

THE NEWS

Policies for digital banking: Part - II

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The journey in pursuit of the vision started in the early 2000s when the SBP decided to mandate banks to join one of either two ATM switches available in the country.

The 1Link switch has played a critical role but still after two decades the number of ATMs remains 17,000 and only one million transactions are taking place every month mainly for cash withdrawal. The Electronic Transaction Ordinance was promulgated in 2000 providing legal recognition to digital signature and documentation reducing the risks associated with the use of electronic medium of business. Commercial banks were allowed to open and operate internet merchant accounts. The SBP acquired a SWIFT connection and made it mandatory for banks to acquire SWIFT connectivity for settlement of cross-border financial transactions.

The other major initiative the SBP took was to complete the largest single project – worth \$30 million – to fully computerize bank operations, set up data warehousing and establish electronic links with the banks. At the same time, a real time gross settlement system – now PRISM – was set up to provide a platform for wholesale transfer and settlement of funds. By 2002 almost 40 per cent of the bank branches had been automated with a phenomenal growth rate. The number of online branches jumped to 1356 in three years' time – an increase of 376 per cent.

During the last five years, the progress in e-banking has been impressive. Its share in the total value of retail payments has risen from 24 to 42 per cent. But paper-based transactions still dominate with Rs190 trillion. This is the slice of the pie digital banks have to nibble forcefully and raise the share of E banking to at least 80–90 per cent in the next five years. Currency in circulation has doubled in the last ten years and is boosting informalization of the economy.

The number of internet banking users is eight million and that of mobile banking 12 million. Even if we add them up, this accounts for only 20 per cent of unique mobile phone owners. Thus the market for digital banks, as they take off, is quite substantial provided they have the right strategies, products and services to capture it.

Having enunciated the purpose digital banks have to serve – financial inclusion and broadening access – it is necessary to outline the policies the digital banks should pursue to advance this goal of financial inclusion. First, they have to demonstrate that their transaction costs are lower than the existing providers, the customers enjoy much greater convenience as they save effort and time, fees and service charges are lower while speed of transactions is faster, accuracy is better, payments are secure and cybersecurity is assured. In other words, this new breed of banks should display a high level of efficiency at a lower cost.

Second, they have to diversify their asset base functionally – sectorally, geographically, by size and gender. Commercial banks are earning fairly reasonable margins by investing in risk-free government paper. The present situation where IDR is 70 per cent and ADR below 50 per cent has to be reversed to facilitate private-sector growth, particularly in those sectors and geographies which have a potential for absorption of credit. These are the areas where conventional and Islamic banks have been unable to make forays so far. For them, the alternatives are fairly attractive and reaching out to these underserved segments is relatively risky and costly.

Commercial banks do not have access to a lot of relevant parameters and data to properly assess prospective borrowers. Small borrowers, particularly women, are also unable to meet the documentation and collateral required by the banks. The administrative cost of processing thousands of small loans impairs the profitability of these banks.

By using machine learning, data capture and data analytics for discerning patterns and behaviours, digital banks can develop credit-scoring models for lending to clients who do not have to go through extensive documentation or securities, collaterals or guarantees to offer. A CRM platform can track

customer history and provide quick online communication. There would be upfront costs in R&D to develop these models but these costs should be considered as an investment in the acquisition of customers, expansion of network, robust screening of credit risk, establishment of competitive advantage and increase in volume of business in the future. This would take a few years but perseverance will ultimately pay off. Those investors and owners of digital banks who are looking for instant gratification and quick returns should quit now as this is a long-haul journey.

Third, digital banks have to develop a portfolio for investment in underserved sectors such as SMEs, small-and-medium farming, low-cost housing but also in nontraditional economic and social activities such as human development by providing loans or Qarz-e-Hasna to students from poor families who are talented but do not have the financial means to study. Programme lending and cash flow lending to SMEs and agribusinesses would become easy for digital banks to handle as compared to commercial banks.

Digital banks should provide financing for educational, health facilities and agri-businesses to private entrepreneurs in areas outside the metropolitan cities where the rising middle class has shown demand for quality services. China's industrial success owes a great deal to the Town and Village Enterprises.

Fourth, collaboration with Fintechs should be incentivized to help the usage by coming up with an Application Programming interface (API) so that the digital banks can enhance business efficiencies, accelerate innovation, integrate disparate systems without customization and improve customer experience. They can extend the functionality of their products while saving time and money and thus stay agile in the marketplace. Fintechs can help with the digitization of the supply chain, invoice-based payments, and payments at merchant-based locations. This should enable digital banks to offer end-to-end solutions to their customers.

Fifth, digital banks would have to maintain financial strength and the capacity to absorb unanticipated shocks and stress. Human resources capable of solving the problems of the customers rather than shuffling papers around, as

is the case with the commercial banks, would have to be inducted and trained. A balance between tech savvy and business savvy professionals would have to be maintained as a tilt towards either extreme can be deleterious for the bank. A new culture is to be nurtured by these digital banks – one that is markedly different and makes the customer's journey pleasant.

Sixth, with rapid advances taking place in technology, banks will have to constantly strive to catch up with new innovations and practices. Partnerships with foreign technology service providers would enable continuous upgrade, enhancement, refinement of the systems and software applications to tailor make them to keep the competitive edge and ensure customer satisfaction.

To conclude, a word of caution is necessary. The risks arising from adoption of technology as a delivery vehicle are, in addition to the credit risk, market risk and other bundle of risks associated with financial intermediation. Ensuring cybersecurity, preventing fraud, guarding against identity theft and hacking of databases, poor customer interface up front or frequent breakdown of back office systems, and congestion of traffic that keeps the customer waiting for a long period – all these issues require vigilance and attention by top managers.

Data governance, API protection, secure connectivity and complete lifecycle management would help manage these risks. These tasks cannot be left routinely to one of the subordinates as the reputational risk for the whole digital-banking sector is likely to be high. Now that licences have been granted for digital banking, the message given in 2002 has to be reiterated 22 years later. There is no reason that the existing commercial banks that are allowed under their existing licences cannot embark upon this line of business and give a tough competition to digital banks.

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