

(Not) the way to promote digital payments

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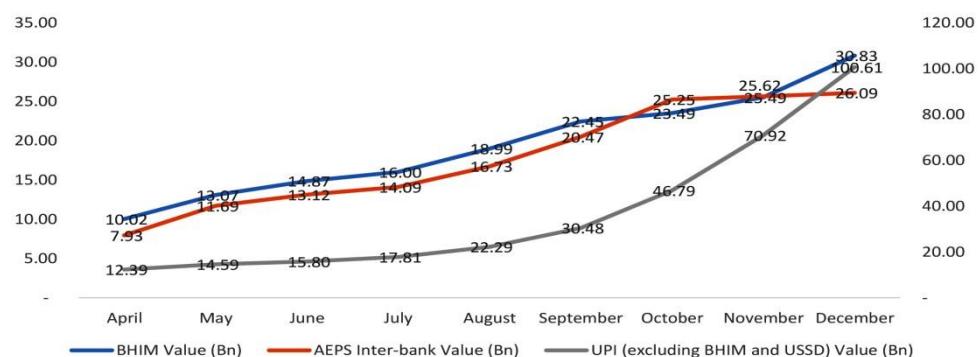
Promotion of digital payments has been stated objective of the Government of India. In the last one year, the government has broadly used three types of tools to promote digital payments. These are: financial, operational and regulatory. The sections below examine the application and effectiveness of these tools with special focus on the developments that took place from September 2017-January 2018.

1. Financial tools: The government provides financial incentives in form of cashback and bonus to individuals and merchants undertaking digital payments. To this end, it has launched schemes like BHIM Aadhaar Merchant Incentive Scheme,¹ BHIM Cashback Scheme for Merchants² and BHIM Referral Bonus Scheme for Individuals.³ For six months starting April 14, 2017, a budget outlay of ₹495 crore was made for BHIM Cashback Scheme for Merchants and BHIM Referral Bonus Scheme for Individuals. Pursuant to notifications dated August 14, 2017, all three schemes were extended till March 31, 2018.

In addition, the government has recently decided that the MDR applicable on all debit card/BHIM UPI/AEPS transactions up to ₹2,000 will be borne by the government for a period of two years with effect from January 01, 2018 by reimbursing the same to the banks. This is estimated to cost the exchequer around ₹1,050 crore in 2018-19 and ₹1,462 crore in 2019-20.⁴

In other words, at least ₹3,000 crore of taxpayers' funds are being used to provide financial incentives for promoting digital payments. It may be recalled that BHIM is a mobile application for enabling digital payments operated by NPCI, country's only retail payments organisation in which banks have majority shareholding. NPCI also operates BHIM Aadhaar to enable payments to merchants through biometric authentication and transfers from customers' Aadhaar number linked bank accounts. UPI and AEPS are payments systems/platforms operated by NPCI which facilitate digital payments. Consequently, it appears that most financial incentives are

Figure: Growth in value of digital payments (2017)



targeted to boost digital payments through applications and systems operated by NPCI. Figure 12 (on page 36) showcases growth in volume of digital payments through such applications and platforms:

While it may be too soon to assess impact of such financial incentives, it may be useful to examine the factors that drive uptake and usage of digital payments among different stakeholders, especially merchants. A recent survey involving survey of micro-merchants revealed that despite having bank accounts and being aware about traditional digital platforms, awareness about mobile and internet banking is lower and the usage is consequently lower. Few merchants rely in formal sources of finance and those who do are unlikely to be satisfied with formal lenders.⁵ Consequently, a holistic service that includes credit extension has been suggested. Low cost value added services like reminders to consumers and merchants for making payments, networking platform with suppliers, indications on potential credit limits could ensure greater uptake and continued usage.⁶

In coming months, it might be useful to conduct an impact assessment of financial incentives provided to promote digital payment and analysis if it is the most cost-effective option to achieve the objective.

2. Operational tools: The government has been nudging banks to make operational/business decisions to promote digital payments. Banks have been requested to charge merchant and customers only such charges as prescribed by the RBI for debit card, UPI and USSD transactions. They have been requested to not pass onto merchants the cost of payment acceptance infrastructure, and absorb such cost by cross-subsidisation with savings from reduction in cash transactions.⁷ Banks have also been asked to re-

examine the policy of allowing certain number of free cash transactions, while charging for every digital transaction.⁸ In addition, the RBI has recently capped the MDR for debit card transactions. The cap differs with turnover of merchants (up to or above ₹20 lakhs) and acceptance infrastructure used (QR code enabled and others).⁹

The fixation with price caps is not limited to Indian regulators, but has been used by regulators in other jurisdictions as well. US, ¹⁰ Australia, Europe and Estonia, among others, regulate interchange fees chargeable in digital payments. Evidence is mixed with respect to the impact of such cap. A recent study in US found that banks subject to such cap decreased the availability of free accounts, raised monthly fees, and increased minimum balance requirements, with different adjustment across account types. Banks exempt from the cap also adjusted prices as a competitive response to price changes made by regulated banks.¹¹ This is very similar to experiences in India wherein regulatory mandates often fail to conduct *ex-ante* impact assessment on different stakeholders, resulting in banks cross-subsidising such services by restricting access or increasing prices of other services.

A 2014 survey among merchants in US found that the price regulation had limited and unequal impact on merchants' debit acceptance costs. Around two-thirds reported no change or did not know the change of debit costs post-regulation. One-fourth of the merchants, however, reported an increase of debit costs, especially for small-ticket transactions. Less than 10 percent of merchants reported a decrease of debit costs. The impact varies substantially across different merchant sectors.¹² It has been noted that price caps cannot be an alternative to operation of market forces¹³ and structural reforms in market.

Further, over the long run, other factors are expected to influence the structure of the payments system. These include technological developments allowing consumers to submit payments directly to other consumers or small businesses via alternative payment systems, and greater competition from non-bank institutions.¹⁴ India is already witnessing impact of innovation in digital payment space. As per data released by NPCI, the UPI platform recorded 145.64 million transactions of ₹131.74 bn in December 2017. Approximately 94 percent volume and 76 percent value is reported to have been driven by innovative non-bank service providers like Google Tez and PhonePe.¹⁵

3. Regulatory tools: These include legislative and regulatory changes impacting digital payments. Pursuant to the budget 2017-18, the Payments and Settlement Systems Act, 2007 (PSS Act) was amended to constitute a Payments Regulatory Board in the RBI by replacing the Board for Regulation and Supervision of Payment and Settlement Systems (BPSS).¹⁶ While the PSS Act was amended, the PRB is yet to be operationalised. The RBI has since dropped the idea of forming a Payments System Advisory Council, an advisory body envisaged earlier to support the BPSS.¹⁷

In addition, the last one year, the RBI has revised the regulatory framework of PPI issuers¹⁸ and has introduced a regulatory framework for peer-to-peer lending platforms.¹⁹ To ensure that such changes promote digital payments, it is necessary that they offer level playing field to different service providers and avoid impose unreasonable costs. Sufficient evidence exists about benefits of optimal regulation and competition across jurisdictions and sectors, including digital finance.

Optimal regulation and competition creates breeding ground for innovation,²⁰ can have significant impact on reducing costs,²¹ and contribute to increase in volume of transactions. It has been suggested that the total mobile money transaction value was 5.4 percentage points higher in markets with enabling regulation, compared to countries with non-enabling frameworks – resulting in greater financial inclusion in the process.²² As elucidated earlier, Tanzania, Uganda and Pakistan are among some markets which have benefitted from increase in competition and interoperability in digital payments.

Consequently, it will be useful to examine if recent regulatory changes move towards optimal competition and regulation. Such assessment can be undertaken by seeking responses to key questions as was pointed in Table 3 on page 10, which summarises approaches of competition assessment. Broad findings of competition assessment of recent regulatory changes in digital payments are set out below:

1. High entry barriers – The PPI regulations provide that all existing non-bank PPI issuers are required to have a minimum positive net-worth requirement of ₹15 crore as on March 31, 2020. Thereafter, the minimum positive net-worth of ₹15 crore is required to be maintained at all times. Previously, banks and non-banking financial companies were required to comply with capital adequacy requirements as prescribed by the RBI from time to time. All other persons were required to have a minimum paid-up capital of ₹5 crore and minimum positive net worth of ₹1 crore at all the times. The substantial increase in net worth requirement may adversely impact smaller players currently operating in the market, who might not be in a position to comply with the revised requirements by March 2020. In addition, the

revised requirements may dissuade smaller interested players to enter the market.

Similarly, the eligibility criteria for non-banks to operate peer to peer lending platforms is net owned fund of ₹2.5 crore, which may discourage several interested players.

2. Disregarding proportionate requirements –

The PPI regulations provide that semi-closed PPIs with outstanding amount of not more than ₹10,000 can be issued by banks and non-banks by accepting minimum details of PPI holder. However, such PPIs are required to be converted into fully Know Your Customer (KYC) compliant semi-closed PPIs within a period of 12 months from the date of issue of PPI. Such fully KYC compliant semi-closed PPIs are eligible to keep amount outstanding up to ₹1,00,000. However, the conduct of full KYC requires collection of proof of identity and address from the customer or conducting KYC verification through e-KYC service of UIDAI.²³

Conducting full KYC can be expensive when compared with collecting minimum details of PPI holder, and may force PPI issuers to rethink their business strategy. In addition, some consumers might not be interested in obtaining enhanced benefits of full KYC and not willing to part with sensitive information. The revised requirements do away with risk based KYC and takes a one-size-fits-all approach, which may adversely impact interests of service providers and consumers.

The peer to peer lending platform regulations also impose high operational costs and adopt one size fits all approach. There are caps on exposures of lenders and amounts borrowed by borrowers. For instance, exposure of a single lender to the same borrower, across all peer to peer lending platforms cannot exceed ₹50,000. This is expected

to reduce the attractiveness of the platform and the design of products which lenders can offer.

3. Escrow requirement – Pursuant to the PPI regulations, non-bank PPI issuers are required to maintain their outstanding balance in an escrow account with any scheduled commercial bank. This accords universal banks, which compete with non-bank PPI issuers, additional leverage in negotiating terms of engagement with the latter.

Similarly, under the peer to peer lending platform regulations, such platforms are required to maintain two escrow accounts, one for funds received, and other for collections from borrowers. Both such escrow accounts are required to mandatorily be promoted by banks. This restriction is expected to constrain innovation in fund transfer and restrict the income generating avenues of such platforms.

4. Preference to banks – Under the PPI regulations, while banks and non-banks can issue closed and semi-closed payment instruments, only banks are allowed to issue open system payment instruments. Further, in case of co-branding arrangements between bank and non-bank entity, the bank is required to mandatorily be the PPI issuer. The role of the non-bank entity is required to be limited to marketing/distribution of the PPIs or providing access to the PPI holder to the services that are offered. Further, cross-border outward transactions can be conducted only through KYC compliant reloadable semi-closed and open system PPIs issued by banks having authorised dealer – I licence.

Similarly, under the peer to peer lending platform regulations, all fund transfers are required to be through and from bank accounts and cash transaction is strictly prohibited. This restriction excludes the possibility of non-bank PPIs from

attaching with such platforms and thus provides an unfair advantage to banks.

5. Grievance redress – The RBI has issued detailed circular in related to limitation of customer liability in case of unauthorised/fraudulent transactions.²⁴ The banking ombudsman facility is available to the aggrieved consumers. However, such circular, including the banking ombudsman facility, is only applicable to banks and consequently to PPIs issued by banks. Non-bank PPI issuers and peer to peer lending platforms are expected to be outside its scope. There is no non-bank ombudsman. This puts consumers of non-banks at considerable disadvantage.

It can be deduced from the above that competition is being distorted at two levels in the digital payments market: by treating similarly placed entities dissimilarly, and by treating dissimilarly placed entities similarly. This imposes significant avoidable costs on service providers and consequently consumers.

Conclusion

It appears that the government intends to use taxpayers' money to promote digital payments through banks and bank-owned NPCI, to the exclusion of non-banks. Such strategy may not be advisable and sustainable in long term. Already, non-banks are leading in terms of product innovation, customer on-boarding and retention. They can be useful in reaching bottom of the pyramid and serving the hitherto excluded.

Regulators across jurisdictions are realising the importance of optimal regulation and regulation and opening up digital payments platforms to non-banks. These include UK, Australia, Brazil, Hong Kong, US, and European Union.²⁵ Indian regulators would do well to sincerely consider this international trend. This is not to suggest that risks emanating from non-banks should be disregarded. There is a need to adopt a risk based regulatory approach and shift from entity based regulatory approach. Advanced tools of regulation making, such as Regulatory Impact Assessment,²⁶ Regulatory Sandbox²⁷ and Smart Regulation²⁸ can help in this regard.

Endnotes

- 1 Incentive of 0.5 percent of the transaction value per transaction provided to merchant, for Aadhaar based biometric merchant transactions up to ₹2000. Pursuant to government notification dated 14 August 2017, the scheme was extended till March 31, 2018. The notification is available at <http://meity.gov.in/writereaddata/files/BHIM%20Aadhaar%20Merchant%20incentive%20schemes.pdf>
- 2 Merchants get cashback on minimum 50 transactions (at least 20 transactions from unique customers) with minimum transaction value of ₹25. Merchants can earn up to ₹1000 per month through this scheme. Pursuant to Government notification dated 14 August 2017, the scheme was extended till March 31, 2018. The notification is available at <http://meity.gov.in/writereaddata/files/BHIM%20cashback%20scheme%20for%20merchants.pdf>
- 3 Individuals get Referral Bonus on completion of minimum 3 unique successful transactions with aggregate value of ₹50 to any 3 unique users. Both the referrer and referee get ₹25 each as Referral Bonus. The bonus will be paid to any new individual doing first 3 unique transactions without any referrer also. Pursuant to Government notification dated August 14, 2017, the scheme was extended till March 31, 2018. The notification is available at <http://meity.gov.in/writereaddata/files/BHIM%20referral%20bonus%20scheme%20for%20individuals.pdf>
- 4 <http://financialservices.gov.in/sites/default/files/Subsidizing%20MDR%20by%20Govt.pdf>

5 IFMR Lead, *The evolving financial ecosystem for micro-merchants in India*, September 2017, available at <http://ifmrlead.org/the-evolving-financial-ecosystem-for-micro-merchants-in-india/>

6 Anisha Singh, What's in It for Me? Increasing the Value Proposition of Fintech for Merchants in India, November 2017, at <https://cfi-blog.org/2017/11/27/whats-in-it-for-me-increasing-the-value-proposition-of-fintech-for-merchants-in-india/>

7 <http://meity.gov.in/writereaddata/files/letter-2.pdf>

8 <http://meity.gov.in/writereaddata/files/letter-1.pdf>

9 The RBI circular is available at <https://rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=11183>

10 The Durbin amendment requires Federal Reserve to limit fees charged to retailers for debit card processing. It was passed as part of the Dodd-Frank financial reform legislation in 2010.

11 Manuszak, Mark D. and Krzysztof Wozniak (2017). "The Impact of Price Controls in Twosided Markets: Evidence from US Debit Card Interchange Fee Regulation," Finance and Economics Discussion Series 2017-074. Washington: Board of Governors of the Federal Reserve System, <https://doi.org/10.17016/FEDS.2017.074>

12 Wang, Zhu and Schwartz, Scarlett and Mitchell, Neil, The Impact of the Durbin Amendment on Merchants: A Survey Study (2014). Economic Quarterly, Issue 3Q, pp. 183-208, 2014. Available at SSRN: <https://ssrn.com/abstract=2655978>

13 Richard A. Epstein, "The Regulation of Interchange Fees: Australian Fine-Tuning Gone Awry," 2005 Columbia Business Law Review 551 (2005), available at https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=2391&context=journal_articles

14 Getter, *Regulation of Debit Interchange Fees*, Congressional Research Service, May 2017, available at <https://fas.org/sgp/crs/misc/R41913.pdf>

15 Verma, *BHIM accounted for only 6% of UPI transactions in December 2017*, Medianama, at <https://www.medianama.com/2018/01/223-bhim-accounted-6-upi-transactions-december-2017/>

16 Part IX of the Finance Bill 2017, see <http://www.indiabudget.gov.in/ub2017-18/fb/bill.pdf>

17 Para IX.10 of Annual Report 2016-17 of the RBI available at <https://www.rbi.org.in/scripts/AnnualReportPublications.aspx?Id=1209>

18 The Master Directions on Issuance and Operation of Prepaid Payment Instruments issued in October 2017 (updated on 29 December 2017), at https://rbi.org.in/scripts/BS_ViewMasDirections.aspx?id=11142

19 The NBFC – Peer to Peer Lending Platform (Reserve Bank), Directions 2017, at www.rbi.org.in/scripts/NotificationUser.aspx?Id=11137&Mode=0

20 Hwang et al, A Practitioner and a Regulator Talk Digital Credit, June 2017, CGAP, www.cgap.org/blog/practitioner-and-regulator-talk-digital-credit

21 GSMA, *Driving a price revolution: mobile money in international remittances*, October 2016, www.gsmaintelligence.com/research/?file=8F31B31705C20A63A41DB9711BF84C25&download

22 Raithatha, July 2017, at www.gsma.com/mobilefordevelopment/programme/mobile-money/future-mobile-money-sub-saharan-africa-foundation-greater-financial-inclusion

23 RBI Know Your Customer Master Direction, 2016, available at https://rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10292

24 RBI's circular DBR.No.Leg.BC.78/09.07.005/2017-18 dated July 06, 2017 on Customer Protection – Limiting Liability of Customers in Unauthorised Electronic Banking Transactions.

25 See Table 7

26 *Ex-ante* impact estimation of costs and benefits of regulatory proposals. For details, see <http://cuts-ccier.org/ria/>

27 Regulatory sandboxes are tailored regulatory environments or "safe zones" for conducting small scale, live tests of new fintech products and delivery models. For details, Duff et al, *Modernizing Digital Financial Regulation: The Evolving Role of Reglabs in Regulatory Stack*, The Aspen Institute Financial Security Program, 2017

28 Zetzsche et al, *Regulating a Revolution: From Regulatory Sandboxes to Smart Regulation*, EBI Working Paper Series - 11, 2017