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PAYMENT BANKS: A CASE OF NEAR YET TOO FAR!

Recently, Aditya Birla Payments Bank (ABPB) announced shutting down its operations from 18 Oct'19 citing unanticipated developments in the business landscape that have made the economic model unviable. This is not the first such development related to payment banks (PBs) . On July 15, Vodafone m-Pesa had also shut shop.

In 2014, RBI conceptualised the PB model on the recommendation of Nachiket Mor committee for furthering financial inclusion by providing small savings accounts and payments/remittance services to unorganised sector entities. However, it seems to have failed to achieve the stated objectives, as only 4-PBs are operational out of the 11 licensed players. In 1990s also, RBI had made an attempt to create Local Area Banks (LABs) that are currently facing a host of issues.

We believe, PBs currently face stringent regulations on both asset and liability side. On the asset side, PBs face a blanket ban on any type of lending. On the liability side too, they cannot accept deposits higher than ₹1 lakh. Besides, capital requirement is quite steep at 15% capital to risk weighted assets ratio. Though the business of PBs is free from credit risk and faces relatively lower market risk, but it is subject to operational and liquidity risk. PBs are turning out to be working merely as an aggregator - a disintermediation vehicle for depositors to invest in G-secs. PBs emerging as a real competitor to banks is not a near-term possibility with deposits up to ₹ 1 lakh comprising only 9% of total deposits of the banking system in terms of value (70% in terms of number of accounts).

Alternatively, the PB model could still be a success - but only with the universal banks and telecom companies working together having strong infrastructure, deep pockets and network in place. Some of the suggestions to revive the banks could be: (i) Arrangement with Universal bank to automatically transfer funds in accounts exceeding ₹ 1 lakh. (ii) Access to Aadhaar based KYC, as manual KYC is at least three times in terms of cost to e-KYC. (iii) RBI should allow PBs to tie up with third-party services to cross sell products, as margins are small, so scale is very important. The future is uncertain, but in time we hope PB business will expand and evolve, with the help of regulatory and Government support. Then they will able to achieve their objectives.

PAYMENTS BANKS: CURRENT STATUS

- Recently, Aditya Birla Payments Bank (ABPB) announced shutting down its operations from 18 Oct'19 citing unanticipated developments in the business landscape that have made the economic model unviable. The ABPB had started operations *wef* 22 Feb'18. This is not the first such development related to payment banks (PBs) shutting down operations due to not being able to find a viable business model around it. On July 15, Vodafone m-Pesa also shut shop.
- In 2014, RBI conceptualised the PB model on the recommendation of Nachiket Mor committee for furthering financial inclusion by providing small savings accounts and payments/remittance services to migrant labour force, low income households, small businesses, other unorganised sector entities and other users. However, it seems to have failed to achieve the stated objectives, as only 4-PBs are operational out of the 11 licensed players. There are many reasons for PB losing its steam in the country and players choosing to shut shops: First, there is lack of proper awareness about it amongst people and whatever little awareness is there has not been able to translate people into customers.; Second, tighter regulatory restrictions; Third, no innovations in products and services.
- In 1990s RBI has also made an attempts to create smaller sized banks to for a specific area, named as Local Area Banks (LABs). It licensed five such banks between 1999 and 2001. These banks are, however, facing a number of issues, such as profitability, competition for funds with scheduled commercial banks and capital and regulatory constraints for expansion.
- Due to the strict regulatory guidelines, PBs business operations are restricted to only mobilise deposits and invest in G-secs. This has led substantial loss in their operations. The operational payments banks showed net losses of ₹ 516.5 crore for FY18, while 'Paytm' PB has declared profit of ₹19 crore in FY19. However, we believe lending seems to be the largest revenue contribu-

Financial Performance of Payments Banks (Rs Million)

	FY17	FY18
Income		
i. Interest Income	314	1,756
ii. Other Income	1,086	10,036
Expenditure		
i. Interest Expended	7	245
ii. Operating Expenses	3,800	16,768
iii. Provisions and Contingencie	15	-56
of which, Risk Provisions	4	-66
Tax Provisions	11	10
Net interest income	307	1,511
Profit		
i. Operating Profit (EBPT)	-2,407	-5,221
ii. Net Profit/Loss	-2,422	-5,165

Source: RBI; Data for FY17 and FY18 pertain to two and five PBs, respectively. Hence, the data for these two years are not comparable.

Select Financial Ratios of Payments Banks

	FY17	FY18
Return on Assets	-25.2	-10.6
Return on Equity	-36.4	-22.4
Investments to Total Assets	29.2	50.1
Net Interest Margin	2.8	4.5
Efficiency (Cost-Income ratio)	272.7	142.2
Operating Profit to Working Funds	-25.1	-10.7
Profit Margin	-172.9	-43.8

Source: RBI; Data for FY17 and FY18 pertain to two and five PBs, respectively. Hence, the data for these two years are not comparable.

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- PBs face a blanket ban on any type of lending. Besides, apart from the requirement of maintaining cash reserve ratio (CRR)/ statutory liquidity ratio (SLR) on the outside liability, they are required to de facto maintain 75% SLR on their demand liabilities and face a cap on keeping deposits with commercial banks at 25% of their current and time deposits. This reduces the business of PBs to that of a fixed spread business akin to asset management companies (AMCs) where higher revenue is directly a function of total deposits mobilized by them.
- The spread thus earned would need to cover the costs incurred on the enabling technology infrastructure and its expansion, employee and other operational expenses, market risk on the investment portfolio, provision for operational risks and a minimum return on capital. Illustratively, if the PBs are perforce required to pay a minimum of 4% on their savings deposits and an average earnings on government securities is 6.5% (benchmarked to 10-year G-secs), their spread would be capped at 2.5%. Interestingly, this will be significant decline from the actual spreads in FY18, reflecting that the term structure of interest rates reveal a decline. This is comparable to that of AMCs with minimal capital requirement.
- On the liability side too, they cannot accept deposits higher than ₹1 lakh. Besides, capital requirement is quite steep at 15% capital to risk weighted assets ratio (minimum 7.5% Tier-I). However, a stricter clause of capital requirement is to put a floor on leverage at not less than 3% (that is, outside liabilities being restrained to a maximum of 33.33 times of net worth). In fact, if we incorporate all these assumptions, the return on equity for PBs comes out to less than 5%!
- Though the business of PBs is free from credit risk and face relatively lower market risk, but is subject to operational and liquidity risk. Perhaps an unintended consequence of a large SLR requirement is the implication of PBs acting as a captive source of finance for the government. PBs may thus turn out to be working merely as an aggregator - a disintermediation vehicle for depositors to invest in G-secs. PBs emerging as a real competitor to banks is not a near-term possibility with deposits up to ₹ 1 lakh comprising only 9% of total deposits of the banking system in terms of value (70% in terms of number of accounts).
- PBs are subject to a whole host of other regulations that are unique. In particular, the higher disclosure norms that oblige them to share their business plan with the regulator could prove to be somewhat tricky when the business model of the technology intensive companies itself could be the biggest source of their competitive strength. There are other regulatory burden including (i) a majority of independent directors (could be a human resources challenge in itself), (ii) a minimum of 25% of physical access points in rural areas, (iii) subsidiary structure like non-banking financial companies are not permitted, and (IV) non-resident Indian deposits not permitted, although foreign remittance is.
- If one takes note of the quick exit of Aditya Birla Payments Bank, some of the factors highlighted above may need revaluation and suitable amendments. Alternatively, the PB model could still be a success - but only with the universal banks and telecom companies working together having strong infrastructure, deep pockets and network in place. Some of the suggestions to revive the banks could be: (i) Arrangement with Universal bank to automatically transfer funds in accounts exceeding ₹ 1 lakh. (ii) Access to Aadhaar based KYC, as manual KYC is at least three times in terms of cost to e-KYC. (iii) RBI should allow PBs to tie up with third-party services to cross sell products, as margins are small, so scale is very important.
- The future of the business will be based on transactions, including cash withdrawals though their network of small stores across the hinterland. Fee income generated by selling financial products should be another revenue stream. However, profits are still not in sight. The initial costs of investments and limitations on business operations have limited operations but as more and more people start availing PBs services, we expect revenue to grow. The future is uncertain, but in time business will expand and evolve, with the help of regulatory and Government support. Then they will able to achieve their objectives.

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