POLICY BRIEF AUGUST 2014

Operationalising Payments Banks For Inclusion

Key Takeaways

The Reserve Bank of India has recently released Draft Guidelines for Licensing Payments Banks, taking forward the move towards differentiated banking and showing the intent for allowing more entry into the banking sector. Payments Banks is a new, welcome concept for India that will help fill gaps in access of the unbanked to the formal payments and remittances system. This policy brief sets out the landscape within which the Payments Banks will be operating, and issues that must be addressed for Payments Banks to fulfil the objective of inclusion. Given the large scale and heterogeneity in the country and ever evolving technology, a more open and well regulated landscape that allows for innovation will be beneficial to the cause of financial inclusion.

- For a new entity, like Payments Banks, entry-level thresholds should encourage more investment, and accommodate players with a track record and commitment to financial inclusion. Specifically, the capital and governance requirements in the proposed guidelines should be moderated, as these banks would not assume credit risk.
- Commercial viability continues to remain a concern in this model. Payments Banks should be on par with full service banks for providing all non-credit activities, e.g. Direct Benefits Transfers, forex remittances etc.
- In order to ensure scale and network effects kick in from the start, Payments Banks should serve even people that are not account holders, including payments between non-account holders based on appropriate KYC protocols.
- Legal issues need to be dealt with at the earliest i.e. the Universal Electronic Bank Account that can create a unique financial identifier across banks and the legal imbroglio over the UIDAI need to be cleared.
- Other links in the chain must be strengthened, thus to ensure scale and network effects, Business Correspondent outlets should be allowed to become common access points for multiple banks including Payments Banks.
- Alternatives to Aadhaar-based identification should be allowed to enable customer authentication especially for cash deposit/withdrawal from Payments Bank networks operating in poor connectivity areas.

Payments Banks: A New Paradigm

The bank-led financial inclusion initiatives in the past have essentially focused on expanding the reach of the banking sector through its own authorised banking correspondent network. However, there has been increasing realisation that accelerating the penetration of financial services will call for integration of the large non-banking retail base into the provision of services, without compromising the security of the financial sector. Unlike Brazil, Malaysia, Tanzania and Paraguay, where legal and regulatory changes have allowed non-banks to operate as specialised payments institutions, under the control of the Central Bank, India has chosen to lead with a differentiated banking structure. Non-banks have restricted operations as Pre-Paid Instrument Issuers (PPIs), and the RBI is currently exploring the feasibility of cash-out services through these outlets in a pilot project.

Under the concept of differentiated banking, specialised banks will now be allowed to function, each with a distinct operational scope. Thus Payments Banks, which will be regulated by the Reserve Bank of India under the Banking Act, will have the freedom to collaborate with a variety of retail networks to provide payment services across the country.

While the guidelines provide ample clarity on the scope and the responsibilities of Payments Banks themselves, there are several grey areas in the operational aspects, and the aim of this paper is to highlight and explore these in some depth.

Payments Banks: What is their value proposition?

Payments Banks seek to serve the financial inclusion cause by providing small savings accounts and payments/ remittance services enabling high-volume, low-value transactions in a secure,

Box 1: Payments Banks: Draft Guidelines- Key Provisions

- To be set up as public limited companies, licensed under Banking Regulation Act 1949.
- Activities restricted to: acceptance of demand deposits, and provision of payments and remittance services.
- Eligibility: Existing non-bank PPI issuers, NBFCs, Corporate BCs, telcos, supermarket chains, companies, real sector cooperatives and public sector entities.
- Banks can hold equity in Payments Banks.
- Minimum paid up equity capital: Rs 100 crores and minimum net worth at all times at Rs 100 crores; minimum capital adequacy ratio of 15%, and net worth: debt leverage ratio more than 5%.
- Maximum balance in customer accounts: Rs 100,000 per customer.
- Payment and remittances channels: branches, BCs, ATMs and mobile banking. Cash out through branches, BCs, ATMs and PoS terminal locations.
- Cannot undertake lending activities. All monies (other than to meet CRR requirements and minimum cash in hand) to be invested in G-secs/ T-bills with maturity of one year and less.

technology-driven environment. However, apart from not carrying out credit operations, and hence the burden of priority sector lending, Payments Banks do not, at first glance, have any significant advantages over conventional banks in reaching the last mile effectively.

While the eligibility criteria list for Payments Banks allows banks to take an equity stake as permitted under the Banking Regulation Act 1949, Scheduled Commercial Banks (SCBs) are already providing remittance and payment services, including cash-out, through their licensed BCs or under tie-ups with telco partners. For instance, ICICI-Vodafone serves 1.4 million customers through 65,000 agents, and even provides cash withdrawals.

When it comes to providing payments services, there are practically no differences in the operational guidelines for Payments Banks and SCBs. SCBs can operate through branches and authorised nested/captive, exclusive BC outlets, and mobile banking; Payments Banks guidelines mention the same channels. Regulations for cash-out at point of sale (PoS) terminal locations are proposed to be governed under the existing instructions under PSS Act, including the existing KYC guidelines issued by RBI for walk-in customers. With the recent regulations removing the 30-kilometre radius for BC coverage, and allowing NBFCs to become BCs, two big bottlenecks have been removed for SCBs in expanding reach and commercial viability of their agents. Presently, SCBs are required to open at least 25% branches in unbanked rural centres (population below 10,000); Payments Banks need not have branches, however, at least 25% of their access points must be in rural centres.

The principal differentiator is in capital requirements: the minimum paid up capital for Payments Banks is Rs 100 crores, compared to Rs 500 crores for SCBs. This is proportionate to the operational scope and the absence of lending risks. Thus, prima facie, the intent seems to be to create a carve-out for the entry (with a lower capital requirement) of non-banking entities interested only in payments services, while keeping supervisory control under the RBI.

However, the proposed capital and governance requirements may deter investment interest in this new concept. The Draft Guidelines recommend a minimum paid up voting equity capital of Rs 100 crores and a minimum net worth of Rs 100 crores at all times. Given the nature of the business, this will necessitate capex in excess of Rs 200-300 crores, which will crowd out many innovative players already existing in the financial inclusion ecosystem. Further, the proposed levels are double those proposed by the CCFS Report, and at wide variance with other parts of the ecosystem: PPIs- which are functionally closest to Payments Banks - entail a minimum equity of Rs 5 crores, while entities setting up White Label ATMs and Bill Payments Services which call for significantly larger capex require a minimum equity capital of Rs 100 crores. Entry-level thresholds should not preclude players with a track record and commitment to financial inclusion. The RBI could consider a tiered structure that will allow for differentiated business models, encourage more investment and encourage competition and innovation:

1. Non Bank PPIs with a minimum capital base of Rs 5 crores (as given by the RBI)
2. Payments Banks with minimum capital of Rs. Y crores (where Y < 100)
3. White Label ATMs/Bill Payments Services with minimum capital of Rs 100 crores (as given by the RBI)
4. Scheduled Commercial Banks with minimum capital of Rs 500 crores (as given by RBI)

Given the narrow range of revenue sources and the tight controls on deployment of funds in government securities, Payments Banks will not be profitable in the initial few years. The requirement of a minimum net worth of Rs 100 crores would require periodic recapitalisation through additional equity infusion. Specifying the need for maintaining positive net worth at all times should suffice, given the nature of business and operations of the proposed banks.

Other governance guidelines e.g. conditions on promoter equity and restrictions on voting rights may well be justified for full service banks but may serve as huge deterrents for investors in Payments Banks. In particular, the proposed phased promoter equity dilution is against the core principles of investor risk and reward, as promoters take the biggest risks in the initial stages of the business, and the proposed regulations force them to progressively dilute stakes in a more mature and profitable stages.

Given that Payments Banks will be investing only in risk-free securities and will be conducting all operations/transactions digitally and therefore transparently, this is an opportunity for the RBI to foster a more open digital environment where regulation does not stifle entry.

In addition, the recent financial inclusion mission Pradhan Mantri Jan Dhan Yojana aims to cover all households with a bank account within a year. In order to meet this target, banks will be forced to set out a network to tap all parts of the country at the earliest. By the time Payments Banks are operationalised, the banking network landscape would have spread all over. The new entrants will have their work cut out for them to create their niche in the payments markets. The value proposition of the Payments Banks will therefore depend on how these new entities tap technology to provide services at the last mile at a low-cost, efficiently. The business model of Payments Banks should be clear to generate commercial viability over the long term, which will draw in the requisite investment interest. Here, a number of issues need to be clarified, which are detailed in the following sections.

Commercial Viability

With no lending operations, Payments Banks have two sources of income: the interest spread on their deposits and the service charges for effecting payment/ remittance services.

Deposits and Cash Withdrawals: The key determinant of viability will be the cost of account servicing, particularly cash withdrawals. Presently, banks do not charge customers for cash withdrawal, despite incurring significant cash management costs – up to Rs 18 per transaction, which is high for small value transactions. This is subsidised to a large extent from the spreads earned on credit and other services. Free cash withdrawal service would impose higher costs for Payments Banks, which will be dealing with much lower levels of funds, without revenues from lending. Thus, cash withdrawal costs will need to be either charged beyond certain thresholds, or subsidised from remittance and payment service revenues.

P2P Remittances: The business case for Payments Banks can rest on migrant remittances and enabling government payments (Direct Benefits Transfers) which, taken together represent annual flows of Rs 500,000 crores. Migrant remittances are expected to be one of the biggest drivers of the retail payments industry, and Payments Banks will have to position themselves in the existing range of service providers. Presently, there is a huge variance in transaction costs, ranging from 0% for cash withdrawal at bank branches, to 5% for money orders, and even up to 8% for personal couriers.

Table 1: Comparison of transaction costs for remittance of Rs. 5000

Channel	Charges
Money Order/ India Post	5.0%
SBI (through BC)	2.0%
Airtel Money	0.5% - 3.0%
Bank Branch	0.0%
Informal channels	5-8%

Source: Committee on Comprehensive Financial Services for Small Businesses and Low Income Households Report 2014; Informal channels data from IIFL India-Telecom Mobile Money Report 2Q2013.

For Payments Banks to be effective, they need to breach existing price points. Based on the government payments model(detailed in the next section), a 2-3% transaction fee seems to be the converging value for payments, considering that telcos already offer a 0.5-3.0% fee depending on transaction size. The attainment of these transaction costs is however entirely dependent on deployment of appropriate technologies, which will entail considerable capital costs. As pointed in the CCFS Report, India will need to expand the retail access outlets from the present level of 0.845 million to over 3 million points. The capital requirements for a nationwide network of PoS terminals can range from Rs. 1500-4500 crores, depending on the features and the need for Internet connectivity. Commercial viability will need to factor in these costs.

Direct Benefits Transfers or Government Payments: The previous government had made it clear that beneficiaries should not be charged for cashing-out DBT credits even though banks estimated handling costs to be in the region of 2-3%. The government proposed a 2% fee for DBT payments, of which 1% was made contingent on proof of full withdrawal. However, in the absence of a clear notification, the revenue sharing of this 1% between banks and BCs remained a thorny issue, and some banks did not even receive the due amounts from government. This became a major obstacle in up scaling the DBT programmes in the target districts. A commensurate charge for payments still waits formal approval, and indicators are that the present government will freeze the transaction fee at 2%, against the 3.14% recommended by the Taskforce on Aadhaar Enabled Unified Payment Infrastructure (subject to a cap of Rs. 15.71 per transaction). If Payments Banks facilitate DBT, their business plans must consider a maximum 1% as their revenue for payouts, because the full service banks nominated for DBT payments will receive 1% on crediting the amounts to Aadhaar-seeded bank accounts.

The two major cost heads in delivering payments/ remittances are: POS terminal capital costs- ranging from Rs 5,000 (mobile assisted transactions) to Rs 15,000 for biometric authentication - and BC remuneration, which the DFS in its recent paper has proposed a minimum of Rs 5000 per month. Payments Banks will have to work with these benchmark values for their costs. To recover even the BC costs, the minimum throughput at 1% share of DBT payments, works out to Rs 500,000 per BC point, which corresponds to 1000 beneficiaries per month transacting an average of Rs 500 per month.

This is in line with the Task Force on Aadhaar Enabled Payments System assumptions of local modules consisting of 150 BC agents servicing 700 accounts each, averaging one transaction of Rs 500 per month.

Table 2: Retail Payment Network Cost Structures

Description		Total outflow
Number of BC Access points	150*	
Customers served by each BC point	700-1000	
Median Transaction size	Rs. 500	Rs 52.5-75,000,000/month
Number of transactions per month per user	1	
BC minimum remuneration as per DFS	Rs. 5000	Rs 750,000/ month
Retail PoS infrastructure	Rs. 5-15,000	Rs 750 -2,250,000

Source: Report of the Task Force on Aadhaar Enabled Unified Payment Infrastructure, February 2012.

Thus, there is no margin for Payments Banks to cover their administrative overheads and capital costs, with the 1% fee for disbursement/ withdrawal from the recipient accounts. In comparison, the transactions between the government, remitting bank and recipients are entirely electronic and in bulk, through the NFS switch, for the same level of revenue (1%). Unless the distribution of the 2% fee is done more equitably, Payments Banks will face a serious viability issue in becoming facilitators of DBT payments. Alternatively, a Payments Bank will perforce have to become a BC of another bank to offer credit and other services that it cannot offer directly, as mentioned in the guidelines.

Enabling scale and network effects

There is no doubt that the business model of Payments Banks will depend crucially on the operations reaching an optimal scale, where the widespread network can also allow cross-subsidisation across regions. However, in order to ensure that these new entities scale up rapidly, certain operational issues need to be clarified.

Customers: The definition of the term 'customer' needs specific clarification, given that the term in conventional banking generally means a bank account holder. The intent behind increasing the number of banks and differentiated banking is to increase the network and access to financial services. However, if each bank is to start afresh, this will be a serious limitation to increasing scale. The key question here is can a non-account holder make a transaction through a Payments Bank to another non-account holder? If this facility is not allowed, Payments Banks will be seriously limited in their ability to address the needs of the migrant and unbanked sections.

The quickest and most economical way to expand the network has already been prescribed in the CCFS report i.e. to allot Universal Electronic Bank Account numbers to every Aadhaar number, which can be opened at any full-service bank. If this scope is extended to Payments Banks, then the UEBA as a permanent, indelible marker along the lines of the UID and PAN number can become an identifier without the need for customised 'account opening' drives by Payments Banks. However, this important step also requires specific legislation on the status of the UEBA as an acceptable identifier for banking and financial purposes. Ideally, the seeding of mobile numbers could be done at the time of issuance of the UEBA to facilitate two –factor authentication for cash withdrawal services.

Another proposed guideline is a cap on the maximum balance per customer at Rs. 1 lakh; while this is justified for individual accounts, it restricts Payments Banks from servicing small businesses or firms that may want to use payments services for their distribution network across the hinterland. The regulatory framework should allow maximum outreach, rather than potentially curb the market.

Expanding network of outlets: Another factor that could be a constraint in rapid scale-up is the validation of existing network of retail outlets for Payments Banks. To enable Payments Banks to set up and scale quickly, there should be minimum paperwork and recruitment costs, and this should be left to the discretion of the players, under due onus and guarantees to the RBI. This is fundamental, because the core assumption of the value addition of non-banking entities is the ready availability of a nationwide network, driven by commercial contracting principles best left to the agencies themselves.

An important related issue is the interoperability of the BC network. Presently, the retail touch points of BC networks must be exclusive to a sponsor bank, in the interests of customer-assurance. Allowing Payments Banks use the existing access points of BCs for payment solutions, against reasonable commercial charges and also to create and access a white-label/ interoperable BC network and make it available to others are some additional features of an interoperable open payments landscape that will facilitate rapid scale for all players.

In fact, the CCFS report recommends that 'in order to ensure that the BC infrastructure that is established is utilised in an optimal manner and shared by multiple banks, which may each have account holders in a specific geography, allow high-quality White Label BCs to emerge with direct access to settlement systems subject to certain prudential conditions.' This recommendation should be implemented at the earliest.

Unified and simple KYC regime: By their very scope, Payments Banks present no capital risks, as the deposits are to be fully invested in government securities. Thus, the main risks relate to money-laundering and faulty KYC/ authentication of users. In this regard, the guidelines seek to apply the KYC guidelines of PPIs to Payments Banks as well. At present, the following rules apply:

- For Non-cash transactions: Minimum customer details, provided the amount outstanding at any point of time does not exceed Rs 10,000/- and the total value during any given month also does not exceed Rs 10,000/; Any 'officially valid document' for Rs.10, 001/- to Rs.50, 000 individual transaction; Full KYC for individual transaction values up to Rs 50,000, reloadable in nature.
- For Cash transactions: Full KYC for walk-in customers, for remittances to a bank account, individual transactions value up to Rs 5000/- with a monthly ceiling of Rs 25,000/- per remitter.

Thus, Payments Banks will be required to insist on full KYC to provide remittance/ payment services for walk-in customers, and one end of the transaction must be a bank account.

This brings back the importance of a uniform KYC regime for India, and once again the importance of a singular identifier, such as the UID. The legal and statutory status of the UIDAI and the increased adoption of the Aadhaar number will go a long way in simplifying the KYC requirements. However, the proof of identity need not be only biometric – finger prints + UID, and alternatives such as OTP + UID/ Bank account or PIN + UID/ Bank account number should be allowed for cash-out transactions, which will be the definitive test of the usefulness of Payments Banks.

The Way Forward

With the RBI ushering in a new set of banks for payments and deposits services, the Indian payments landscape is set to change. However, while the CCFS report and the Draft Guidelines have shown the direction and the regulatory framework governing payments and remittance institutions, there is need for a closer look at the provisions to ensure that the final operational guidelines represent a significant improvement in creating an enabling environment for payments, without in anyway compromising on the need for security and transparency. Given the large scale and heterogeneity in the country and ever evolving technology, a more open and well regulated payments landscape that allows for innovation will be beneficial to the cause of financial inclusion.