15 April 2017

COMMENTS ON DRAFT MASTER DIRECTIONS ON ISSUANCE AND OPERATION OF PREPAID PAYMENT INSTRUMENTS IN INDIA

1. Background

The Reserve Bank of India (RBI) has invited comments on the draft Master Directions on Issuance and Operation of Prepaid Payment Instruments (PPIs) in India (Directions).

CUTS International (www.cuts-international.org) is an independent, non-profit economic policy research and outreach organisation. It works towards improvement in quality of regulation, competition, governance across sectors with the objective of enhancing consumer welfare.

2. General comments

CUTS International welcomes the issuance of draft Directions which have consumer welfare as their intent and are forward looking in many aspects. It needs to be ensured that consumer welfare is achieved at minimum cost and is not indirectly reduced by imposing avoidable costs on market players. Consequently, some unintended adverse impacts of draft Directions are highlighted, while pointing out better alternatives to achieve consumer welfare.

A graded/ tiered risk based regulation is advocated in this regard wherein choice rests with the consumer, subject to compliance with clear disclosure and transparency standards by PPI operators. Further, emphasis has been put on stringent monitoring, fixing accountability and facilitating grievance redress by regulator rather than restricting entry and inhibiting competition and innovation in the sector.

3. Specific comments

3.1. Minimum net worth requirement

Direction 5.2: All entities seeking approval of the RBI under the Payment and Settlement Systems Act, 2007, are required to maintain a minimum positive net worth of Rs. 25 crore.

Comment: It appears that the objective behind the minimum net worth requirement is to ensure entry of genuine operators in the PPI market, and prevent entry of fly by night operators who siphon consumer funds.

The key function of PPIs is to facilitate payments/ transfer of funds between consumers and merchants. PPIs are not allowed to pay interest on deposits thus disincentivising consumers to hold large sums in PPI accounts. Several mechanisms exist to safeguard customer finances (such as ring fencing of consumer funds/ investment in highly rated liquid securities etc), and high net worth requirement might not be the most efficient option. Such requirement has the potential to act as an entry barrier for new entrants, and limit innovation in the market.

In addition, it limits choices available with consumers and increases the cost of access, in effect reducing consumer welfare. This can have adverse impact on the digital payments drive of the government. Low entry barriers will increase the burden of regulator as the regulator will have to ensure effective monitoring and supervision, enable transparency in operation of PPIs, and facilitate speedy consumer grievance redress. However, the benefits of low entry barriers to consumers in terms of enhanced access, improved quality of services and reduced cost has the potential to outweigh cost on regulators.

Consequently, it is important to establish a healthy regulatory environment which is competition-friendly. This includes creation of a level playing field between leading market players and prospective participants wishing to enter into the market. Level playing field does not only mean ensuring similar treatment of similarly placed entities but also avoiding similar treatment of dissimilarly placed entities. The PPI market is unique as bank operated PPIs might not find it difficult to comply with high eligibility conditions when compared with non-bank PPI operators. Consequently, there is a need take a comprehensive look at the PPI market and avoid a one-size-fit-all approach to PPIs.

Recommendation: A tiered approach with respect to minimum capital linked with the individual account limit could be adopted. For instance, a minimum capital requirement of Rs. 5 crore, could be allowed for PPIs with PPI account balance up to Rs. 20,000. A second tier of minimum capital requirement of Rs. 10 crore with PPI account balance up to Rs. 50,000, and a third tier of minimum capital requirement of Rs. 20 crore with PPI account balance up to Rs. 1,00,000 could be allowed.

3.2. Applicability of minimum net worth requirements to non-banks

Direction 5.6: While all new PPIs are required to maintain the minimum net worth requirements at all times, <u>existing non-bank PPI issuers</u> are required to comply with the enhanced capital requirements by September 30, 2020 for the financial position as on <u>March 31, 2020</u>, failing which they shall not be permitted to carry on this business beyond December 31, 2020.

Comment: The proposed direction recognises the difference between bank and non-bank PPI, and thus allows significant time period to existing non-bank PPIs to comply with the revised/ enhanced capital requirements. However, it creates an artificial distinction between old and new non-bank PPIs and preferentially treats the former.

Non-banks have led innovation, user friendliness and customization in the PPI market and the same should not be restricted. Consequently, there is a need to ensure that all non-bank PPIs have an opportunity to comply with the enhanced capital requirement by the prospective time frame. Inability of interested non-bank entities to obtain PPI license due to lack of capital will limit the number of players in the market. This will restrict the opportunities available to consumers.

Recommendation: To maintain competitive parity, the new non-bank entities seeking RBI’s approval should be made subject to the same conditions vis-à-vis capital requirements as existing non-bank PPI issuers.

3.3. Conversion of minimum KYCed PPIs to full KYCed PPIs

Direction 9.2(i)(e): Semi-closed PPIs with outstanding amount not exceeding Rs. 20,000 at any point of time can be issued by accepting minimum details of the consumer. These PPIs <u>are mandatorily required</u> be converted into <u>full KYC</u> semi-closed PPIs within a period of 60 days from the date of issue of PPI, failing which no further credit shall be allowed in such PPIs. However, the PPI holder shall be allowed to use the balance available in the PPI.

Direction 9.3(a): PPI Issuers are mandatorily required to ensure that all the existing minimum detail semi-closed PPIs are converted into full KYC semi-closed PPIs by June 30, 2017, failing which no further credit shall be allowed in such PPIs.

Comment: The objective behind mandatory conversion of minimum KYC PPIs to full KYC PPIs appears to ensure that PPIs are not misused for fraudulent purposes. However, several genuine consumers might not be interested to share their full KYC details and might be interested to operate PPIs for limited purposes. Further, several alternatives exist, in terms of robust supervision, and transparency, to enable monitoring usage of PPI accounts. Such mechanisms can aid in identification and red-flagging of suspicious accounts, based on transaction history and PPI usage.

The requirement to mandatory convert limited KYC PPIs to full KYC will impose a cost on PPI operators which will be passed on to consumers. This will increase the cost of access to consumers and thus limit the reach of PPIs. It might be argued that with the advent of aadhar, it might not be difficult for PPI operators to undertake e-KYC. However, it has been suggested that aadhar based e-KYC is not fool proof, and is contingent upon availability of electricity and internet connectivity. There are several electricity and internet dark zones in the country, which might result in inability to successfully conduct e-KYC, thus depriving genuine consumers from the benefits of PPIs.

Recommendation: The choice to upgrade to higher eligibility PPI, on submission of full KYC documents, must rest with consumers and should not be mandated by directions. There is no need to subject PPIs with lower amount eligibility to full KYC, but to improve monitoring and supervision to prevent fraud and misuse.

3.4. Issuance of open system PPIs

Direction 9.4: Only banks are permitted to issue open system PPIs after full KYC.

Comment: During the infancy of PPI industry, only banks were allowed to issue open system PPIs, i.e. allow cash-in and cash-out facility, after full KYC. Despite the industry gaining required maturity and experience, non-banks are not allowed to issue open system PPIs. Such restriction limits competition, innovation and customer experience in the open system PPIs market and limits the industry from realising its potential.

Recommendation: Non-banks should be permitted to issue open system PPIs after full KYC.

3.5. Cross border transactions

Direction 4.2: Full KYC reloadable semi-closed PPIs issued only by bank PPI issuers having authorised dealer license are permitted to be used in cross-border transactions, with a transaction limit of Rs. 5,000.

Comment: It is difficult to understand why semi-closed PPIs issued only by bank PPI issuers are permitted to be used in cross border transactions. India is one of the fastest growing markets for cross border transactions and the consumers should not be deprived of benefits of innovative, user friendly and customised payment services. This can only be offered if multiple players, including banks and non-banks, are eligible to offer cross-border transactions facilities. Moreover, if the customers are fully KYCed, a blanket transaction limit of Rs. 5,000 for all customers might not be advisable. The consumers should have the opportunity to choose the transaction limit for herself, subject to detailed description of associated risks and responsibilities by the service provider. The service providers would be in a better position to offer customised transaction limits based on analysis of transaction history of consumers.

It appears such stringent conditions to entry and operate have been put in place with the objective of consumer protection. However, consumer protection needs to be upheld by putting in place robust monitoring, supervision and accountability provisions and ensuring effective grievance redress. Protecting consumer rights by limiting consumer choice and options might have adverse impact on cost of access, quality of service and overall consumer experience.

Recommendation: Non bank PPI issuers should be permitted to be used in cross-border transactions. Also, consumers should be allowed to set the transaction limit depending on their transaction history and profile.

3.6. Deployment of money collected

Direction 11.3: Non-bank PPI issuers are required to maintain their <u>outstanding balance in an escrow account with any scheduled commercial bank</u>.

Comment: As indicated in the draft Directions, the objective behind requiring non-bank PPI issuers to maintain outstanding balance in escrow account with any scheduled commercial bank is to enable timely settlement and ensure public confidence on PPIs. However, scheduled commercial banks are potential competitors of non-bank PPIs as they are eligible to issue and operate PPIs. Mandatory access to funds of potential competitors might put banks at a competitively beneficial position when negotiating terms and conditions of escrow with non-banks, and while designing their strategy for the PPI market.

The draft Directions mention that PPI issuers are required to submit confidential business information, such as list of merchants acquired by it to the bank with which escrow amount is maintained. The non-bank PPI operator might not otherwise want to share such details with its potential competitor. In case the PPI operators have necessary arrangements with digital marketplace/ payment aggregator/ gateway, the PPI operators are required to obtain list of merchant from such intermediary to be submitted to the escrow account holding bank. Such process might be against business interests of the PPI and relevant intermediary, time consuming and expensive.

Further, there are secure and liquid alternatives of investment of funds available with the non-banks, such as government securities and highly rated bonds. Such investment options do not inspire lesser confidence than investment in escrow account in banks. Unavailability of other modes investment also put non-banks at a disadvantage as they might not have much say in negotiation of charges imposed by banks in offering escrow facility. Such charges are eventually effectively passed on to the consumers, directly or indirectly.

Recommendation: Non-banks should have discretion to invest funds in highly rated and liquid securities in addition to escrow with scheduled commercial banks, subject to undertaking of timely settlement.

Further, wherever the amount is kept as escrow with scheduled commercial banks, the information related to merchants of PPIs must be kept confidential by the bank.

3.7. Security, Fraud prevention and Risk management

Direction 15: PPI issuers are required to put in place adequate information and data security infrastructure and systems for prevention and detection of frauds.

Comment: Some of the key features of security, fraud prevention and risk management practices, as envisaged under the draft Directions include:

i) PPIs are required to review security measures on an ongoing basis but at least once a year – Given the fast paced developments taking place in this sector, PPIs should be encouraged to conduct review of security measures on a quarterly basis. Results of such review, including deficiencies identified and corrected must be available in public domain. Changes to PPI security policies must also be available in public domain and consumers must have option to transfer funds to their linked bank account if they so desire.

ii) PPIs shall ensure that separate login is provided for the PPI account, and access to PPI is not made part of access to other services offered by the PPI Issuer or its associate / parent / group company etc – Dual login for PPI and other services would increase consumer inconvenience without necessarily enhancing security and preventing fraud. PPIs must be free to design innovative user friendly mechanisms to prevent fraud and enhance security without necessarily compromising consumer convenience. Consumers must be informed in advance of different security features to access PPI accounts. They must be in a position to compare different features and make an informed decision on the PPI they would like to use.

iii) PPIs are required to introduce a system of additional factor of authentication for authenticating transactions in PPIs, including where PPIs are issued in the form of cards – Additional factor of authentication is not necessarily a fool proof mechanism of fraud prevention is contingent upon good network connectivity. PPIs must be encouraged to design innovative methods of transaction authentication which should be clearly explained to consumers in advance.

iv) PPI issuers shall put in place suitable cooling period for funds transfer upon opening the PPI or loading of funds into the PPI or after adding a beneficiary so as to mitigate the fraudulent use of PPIs – The cooling off period between funds loading and transfer is expected to adversely impact user interface and increase user inconvenience. Basis user profile and transaction history, PPIs should be in a position to design alert and confirmation systems to mitigate fraudulent use of PPIs.

v) PPI issuers shall report the frauds on a monthly / quarterly basis to the concerned Regional Office. Also, PPI issuers shall establish a mechanism for monitoring, handling and follow-up of cyber security incidents and cyber security breaches. The same shall be reported to RBI and CERT-IN – PPI issuers should be obliged to publicly report frauds on a periodic basis. Further, updates on monitoring, handling and follow up of cyber security incidents and breaches must be available in public domain in understandable language. Such transparency is essential for consumers to evaluate risk mitigation standards of different PPIs and make an informed decision.

Recommendation: Given the nature of industry, the regulator must not prescribe conditions for security which might become outdated in future and hamper user convenience. Innovation, transparency and disclosure must be encouraged to facilitate competition to enable service providers offer best standards at minimum cost to consumers. In addition, the RBI should ensure coordination with other agencies like Ministry of Electronics and Information Technology in areas like security, fraud prevention and risk management to avoid over regulation and facilitate regulatory certainty and predictability.

3.8. Disclosure of terms and conditions

Direction 16.1: PPI issuers are required to disclose important terms and conditions in clear and simple language while issuing the instruments.

Comment: Mere disclosure of key terms and conditions at the time of issuance of instrument is grossly inadequate. Customer understanding of terms and conditions is crucial for express and informed consent. In this regard, important terms and conditions must be available in pictorial and audio format to facilitate better understanding. A standard question and answer directory/ interactive games must be available for consumers to better understand the conditions and the situations they trigger.

Focus must be to inform consumers of different charges, and situation they come into effect. In addition, before completion of a transaction, consumers must be informed in advance of the charges involved in such transactions and consumers should have an option to opt-out of transaction to avoid charges. Further, no different charges must be linked with each other, and the consumers must have an option to make an informed choice about transactions/ services which attract charges. Situations which trigger consumers’ responsibility and accountability must be clearly disclosed.

Recommendation: It must be ensured that consumers are aware of terms and conditions and the situations they trigger. Consumers must have knowledge of the charges involved in transactions before their completion, and should have the option to opt-out of such transactions. Places and cost of accessing hard copy of terms and conditions must be disclosed to consumers.

3.9. Consumer grievance redress framework

Direction 16.2: PPI Issuers are required to put in place a formal, publicly disclosed customer grievance redressal framework.

Direction 16.3: In case of PPIs issued by banks, customers shall have recourse to Banking Ombudsman Scheme for grievance redressal.

Comment: It must be ensured that the complaint filing facility is available to the consumers round the clock, and follow-up is undertaken in a time bound manner. Further, disclosure of consumer complaints received, their resolution, must be disclosed in public domain. Further, it must be ensured that an independent ombudsman facility is available for customers of non-bank PPI issuers, to enable independent resolution of complaints.

Recommendation: An efficient and time bound grievance redress mechanism, with an independent complaint filing body, is key to ensure consumer trust and confidence in PPI sector. In this regard, it must be ensured that robust consumer standards are adopted by PPI operators, compliance with which is ensured through disclosure and transparency in public domain.

3.10. Interoperability

Direction 18: Entities meeting the revised eligibility criteria and adhering to other instructions shall be allowed to participate in other interoperable payment systems, as and when specific directions are issued in this regard.

Comment: Non-banks PPIs do not have direct and interoperable access to payments systems. Much time has elapsed since non-banks were promised interoperability. The draft directions do not provide any clarity on when interoperability will be allowed, as no visibility on issuance of specific directions for interoperability has been provided. Given that the market has matured, interoperability must be allowed at the earliest. Interoperability will reduce cost of access and risk, enable speed, efficiency and accountability in digital payments.

Recommendation: A clear time frame must be issued to allow interoperability in PPI sector. There is a need to adopt risk based regulation in place of entity based regulation of payments sector, thus ensuring all entities with similar risks having access to similar interoperable systems.

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