Inputs on draft Master Directions on issuance and operation of Pre-paid Payment Instruments (PPIs) in India

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1 Executive summary

In this note, we identify six areas of concern with respect to the Draft Master Direction (DMD) that will pose challenges to the goal of achieving higher financial inclusion through the *Prepaid Payments Instruments* (PPI) channel.

First, the DMD discriminates between bank and non-bank PPI issuers as well as between new and existing entrants in the PPI business, on various counts. For example, only banks can issue open system PPIs. As another example, only banks have the benefit of full-fledged cross-border remittance operations. Such features differentiating entities, who are all providing the same service, violate the principles of competitive neutrality, and are inconsistent with the goal to foster innovations and growth in the payments ecosystem.

Recommendation: The regulatory framework for PPIs must be competitively neutral for banks and non-banks. Reserve Bank of India (RBI) must frame guidelines for access to the Real-Time Gross Settlement (RTGS) and National Electronic Funds Transfer (NEFT) system with a common eligibility criteria that is agnostic to the type of entity that applies to be a PPI issuer.

Second, the DMD imposes higher entry barriers for new entrants through higher capital requirements, which do not take into account the risk involved in the PPI business. Also, the requirement to keep the entire outstanding liabilities of PPIs in an escrow account is excessive, given that PPIs are not engaged in the lending business, and is inconsistent with global regulatory practices for PPIs issuers. A detailed analysis, including a global comparison, is presented in Sections 4 and 5.

Recommendation: The DMD must propose a common capital requirement for PPI issuers that reflect the risk of their operational and, consequently, business failure of a PPI. The DMD must allow PPI issuers to invest the outstanding liabilities in safe and liquid securities.

Third, the DMD is lacking on protecting consumer interests. Restricted interoperability across payment platforms and ambiguity in the mandatory limits imposed on cash transactions despite compliance with KYC norms hurts the ability of the customer in carrying out financial transactions efficiently. The DMD lacks clarity on what constitutes "permitted payment instruments" and the right of a consumer to redeem her money before the expiry of the PPI. Section 6 presents a detailed list of problems in this area.

Recommendations: The DMD must revisit and revise restrictive measures

on the use of PPI by holders, and restrictions on the interoperability of payment platforms.

Fourth, there is ambiguity in the operational burdens that DMD suggests for PPI issuers. For instance, mandating blanket Know Your Customer (KYC) requirements for all consumers is inconsistent with the risk-based approach towards KYC that is adopted the world over. A mandatory KYC requirement ,that is agnostic to risk, adversely affects payment system providers with higher costs of acquiring information, and increases the inconvenience of use by holders. Since consumers attach a premium to safe and secure payment systems, the private sector is incentivised to implement consumer friendly systems. A regulatory prescription on the precise form of technology and anti-fraud mechanisms is counterproductive as it inhibits innovation. These arguments are presented in detail in Section 7.

Recommendations: The DMD must substitute the existing KYC process with a risk-based KYC approach which is technology-neutral. The PPIs must have the flexibility to offer additional factor authentication to consumers, and allow the issuers to bear the risk of loss to consumers that may arise from a single factor authenticated transaction.

Fifth, the licensing process in the DMD is replete with ambiguities. These are listed in Section 8.

Recommendations: The licensing process in the DMD must be made more transparent to allow for greater ease of doing business, and be in line with the standards currently applied by other financial regulators in India.

Finally, a master direction setting out a new licensing framework for PPI issuers is not legally tenable under the *PSS Act*. The *PSS Act* already contains a licensing process applicable to all payment service providers, which is significantly different from the process proposed in the DMD. For instance, the *PSS Act* does not contemplate an in-principle approval stage, and defines 'fit and proper' criteria in more precise terms than the definition proposed in the DMD. The framework in *PSS Act*, therefore, cannot be over-ridden except by an amendment to the *PSS Act*. At the least, the DMD must be enacted a regulation. Enacting the a separate framework governing PPIs through regulations would also be in line with global best practices and increases the certainty of rules, as regulations go through Parliamentary oversight mechanisms and are not amenable to frequent amendments through circulars or press releases.[1]

Recommendations: The PSS Act *must be amended to exclude PPIs from the licensing process under the* PSS Act. *If RBI takes a view that the* PSS Act *allows the RBI to make delegated legislation for carrying out the*

[1] FSRLC. *Report of the Financial Sector Legislative Reforms Commission.* 2013.

purposes of the PSS Act, *then such delegated legislation must be issued in the form of regulations. A separate licensing process in the form of Master Directions is not tenable under the current language of* PSS Act.

2 The draft Master Direction on PPIs from RBI

On March 20, 2017, the RBI published on its website a DMD on the issuance and operation of PPIs in India. This note contains our comments and inputs on the DMD. There are several issues that arise in the reading of the DMD that will pose problems in facilitating the ability of the PPI to improve financial inclusion in India. These can be categorised into the following sets of issues:

1. Lack of competitive neutrality.
2. Inconsistencies in capital requirements of various types of PPI providers.
3. Restrictions on use of capital.
4. Excessive operational requirements.

Concerns on each of these issues are detailed in the Sections that follow. The note ends with a summary of the recommendations in Section 9 on how the DMD can be modified to counter and adjust to some of these concerns.

3 Lack of Competitive neutrality

One of the issues consistently highlighted by expert committees constituted for making recommendations in relation to payment systems in India, is that the payments ecosystem continues to be dominated by banks.[2] While this is not unique to India, other jurisdictions are increasingly moving towards a more competitively neutral payments system, which is inclusive of all kinds of entities having the capacity and the expertise to innovate.[3] For instance, the *Directive on Electronic Money*, which governs the issuance of PPIs in the European Union (EU), underscores the necessity of competitive neutrality among payment system providers, by stating the following in its Preamble:

> With the objective of removing barriers to market entry and facilitating the taking up and pursuit of the business of electronic money issuance, the rules to which electronic money institutions are subject need to be reviewed so as to ensure a level playing field for all payment services providers.

[2]Committee on Digital Payments. *Medium term recommendations to strengthen digital payments ecosystem.* 2016; FSRLC, see n. 1; Working Group on Electronic Money. *Report of the Working Group on Electronic Money.* 2002.

[3]See, for instance Mike Carney. *Enabling the Fintech Transformation.* 2016. URL: http://www.bankofengland.co.uk/publications/Documents/speeches/2016/speech914.pdf.

The DMD creates an unequal playing field by discriminating between issuers of PPIs which are banks and non-banks and new and existing entrants. Some instances of such discrimination are described below:

Product based differentiation between entities: While the DMD allows non-banks to issue closed system and semi-closed system PPIs, it specifically excludes non-banks from issuing open system PPIs.[4] No economic rationale has been provided for not allowing non-bank PPIs to issue open system PPIs.[5] This is inconsistent with the practices of jurisdictions that are consciously encouraging innovation in the payment systems. For instance, in jurisdictions such as the UK, USA and South Korea where PPIs are very popular and widely used, there is no such product based discrimination between entities. Any entity which fulfills the basic eligibility criteria and is authorised to issue PPIs, may issue any kind of PPI.

Differentiated capital requirements : The DMD has increased the minimum capital requirements from Rs.1 crore to Rs.25 crores. While this is immediately applicable to new entrants, the DMD provides a 3 year long window to existing market participants for complying with the new minimum capital requirements.

Deployment of funds : All credits made to a PPI, whether issued by a bank or a non-bank are deposits callable at par. Hence, the same principles of prudential regulation that apply to credits made to a PPI issued by a bank apply to a PPI issued by a non-bank issuer. In fact, non-bank PPI issuers do not undertake lending activities, unlike PPI issuers that are banks. Hence, the asset-liability mismatches that bank balance sheets are vulnerable to, does not apply to a non-bank PPI. However, the DMD applies a higher cash reserve ratio requirement on PPI issuers that are non-banks. While the amount outstanding in the PPIs issued by banks is counted as part of its net demand and time liability for the purpose of maintenance of its Cash Reserve Ratio (CRR), PPI issuers that are not banks are required to keep the *entire amount* received from consumers, locked in an escrow account with a bank.

Given that all issuers of PPIs, whether banks or non-banks, undertake the same kind of liabilities, the reason for imposing a 100% CRR requirement for non-bank PPIs, which do not undertake lending activity, is unclear and another instance of the violation of the principles of competitive neutrality.[6]

[4] See Direction 2.6.of the DMD.

[5] While the DMD allows holders of open system PPIs to withdraw cash from such PPIs, that cannot be a basis for restricting non-bank PPIs from this segment of the business.

[6] Also see section 5.

Cross-border payments : Non-bank PPI issuers are allowed to accept inward remittances under RBI's money transfer service scheme. For all other kinds of cross-border payments, only PPIs issued by banks having an authorised dealership license are allowed to be used. This again creates an unequal playing field between bank and non-bank issuers of PPIs. [7]

The *Medium term recommendations to strengthen digital payments ecosystem* had recommended that the restriction of only AD category banks being able to make cross-border payments can be resolved by creating a new limited Authorised Dealer licenses for non-bank players only for the purpose of inward remittance. This would ensure that non-bank PPIs do not have to depend upon banks for their remittance operations, and would ensure a level playing field and regulatory parity for bank and non-bank PPI issuers.[8]

Access to RTGS : The DMD does not permit non-bank PPI issuers to access the RTGS. For payment system participants to function seamlessly and innovate secure and cheaper products for consumers, they must be given access to essential payment infrastructure such as the RTGS. This has also been recommended by the *Medium term recommendations to strengthen digital payments ecosystem.*[9][10] The RBI must, therefore, instead of a prohibiting access to for all non-bank PPI issuers to its settlement systems, make eligibility criteria for access which are neutral to the nature of the entity seeking such access.

Discrimination on operational freedoms : The DMD differentiates between bank and non-bank PPI issuers in matters of operational freedom as well. For instance, the DMD mandates an additional factor authentication (AFA) process for all PPI issuers. This is inconsistent with the standards prescribed for banks. For instance, banks have been exempted from the AFA process for card-not-present transactions below Rs.2000 and transactions executed through NFC cards. Similarly, while banks are allowed to have a common log-in interface for both banking as well as non-banking services (including services provided by third party vendors), the DMD mandates a separate log-in interface for accessing the PPI account and other services provided by PPI issuers. Apart from being over-prescriptive, such requirements add to the discriminatory treatment between banks and non-banks.

[7] Also see section 7.2.1 for further critique of this restrictive approach.

[8] See section 6.1.4 of the Digital Payments, see n. 2.

[9] See *Infrastructure neutrality* on page 67 of the ibid.

[10] Also see Carney, see n. 3, noting that, We are already clear that we stand ready to act as settlement agent both for regulated systemically important schemes supervised by the Bank, and, on a case-by-case basis, for other new systems. The Bank will use this to enable innovation and competition, without compromising stability.

4 Inconsistencies in capital requirements

The *Master Circular on Policy Guidelines on Issuance and Operation of Pre paid Payment Instruments in India, 2016*, which is currently applicable to issuers of PPIs imposes the following capital requirements on PPI issuers:

- Minimum paid up capital of Rs.5 crores
- Minimum positive net worth of Rs.1 crore.

The DMD has dispensed with the specific paid-up capital requirement and replaced it with an ongoing minimum positive net worth requirement. Further, the minimum positive net worth requirement has been increased, five-fold, to Rs.25 crores. The DMD does not give any rationale for this five-fold increase. The increase in capital requirements is unjustified for the following reasons:

Disproportionate to the risk that a PPI business entails: The capital requirements for a regulated entity must cover the risks arising to consumers from (a) the failure of operations of the entity, and (b) where the entity is systemically important, the risks arising to the financial system from the failure of the entity.[11] Capital adequacy requirements are, thus, inherently linked to the riskiness of the business that an entity engages in. A capital requirement that accounts for factors other than risk, has the potential to create unwarranted entry barriers and stifle innovation.[12]

PPIs are in the business of accepting money that is callable at par. They neither engage in lending activity nor do they pay interest to their consumers. They are not systemically important entities. Under the DMD, they can only hold the funds in an escrow account and cannot even invest them in liquid securities. Hence, the three risks that arises from the operations from a PPI are (a) settlement failure; (b) operational failure; and (c) fraud. The risks of the first failure

[11] See Board of Governors of the Federal Reserve System. *Capital Guidelines and Adequacy*. URL: https://www.federalreserve.gov/supervisionreg/topics/capital.htm, noting that, the types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

[12] See Uchida Yuichiro and Cook Paul. *Innovation and Market Structure in the Manufacturing Sector: An Application of Linear Feedback Models*. 2007. URL: http://onlinelibrary.wiley.com/doi/10.1111/j.1468-0084.2007.00450.x/full, quoting Dasgupta and Stiglitz, to state that competition from new entrants in the market, that experiment with new technologies, becomes the driving force for innovation, and in turn, market incumbents are forced to innovate for their survival. Entry barriers such as high minimum capital requirements hinder such growth by competition in the market.

can be insured against by giving PPIs access to the RTGS. Even if PPIs are not given access to the RTGS, the RBI must assess the costs associated with settlement and operational failure. The third failure can be protected against by mandating fraud insurance for PPIs. In the absence of a cost and failure probability analysis of this industry, increasing the capital requirements five-fold is arbitrary.

Inconsistent with global best practices: A five-fold increase in minimum net worth requirements for PPIs is inconsistent with global practices. Several jurisdictions have adopted an approach of requiring a minimum initial capital and then an ongoing risk-based capital that is proportionate to the outstanding amounts deposited by consumers with the PPI issuer.[13] The approaches to capital adequacy requirements adopted by two jurisdictions are described below.

4.1 Global comparison 1: the UK

The UK has imposed a one-time minimum capital requirement of EUR 350,000 on PPIs, in line with with the *Directive on Electronic Money*. There is also an ongoing capital requirement on PPI issuers (referred to as Electronic Money Institutions (EMIs) in the UK). However, the ongoing capital requirement is *not* in addition to the minimum capital requirement. There are significant differences between the capital requirements prescribed by the UK and those proposed by the DMD:

1. *Differentiated PPIs*: In the UK, the *Electronic Money Regulations* creates differentiated categories of PPI issuers, depending on the size of their respective businesses. It, thereafter, mandates, proportionate prudential requirements for different categories of PPI issuers. For instance, it creates a category of small EMIs, whose six monthly average outstanding liabilities do not exceed a certain threshold. There is no initial capital requirement for small EMIs whose business activities generate average outstanding liabilities of not more than EUR 500,000. Small EMIs whose business activities generate average outstanding liabilities exceeding EUR 500,000, have a reduced initial capital requirement of 2% of their average outstanding liabilities.

   The intent underlying differentiated EMIs in the UK is to not subject small EMIs to entry barriers that virtually block access.

[13] See, for instance *Directive on Electronic Money*. 2009, noting that there is a need for a regime for initial capital combined with one for ongoing capital to ensure an appropriate level of consumer protection and the sound and prudent operation of electronic money institutions.

Table 1 Capital adequacy requirements for PPFs in Australia

Risk level	Capital adequacy requirement
Where the PPF has deposited the funds received from consumers in an account with a regulated deposit-taking institution, over which the PPF has no operational control.	No minimum capital adequacy requirements.
In all other cases	Minimum start-up capital to be determined by the APRA on a case-by-case basis (for which guidelines have been provided)[15] or 5% of total outstanding liabilities arising from consumers' deposits.

The DMD does not provide for such flexibility. At the same time, it mandates continuing minimum net worth requirements.

2. *Capital resources eligible for calculation of ongoing capital requirements*: In the UK, PPIs can take into account a wider set of resources, such as fixed term cumulative preference shares and borrowers' commitments having a tenure of at least five years, for computation of their ongoing capital requirement.

   The DMD, on the other hand, allows only the equity capital of the PPI and reserves to be accounted for, in the computation of the mandated minimum net worth.

4.2 Global comparison 2: Australia

In Australia, the Australian Prudential Regulatory Authority (APRA) has adopted a risk driven approach towards capital adequacy requirements for PPI issuers (referred to as Purchased Payment Facilities (PPFs) in Australia).[14] The regulatory framework governing capital requirements for PPFs in Australia is summarised in Table 1.

Thus, unlike the DMD, global regulatory frameworks of mature economies have less stringent capital adequacy requirements for PPIs, which take into account the risk associated with the non-lending oriented business model of PPIs.

[14] *Prudential Requirements for Providers of Purchased Payment Facilities*. 2015.

Table 2 Safeguarding requirements for EMIs in UK

Safeguarding Option 1	(a) Place them in a separate account held with an authorised credit institution; or (b) Invest the relevant funds in secure, liquid, low-risk assets and place those assets in a separate account with an authorised custodian.
Safeguarding Option 2	Place the funds in other assets, and obtain an insurance or a guarantee policy covering the funds and ensure that the benefits of the policy accrue only to the consumers of the EMI.

5 Restrictions on use of capital

The DMD mandates that:

1. For PPIs issued by banks, the amount received from consumers will be part of the net demand and time liabilities and taken into account for the purpose of maintaining CRR.
2. For PPIs issued by non-banks, the amount received from consumers must be kept in an escrow account maintained with a scheduled commercial bank.

As mentioned above, apart from creating disparity between banks and non-banks, this requirement is excessive, given that PPI issuers are not engaged in lending activity.[16] The risk associated with settlement of transactions with merchants can be covered with allowing PPI issuers to invest the money in liquid and safe securities, such as the securities eligible for meeting the Statutory Liquidity Ratio (SLR) requirements. RBI may specify the list of eligible securities. This would also be in line with global regulatory frameworks governing prepaid instruments. The regulatory framework in UK for safeguarding consumers' funds lying with PPIs is summarised in Table 2.

In Australia, the APRA merely mandates that the consumers' funds lying with PPFs are kept invested in high quality liquid assets, which are free from encumbrances, except where approved for a prudential purpose by the APRA. Eligible assets include cash, securities eligible for repo with the central bank, bank bills and CDs issued by authorised depository institutions provided the issuer is rated at least investment grade, deposits which can be converted into cash within 2 business days, and other assets approved by APRA.

[16]See section 3.

6 Protection of consumer rights

While the DMD is over-prescriptive with respect to some elements of consumer protection, it is weak on some fundamental aspects of protecting consumer rights. Some instances where the DMD is damaging from the consumers' perspective are as follows:

Transaction and other limits on consumers : The DMD allows PPI issuers to impose transaction limits on consumers and limit the number of beneficiaries that can be added by consumers to their PPIs. The intention for imposing transaction limits and restricting consumers from transacting with their own money is unclear. Every payment system in an economy is susceptible to fraud. However, we do not impose limits on the use of payment systems to preempt frauds. For example, the susceptibility of credit card transactions to frauds does not lead us to impose limits on individual credit card transactions. On the contrary, imposing transaction limits on consumers is contrary to their interests. Similarly, per-day limits on the number of beneficiaries is not correlated with fraud, and only makes it cumbersome for consumers to use their PPIs. Similarly, a mandatory cooling-off period after the PPI account is opened by a consumer, imposed by the DMD, is unnecessary and hinders the efficiency of using PPIs for consumers. Especially so, when the DMD also simultaneously mandates PPI issuers to put in place an AFA system for every user for every transaction through a PPI.

Forfeiture and redemption of PPIs : The DMD states that the RBI will notify a framework for the forfeiture of PPIs in due course. It is not clear whether PPI issuers may forfeit consumers' deposits in PPIs, in circumstances other than the expiry of the PPI maturity.

The DMD states that the holders of prepaid instruments shall be permitted to *redeem* the outstanding balance within the expiry date, if for any reason the scheme is being wound-up or is directed to be discontinued by the RBI. This creates confusion on whether a consumer can *redeem* the entire outstanding amount before the expiry period at will. Consumers should not be statutorily locked in with a PPI for the entire validity period of a PPI. This may be left to the contractual freedom of PPI issuers and consumers. Ideally, consumers must have the freedom to transfer the amounts deposited by them even before the expiry of the PPI, at will, unless they have knowingly contracted otherwise. The DMD provision on redemption imposes a statutory lock in on consumers' moneys in their PPI accounts.

Restricted interoperability : Guideline 18 of the DMD states that au-

thorised entities will be permitted to participate in other interoperable payment systems, *as and when specific directions are issued in this regard.* Interoperability across payment platforms has been recognised as being most essential for consumer welfare.[17] It is unclear why despite there being a clear case for mandating interoperability among payment platforms (namely, inter-PPIs and between banks and PPIs) the DMD does not do so. It merely states that PPIs satisfying certain criteria may be *permitted* to participate in interoperable systems.

Further, the DMD imposes several restrictions on the interoperability of consumer funds across different payment platforms. The reason for imposing limits of Rs.10,000 per month for fund transfers between PPIs to banks and between PPIs of the same issuer, is detrimental to consumers.[18] Similarly, specifically allowing the PPI issuers to impose limits on funds which can be transferred from the PPI to the source account or the account of the PPI holder, amounts to locking in the consumer and serves no regulatory purpose.[19]

Such provisions are peculiar to the DMD and are not found in any other jurisdiction.

Privacy and confidentiality of consumer data : Guideline 15.1 mandates PPI issuers to put in place adequate information and data security infrastructure *for prevention and detection of frauds.* There is nothing in the DMD which mandates PPI issuers to maintain the confidentiality of consumer data.

In the absence of a strong privacy law, it is imperative for the DMD to ensure that PPIs do not share consumer data with third parties or for cross-selling, without the consent of the consumers. Consumers must also be informed about the uses that a PPI issuer will put their data to, even if they do not share it with third parties. This is one of the most basic rights of consumers.

7 Excessive operational requirements

7.1 Mandatory blanket KYC requirements

Guideline 9.2(i) and 9.3 of the DMD require:

- Semi-closed PPIs with a stored value upto Rs.20,000 to require minimum details of the customer at the time of on boarding; and a full

[17] Digital Payments, see n. 2.
[18] See Guideline 9.2(i)(g) of the DMD.
[19] See Guideline 9.2(i)(h) of the DMD.

KYC process to be conducted within 60 days from the date of its issue, failing which no credit will be allowed in such a PPI.

- existing minimum detail semi-closed PPIs issued by banks and non-banks to be converted into full-KYC semi-closed PPIs by *June 30, 2017*.

There are three problems with a mandatory full-fledged customer due diligence process for all PPI consumers:

Repetitious : The purpose of a customer due diligence (CDD) is to prevent money laundering by ensuring that the money can be traced to an identifiable account-holder.

Several consumers load their PPI account with their bank account (such as internet banking or debit cards) or credit cards. Similarly, several consumers will specify a bank account to which they wish their PPI balance to be transferred. Such consumers have already undergone a full KYC process with the bank. The bank account details provided by consumers of PPI accounts will provide the necessary trail to an identifiable account holder, if the transactions in the account are found to be suspicious. Requiring such consumers to undergo the entire KYC process again is, therefore, repetitious, unwarranted and causes inconvenience to consumers.

Assuming that consumers are allowed to load their PPI account with cash, then a KYC process may be mandated only for such consumers. This is also in line with a risk-based approach that several countries have adopted towards KYC processes (see below).[20]

It is precisely to avoid subjecting consumers to repetitious KYC procedures that the RBI had allowed *payment banks* to obtain the KYC details of consumers who have already undergone a KYC process with a telecom company, from the telecom company.[21] The same principle should be applied to consumers who load their PPI account with a remittance through the banking channels where KYC would have been performed.

Agnostic to risk : A blanket KYC requirement for all consumers of PPI departs from the risk-based approach towards KYC that has been recommended by the Financial Action Task Force (FATF). A risk-based approach to KYC enables financial intermediaries to allocate resources most efficiently and concentrate on consumers who pose the highest

[20] The DMD does not clarify whether PPI issuers may accept credit to PPI accounts through cash. While Guidelines 8.11 and 8.12 refer to "permitted payment instruments" for loading PPI accounts, the list of permitted payment instruments has not been specified.

[21] See *Operating Guidelines for Payment Banks*. Oct. 6, 2016.

risk. It resultantly makes the Indian payment ecosystem noncompetitive with competing jurisdictions, such as Hong Kong, EU and Australia that adopt a risk-based approach towards KYC.

Hong Kong requires a customer due diligence process based on the riskiness of the Stored Value Facility (SVF) product[22]. The degree of risk for an SVF product depends on factors such as the transaction amount of the SVF, method of funding-cash or electronic, cross-border usage, person-to-person fund transfer function. It suggests tiered customer identification requirements based on the risk factors. For instance, in the case of a device-based SVF with a stored value not exceeding HK$3,000, there is no requirement to conduct any due diligence. Similarly, for a prepaid gift card that cannot be reloaded, like instruments with an amount not exceeding HK$8,000, customer due diligence is not required.

The EU allows institutions and persons to not apply certain customer due diligence measures with respect to certain categories of low risk services. For instance, a payment instrument that is (a) cannot be reloaded or has a maximum monthly transaction limit of EUR 250 and (b) has a maximum stored value of not more than EUR 250 and (c) is used exclusively for the purchase of goods and services; and (d) cannot be funded with anonymous electronic money, is exempted from customer due diligence if the issuer carries out sufficient monitoring.[23] At the same time, it requires the institutions and persons to apply on a risk-sensitive basis enhanced customer due diligence measures, in situations where there is higher risk of money laundering or terrorist financing[24].

In Australia, the reporting entity is required to collect the consumer's full name, date of birth and residential address at the minimum. Over and above that, the entity is required to include appropriate risk-based systems and controls to determine whether, in addition to the minimum KYC information, any other information is required to be collected about a consumer.[25]

Applying extensive full KYC process for all consumers, without taking into account the risks associated with different kinds of consumers,

[22] See "Guidelines on Anti-Money Laundering and Counter-Terrorist Financing" for SVF licensees.

[23] Article 12 of *Directive (EU) 2015/849 of the European Parliament and of the Council of 20 May 2015 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, amending Regulation (EU) No 648/2012, and repealing Directive 2005/60/EC and Commission Directive 2006/70/EC*. 2015.

[24] Article 13 and 14 of ibid.

[25] Provision 4.2.3 and 4.2.5 of Anti-Money Laundering and Counter-Terrorism Financing Rules Instrument 2007 (No.1)

especially the small value holders, is excessive and will render the payments ecosystem in India noncompetitive.

Counter-productive to financial inclusion objectives : One of the important achievements of PPIs is to include participants in the informal economy into the formal financial system. Mandating KYC processes, irrespective of risks, at the time of onboarding will defeat this objective. For instance, a minimum level KYC process at the time of onboarding requires the submission of an officially valid document issued by an authority of the government. This, by itself, will end up excluding a segment of the population who do not have such documents or are unable to immediately access them at the time of opening a PPI account.

A non-risk based blanket KYC process will deprive the system of behavioural changes that PPI issuers are able to push for by reasons of its sheer convenience.

Unreasonable : *Master Circular on Policy Guidelines on Issuance and Operation of Pre paid Payment Instruments in India, 2016* does not require mandatory conversion of semi-closed minimum KYC PPIs into full KYC PPIs. The time-line of less than a month (assuming a buffer for the enactment of the DMD) granted for migration for existing PPIs is unreasonable given the huge number of users enrolled with semi-closed PPIs.

The DMD provides no rationale for the extension of full KYC requirements to low value semi-closed PPIs. Specifically, a full KYC requirement is undesirable for PPIs of an amount upto Rs.20,000, since it carries low risk. The stored value amount in this category, is small. Additionally, fund transfer limits are not allowed to exceed Rs.10,000 per month. Moreover, given these are semi-closed PPIs, cash withdrawal is not permitted, which further reduces risk.

Majority of the semi-closed PPI accounts contain value under Rs.20,000. Hence, this guideline will have a big impact both on the payment system providers (in terms of cost of acquiring information) and users (in terms of inconvenience). Full KYC requirement for low value PPIs will also discourage users from opening accounts with PPIs, as this would prove to be burdensome. This in turn, is a hindrance in achieving RBI's vision of making India a "less-cash" society.

7.2 Over-prescriptive technological specifications

The DMD makes several other operational specifications, which are over prescriptive and not technology neutral. Over prescriptive regulatory requirements run the risk of being excessive and easily circumvented, especially in technology-oriented industries. For this reason, financial regulators in advanced economies have adopted a principal based approach towards regulating the payment space. A bare perusal of the *Practice Note on Supervision of Stored Value Facility Licensees* in Hong Kong will show that the Hong Kong Monetary Authority (HKMA) has adopted the approach of laying down the principle and then supplementing it with examples of how the principle may be achieved. For instance, the requirement to protect sensitive data has been made principle-based, as under:

> A licensee providing payment card services should implement adequate safeguards to protect sensitive payment card data. A typical example is the deployment of chip cards to store those data and the implementation of strong card authentication methods for point-of-sale and ATM card transactions.[26]

The DMD, on the other hand, prescribes the specific technology which PPI issuers must use in several operational matters. Two examples are given below:

Prohibition on installing PPI application on rooted devices : The DMD mandates that the PPI mobile app should not be allowed to be installed on rooted devices i.e. system level access should not be allowed. This prohibition is difficult to monitor as PPI issuers cannot monitor if the phones on which the app is proposed to be downloaded are rooted or not. Moreover, if consumers root the phone after having installed the app, PPI issuers have no control on such activities of the phone user.

The objective of securing the payment system in a PPI can be achieved by a principal-level regulatory mandate. For instance, the HKMA requires PPI issuers to safeguard payments through user device, without recommending the specific mechanism to achieve this mandate. It recommends the issuer to implement appropriate security measures to guard against different situations including unauthorized device access, malware or virus attack, the compromised or insecure status of mobile devices and unauthorized mobile applications.[27]

Additional factor authentication : The DMD requires PPI issuers to

[26] Section 7.3.3(a) of the HKMA. *Practice Note on Supervision of Stored Value Facility Licensees*. 2016.

[27] See section 7.3.3 of ibid.

introduce a system of AFA for authenticating transactions in PPIs, including where PPIs are issued in the form of cards.

Wallets are primarily preferred by consumers for convenience and for undertaking high-frequency and low-value transactions (primarily, goods and services). The average transaction value in an Indian PPI is Rs.200.[28] By their very nature, the liability of a PPI is limited to the balance of users.

The introduction of an AFA requirement for every transaction, irrespective of its size, will severely degrade the user experience. This is because compared to cash, an AFA process will involve several hops/ steps before the consumer can complete the transaction. It also increases the failure rates for merchants resulting in loss of sales. It is submitted that a risk-agnostic AFA process will defeat the purpose of shifting users to go digital instead of cash.

Instead, the RBI can consider a zero customer loss approach where the PPI issuer takes on the liability where it chooses not to apply AFA. This allows the issuer to take a risk based approach and balance security and convenience, fully cognizant of the penalty for any failure in AFA.

7.2.1 Restrictive approach towards cross-border payments

As mentioned above, non-bank PPI issuers are allowed to accept only inward remittances under the RBI's Money Transfer Service Scheme (MTSS) notified under *Foreign Exchange Management Act*. The money transfer service scheme allows very specific personal inward remittances, such as maintenance from family members. It does not allow remittances to be made for the purchase of goods and services. It also does not allow outward remittances, such as when consumers wish to send money abroad for their children or for educational purposes. This severely restricts non-bank PPI issuers and is extremely discriminatory to their PPI business vis-a-vis bank PPI issuers.

Further, approvals granted under the MTSS are valid for only one year and there is a separate authorisation process under the MTSS. It is unclear if the same restrictions apply to PPI issuers who make remittances under the MTSS, or if the DMD confers is a one-time approval that runs concurrently with the PPI license.

[28] This is based on conversation with market participants.

8 Problems with the licensing process

The DMD provides for an authorisation process for non-bank entities. Presently, entities issuing PPIs have been directed to comply with the authorisation requirements for payment systems as laid down in *PSS Act*.[29] Hence, if a separate process is intended to be followed for licensing of PPIs, the *PSS Act* must be revised to make an exception for PPIs, as the DMD will not automatically over-ride the licensing process set out in a primary law, unless the primary law is amended to state so.

While the DMD attempts to make specific guidelines and processes for authorisation of PPI issuers, the process lacks clarity in several stages. Instances of these are enumerated below

- Guideline 6.2 states that all applications will initially be screened by the RBI to ensure the *prima facie* eligibility of applicants. No further details have been provided as to what this prima facie eligibility entails. Does it only deal with capital requirement norms or involves a scrutiny of any other requirements as well, has not been specified.

- Guideline 6.2 states that the RBI shall also check for 'fit and proper' status of the applicant and its management by obtaining inputs from other regulators, government departments and self-declarations of the entities' directors, as deemed fit. The criteria for deciding whether an entity is 'fit and proper' to be authorised as a PPI issuer, have not been provided. Financial sector legislation around the world generally have a list of what constitutes 'fit and proper', to avoid vagueness and ensure that a licensing process is fair and non-discriminatory on the basis of vague criteria.[30][31]

- Guideline 6.3 states that in addition to the above, RBI shall also 'apply checks, inter alia, on certain essential aspects like customer service and efficiency, technical and other related requirements, before granting authorisation to the applicants'. No details have been provided as to the nature of such checks and what each check would entail.

  No standards have been specified for what technical requirements must applicants satisfy for being eligible for a PPI issuer license. Further, it is unclear as to how the RBI will measure the efficiency of the applicant

[29] RBI. *Master Circular on Policy Guidelines on Issuance and Operation of Pre paid Payment Instruments in India, 2016*. July 01, 2016.

[30] See for instance *Prudential Standard APS 520*. 2008.

[31] See also FSRLC, see n. 1, recommending "fit and proper" criteria as including professional expertise and experience carry out the functions required to be performed; not having been sentenced to imprisonment for 180 days or more; not having been convicted of an offence involving moral turpitude or any offence under the defining law.

or the customer service for new entrants in the market.

- Guideline 6.4 provides that if the applicant satisfies the criteria in the first stage, the RBI "issues" an 'in-principle' approval valid for 6 (six) months from the date of grant of such approval. It is not clear if RBI is obligated to issue such approval or it may choose to refuse such approval even for applicants who have satisfied the first-level eligibility criteria. Within these 6 (six) months, the entity is required to submit a System Audit Report, the details of which are, once again, not mentioned in the DMD.
- Even after the issuance of an 'in-principle' approval, Guideline 6.5 provides that if the RBI observes any *adverse features regarding the entity/promoters/group*, it may impose additional conditions on such entity and may even withdraw the 'in-principle' approval for the same. There are no specifications with respect to what these adverse features may be and what kind of additional conditions are likely to be imposed on entities. Additional conditions which impose unanticipated costs, may lead to applicants surrendering their licenses, leading to significant loss of time and opportunity costs for applicants and resulting in overall harm to consumers and the payments ecosystem.[32]
- No time-line has been specified within which the RBI will process the application and intimate its decision of approval or refusal of the license.

Apart from costs to applicants and consumers, lack of clarity in licensing procedures lead to severe rule of law concerns.[33]

[32] See for instance, Aparna Iyer and Sanjay P.R. *Tech Mahindra latest to drop plan for payments bank*. May 25, 2016. URL: http://www.livemint.com/Companies/JQO9xhKcVemcKDUU6MET3I/Tech-Mahindra-drops-plan-to-launch-payments-banks.html.

[33] Shubho Roy and Ajay Shah. *Payment bank entry process considered inconsistent with the rule of law*. Sept. 1, 2015. URL: https://ajayshahblog.blogspot.in/2015/09/payment-bank-entry-process-considered.html.

9 Recommendations on revisions to the Draft Master Directions

On the basis of the inputs given above, we submit our specific recommendations on the DMD below:

1. RBI must restore the competitive neutrality between all PPIs issuers by:
   (a) allowing all PPI issuers to issue open-system PPIs;
   (b) framing appropriate eligibility guidelines for allowing access to non-bank PPIs to the settlement systems operated by the RBI;
   (c) dispensing with the five-fold increase in capital adequacy requirements;
   (d) dispensing with the requirement for non-bank PPI issuers to hold a 100% cash reserve ratio in the form of keeping the amount of end-of-day outstanding liabilities an escrow account;
   (e) allowing non-bank PPI issuers to accept inward remittances and make outward remittance under a limited AD license framework (instead of the restrictive MTSS framework);
   (f) rationalising capital adequacy requirements across existing and new PPI issuers.
2. RBI must reduce the capital adequacy requirements and keep the minimum capital adequacy ratio at a threshold that accounts for the operational and business failure of a PPI, and if required, mandate an ongoing risk-based capital requirement proportionate to the outstanding liabilities of the PPI.
3. Allow PPIs to invest the moneys received from consumers in safe and liquid securities, such as securities eligible for SLR.
4. Strengthen the consumer protection measures by:
   (a) Dispensing with mandatory limits on the rights of consumers to deal with and manage the moneys lying in their PPI account, such as daily limits on beneficiaries, limits on cash transactions or limits on the amount that can be transferred from the PPI account to the source bank account;
   (b) Removing all restrictions on interoperability of payment platforms;

(c) Mandating PPIs to frame a privacy and confidentiality policy that must be approved at the time of licensing of the PPI.

5. Mandate a risk-based KYC process instead of mandating a full-KYC for every single consumer of a PPI issuer, based on the following parameters:

   (a) No KYC for low risk consumers.

   (b) AADHAAR-based E-KYC for medium risk consumers.

   (c) In person and OVD-based KYC for high risk consumers.

6. Revise the operational norms in the DMD by making them principle-based and technology neutral. Specifically, dispense with the mandatory AFA requirement.

   (a) Substitute it with a risk based approach by allowing PPI issuers to take the liability for transactions without demur, where no AFA is applied; and

   (b) In any case, no AFA must be mandated for transactions of less than Rs.2000 so that such transactions through PPIs are at par with the card-not-present transactions which are allowed to be undertaken without AFA for regulated entities with the prior consent of consumers.

7. Revise the *PSS Act* to ensure that the licensing process proposed under the DMD does not end up conflicting with that specified under the *PSS Act*.

8. Issue the DMD as a regulation, and not a direction.

9. Strengthen the licensing process by precisely clarifying the eligibility criteria

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