REPORT OF THE WORKING GROUP ON PAYMENTS

1. The Financial Sector Legislative Reforms Commission (FSLRC) constituted a Working Group (WG) on 25th October 2011 to propose changes to the existing law on Payments. Details of the WG are contained in the Annexure, and its report and recommendations are given below.

I. TECHNOLOGY AND NEW BUSINESS MODELS IN THE PAYMENTS INDUSTRY

2. The payments industry globally has transformed rapidly in recent decades, providing promise for a similar transformational change in India. There are compelling reasons to argue that the perspectives governing the future of this industry need to be markedly different from those which guided it in the past, as the growth dynamic of this industry has changed. Understanding the manner in which innovation in payments technology and payments business models has altered the industry has implications also for the manner in which we think about the regulation of this sector.

3. With experimentation in the usage of myriad forms of technology platforms evident globally, it is clear that preconceived regulatory templates on how payment systems should be designed or structured will not be conducive to encouraging innovation. Equally, it is desirable that all such payment systems go through a process of mandatory registration, as they deal with the transfer of their client funds. In order to reconcile these objectives, we propose:

Recommendation 1: The Payments Regulator should permit self-registration of payment system providers, including through online modalities.

4. This automaticity in registration would help promote innovation in a fast-changing technology business, so that a new set of ideas which could enhance payment efficiencies, provide risk-analytics to participants, or handle risk-mitigation on their behalf could be converted into businesses and launched without prior scrutiny of the regulator. Payment innovation overseas has typically facilitated start-up businesses in this manner without any regulatory intervention. As the payment system grows in scale and significance and begins to become systemically important, the regulator would subject it to greater scrutiny and possibly impose micro-prudential regulatory standards and constraints. The start-up business would of course be bound by a minimalist set of regulatory rules, but these would need to avoid being stringent in order that new players can enter the business. Intrusive regulation and supervision by the regulator would typically kick in only when the business has acquired a minimum threshold scale, unless (by exception) the regulator has reasons to believe that the payment system imposes unacceptable risks or there are customer complaints.

5. The self-registration process proposed above could also possibly lead to other forms of existing businesses combining their business models with payments, thereby expanding the range of pathways through

which payments innovation occurs. Thus, a payment business need no longer be a 'monoline' business, but could instead also be a 'joint product' together with another business. While a payments business in the past would typically be centred on payments as its sole business function, in future such a business could instead emerge as an offshoot of a newer non-banking business unrelated to payments, but where the existing business model could be extended to cover payments as well. This leads to:

Recommendation 2: The Payments Regulator should permit existing non-payment businesses to extend their business models to cover payments, in order that customer coverage could thereby expand.

6. The business model, rather than a regulatory philosophy which has comfort with conventional payment systems, should thereby become the prime determinant of how innovation spreads within the payments industry. We have seen examples of such payments innovation in other countries: In the US, payment solutions have wrapped themselves around auction portals for retail goods, like eBay, to create PayPal, the global leader in online payments. Similarly, as an example of international remittances, Western Union operates on a business model which need not utilise the services of commercial banks. Further, in Kenya, a mobile service provider has extended its business to M-Pesa, the remittance portal which permits micro-payments to be made by the poor, thereby facilitating financial inclusion. For the M-Pesa business model to operate, the business needs also to take in retail deposits, for which it has a license. In the Indian context, the parallel would be to permit telecom service providers (telcos, henceforth) to accept financial deposits. Presently, non-banks (including telcos) need to act as business correspondents (BCs) of banks in order to facilitate payments. However, the business models of banks (traditionally spurred more by the imperative of low-cost deposit mobilisation, rather than payments per se) are often at variance with the business models of the telco-based BCs (which would like to leverage their technology platforms to effect payments). Organisational cultures between banks and telcos also differ. The sharing of revenue spreads, at best very thin, particularly in the initial years of such businesses, also leads to commercial dissonance. Payment transactions would receive an impetus if telcos could be permitted to mobilise deposits and remit them across their customers.

7. Every deposit-taking institution should ideally be licensed as a bank. This is feasible if RBI recognises different categories of banks, including telco-sponsored banks or other industry-sponsored banks focused primarily on payments, with their deposits deployed in risk-free government securities, so as to protect depositor interests. Hitherto, RBI has provided universal banking licenses and (outside of the cooperative sector) has not licensed limited-purpose banks other than regional rural banks and a few local area development banks. FSLRC would need to separately recommend that other categories of limited-purpose banks be permitted by RBI. (The option to such deposit-taking institutions being set up as limited-purpose banks is to permit them to operate as a new category of NBFCs, those classified as payment system providers. However, RBI's reluctance to permit institutions other than banks to collect deposits, might make this option infeasible).

8. As an example, given the much wider customer reach of telcos compared to banks, permitting telcos to act as limited-purpose banks will further the cause of financial inclusion more strongly than the present artifice of requiring telcos to act as BCs of banks. Telcos will then also be in better control of defining the payments business model and of executing transactions. The present regulatory stipulation that telcos need to ally with banks in order to provide payment solutions appears to consume so much management bandwidth in both organisations towards forging the partnership that it erodes the original focus of converting payments innovation into a successful commercial enterprise.

9. In allowing non-payment businesses to extend their business models to cover payment systems, there is a prior regulatory issue that needs attention. A clear separation is needed between the infrastructure-provider function and the service-provider function, when the two functions are provided by the same entity. When a corporate extends its existing infrastructure to encompass the payments business, regulation must ensure that competing payment systems are not subject to price or non-price barriers in the utilisation of this same infrastructure. As an example, a telco acts as a service provider when offering payment services, but is also an infrastructure provider offering communication access services to banks, BCs and other payment system providers. The payments regulator would need powers to ensure that no restrictive practices exist in opening out such communication access to other payment system providers. Presently, these restrictive practices do exist in the industry, with RBI - as the payments regulator - having no jurisdiction to intervene in the affairs of telcos, which are regulated by TRAI. This therefore necessitates:

Recommendation 3: Empower the payments regulator to ensure that access to infrastructure services is open and free of restrictive practices.

10. There is, however, another bottleneck to overcome, which is the validation of know-your-customer (KYC) checks through appropriate documentation. Requiring low-income people to provide such documentation, particularly in rural areas, is often impractical and a cause of considerable anguish. There is nevertheless a practical way of limiting such requirements. Certain identified payment transactions will not need KYC validation, as the service for which a payment is being made is itself the basis of validation. An example would be the payment of utility bills, where a prior identification of the customer by the biller may be presumed and need not be repeated by the payment systems provider. Today, all such utility bill payments and ticketing up to Rs 10,000 are exempt from KYC requirements. More generally, small payments made through systems providers, particularly where they subserve financial inclusion, could be regarded as cash-substitutes. In the same manner as small-value cash payments do not typically require prior payer-identification, a range of specified payments through systems providers should be similarly exempt from customer identification, and hence from KYC checks. This leads to:

Recommendation 4: In order to foster financial inclusion within payments, the Payments Regulator should encourage the concept that certain categories of small-value payments could dispense with KYC requirements for the entity making payments. Further, the categories of such payments should be clearly identified.

11. The adoption of this principle would enhance the impact of financial inclusion within payments, as low-income and poor people are typically challenged in providing the paper-based documentation for KYC checks, and are therefore unable to participate in making remittances or other forms of payments. In this sense, the present KYC insistence can lead to exclusion of the disadvantaged from the payments process, and regulation needs to correct this.

12. We must also recognise that within a few years, as biometric identification through UID reaches total coverage of the population under Aadhaar, it will provide a further reinforcement of customer authenticity, eventually replacing other KYC modalities.

13. Moreover, electronic modes for KYC recognition go beyond financial inclusion. The requirements of e-commerce and e-governance will necessitate KYC validation being conducted electronically, with digital validation backed by biometric authentication, and legislation would need to rapidly recognise this. The national biometric identity management project of the Government of India will facilitate this. This leads to:

Recommendation 5: The Payments Regulator should permit, and indeed encourage, electronic KYC authentication as a full substitute for paper-based KYC authentication.

II. REGULATION FOR PAYMENTS

14. Start-up business innovation in transaction processing emerges typically in private sector businesses. For such entrepreneurial businesses to grow there must be no regulatory biases in favour of the public sector or in favour of bank-mediated payment solutions. Ownership and category neutrality then implies:

Recommendation 6: Regulation must maintain a level playing field within the payments industry between the public sector and the private sector, and between bank and non-bank players. It would need to be neutral to the ownership and category structures of the regulated entity, in the absence of which innovation within the payments industry is liable to be stifled.

15. More generally, as an increasing proportion of payment transactions in future is expected to use payment systems other than banks, any regulatory 'bank bias' in nudging payment systems towards banks would need to be resisted.

16. The setting up of the National Payments Corporation of India (NPCI) is particularly relevant in this context. This entity was set up in accordance with an RBI regulatory philosophy which argued the need for a dominant bank-owned payments infrastructure organisation which would provide inter-operable switching technology, initially for ATM transactions, although there were private sector players providing this technology. With RBI driving this venture (though ownership control is with the commercial banks) and with commercial pricing which has driven the other ATM switch providers out of the market, there is the

worrisome prospect that a monopoly-by-design has been created. It is important that RBI generates confidence that there is no regulatory resistance to other payment system providers competing with NPCI, and that the latter does not resort to predatory pricing. It is desirable to prevent anti-competitive behaviour, by permitting such behaviour to be challenged in the Competition Commission. This principle needs to be protected notwithstanding the good work done by NPCI.

17. The existing law also violates this principle of ownership neutrality. The proviso to section 4(2) of the Payment and Settlement Systems Act, 2007 stipulates that equity clearing houses set up as companies should be owned not less than 51 per cent by public sector banks. This violates the principles of both category neutrality (insistence on banks controlling the clearing house) and ownership neutrality (requirement of public sector majority control).

18. To understand why it is unnecessary to mandate that clearing houses should be run only by banks, an analogy with telecom tower companies may be helpful, as several of these are now run by independent professional technology service companies, rather than by the individual telecom service operators. Further, the emergence of competitively run BPOs in India suggests that their operating models could be used beneficially to create efficiencies in the payments industry. The dismantling of any implicit regulatory entry barriers to such firms extending their reach into the payments industry appears very desirable. This leads to:

Recommendation 7: Regulation should encourage independent payment system providers, which are not linked to payment participants, thereby minimising moral hazard through conflict of interest.

19. The continuance of RBI as the regulator of payments is premised on the adoption of these principles of providing a level playing field and of permitting independent payment providers to enter payment businesses which have historically been controlled by banks. There is every reason to believe that the productivity gains and consequent improvements in operating efficiencies will be material, and the reasons for opposing this are not compelling.

20. Similarly, it is important that the payments regulator does not run any payment systems. Presently, RBI runs real time gross settlement (RTGS) and National Electronic Fund Transfer (NEFT), which are payment systems. It is therefore necessary that RTGS and NEFT be spun off from RBI.

21. The governance structure for payments regulation within RBI occurs through the Board for Regulation and Supervision of Payment and Settlement Systems. However, the present criteria for membership of this Board, as laid down in The Payment and Settlement Systems Act are not conducive to the principle of encouraging innovation. The Board consists of the Governor, all the Deputy Governors and not more than three Directors from the Central Board of RBI. It is unlikely that domain skills for the regulation of fast-changing technology and payment systems will emerge from the present Board composition.

22. Instead, it would be desirable to draw the majority membership of the Board from people who have had direct familiarity with payment

processes or allied businesses such as BPOs, technology companies or banks. RBI representation on this Board should be confined to the Governor (as Chairman) and the Deputy Governor in charge of Payments. The present Act therefore needs amendment, resulting in:

Recommendation 8: Encourage innovation in payments regulation and supervision, by recognising that this is a fast-changing technology-enabled business. Bring in relevant expertise into the regulatory body in order to improve the regulation and supervision of this industry. Restrict representation from within RBI on the Board for Regulation and Supervision of Payment and Settlement Systems to the Governor (as Chairman) and the Deputy Governor in charge of Payments.

23. In a fast changing technology-enabled business like payments, where standards and efficiency levels are continually in flux, and where new categories of payment system providers evolve, while others become uncompetitive, leading to rapid changes in market structure, industry feedback to regulators becomes more critical than in sectors with more stable technologies and market structures. In some countries, including the UK and Canada, as also at a regional level as in the European Union, institutional arrangements for such a feedback have been put in place through properly crafted governance structures. For example, the UK government formed the UK Payments Council in 2007, which represents payment systems providers and user groups. The Council thereby constitutes a consultative mechanism engaging all stakeholders with an interest in payment systems. The European Payments Council operates in a similar manner. Payments regulators in central banks thereby obtain a more nuanced feedback on industry changes and their implications for regulation. It would be similarly desirable for RBI, as the payments regulator, to actively encourage the constitution of a Payments Council, with regulations laying down the precise consultative role which RBI would expect the Payments Council to play. This leads to:

Recommendation 9: The Payments Regulator would need actively to sponsor the constitution of a Payments Council, a body which would be representative of payment system providers and users of payment systems. Regulations would be issued by the Payments Regulator which would define the role which the Council would play in advising the payments regulator on industry standards and other related matters. It would be mandatory for the payments regulator to consult with the Payments Council on such matters.

24. In addition to focusing on a governance structure within the payments regulator, it is also crucial to ensure that regulation is comprehensive (in the sense of covering all payment-transacting businesses). The present enactment (in section 2(1)(i)) leaves out stock exchange clearing, which impedes the adoption of uniform regulatory standards. Allowing businesses to fall 'between the cracks' within regulation appears undesirable, leading to:

Recommendation 10: All payment system providers should be governed by one consistent legislative framework.

25. Having recognised this, however, it is necessary to emphasise that the extent of intrusiveness in a payment business entity by the regulator could vary, a point made earlier in this report. New

businesses might merely need registration while systemically important businesses would require oversight through periodic inspections and supervision. Thus:

Recommendation 11: A system of 'proportionate regulation' would be helpful, allowing nascent businesses to adapt technology solutions without undue regulatory intervention, while requiring systemically important businesses to submit to stronger regulatory oversight.

III. RULE OF LAW

26. There is presently a perception that the reasoning behind orders issued by RBI as the payments regulator is sometimes opaque - decisions rejecting applications sometimes provide no reasons - even though RBI may feel it has good reasons which justify these orders. Adherence to the rule of law requires that regulatory orders be properly reasoned and that they be subject to an appeals process which is quick. The appeals process envisaged is similar to the process in the securities market, and a convenient way of ensuring this is to extend the ambit of the Securities Appellate Tribunal (SAT) to cover regulatory orders on payments. This is readily achievable if the FSLRC approves the constitution of a Financial Sector Appellate Tribunal (FSAT) to cover appeals against all financial sector regulatory orders.

27. The existing law (embodied in section 24(3), (4) & (5) of The Payment and Settlement Systems Act) also empowers RBI and the Finance Ministry to act as adjudicators in certain categories of disputes. This appears unwise. When the appeal is against an RBI order, the appeal should lie properly to FSAT. When it is an appeal against the order of a panel constituted under section 24(1), it would also be more appropriate for it to be heard and disposed of by FSAT. To summarise:

Recommendation 12: It is important to infuse a transparent and fair rule of law into regulatory decisions. Legislation needs to provide for a quick appeals process, equally fair to both disputants, especially when one of them is the regulator. Further, all appellate powers presently vested in RBI and the Finance Ministry should be transferred to the appellate body.

28. It is also necessary that arbitrariness in regulatory law, and excessive powers arrogated by the regulator, be contestable through appeals to FSAT, the appellate body, and regulatory law would therefore need to be consistent with the principles laid down above, as contained in Recommendations 1-12. Thus, it is not just specific regulatory action against a payments entity, but also regulations issued by the payments regulator, which could be challenged in FSAT. The rule of law would thereby be further strengthened. This leads to:

Recommendation 13: All regulations made by RBI on payments would need to be consistent with the principles listed above as contained in Recommendations 1-12 above, which would be incorporated into a new enactment on payments. Regulations could thereby be challenged in the appellate body on grounds of violating the new legislative law.

IV. CUSTOMER PROTECTION

29. In line with the strengthening of financial market consumer protection which FSLRC is separately proposing, it is important to ensure that customers who use payment systems are also similarly protected in terms of adequate compensation in the event of losses, and through civil and criminal action against perpetrators of frauds. The challenge in the design of such a customer protection mechanism will be to ensure quick redressal, in the absence of which contracts in the financial sector (including in the payments sector) will not be readily enforceable. This implies:

Recommendation 14: Strong legal protection for payment system participants and other customers of payment systems would need to be incorporated in the new legislation. The constitution of a separate Customer Protection Agency to ensure this, backed by laws that require the enforcement of contracts by payment system providers, would facilitate this. Customer protection would no longer be the prime responsibility of RBI as the payments regulator.

V. BANKRUPTCY

30. FSLRC is separately proposing a bankruptcy law for financial sector entities, and it is necessary for such a law to cover payment systems providers as well. It would also be desirable for revenue payables of a systems provider to have priority in the context of its bankruptcy, in order to ensure that the repercussions of bankruptcy have a minimal impact on system participants. This implies:

Recommendation 15: Introduce a uniform and quick process for handling bankruptcy within the payments sector, with revenue payables of a payment system provider having priority in the context of bankruptcy.

ANNEXURE

FSLRC constituted a Working Group (WG) on Payments on 25th October, 2011, comprising P.J. Nayak, as Chairman, and Ranjit Tinaikar, Uttam Nayak, Bharat Poddar, A.P. Singh and Abhishek Sinha as Members. Five meetings of the WG were held.

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The WG also met with regulators and representatives of the payments industry, and would like to thank for the many suggestions received G. Padmanabhan, Executive Director, and G. Srinivas, General Manager, from Reserve Bank of India; A.P. Hota from National Payments Corporation of India; Nath Parameshwaram, Salil Mody and Judy Chang from PayPal; Sunil Sood and Shridhar Rao from Vodafone; Sriram Jagannathan from Bharti AirTel; and Anurag Gupta from A Little World.