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Concerns with Respect to Payments Banks in India

In late August 2015, the Reserve Bank of India (RBI) granted in-principle approval to 11 applicants to set up payments banks in India.[1] Payments banks are first set of differentiated banks, aimed at providing deposit, payments and remittance services to low income groups, and other non-risk sharing simple financial services. They are not allowed to undertake lending activities. The RBI had issued operational guidelines for payment banks in November 2014 (RBI guidelines)[2] and provided clarifications thereon in January 2015 (RBI clarifications).[3]

The successful applicants are required to comply with relevant conditions under RBI guidelines and respective in-principle approval within 18 months. This has triggered analysis of RBI guidelines and clarifications in greater detail, amongst relevant stakeholders. The Briefing Paper highlights competition and regulatory concerns with respect to structure and operation payments banks, on the basis of review of existing literature and guidelines.

Preliminary Concerns

A preliminary review of existing literature, RBI guidelines and clarifications reveals existence of several regulatory and competition concerns, which have the potential to impose avoidable burden and restrict the growth of payment banks. An indicative list of such concerns is set out below:

Customer Acquisition

The RBI guidelines provide that payments banks are required to conduct their own Know Your Customer (KYC)/Anti-Money Laundering (AML)/Combating the Financing of Terrorism (CFT) exercise like any other bank. The RBI clarifications also indicate requirement to conduct KYC exercise, even if customer due diligence exercise has been conducted by promoter group entities of payment banks for customer acquisition, or if potential customers already have bank accounts. Moreover, as a result of a recent order of Supreme Court, *Aadhar* card details are unlikely to be used for customer verification.[4] This has the potential to increase customer acquisition costs for payment banks.

In addition, payment banks are expected to rely on technology and mobile network for verifying customer details and acquire customers. Some of the payments banks promoters will be established players in mobile network market. Consequently, possibility of differential treatment of competitors for customer data verification cannot be ruled out. Such anticompetitive practices could adversely impact growth of payment banks.

Agent Infrastructure

Controlling office: Payment banks are expected to provide payment and remittance services through various channels including branches, automated teller machines (ATMs), business correspondents (BCs) etc. In addition, they are required to have at least 25 percent of '*physical access points*,' including

BCs in rural areas. Further, a '*controlling office*' for a cluster of access points is required to be established for control over various outlets and for customer grievance redress. The RBI has clarified that controlling offices should be manned by employees of the payments bank. BCs are agents and therefore, BC outlets cannot be designated as controlling offices. Consequently, payments banks will be required to make significant investments in setting up controlling offices.

Physical access point: Also, under existing guidelines on BCs, interoperability at the retail outlets or sub-agents of BCs (i.e. at the point of customer interface) has been allowed, subject to compliance with certain conditions. However, on a preliminary review, it is not clear if a sub-agents of BC appointed by another bank, available to customers of payment banks in interoperable manner, would qualify for being designated as 'physical access point'. The alternate scenario of payment banks establishing exclusive physical access points could impose additional costs.

Promoter as BCs: The RBI clarifications allow payments banks to appoint promoter group company (promoter or other subsidiaries) as corporate BCs, on an arm's length basis and subject to RBI guidelines on BCs. However, there might be operational and accountability concerns in such structure. For instance, guidelines on appointment of non-bank financial companies as corporate BCs require avoidance of comingling of bank's and BC funds and contractual arrangements to take care of conflicts of interests.[5]

It not clear how such arrangements would work if the bank and BC belong to the same group. In addition, promoters of payments banks are required to hold at least 40 percent of paid-up equity capital for first five years, hence putting them in effective control on the bank. However, the promoters are also eligible to act as BCs/agents of payments banks and thus payment banks would be effectively accountable for actions of such promoter-agents. This could create uncertainty.

Training and capacity building costs: Literature also suggests that payments banks will have to make significant investments to develop and train customer facing agents, to handle technology and acquire customers.[6]

Agent Interoperability

The RBI guidelines on interoperability allow BC/ATM level interoperability. Further, interoperability at the retail outlets or sub-agents of BCs (i.e. at the point of customer interface) has been allowed, subject to compliance with certain conditions. These include: availability of requisite technology, on-line conduct of transaction and authentication on core banking solution platform, and compliance with standard operating procedures as set out by Indian Banks' Association. However, the guidelines also provide that BC or its retail outlet or sub-agent at the point of customer interface would continue to represent the bank, which has appointed the BC.[7]

Lack of clarity exists on applicability of such guidelines for payments banks, given the requirement of dedicated controlling office and physical access points (as mentioned above) for payments banks. Significant investment in technology could be needed for payment banks to comply with these guidelines. Moreover, technological complications have the potential to result in increased number of over the counter transactions by customers.

Merchant Acquisition and Interoperability

In order to make payment services ubiquitous, payments banks will be required to enter into business arrangements with merchants. Such arrangements will enable use payment services for acquisition of goods and services by customers. Exclusive business arrangements, restricting merchants' ability to enter into similar arrangements with other payments banks, are *per se* not permissible under competition law, at present, if it result into appreciable adverse effect on competition. However, it is not clear if adequate understanding and processes/structures are in place to ensure interoperability between merchants and payment banks.

In addition, promoter/promoter group entities of several payment banks could be having merchant operations. Consequently, it is not clear if such entities would be willing to enter into business arrangements with competitors of payments banks' promoted by them. In addition, the financial considerations in arrangements between payments banks and merchants, could have implications on costs of products and services which merchants offer to consumers.

Data Privacy and Sharing

As payment banks are expected to provide remittance services to consumers, they will have access to expenditure data of its consumers which could be valuable to entities operating in other sectors/promoters/promoter group entities of payment banks (such as banks and insurance firms– to ascertain creditworthiness, FMCG companies – to ascertain demand for products and services etc). However, it seems that payment banks are not expected to engage in data mining, analysis and advisory services.

In order to monetize available useful information, payment banks might have to share it with expert data mining/analysis entities and relevant sector operators/promoters/promoter group. While RBI clarifications require building of suitable firewalls and maintaining confidentiality, no detailed guidelines seem to be present on the issue of data privacy and data sharing between payment banks and other related or unrelated entities. Data privacy and protection is also important from the point of view of consumer protection and gaining customer trust.

In addition, the RBI guidelines require payment banks to be ring-fenced from promoters and operate at arm's length. Consequently, they might not be able to share customer data with promoters. However, in cases where promoters are acting as BCs of payment banks, maintaining data exclusivity could be difficult.

Regulatory Coordination

With increase in complexity in the entities operating in financial services sector and imminent entry of hitherto non-bank players in the market, greater coordination amongst different sector regulators (such as Telecom Regulatory Authority of India, specific government departments) and banking regulator will be expected. The objective of regulatory coordination will be to promote healthy competition and cooperation amongst the market players (in form of interoperability), check transfer of dominance from a sector (like, telecom) to banking sector and its abuse, and to prevent anticompetitive agreements.

In addition, as payment banks will be allowed to distribute pension, insurance and mutual fund products, coordination between RBI and regulators such as Securities and Exchange Board of India, Insurance Regulatory and Development Authority of India and Pension Regulatory and Development Regulatory Authority will be required. Based on preliminary assessment, it is not clear if adequate mechanisms are in place to ensure effective coordination between different regulatory entities. Absence of effective coordination may result in inefficient, unpredictable and uncertain regulatory environment.

Use of Payment Banks for Transfer of Subsidies

The government has recently initiated direct transfer of cash subsidies into the bank accounts of citizens, through use of unique identification number. In addition, it has launched *Jan Dhan Yojana* (JDY) to ensure that every household in the country has a bank account, and thus enable transfer of cash subsidies. The accounts opened in JDY are expected to remain operational with help of subsidy transfer from government and withdrawal by account holders.

On the basis of preliminary review, it is not clear if the accounts opened in payment banks would be eligible to qualify for direct benefit transfer and if the government would consider the payment bank route for transfer of cash subsidies.

Service Charges and Agent Commission

Service charges: The payment banks are allowed to provide interest on deposits and charge commission on services. However, the RBI guidelines do not currently provide any indication about the interest or commission limits, which might raise competition and consumer protection concerns. Moreover, a study revealed that fund remittance charges are relatively lower in India, when compared with other jurisdictions.[8] Consequently, the payment banks will have to keep charges low to attract customers. However, such practices might not be sustainable in long term for payment banks.

Commission: The RBI guidelines provide that the commission charges for payment bank activities will be governed by RBI but the charges for other distributional activities will be governed by guidelines issued by other sectoral regulators. This might result in inconsistency in commissions to BC/agents.

Over-regulation of Payment Banks

With the entry of payment banks and small banks (in near future), the competition in banking market is expected to intensify. The entities competing for customer attention will include universal banks, prepaid payment instrument (PPI) providers, small and payment banks. Different entities in the market will be governed by regulations of different complexity. However, payment banks will be governed by RBI guidelines; guidelines under Payments and Settlement Systems Act, 2007; and other relevant regulations issued for universal banks. This could result in over-regulation and inconsistent regulatory scenario for payment banks.

Other Issues

Business restructuring: RBI clarifications provide that any PPI entity cannot co-exist with payment bank in the same group. However, payment banks can issue PPIs along with payment bank accounts. This would require business restructuring in payment banks.

Daily balance: RBI clarifications provide that the balance at the close of any day cannot exceed R. 100,000 per individual customer in a payment bank account. However, there could be consecutive bank holidays or weekends wherein this might be breached. Not much clarity is available in this regard.

Endnotes

1 RBI Press Release dated August 19, 2015

2 RBI guidelines for licenses of payments banks dated November 27, 2014

3 RBI Press Release dated January 01, 2015

4 Supreme Court order dated August 11, 2015 in *Justice K.S. Puttaswamy v. Union of India* notes, "*The Unique Identification Number or the Aadhaar card will not be used by the respondents for any purpose other than the PDS Scheme…The information about an individual obtained by the Unique Identification Authority of India while issuing an Aadhaar card shall not be used for any other purpose, save as above, except as may be directed by a Court for the purpose of criminal investigation.*"

5 RBI circular dated June 24, 2014 on financial inclusion by extension of banking services

6 Daniel Radcliffe, *Game changers,* Indian Express, September 01, 2015

7 RBI master circular on branch authorisation read with RBI letter dated March 2012

8 Kabir Kumar et al, *What will it take for payments banks to succeed in India?,* CGAP, January 27, 2015

This Briefing Paper, prepared by Amol Kulkarni, Senior Policy Analyst, CUTS International (amk@cuts.org) is based on preliminary literature review and needs to be refined through in-depth research and stakeholder interaction.