DIGITAL BANKING – FINANCIAL SERVICES MARKET DISRUPTIONS

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NAQIZ & PARTNERS

CLIENT ALERT: DIGITAL BANKING – FINANCIAL SERVICES MARKET DISRUPTIONS

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The Licensing Framework for Digital Banks

On the last day of year 2020, Bank Negara Malaysia (the "BNM") issued its Licensing Framework for Digital Banks (the "Licensing Framework"). The Licensing Framework sets out (i) the eligibility requirements and procedures to apply for a digital banking license; (ii) the business limitations and regulatory framework applicable to a licensed digital bank during the foundational phase; and (iii) the business activities that must be undertaken and the physical access points that may be established by the licensed digital bank. The deadline for interested parties to submit their application for the digital banking license falls on 30 June 2021. BNM is expecting to issue up to a total of five (5) digital banking licenses to selected applicants by first quarter of 2022.

The Licensing Framework was the result of a six-month public consultation undertaken by the BNM. Many countries in the world have recognised digital banking as the next step in financial services market advancement. Closer to home, some Asia countries such as Hong Kong and Singapore have already awarded their own digital banking licenses to industry players. Through the announcement of the Licensing Framework by the BNM, Malaysia has finally hopped on the bandwagon and digital banking is surely to bring a fresh wave of disruption in the current financial services market in Malaysia.

Solution for Financial Inclusion

As can be seen from the Licensing Framework, BNM's objective in the allowance of digital banking licenses is so that banking products and services can better reach the unserved and underserved market wholly or almost wholly through digital or electronic means. As it is, the current financial services market may to some extent exclude certain segments, such as gig workers and those in rural areas. Many gig workers are struggling to access financial products because most of them do not have salary slips due to the nature of their work, and banks usually require salary slips during credit assessment processes. On the other hand, those in rural areas may have limited access to financial products as some physical bank branches are only located in urban areas. These circumstances create a gap in the state of financial inclusions and digital banking may just be the solution to bridge that gap.

Digital banking license offers non-financial institutions, particularly technology service providers, the opportunity to venture into the financial services market. Unlike traditional financial institutions, digital banks may be better equipped to utilise technologies to serve the needs of unserved and underserved segments. It is undeniable that almost every Malaysian has access to smartphones nowadays (according to a survey by the Department of Statistics Malaysia in 2019, 91% of Malaysian household has access to smartphones). Digital banks can tap into the potential of smartphones to deliver financial products to every user of smartphones – imagine being able to access a whole host of financial products with only a few clicks of your phone!

Of course, the entry into the financial market by non-financial institutions is going to be a journey laden with challenges. Non-financial institutions lack the expertise and experience in financial products and services. In addition to tackling this inherent shortcomings, digital banks will also have to ensure that their roles as the bridge to the unserved and underserved segments are met. During the application process, applicants will have to demonstrate their commitments in driving financial inclusion in the country, particularly to underserved and hard-to-reach segments.

One of the key requirements is the submission of a five (5) years business plan that sets out, among other things:

1. Description of the specific unserved and/or underserved target segments, supported by market studies and analysis of the market gaps;

2. Proposed financial products and services that will be offered and how they can address the specific needs of the target segment, promote responsible usage of financial services and crate positive impact to the target segment;

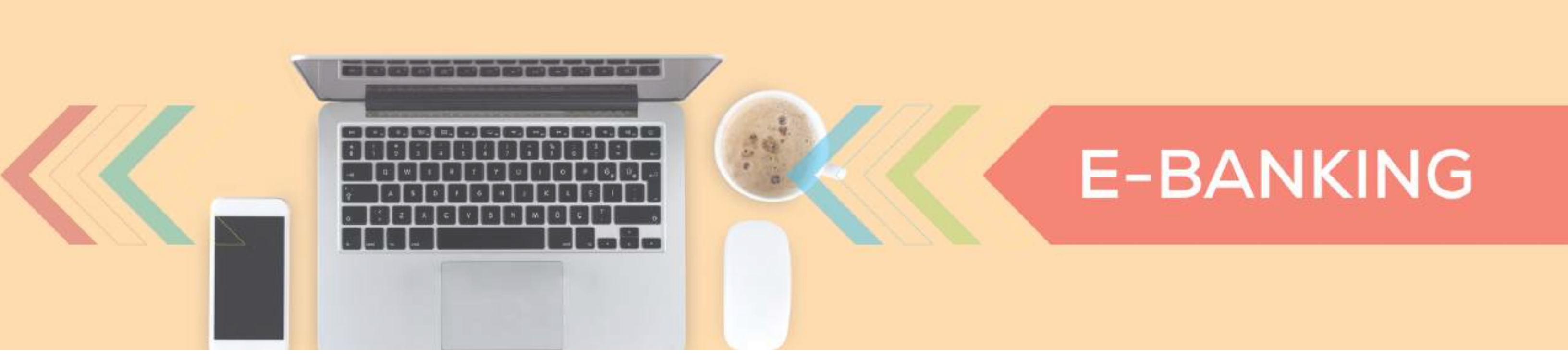
3. Indicate in the pro-forma financial statements, the share of business from the identified unserved and/or underserved segments relative to the overall projected operations; and

4. Performance indicators that reflect the applicant’s value proposition in driving the financial inclusion objectives.

The business plan will be one of the key considerations for the BNM to assess whether or not to grant the digital banking license to a particular applicant.

<u>A Simplified Regulatory Requirements</u>

As mentioned earlier, digital banks would inevitably lack expertise and experience in the financial market. Thus, it may be a little unfair if they are required to at the get-go adhere to the full reign of the regulatory requirements that would otherwise be applicable to traditional financial institutions.



Whilst a total waiver of applicable regulatory requirements is not viable or even practical, the Licensing Framework has instead dedicated a “foundational phase” for digital banks with simplified regulatory requirements. A licensed digital bank will undergo a foundational phase of a minimum of three (3) years or a maximum of five (5) years from its commencement of operations, during which the regulatory requirements applicable will be simplified and adjusted for the digital bank’s operations but its total asset size will be capped at RM3 billion.

Some of these simplified regulatory requirements are (i) exemptions from stress testing; and (ii) temporary relief from compliance with policy documents on *Risk Weighted Capital Adequacy Framework – Disclosure Requirements and Capital Adequacy Framework for Islamic Banks – Disclosure Requirements.*

A licensed digital bank has the option at the end of the 3rd year of the foundational phase to apply for the foundational phase to end and for the business limitation to be lifted, subject of course to the BNM’s approval. Otherwise, the foundational phase will come to a natural end after a period of five (5) years and the BNM will assess a licensed digital bank’s performance during the foundational phase to decide if continued operation should be allowed. Licensed digital banks that pass the BNM’s assessments will be able to continue their operations under the full regulatory requirements applicable to financial institutions and the business limitation of RM3 billion maximum total asset size will be lifted.

In case it may be helpful, below is a illustration chart extracted from the Licensing Framework:

Commencement of operations

Simplified regulatory requirements apply

Regulatory requirements of existing licensed bank or licensed Islamic bank apply

GRANT OF LICENSE	OPERATIONAL READINESS	OPERATIONS WITH ASSET LIMIT (FOUNDATIONAL PHASE)	OPERATIONS WITHOUT ASSET LIMIT

A minimum of three years or up to a maximum of five years

Exit Strategy

The Licensing Framework is a bold and revolutionary move that will undoubtedly propel the maturity of the country's financial market forward if implemented successfully. At the same time, it attracts risk to the current financial market. It goes without saying that such risks, if not properly managed, can pose strains to the financial system.

To address this, BNM has made it a requirement for applicants of the digital banking license to prepare a business exit plan for the unfortunate event that the business models prove to be unsustainable or ineffectual or if BNM decides after the foundational phase that the licensed digital bank is not to continue operation. The exit plan is necessary to ensure that the licensed digital bank is able to voluntarily unwind its business operations without any regulatory intervention and in an orderly manner without causing any disruption to its customers and the financial system.

Digital Banks – Forces to be Reckoned with

As mentioned in the beginning of this article, digital banks will surely bring forth substantial disruption to the existing financial market. It is still too early to speculate its success and whether the objective of promoting financial inclusion through adoption of FinTech can truly be met. We are however looking forward to this upcoming chapter in the country's growth and hoping that strong and resilient digital banks can be birthed forth through this process. Who knows, maybe queues and physical waiting time at bank branches will become a thing of the past in the not-so-distant future.

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