements of success in place – a wide range of institutional types, well-developed financial markets, an established regulatory framework, high quality authentication and a transactional platform. The committee came up with the recommendation of two broad categories of differentiated banks - the Horizontally Differentiated Banking System (HDBS) and the Vertically Differentiated Banking System (VDBS). These two differentiated banking models were proposed on the basis of the functional building blocks of payments, deposits and credit. One of the proposed banking models was vertically differentiated banking system those are specialized banks offering specific financial service or products or in a niche segment unlike universal banking. They also recommended licensing of payments banks which will be designed for making provisions for payments and deposits, but not for granting credit. Accordingly, the Reserve Bank of India decided to license differentiated banks and laid down framework and guidelines of "vertically differentiated banking system" such as Payments Banks (PBs) and Small Finance Banks (SFBs). RBI designed payments banks to accelerate digital financial inclusion by performing two primary roles (a) provision of payment services and b) deposit products to small businesses and low-income households through high technology-low-cost operations. In "Trend and Progress of Banking in India" in 2016-17, it was mentioned that payments banks are expected to focus on two key aspects – first, expansion of geographical penetration of banking services at a low cost and in an affordable manner to support the agenda of financial inclusion and second, to introduce innovative products for digital payments to boost the objective of a "less-cash" economy.

Literature Review

Gibson et. al (2015) argued that the traditional physical bank branch network in developing countries is incapable to include billions of people in those countries into formal financial system due to its costly infrastructure and other limitations. This paper proposed a system of delivering digital financial services through banks and agents like mobile money providers to those people, However, it also warned that this type of set-up needs well-functioning legal and regulatory system.

D'Silva et.al. (2019) acknowledged the fact that India's approach to provide digital financial services as a public good and also encouraging private innovation by providing open access to this infrastructure and creating a level playing field through the regulatory framework has the potential to bring billions of unbanked people into the formal financial system. However, there are some cautionary facts should also be kept in mind as this new digital financial infrastructure collects and share huge amount of personal data to overcome information asymmetries that may result into increase the risk of fraudulent behaviour, and the potential for fraud is exacerbated when consumers are less educated and technologically illiterate. Therefore, effective regulatory measures should be taken to reduce these risks and to spread digital financial literacy among people.

Draboo (2020) emphasized on the importance of digital initiatives like the "digital India" or the J-A-M (Jan Dhan-Aadhar-Mobile) Trinity and reliance on technology to accelerate the process of financial inclusion in India.

Jain et al (2020) conducted a case-study of India with respect to the challenges and opportunities of digital banking and concluded that the introduction of digital banking through smart phones in India has revolutionized banking services and it has great potential to contribute to the objective of financial inclusion in near future. Similar view has been depicted in the study by Mehta et. al. (2020) and this study argued that digital revolution in India has brought paradigm shift in Indian banking. It concluded that payments banks in particular are much more transformative and innovative in nature than the other digital banking service providers in India and with some recommended policy changes, the payments banks could be a game changer in Indian banking scenario.

A study by Ghosh et.al. (2020) reviewed the history of payments banks in India and assessed their viability and concluded that the present regulatory framework in India does not adequately respond to the real challenge of enabling success for payments banks.

Structure of payments banks

Payments Banks were introduced as specialised banks to cater the needs of lower income group and small business firms and other unorganized sector entities. The primary objective was to have a bank account for each adult Indian, boost financial inclusion by achieving "last-mile connectivity". Separate guidelines were issued for Payments Banks considering their differentiated nature of banking activities and their primary focus on financial inclusion. Based on the draft guidelines by the More Committee, RBI published guidelines for licensing of payments banks on July 17, 2014. As per the guidelines, payments banks would register themselves under the Companies Act, 2013 as public limited company and also will be licensed under Section 22 of the Banking Regulation Act, 1949. These new model banks would restrict their financial operations without any involvement of credit as they can only receive deposits, offer payment services and provide remittances but cannot be involved into lending activities. A payments bank could primarily accept demand deposit up to Rs. 1 lakh per individual and issue debit cards and other prepaid instruments. In April 2021, this deposit amount limit has been upgraded to Rs 2 lakh per individual. Payments banks have to maintain a minimum investment of 75% of the demand deposit balances in Government securities/ Treasury Bills to maintain Statutory Liquidity Ratio and a maximum of 25% can be held in the form of current and time/fixed deposits with other commercial banks. A payments bank can issue debit card and other prepaid instrument. They may work as business correspondents with commercial banks to sell mutual funds, insurance services and pension provisions with approval from the RBI. In addition, they are allowed by the RBI to provide internet and mobile banking services to its customers. Even if payments banks do not face any credit risk as they are not involved any lending activities; they are subject to other risks such as operational risks, liquidity risks and market risks. They are allowed to implement suitable risk management methods to manage those risks. It was also clarified that every customer of payments banks must comply with KYC regulations.

Role of payments banks

The vision statement of the Report of the "Committee on Comprehensive Financial Services for Small Business and Low-Income Households", which laid down the foundation stone of the Payments Banks, submitted in 2014 stated that by January 1, 2016, each adult Indian resident would have a "full-service, safe and secure electronic bank account". It also had in view a target that through this new system of payments banks, "the number and distribution of electronic payment access points would be such that every single resident would be within a fifteen-minute walking distance from such a point anywhere in the country". Each such point would allow residents to deposit and withdraw cash to and from their bank accounts and transfer balances from one bank account to another, in a secure environment". The same report acknowledged the fact that in spite of numerous efforts by the RBI, there was still a vast gap in the availability of basic payments and savings services for small businesses and low-income households both in rural and urban India. The committee estimated that given the sheer size of the country and the absolute poverty of the majority of its citizens, more than 30 lakh payments and transaction points would be required to achieve the vision. It was also realized that traditional banks, being the most effective and efficient mode to offer credit and savings product together, will not be able to satisfy the vision as lending activities by their very nature. The traditional commercial banks are subject to customer protection, credit risk management and presence of highly skilled and trained personnel. To provide that to the 30 lakh points of transaction is neither cost effective nor supportable for the existing banking models from the point of view of feasibility and viability. This report thus recommended for exploration of potential of new channels and inclusion of additional players in the formal financial sector to offer payments and savings services to the unprivileged section of the population. The primary goal of payments bank was enhancing the range of digital financial inclusion leveraging the user-friendly app-based financial service platform to provide effective services in a more accessible form for low-income households and small business firms. This primary goal was expected to be fulfilled by providing (i) small savings accounts, and (ii) payments/ remittance services using the digital medium to migrant labour, small businesses, low-income households and other entities in the unorganised sector.

This new model of banking focused on bringing non-traditional players – telecom companies, fintech, industrialists, postal service to the formal banking sector so that the goal of digital financial inclusion can be achieved through their already existing customer base and distribution channel networks. RBI received total of 42 applications and gave licence to 11 Payments Banks among which only six are currently operational in India. Bharati Airtel launched India's first Payments Bank named Airtel Payments Bank in 2017. India Post Payments Bank (IPPB) was the second to start operation in the same year and aimed at utilizing the network of already existing postal services of India. IPPB, operating with the Department of Posts under Ministry of Communications has acquired more than five crore customers as of in January 2022 through digital and paperless mode by leveraging 1.36 lakh post offices around the country out of which 1.20 lakh are in rural areas. However, Paytm emerged as the leader of this sector with more than 6.4 crore customers followed by Airtel Payments Banks with over 6 crore customers in January 2022 (The Economic Times, 2022).

Although it is way too early to make a judgement on the competency of Payments Banks in achieving this goal, this is undeniable that the effects are so far positive. In the end of March 2021, there were six operational payments banks. Table 1 describes some performance indicators of payments banks in the last five years.

Table 1: Performance of Payments Banks (Amount in Rs. Crore)

Item	2016-17	2017-18	2018-19	2019-20	2020-21
Deposits	68.5	438	882	2,306	4,622
Interest Income	31.4	175.6	290.80	349	360
Non-interest Income	108.6	1,003.60	2,099.10	3,115	3,562
Interest Expenditure	0.7	24.5	35.40	62	100
Operating Expenditure	380	1,676.80	3,265.30	4,337	4,584
Net Profit	-242.2	-517.2	-937.1	-833.00	-798
Operating Profit	-240.7	-522.00	-910.8	-935.30	-762
Efficiency (Cost-Income Ratio)	272.7	142.2	136.6	125.20	116.9
Investments to Total Assets	29.2	50.10	43.7	48.40	56.6
Return on Assets	-25.2	-10.6	-13.10	-9.90	-6.4

Note: Data for end-March 2017 and end-March 2018 pertain to two and five PBs, respectively. Hence, the data for these two years are not comparable. Data for end-March 2018 and end-March 2019 pertain to five and seven PBs respectively. Hence, the data for these two years are not comparable.

Source: Tables from Report from Trend and Progress of Banking in India, RBI.

In the initial years, the payments banks had to bear large expenses on creating new infrastructure in the initial stage of their operation. Hence, the profit parameters were negative and it was expected to improve in the following years. However, the profit parameters continued to be negative in the following years notwithstanding improvement in both interest and non-interest income in those years. Even in 2020-21, both the operating profit and net profit are are negative indicating huge financial losses by payments banks. RBI, in their "Report on Trend and Progress of Indian Banking" reasoned that payments bank of India are still in a nascent stage incurring extensive investment costs for developing basic infrastructure and their customer-base is yet to develop fully, making "break-even" challenging. If we consider other performance indicators, Return on Assets (ROA), even if it remained negative in the past years, there in a sign of improvement. Considering efficiency of payments banks measured in terms of cost-to-income ratio also improved along the study period. In 2020-21, share of deposits of payments banks in the total liabilities increased to 36.8 per cent as compared to 27.4 per cent in the previous year. The deposit base is further expected to improve in the future years on account of the enhancement of the limit of the maximum deposit balance per customer from ≠ 1 lakh to ≠ 2 lakh to grant payments banks more flexibility in their operations in April 2021.

Future challenges

There is no denial of the fact that in future, the payments banks are going to play a vital role in the Indian banking scenario because of their unique features. Payments banks operate at a much lower servicing costs than the traditional banks, their operations are entirely based on digital technology which is continuously getting upgraded with time and they have access to a larger customer base. The most eminent challenge that is being faced by the payments banks in India is regarding their profitability. Ghosh (2020) has questioned RBI's argument that payments banks will successfully accelerate the financial inclusion process while still being competitive and profitable and argued that the payments banks would be able to satisfy the goal of financial inclusion only if the "regulatory framework is fundamentally altered to allow for experimentation and even possible failure". Payments banks have to incur huge operational costs and investment needs as they are in constant pressure to offer basic banking services to the underserved people by leveraging technology and also to invent innovative banking products to remain competitive in the market. Initially, there were eleven payments banks those were granted license from the RBI. But only six of them are currently operating. In 2019-20, payments banks of India incurred a loss of Rs 334 crore which slightly decreased to Rs 300 crore in the following year. The underlying business model of payments banks is actually a great hindrance towards their profitability. As payments banks are not allowed to lend the money raised from their deposits, they have little scope to earn good margins from interest income. Their only source of revenue is their deposit accounts. This source of revenue is clearly not sufficient to cover their huge establishment costs and ongoing operational costs. The customer base of payments bank is mainly comprised of the rural and urban middle-income people and it is very unlikely to generate significant revenue from the deposit accounts of these customers. Their income comprises mostly of interest from investments in government securities and fee income that they can earn by acting as Business Correspondents of other commercial banks and selling simple financial products such as mutual funds and insurance. On the other hand, to remain competitive in the market with the commercial banks engaged in universal banking, payments banks have to offer attractive interest rates on their savings deposits, creating further downward force in their profit margin.

Payments banks also need to be vigilant in their operations and develop an efficient customer complaint redressal system as there are higher incidence of frauds and complaints about their operations. In 2020-21 only, there were 5277 complaints against payments banks' operations as received at banking Ombudsman Office (Report on Trend and Progress of Banking in India, 2020-21). Number of frauds has increased in payments banks' operation as revealed by RBI Report 2020-21. There were 39 fraud cases for payments banks in 2018-19 which increased to 88 in 2020-21. For public sector banks, the number was 2903 and it was 3710 for private banks. Development of a technologically sound and intuitive user interface was recommended by Reserve Bank of India to ensure continued public confidence in payments banking system and digital transactions as a whole. The primary customer base of the payments banks is supposed to come from rural and remote areas of the country where people are underprivileged. Therefore, it is a challenge for the payments banks to spread awareness and knowledge among their customers regarding digital transactions and innovative banking products offered by them. Extensive financial literacy programmes may prove to be beneficial for the operations and profitability of payments banks. Nevertheless, payments banks are game changer in the Indian banking sector enhancing the drive of digital financial inclusion and also due to their user-friendly app-based platform and attractive services.

Conflict of Interests

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