INDICUS FOUNDATION

INDICUS CENTRE FOR FINANCIAL INCLUSION

POLICY BRIEF
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Fostering innovation for financial inclusion

Key Takeaways

Since the Pradhan Mantri Jan Dhan Yojana launch in 2014, the objective of universal access and coverage of banking services is close to being achieved. The focus is now shifting to enabling usage. While so far top down policy actions have helped catalyse universal access and coverage, the question now is whether top down policy actions can create an ecosystem where innovation and inclusion reign, that will promote usage of financial services. In other words, the character of policies associated with financial inclusion is now changing towards empowering ground-up innovation, which, in turn, requires a different class of policy action. The policy objective now is to enable traditional and new financial sector stakeholders to innovate without being hindered by unnecessary rules and procedures.

This Indicus Policy Brief looks at precisely this aspect of creating an ecosystem where innovation and experimentation can occur at low cost and by diverse service providers in the banking and payments sectors. In the process, it identifies the key tasks ahead under three main categories:

1. Enabling Open Access and Interoperability:

a) To enable easy access and interoperability, a comprehensive time bound road map can be evolved and shared with the industry. Innovation and new product launch is a lengthy process and policy uncertainty or ambiguity tends to hinder it. The road map would lay out the government position on major recommendations of the Report of the Watal Committee on Digital Payments (Ministry of Finance, 2016), including currently grey or indeterminate areas if any. The ideal, of course, is for all major payment systems including RTGS, NEFT, IMPS and UPI to operate on a non-exclusive and non discriminatoy basis for both banks and non-banks.

b) The recommendation from the Watal Committee to declare the National Payments Corporation of India (NPCI)as a critical payments infrastructure should be examined by the RBI. For improving access and participation from non-banks, diffusing the shareholding structure of NPCI and allowing for non-bank participation, as well as independent members will reduce the current large bank orientation and incentivize greater openness to other stakeholder views.

c) The Business Correspondent outlet is often the sole access point to formal banking in a cluster of villages. Without interoperability at the BC level, the choice of rural poor is limited, footfall at the banking outlet is reduced and opportunities for innovative solutions are blocked. Standardised guidelines for a White Label BC framework should be issued by the RBI; this will allow access to innovative solutions for the rural poor, who are currently under-served by single or few banking outlets.

2. Data sharing, protection and privacy: The Committee of Experts on a Data Protection Framework for India has released a comprehensive White Paper on these issues and public feedback has been invited. The critical tasks for India this year are to build a framework that will:

a. Set up data sharing protocols amongst banks and non-banks
b. Set up rules for data standardization that will allow for cross-platform usage
c. Define appropriate data privacy rules, and ensure their enforceability
d. Ensure that the consent architecture is effective, particularly for low income customers.

3. Comprehensive reporting and monitoring:

a. An analytics and monitoring unit, potentially within the RBI and coordinating with the Ministry of Finance, is critical now to monitor transaction and pricing activity, identify transactional hurdles and gaps as they emerge and resolve them through regulatory/policy action.

b. Aggregated, generic results of the analysis must be shared publicly to create a more informed environment for new entrants and for course correction by existing players.

c. An institutional mechanism set up for inter-regulatory coordination, including Telecom Regulatory Authority of India and the Competition Commission of India would help circumvent many hurdles in a timely manner.

Background

India has become a global leader in financial inclusion policy and the 2017 Brookings Financial and Digital Inclusion Project Repor thas once again given it a 100% rating on the parameter, "Country Commitment" to financial inclusion. India's rating on the "Regulatory Environment" parameter has increased from 94% to 100% over the year. However, the country continues to score a low 44% on the crucial parameter of "Adoption of traditional and digital financial services". India has followed a bank-led model for financial inclusion over the last ten years, mandating targets to banks for increasing rural branches/BC agents and number of BSBDA or PMJDY accounts. This strategy has succeeded admirably in increasing coverage and improving access, due to tight implementation largely due to the proactive efforts of government controlled banks. It is however important now to re-calibrate policy away from universal coverage and access, to usage.

Raising use of formal sector financial services by low income customers should be the key target now. However, usage does not automatically and sustainably result from supply side and mandate driven efforts. Usage of new modes and services is driven by innovation, experimentation, learning by doing, etc. and these are best created in a more competitive environment. This intrinsic link between competition and creative change, is well recognized both globally and nationally. Diversity is a part of the G20 Principles for innovative financial inclusion (GPFI, 2010) i.e."Implement policy approaches that promote competition and provide market-based incentives for delivery of sustainable financial access and usage of a broad range of affordable services (savings, credit, payments and transfers, insurance), as well as a diversity of service providers."

Within the Reserve Bank of India as well, there is a general agreement that the route to financial inclusion travels through competition driven innovation, which implies increasing the role of non-banks as well as pushing competition between banks. This policy brief highlights the way ahead for India in putting in place a level playing field where incumbent, new and emerging organizations can all compete and cooperate towards financial inclusion. The aim here is to focus on those issues that will enable innovation and product introduction with a special objective of serving the ends of financial inclusion.

Providing Banking Services to the Last Mile

After multitude of conversations with stakeholders across the financial inclusion landscape, three specific areas of action have been identified. These will have a deep, and sometimes immediate, impact on cost reduction and new product introduction, and therefore financial inclusion. The three areas with the greatest impact-to-effort ratio are open access and systemic interoperability, data democratisation and comprehensive monitoring. Clearly if these are ensured in an environment of progressively reducing entry barriers the beneficial impact will be that much higher. However, if greater entry is enabled, without open access and interoperability, data sharing or stringent monitoring, the potential benefits would at best be miniscule.

A. Open Access and Interoperability

Opening access to essential payment platforms is an integral part of allowing competition in financial services, which fosters innovation. As technology evolves, without open and fair access to the essential payments infrastructure, new payments modes that suit low income customers may not see the light of the day.

Principle 18 of the CPMI-IOSCO "Principles for Financial Market Infrastructures (FMI)" (Bank of International Settlements, 2012), states, "An FMI should have objective, risk-based, and publicly disclosed criteria for participation, which permit fair and open access."Following this principle, the Watal Committee on Digital Payments recommended open access to payment systems to all players on a non-exclusive and non-discriminatory basis, subject to proportionate risk based restrictions. This includes access to the NPCI owned IMPS, UPI and other payment systems. Globally, the trend is towards opening access to payments systems. The Bank of England is putting in place regulation to allow non-bank payment service providers to apply for a settlement account in the Bank's RTGS system, with appropriate safeguards for financial stability(Bank of England, July 19th, 2017).

It is also crucial for the regulators to ensure that ownership of payments infrastructure does not constrain a level playing field for all providers. For instance, telecom operators, who own the rails of digital payments (and often have PPI licenses themselves), and NPCI, who owns critical transaction platforms, must play fair with bank and non-bank payments providers. The history of the USSD channel in India is a good example of the need for continuous regulatory intervention to unblock a payments channel that is recognised as integral to financial inclusion (See Solving the USSD imbroglio – Indicus Policy Brief November, 2016). It is for these reasons that the Watal Committee recommended declaring NPCI as critical payments infrastructure and to broad base and democratise NPCI shareholding, that is currently dominated by public sector banks.

Apart from open access, interoperability is also recognised as an integral component for competition and innovation. Over the past decade, interoperability has been brought about through the regulator or by the market itself, essentially with the objective of increasing the scale and therefore adoption of new products and services - it lowers costs and brings in better customer experience. However, mobile money that has met the remittances needs of the poor in Africa has limited adoption when the solutions are restricted to a single telecom network. Thus, in Ghana and Nigeria, regulators imposed interoperability from the outset of mobile money, whereas in Tanzania key market players themselves collaborated to develop rules for an interoperable scheme. In some markets, "payment aggregators", typically non-banks,have emerged to facilitate interoperability between new, different systems.

While India has clearly benefited from RBI's standardised guidelines on interoperability of ATMs, interoperability between Pre-Paid Payment Instrument issuers (PPIs) has only recently been introduced, to be implemented in phases from April 2018 (RBI, October 11, 2017). Customers will be able to switch funds between different mobile wallets, a long-standing demand of the PPIs, and then eventually also between wallets and bank accounts.

However, another long-standing demand from Business Correspondents has remained unaddressed – i.e. interoperable banking agent networks. The Mor Committee (RBI, 2013) had recommended the following: "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." Yet, even though interoperability has been conditionally permitted for long in principle (RBI, March 02, 2012), in the absence of standardised guidelines on White Label Business Correspondents, the recommendation remains un-operationalised.

There is a compelling need for solutions for the unmet financial needs of the rural poor, and currently the BC outlet is often the sole access point to formal banking in a cluster of villages. Without interoperability at the BC level, the choice of rural poor is limited, footfall at the banking outlet is reduced and opportunities for innovative solutions are blocked. The RBI needs to step in with standardised guidelines to fill this gap and give the rural poor a better chance to be financially included.

B. Data democratisation - data sharing, protection and privacy

Access to data is key to allowing creative forces to flourish, to bring a level playing field between the incumbents who have control over data and potential entrants who start with a clean slate. Even as concerns on data protection and privacy are taking centre stage in the debate on financial inclusion, data sharing protocols need to be well established. For example, customer specific solutions in micro-credit can be encouraged through data sharing of credit history and collateral or digital payments history that will allow determining the creditworthiness of a low-income customer. However, this will call for defining data sharing guidelines, regulation to prevent and monitor fraud and misuse of data and ensuring that consent architecture is effective, particularly for low income customers. It is crucial that India establishes data sharing protocols that ensure that the customer has ownership of her data, that she understands the control that she has and can choose to share with anyone she wants.

Work is underway in India to establish a regulated environment for data sharing, set rules around data standardization that will allow for cross-platform usage and most importantly, define and enforce data privacy laws. RBI set up an inter-regulatory working group to study the entire gamut of regulatory issues relating to fintech and digital banking in India in July 2016, the report is awaited. The Ministry of Science and Technology has formulated the National Data Sharing and Accessibility Policy (NDSAP), for which the Ministry of Electronics and Information Technology (MeitY) is the nodal implementing ministry. Recently, the White Paper of the Committee of Experts on a Data Protection Framework for India was released and public feedback has been invited till January 31st 2018. The White Paper of the Justice Sri krishna headed committee is comprehensive, covering all aspects of data protection and has noted, "Instrumentally, a firm legal framework for data protection is the foundation on which data-driven innovation and entrepreneurship can flourish in India. Fostering such innovation and entrepreneurship is essential if India is to lead its citizens and the world into a digital future committed to empowerment, experiment and equal access."

While a forthcoming policy brief will take up the recommendations of the report in depth, the critical issue to flag for policy attention at this juncture is the interplay of regulation and power-play in the market. It is well known globally that incumbents do not like to cede space to new entrants. While small fintech firms are expected to bring innovative solutions, they would need to engage with the existing players, in most cases, the big banks, to take the solutions to the market. Given the low bargaining power of new small potential players, here, our regulators would need to play fair, as prudential regulation, by its very nature would favour the bigger banks in the country. Take the case of open banking for instance where banking data is shared through APIs between banks and non-banks. This has gained momentum globally with numerous applications – digital credit for the under banked from M Shwari and Tala in Africa, digital payments solutions from WeChat and Alipay in Chinaetc. In the US and the UK, banks are resisting the move to lose control over their data (Chris Skinner, How banks are getting around open banking and PSD2, February 7th, 2017).

In India, it is important that these issues are debated openly and well understood, even as we work towards a more open, level environment in financial services.

C. Comprehensive reporting and monitoring

The third crucial task for regulators in India is to institute a system of comprehensive reporting and monitoring. Ensuring systemic stability, restricting unethical or illegal practices and checking cross-platform or cross-organizational inconsistencies are some examples where monitoring becomes critical. Further, in the absence of comprehensive monitoring, innovation slows down – organisations are wary of committing errors, while regulators and policymakers become overly conservative towards new approaches and tools.

New product introductions may impact other products in different and unforeseen ways and credible information can encourage further innovation by other organizations or platforms. Regulatory sand boxes are now being encouraged around the world, where new concepts can be tested by private firms, under controlled conditions, with regulatory supervision. While the Watal Committee and the Committee on Household Finance have recommended this, it is not clear whether India has the regulatory capacity for such experimentation yet, nor is there a path laid out for regulatory learning. As the G20-GPFI brief, "Digital Financial Inclusion: Emerging Policy Approaches" (GPFI, 2017) notes, even as the emphasis in a regulatory sandbox is to encourage new concepts, the regulator must avoid creating market-distorting excessive 'first mover' advantages through the process. Therefore, caution must be exercised while implementing a sandbox.

Meanwhile, as noted in the Indicus Policy Brief "Monitoring the Progress of Financial Inclusion in India" (March 2017), detailed analytics can help resolve many persistent issues that are plaguing adoption of innovative digital payments. For example, while the USSD channel has been postulated as the best channel for financial inclusion since 2011, banks and telecom companies have blamed each other for the low adoption by customers. TheWatal Committee has highlighted the high failure rates for USSD service at 50 percent. In a closed-door workshop conducted by Indicus with stakeholders from bank and telco regulators and firms, a Root Cause Analysis of the failed transactions was recommended that would help identify the precise failure points. The Economic Survey 2016-17 had used data provided by the NPCI on Aadhaar-enabled payments to show the possibility that individual banks can thwart interoperability. Continuous monitoring of data and rigorous analytics can throw up such patterns, test issues as they arise and stem the incentives to stymie access and interoperability.

It is therefore critical to set up an analytics and monitoring unit, within the RBI or independently, and coordinating with the

BOX: Case of Aadhaar-enabled payments

"The success of digitalization will depend considerably on the inter-operability of the payments system. The Unified Payments Interface (UPI) created by the NPCI is the technology platform that will be the basis for ensuring interoperability. But to ensure this, individual banks should facilitate not thwart inter-operability. One way of quantifying the degree of inter-operability is to contrast the decline rate of transactions that involve the same issuing and remitting bank (On-US transactions), on the one hand, and transactions that involve different banks (Off-US). Based on detailed data provided by NPCI, the decline rates were calculated for Aadhar-enabled payments (Figure 9) as of mid- Jan 2016. the decline rate for Off-US transactions was nearly 56 percent, almost double that for On-US transactions. One plausible hypothesis for this differential is that the larger banks are declining transactions involving smaller remitting banks while ensuring that transactions involving themselves are honored. There could be valid reasons for this. But such problems will need to be addressed, since payments banks, telecommunications companies, and small banks are in the vanguard of financial inclusion. So their access to the UPI platform will be critical for advancing digitalization, especially for the poor. "http://indiabudget.nic.in/es2016-17/echap03.pdf

Ministry of Finance. Maintaining all privacy and confidentiality guidelines, the aggregated, generic results of the analysis must be shared publicly to create a more informed environment for new entrants and for course correction by existing players.

Concluding Note

The world over, financial services markets are changing dramatically, with regulators forever playing catch-up with technology. At this stage, India can do well by examining the current state of innovation in basic banking and payments services and understand how regulators and policy can assist, rather than restrict, avenues for new ideas.

Financial inclusion policy will now naturally shift from being mandate driven to being ecosystem oriented, and while some may call this a paradigm shift in the regulatory mindset, it is the only way that positive movement will be achieved. The Watal Committee has also suggested either an independent payments regulatoror strengthening the current Board for Regulation and Supervision of Payment and Settlement Systems (BPSS). It could be argued that a separate regulator will create additional coordination issues in an environment which is already fairly fractured. Therefore, there is also a valid argument to make the current BPSS within the RBI more independent, including by taking in non-RBI experts.

Further, India could constitute a committee on the same lines as the FinPay in Canada, a forum with public and private sector representatives chaired under the aegis of the Canadian Finance Ministry that oversees industry level developments in the Canadian payments system. In India, an institutional mechanism through such a forum would ideally have representation from RBI, NPCI, UIDAI, telecom and other financial services regulators as well as industry participants to facilitate dialogue related to all public policy aspects including competition, innovation, security, customer protection etc.

The road ahead for financial inclusion will not look like the one we have moved on so far, there is much learning to be done. The RBI and the Finance Ministry have to move towards encouraging the forces of competition, collaboration and coordination to play out under regulatory supervision. Adoption of formal financial services by the poor will then follow automatically.

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