IKIGAI LAW

MASTERCLASS ON FINTECH

BROADER THEMES

Part I

Digital Payment Infrastructure in India

Digital Lending

Prepaid Payment Instruments (PPI)

Payment Aggregators

Digital Banking

Fintech Policy in India

Part II

Case study: Credit on UPI

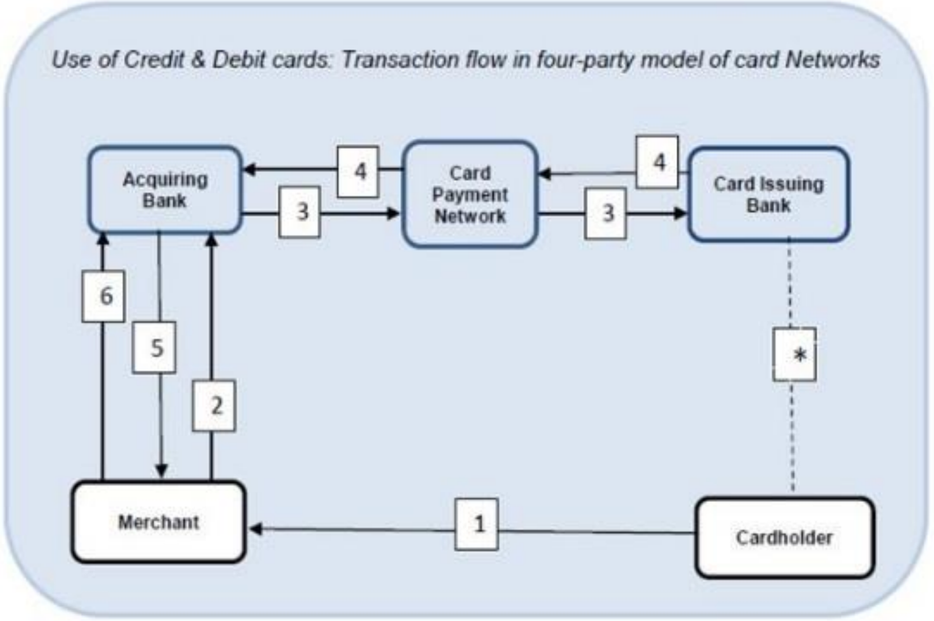
DIGITAL PAYMENT INFRASTRUCTURE IN INDIA

INTRODUCTION

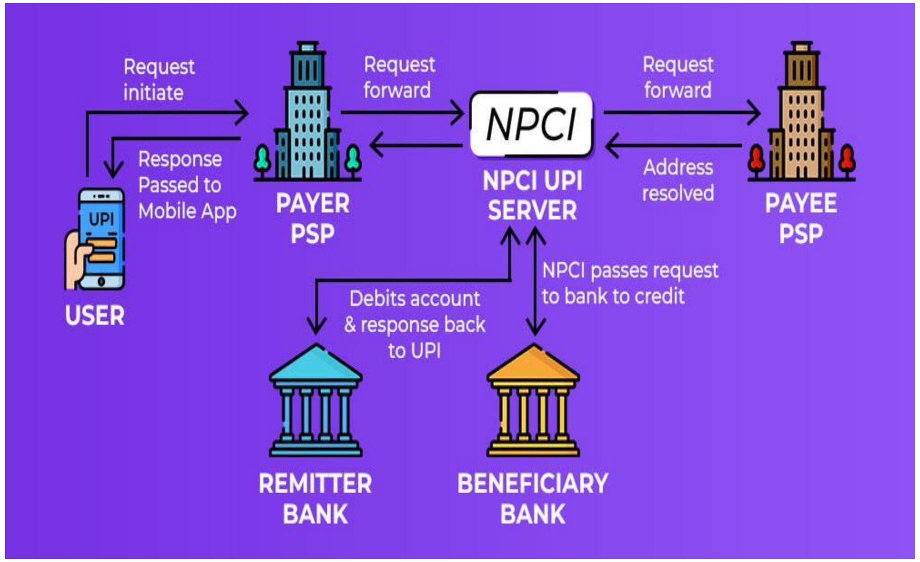
- Payment infra has two sides - demand and supply.
- **Demand side**: credit and debit cards, Prepaid instruments (“**PPIs**”), mobile and internet banking, and UPI apps.
- **Supply side**: bank branches, business correspondents (agents of banks and NBFCs), ATMs, point of sale terminals, Payment Aggregators (“**PA**”), and QR codes.
- **Enablers**: Internet penetration (for access), Aadhar (for identity verification), Traditional financial institutions (like banks and NBFCs), NPCI products like UPI, Bharat Bill Payment System and increased participation of customer and merchants.

PAYMENT INFRASTRUCTURE

Participants in card payment infra: (i) merchant, (ii) acquirers - entities which facilitates the acceptance of card payments, (iii) card network - entities routing and settling the transaction (like Visa, Mastercard, and RuPay), (iv) cardholder - the payer, (v) issuing bank - the bank which issues the card to the cardholder.



Participants in UPI payment infra: (i) NPCI - manages and operates UPI, (ii) payer payment service provider - onboards customers, (iii) payee payment service provider - onboards merchants, (iv) remitter bank – payer's bank, (v) beneficiary bank – receiving party's bank, and (vi) third party application providers - provide front-end interface (like google pay, phone pe).



APPLICABLE REGULATIONS

- **The Payment and Settlement Systems Act, 2007 (PSS Act)**
  - Governs the operation and management of payment systems (in India) - that enables payment to be effected between a payer and a beneficiary.
  - Payment system enables payment transaction to be settled between a payer and a beneficiary.
  - The RBI regulates payment systems under the PSS Act. The entity which operates a payment system is a payment system provider (**PSP**). A PSP require prior RBI authorization (under the PSS Act) before it can start operating a payment system.
  - Examples of payment system: card network, PPI, PA, etc.
- **RBI Master Direction on Credit Card and Debit Card – Issuance and Conduct Directions, 2022**
  - Regulates the issuance of credit and debit cards (including co-branding arrangements).
  - Banks and NBFCs with specific RBI authorizationare allowed to issue debit, credit cards or any similar products in India.

APPLICABLE REGULATIONS

- **RBI card-on-file tokenization norms**
  - No entity in the payment chain except card issuers (like HDFC) and card networks (like VISA) must store card related data (like card number, CVV, etc.).
  - But PAs and merchants need to store card data so that customers need not enter their card details for every payment. This would have led to major customer inconvenience. RBI suggested tokenisation as a solution – which means replacement of card details with a token. The deadline for purging of card data (by participants other than card issuers and networks) was 30 September 2022. So, this also was a deadline for implementation of tokenization - to avoid any inconvenience at customer's end.
- **RBI circular on localisation of payments data**
  - RBI circular prescribes that PSPs can process payment transactions outside India but must store payment data only in India (after the processing). If processing is done abroad, the data must be deleted from the systems there, and brought back to India within the specified time.
- **The UPI Procedural Guidelines and circulars released by NPCI prescribe the operational framework for UPI.**
- **Credit Linkage with UPI**: In October 2022, the NPCI released an operating circular to enable the linking of RuPay Credit Cards to UPI. UPI acceptance infra will enable a wider set of merchants to accept Rupay credit card. In September 2023, RBI permitted linking of bank-sanctioned credit lines to UPI. With this, users can directly draw on their bank-led credit lines to make UPI payments. NPCI also released operating guidelines to enable linkage of bank-led credit lines to UPI.

POLICY DEVELOPMENTS

- **NUEs**: In August 2020, RBI released a draft framework for authorization of a pan-India NUE for setting up of newer retail payment infras. NUE will perform functions similar to NPCI: it will operate its own payment systems, create new payment methods, and monitor the growth of digital payments. Given what NPCI has achieved with UPI, BBPS, and RuPay, setting up the NUE can be rewarding.
- **Cap on volume**: In November 2020, the NPCI released a circular imposing a cap on the volume of UPI transactions. The deadline for implementation of the 30% UPI market share cap is 31 December 2024.
- **PIDF**: In January 2021, the RBI released a notification to operationalize PIDF. In this scheme, the RBI subsidizes the deployment of payment acceptance infrastructure (like PoS terminals, QR codes) in Tier-3 to Tier-6 cities. In October 2023, RBI extended the PIDF scheme by 2 years - until 31 December 2025.
- **Geo-tagging**: In March 2022, RBI released a framework for geo-tagging of payment system touch points. Geo-tagging means the collection of geo-coordinates for payment acceptance infra (like QR codes, and POS Machines).
- **Zero MDR on UP**I: The Government has implemented a zero MDR policy for UPI payments. But the industry has consistently raised concerns against this policy as it shifts the monetary burden of providing UPI infrastructure on industry players (like banks and PAs). The Government compensates industry players for losses they suffer due to the policy through incentive schemes. Under the scheme, banks must share the incentives they receive with other payment system operators and participants. But historically, these incentives haven’t trickled down to fintechs (like PAs) in the payment chain. So fintechs have been demanding that they get their fair share to cover up for the costs incur.

POLICY DEVELOPMENTS

- **Self-regulatory organization:** The RBI has announced it will release a comprehensive Self-Regulatory Organization (**SRO**) framework for regulated entities. The framework will be sector-agnostic and list broad objectives, functions, eligibility criteria, governance standards, etc. for SROs. The RBI will notify sector-specific requirements later – just before it starts accepting SRO applications. SROs can benefit the fintech sector in many ways, including effective policy making and promoting responsible innovation. However, it remains to be seen if the RBI will permit unregulated entities to be a part of the SRO. Many industry bodies (like DLAI, PCI and FACE) are in talks with the RBI regarding SRO formation.

DIGITAL LENDING

DIGITAL LENDING

- Digital lending makes the lending process automated, paper-less and presence-less.
- RBI regulated lenders (like banks or NBFCs) on their own or in partnership with fintech offer loans through digital lending apps (**DLAs**).
- It disrupts traditional lending in many ways. DLAs offer proprietary credit evaluation algorithms - which help regulated lenders underwrite borrowers more accurately, reduce NPAs and build their loan-book. DLAs also enable speedier approval of credit, lower the customer acquisition cost (for the lenders), help in loan recovery and offer better customer experiences.
- All in all, DLAs help build a larger and healthier loan book.

ROAD TO DIGITAL LENDING GUIDELINES

Nov. 2021

But some rogue DLAs harassed borrowers and adopted unethical practices. Alarmed by this, the RBI constituted a working group to suggest a regulatory framework for digital lending. The WG released its report in November, 2021.

Aug. 2022

In August 2022, the recommendations of the working group report were implemented through a framework on digital lending. This framework included obligations that (i) were applicable immediately; and (ii) RBI was still deliberating on.

Sep. 2022

In September 2022, RBI released the Digital Lending Guidelines.

DIGITAL LENDING GUIDELINES (**DL GUIDELINES**)

The DL Guidelines categorizes any lending processed primarily through digital channels as digital lending. It applies to RBI regulated lenders like banks and NBFCs.

The DL Guidelines also define lending service providers (**LSPs**) - entities which perform one or more digital lending functions on behalf of lenders (like unregulated fintechs providing access to DLAs). The LSPs are categorized as outsourced service providers of lenders. And lenders must ensure that LSPs comply with DL Guidelines.

The DL Guidelines prescribe borrowers protection measures like mandatory disclosure of key facts like (a) cost of loans, (b) recovery process, (c) coordinates of grievance redressal officer and (d) list of LSPs that borrower engages. It also prescribes norms for handling borrower data - like taking borrower's specific consent before data collection, need-based data collection, and maintaining audit trail for consent.

FAQS TO DL GUIDELINES

- In February 2023, the RBI released frequently asked questions **(FAQs)** to clarify different aspects of the DL Guidelines. The FAQs, among other things, clarified the manner in which payment aggregators (PAs) can participate in loan disbursal and repayments. They said that a PA whose role is limited to providing PA services (like pooling of funds, and onward settlements to merchants) can facilitate disbursements and repayments. If, however, the PA provides lending services like customer acquisition, underwriting support, monitoring and recovery of loans, it cannot participate in disbursements and repayments.

- Some other clarifications included in the FAQs were: (a) Regulated Entities **(RE)** must communicate details of empanelled recovery agents to borrowers at the time of sanction of the loans, and name of the assigned recovery agents before they contact borrowers for repayments, and (b) in case of non-repayment of loans, a digital lender is free to levy penal charges on an amount lower than the outstanding loan amount.

FLDG GUIDELINES

- First Loss Default Guarantees **(FLDG)** is a risk-sharing arrangement, in which fintechs compensate regulated entities or 'REs' (like banks and NBFCs) for default on loans. Fintechs, using their proprietary credit algorithms, help lenders underwrite borrowers. The DL Guidelines had raised questions on the legality of FLDG arrangements. Since then, the industry was seeking for clarity. IN June 2023, the RBI released new guidelines which allowed default loss guarantee (DLG) arrangements (also called FLDGs). REs can now accept DLG from a LSP or another RE that acts as an LSP. RBI has, however, capped the risk exposure that LSPs can take to 5 % of the loan portfolio that the LSP sources.

- The guidelines bring in the much-needed relief for the digital lending industry. They re-open doors for fintechs to partake in risk-sharing. By offering FLDG, fintechs assure lenders of the quality of their underwriting services. This bolsters lender's confidence to lend to customers with limited credit history. So FLDG helps lenders bridge the credit gap, and enables financial inclusion.

ISSUES CONCERNING DLG

DLG and Digital Personal Data Protection Act (DPDP)

The recently notified Digital Personal Data Protection Act is an overarching legislation and operates in the same field as the pre-existing sectoral norms such as RBI's DL Guidelines. As a result, the two laws offer diverging views in same areas. For instance, the RBI mandates that digital lenders can store data only in India. But the DPDP Act does not provide for local storage of data and only restricts transfers to those countries which are barred by the government through a notification.

Further, the provisions of the DPDP Act are in addition to and not in derogation of any other law (like sector specific regulations). So fintechs will have to comply with the prescriptions under both laws – the DPDP Act and sector specific data norms. If there's a conflict between both laws, then DPDP Act will prevail to the extent of the conflict.

THE ROAD AHEAD

RBI is still deliberating on implementation of some of the WG proposals including:

(a) Setting up of Digital India Trust Agency ("**DIGITA**"): DIGITA will be responsible for verifying DLAs before their distribution. The intent is to ensure that only authorised and trusted DLAs are used by borrowers,

(b) Use of ethical AI for digital lending: DLA must adopt ethical AI standards to use AI for creditworthiness assessment of borrowers.

PREPAID PAYMENT INSTRUMENTS

PREPAID PAYMENT INSTRUMENTS (**PPI**)

- PPIs are store-of-value. They can be used through these form factors: cards or wallets.
- PPIs can be used to make payments to other individuals or merchants.
- Merchants who accept payments through PPIs either have contracts with the PPI issuer, or with a payment aggregator.
- RBI Master Direction on Prepaid Payment Instruments 2021 (**PPI Directions**) - the regulatory framework for PPIs.
- Entities that issue PPIs are called PPI Issuers - which can be both banks or non-banks.

Features	Small PPIs	Full KYC PPIs
Permitted payments	• Payments allowed only to merchants that the PPI issuer has on-boarded contractually. • Must be converted into Full-KYC PPIs within 24 months of issuance.	Can be used to pay a wider merchant set, and for funds transfer and cash withdrawal.
Details Required for Issuance	Minimum details of the PPI holder like mobile number (verified by OTP), self-declaration of name, and identification number of any officially valid document (like driving license).	Authentication of the user to be completed as per RBI's KYC Master Directions.
Amount that can be loaded	Total amount loaded cannot exceed INR 10,000 in a month, and INR 1,20,000 in a year.	Total amount can be up to a maximum of INR 2,00,000 at any point of time.
Cash Withdrawal	Not permitted	Permitted. But subject to prescribed limits.

TYPES OF PPI

As per PPI Directions, there are three type of PPIs: (a) Closed System PPIs; (b) Small PPIs; (c) Full-KYC PPIs.

Closed System PPIs are used to purchase goods and services only from the PPI issuer. They are not regulated by RBI. Other categories are RBI Regulated

Other type of PPIs that can be issued are (i) Gift PPIs and (ii) PPIs for Mass Transit Systems (PPI-MTS). Both can be issued with RBI authorization.

PPI INTEROPERABILITY

- Interoperability - RBI Directions require all full KYC PPIs to be interoperable - made mandatory in May 2021.
- Interoperability can be enabled through card networks (if form-factor is card) or UPI (if form-factor is wallet).
- **Financial inclusion play** - For customers in remote locations (who face issues in access to banks) PPI opens up possibilities. They can transfer & receive money especially salaries and government subsidies.

KEY REGULATIONS

- RBI PPI Master Direction ("**PPI Directions**") govern issuance of PPIs.
- The PPI Directions prescribe:

(a) the eligibility criteria - like minimum net-worth and authorization process for non-bank PPI issuers,

(b) guidelines for issuance, loading, reloading, validity and redemption of PPIs,

(c) governance norms like security, fraud prevention and risk management framework and customer grievance redressal framework, and

(d) other compliances like reporting requirements.

LOADING PPI WITH CREDIT LINES

- Fintech start-ups, especially BNPL players like Slice, Uni, etc., enabled loading of PPIs with a revolving line of credit. The credit lines were sourced from partner lenders like a bank or a NBFC. The payment facility mimicked a credit card payment flow (and convenience)
- RBI regulations require credit cards to only be issued by RBI regulated entities like banks or NBFCs. So, in RBI's view, this was a case of regulatory arbitrage.
- In June 2022 RBI released a letter prohibiting loading of credit lines onto PPIs.
- This forced BNPL players offering credit facilities to re-think on their business model. And forced a lot of major fintech players to pivot.

THE ROAD AHEAD FOR PPI

Double whammy:
RBI mandated KYC for e-wallets and the Supreme Court's decision in the Aadhaar case which barred non-bank e-wallet issuers (like Ola, PhonePe) from conducting Aadhaar OTP based e-KYC

At the same time, UPI evolved as seamless option for making quick and efficient small ticket transactions – further decline in PPI's popularity

RBI's step to make PPI interoperable with UPI opened new doors for PPI as payment instruments.

RBI, in its Payments Vision 2025 document mulls revisiting the existing RBI Directions – to enhance security and promote growth. Definition of closed PPIs may also be revisited.

RBI expects to make suitable changes to the PPI ecosystem to increase PPI transaction by 150% until 2025.

Future use cases:

Loyalty programs

Financial Inclusion initiatives

PAYMENT AGGREGATORS

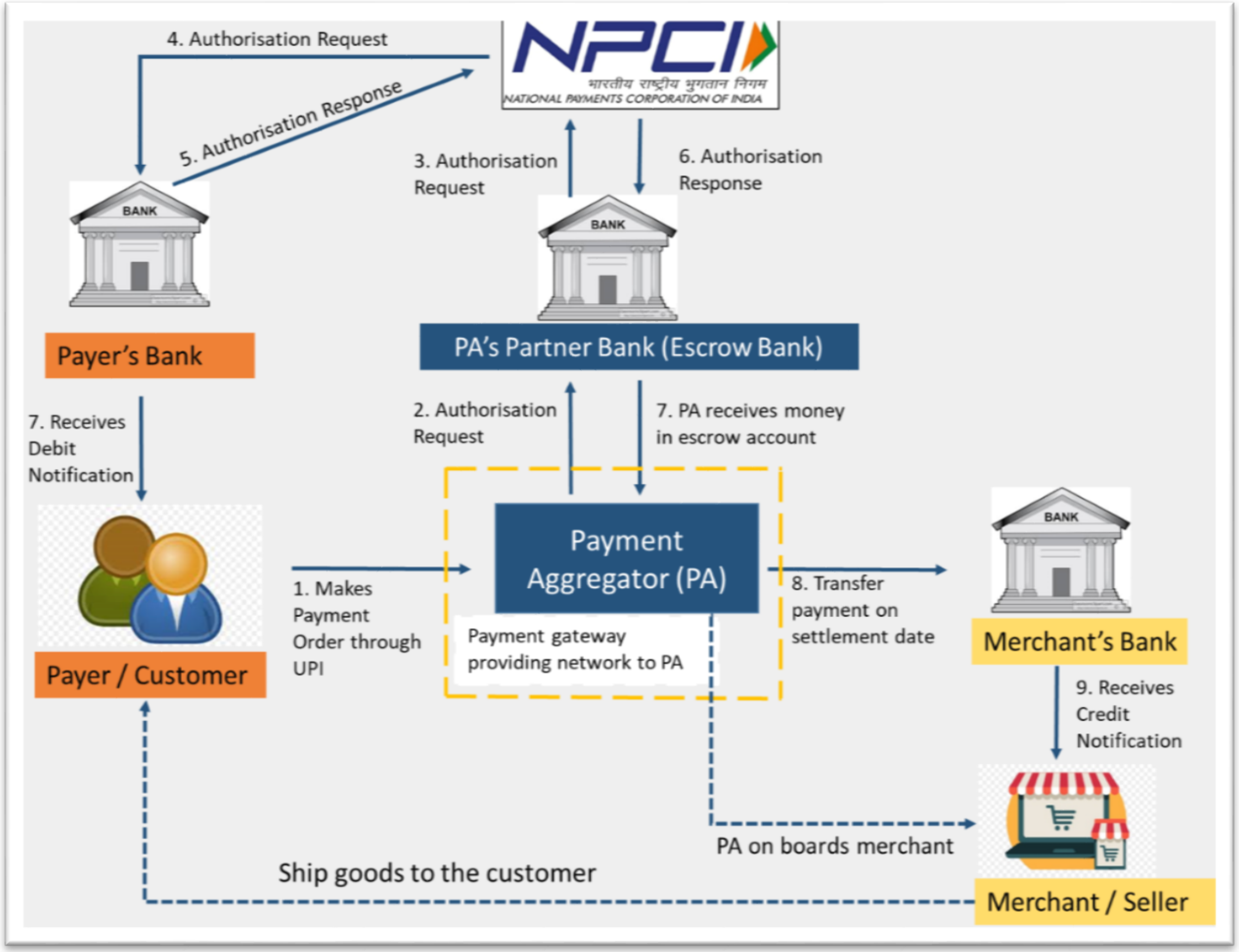


Fig 1: End to end non-bank payment aggregator transactional flow

The blue dotted lines in the fig. do not form part of payment system, but forms an important part of legal basis in merchant on-boarding process and shipment of goods to the customers in a PA business model.

Source: Author

PAYMENT AGGREGATORS

- The participants in an online payment transaction includes customer, merchant, merchant's bank, customer's bank, intermediaries, clearing houses, etc. Payment Aggregators (**PAs**) and Payment Gateways (**PGs**) are intermediaries in an online payments system.

- A PA integrates various payments options in one place for the merchant.

- PAs are often confused or equated with Payment Gateways. However, PG is a software used by acquirers to process transactions. And entities operating as PGs are not RBI regulated (because they don't handle public funds like PAs).

- For e.g., Razorpay. BillDesk, PayU, etc.

HISTORY OF REGULATING PA AND PG

- In November 2009, RBI released a notification to regulate payment intermediaries
- In the monetary statement for the year 2018 – 2019, RBI proposed direct regulation for e-payment intermediaries.
- In Sept. 2019, RBI released a discussion paper on PAs and PGs.
- In March 2020, the RBI repealed the Intermediary Directions and issued the Guidelines on Regulation of Payment Gateways and Aggregators to regulate PAs.

GUIDELINES ON REGULATION OF PAYMENT AGGREGATORS AND PAYMENT GATEWAYS (**GUIDELINES**)

I. RBI Guidelines on PA and PG Regulation ("**PA Guidelines**"): prescribe:

(a) authorization process and eligibility criteria (like minimum net-worth) for non-bank PAs,

(b) governance norms like promoters being 'fit and proper', merchant due-diligence, and safeguards against money laundering,

(c) maintenance of funds in RBI regulated escrow accounts,

(d) security and fraud prevention measures, and

(e) reporting requirements (like submission of Information Security Audit Report).

II. All non-bank entities that wish to operate as a PA are required to,

(a) obtain prior authorization from RBI; and

(b) maintain the amount they collect from customers in an escrow account with a scheduled commercial bank.

POLICY ISSUES

Payment Vision 2025 and PAs

- The Guidelines only regulate PAs which facilitate online payments.
- RBI has proposed to bring all significant payment intermediaries, including offline PAs, within direct regulatory oversight.

RBI's approach on granting PA licenses

- RBI has been stringent in evaluating PA license applications. No single player has received a final license from the RBI. Many applications have been returned due to non-compliance with the Guidelines.
- The entities are scrutinized for KYC related issues, operating business models, compliance with tokenization norms, money laundering concerns, past dealings with crypto exchanges and gaming apps, among others.

PAYMENT AGGREGATORS - CROSS BORDER

The RBI has released guidelines to regulate Payment Aggregators-Cross Border **(PA-CB)** – means intermediaries that process online cross-border payments. Until now, such entities were called online payment gateway service providers (**OPGSPs**), and RBI regulated them through authorized dealer banks (banks that process cross-border payments). The RBI has now decided to regulate OPGSPs/PA-CBs directly.

Key highlights:

- Entities engaged in or planning to start PA-CB activity must apply to the RBI for a license. Existing PA-CBs must apply before 30 April 2024.
- PA-CB applicants must comply with several obligations before submitting the application: (a) existing PA-CBs must, by 31 December 2023, comply with governance and risk management norms under the PA guidelines notified in March 2020; (b) they must have a net-worth of Rs. 15 crore on the application date; and (c) they must also register with the Financial Intelligence Unit-India (FIU-IN).
- PA-CBs are governed by the same guidelines as domestic Payment Aggregators.
- **Policy Issue**: The new guidelines to regulate PA-CBs is a significant development for the entire fintech ecosystem. The direct regulations of key fintech players under RBI regulations and anti-money laundering laws (**AML**) laws has been a hotly debated topic these last few months. OPGSPs/PA-CBs like Paypal and UPI apps like GPay have debated (in courts and other forums) that, as tech players, they must not be regulated directly (under the RBI and AML laws). After all, they do not handle funds – banks do it as per instructions that they convey. It is, however, unlikely that this can, anymore, be a sole defence to remain unregulated.

DIGITAL BANKING

DIGITAL BANKING

- Digital Bank - Principally rely on the internet and other digital channels to offer services. Also referred to as Neo-banks or Challenger banks.
- Neo-banks have three models:
  - front-end only neo-banks (e.g., RazorpayX),
  - full-stack licensed digital banks (e.g., Monzo), and
  - autonomous units of traditional banks (e.g., SBI Yono).
- Advantages of neo-banks:
  - tailored services for niche segments,
  - smooth and quick user experience, and
  - low and transparent pricing.
- Limitations of a front-end only neo-bank model are:
  - limited revenue potential (only earn referral fee and fraction of interchange income),
  - reliance on partner bank’s outdated tech stack,
  - reliance on equity capital to fund innovation and operations, and
  - lack of entry barriers which can put consumers at risk.

APPLICABLE REGULATIONS IN DIGITAL BANKING

- In July 2022, Niti Aayog released a proposal for full-stack digital banking license.
  - Creating a framework for digital bank licenses under the Banking Regulation Act.
- In April 2022, RBI released a notification for the establishment of Digital Banking Units (DBUs). DBUs were launched across 75 districts in October.
  - DBUs are brick-and- mortal outlets which will provide 24x7 digital banking services to those who do not have access to internet or digital infrastructure.
  - DBUs will provide services in two modes: self-service mode and digital assistance mode.
  - RBI wants clear segregation between DBUs and banks’ other units.
  - Banks can engage digital business facilitators to expand footprint of DBUs.

EMERGING POLICY ISSUES

In Nov 2021 and July 2022 Reports, Niti Aayog proposed implementation of full stack digital banks in three stages:

- Stage I: Introduction of a restricted digital business bank license and a digital consumer bank license.
- Stage II: Assessment of the licensee under the RBI’s regulatory sandbox.
- Stage III: Grant of a full-stack digital business or consumer bank license.

RBI is reluctant to accept the proposal of issuing licenses to digital banks.

- Digital bank licenses could further fragment the market.
- Applicants may not be able to meet the fit and proper criteria.
- Many small finance bank licenses have been issued but these banks have failed to grow.

WAY FORWARD

- Neo-banks struggle to attract large deposits for their partner banks because customers don’t use them as a primary account.
- To counter this, Neo-banks in India are trying to get different licenses besides a banking license.
  - Revolut is looking to get a PPI license, NBFC license and AD Category II license. It has acquired an entity which has an AD Category II license.
  - Neo-banks are also making use of RBI’s regulatory sandbox. For e.g., Open tested its blockchain based cross-border payments product in the RBI regulatory sandbox.

FINTECH POLICY

CENTRAL BANK DIGITAL CURRENCIES (CBDC)

In October 2022, RBI released a Concept Note on CBDC for India.

A CBDC is a legal tender issued by a central bank in a digital form. It is a digital alternative to fiat currency which is freely convertible against commercial bank money and cash.

- Objective: (i) save on currency printing and handling costs, (ii) complement existing digital payments systems, (iii) reduce the credit and liquidity risk in case of bank failures, (iv) reduce settlement risk in inter-bank transfers, (v) a risk- free alternative to private cryptocurrencies.
- Types: (i) retail CBDC, (ii) wholesale CBDC.
- Anonymity: partial anonymity.

RBI commenced the CBDC pilots for the wholesale and retail segments in November 2022 and December 2022, respectively. However, rate of adoption of CBDC by merchants has been low – merchants have to install different QR codes to accept CBDC and UPI payments. This increases their costs. To solve for this and promote CBDC adoption, RBI and NPCI have taken steps to make UPI QR codes interoperable with CBDC QR codes – means merchants can use same QR code can to accept both UPI and CBDC payments.

USE OF TECHNOLOGY IN KYC

- The Master Directions on KYC (**KYC Norms**) do not provide space for innovation. RBI has issued several amendments to the KYC norms, each one raising the complexity bar for REs.
- KYC Norms prescribe granular norms for conducting KYC. This limits the scope to leverage innovative technologies.
  - Use of AI/ML for document verification.
  - Use of facial recognition, liveness check and geo-location tracking for identity verification
- Issues with Remote KYC options (like Video-based KYC): It is an expensive and high friction process. It also requires presence of RE's official on a real-time basis.
- This gap can be bridged through simpler Remote KYC processes.
  - For e.g., KYC done through live-selfie without the need for presence of RE's official.

NPCI AND ITS PLANS WITH UPI

- NPCI products like RuPay cards and UPI are being structured to be interoperable with financial systems of other countries.
  - NPCI has partnered with payment network operators from different jurisdictions to enable UPI as a payment option.
  - RBI has also linked Singapore’s fast payment system, PayNow with UPI. This enables direct p2p money transfer between Indian and Singapore residents.
- NPCI collaborates with technology service providers and application service providers in the payments space to conceptualize innovative products.
  - NPCI has launched a partner program to train technology service providers in the UPI ecosystem.
  - NPCI has launched an open-source licensing model for its BHIM App.

INTER-OPERABLE REGULATORY SANDBOX

- RBI has announced a SOP for the Interoperable Regulatory Sandbox (**IoRS**) prepared by the Inter-Regulatory Technical Group on FinTech.
- The IoRS will facilitate testing of hybrid financial products/services falling in the ambit of more than one financial sector regulator (like SEBI, RBI, IRDAI, and PFRDA).
- The dominant feature of the product will determine the principal regulator, while other regulators would be associate regulators.
- The dominant feature of the product will be decided based on two factors:

  (1) the type of enhancement to an existing product, and

  (2) the number of regulatory relaxations sought by an applicant - the number of regulatory relaxations will have greater weight in deciding the dominant feature.

RBI PAYMENT VISION 2025

- In June 2022, RBI released a document encapsulating its vision for the evolution of payment systems in India.
- The theme for the payment vision document is E-Payments for Everyone, Everywhere, Everytime (4Es).
- The document anchors its proposals on five goalposts - integrity, inclusion, innovation, institutionalization, and internationalization.
- Expected Regulatory Changes -
  - A uniform user onboarding processes and transparency in operation of intermediaries.
  - Review of the existing regulatory framework for PPIs.
  - Review of digital payment charges.
  - Processing transactions through a payment system instead of intermediaries like payment aggregators.
  - Regulate offline payment aggregators.

SLICE-NORTH EAST SMALL FINANCE BANK MERGER

- Slice, one of India's leading fintechs, and North East Small Finance Bank (**NESFB**) announced their merger. Both Slice and NESFB are REs. So, the RBI's approval (for the merger) was necessary.
- The RBI approved the transaction because it was reportedly satisfied with Slice's proactive compliance and risk management measures. It also believed that Slice's technical prowess and NESFB's experience of servicing underbanked and underbanked segments can be combined to foster financial inclusion.
- Further, NESFB's failure (due to lack of capital, poor credit ratings and asset quality) would have had an adverse impact on the Indian economy.
- The merger is a win-win for both entities – NESMB gets capital to bolster its balance sheet, and Slice gets a banking license to foster product innovation. With a banking license, Slice can (a) accept deposit from customers, (b) directly issue credit cards, and (c) expand its services to segments that it has not serviced before.

- **What are the implications of the merger:** The merger is one-of-its kind deal in the Indian banking and finance space. This is a rare instance in which a fintech will be allowed to operate as a bank. The RBI has, in the past, been wary of giving banking and NBFC license to fintechs. For instance, it has rejected banking license application of Navi – an established player in the digital lending space. However, RBI's approval on the deal indicates that the regulator is willing to let fintechs operate as banks and NBFCs if their compliance, risk management and governance practices are good.

CASE STUDY

CREDIT ON UPI

BACKGROUND

- All players in the UPI ecosystem must adhere to UPI Procedural Guidelines.
- NPCI mandates PSPs and Remitter banks to implement 2-FA for UPI transactions.
- RBI and NPCI have the right to audit PSPs. NPCI also has the right to audit any participants in the UPI ecosystem including technology service providers.
- Consequence of breach of NPCI regulations - (i) termination of membership of a PSP, (ii) penalty on partner banks.
- PSPs are obligated to report to NPCI if service providers do not comply with the rules, regulations, operational requirements, and instructions for any NPCI products.

PERMITTED MODELS

- RBI and NPCI have permitted credit disbursal on UPI through (a) linking RupPay credit cards with UPI, (b) bank overdraft accounts, and (c) bank-sanctioned credit lines on UPI.
- RuPay and UPI -
  - One-time mandate with block functionality.
  - Two factor authentication.
  - Only P2M transactions.
- Overdraft Account (OD) and UPI -
  - Onboarding to be same as CASA.
  - Transaction to OD would mean repayment.
  - Both P2P and P2M transactions are allowed.

- Credit lines and UPI -
    - Users can link a credit line sanctioned by their bank to their UPI account.
    - Inward payments to UPI ID (by debiting CASA) would mean repayment of credit line.
    - Only P2M transactions are allowed.

Policy Issues

Credit lines on UPI have the potential to ease access to credit to even for those without credit cards. Although, RBI has allowed linking of Rupay credit cards to UPI. But only a small portion of the population can reap its benefits. Because credit card penetration in India is low. Despite this advantage, credit lines on UPI may not help in enabling financial inclusion at scale. Because RBI has not enabled credit line on UPI facility for credit lines extended by NBFCs – only bank-sanctioned credit lines have been permitted to be linked to UPI. Whereas, BNPL products targeted at new-to-credit and thin-file customers often involve a credit line issued by an NBFCs (not a bank).

ILLUSTRATION #1

- Payday (Pseudonym) - A BNPL platform offering a range of credit products.
- Payday decides to launch credit on UPI.
    - Payday partners with an NBFC to offer credit lines to its customers. Customers can make online/ offline payments using merchant QR codes or by using the UPI ID assigned to users by PayDay.
    - Payday receives details of the merchant's UPI ID once customers scan the QR.
    - Payday's NBFC partner makes payment to the merchants directly (through UPI rails) from a nodal bank account.
    - The customer repays the loan amount after 15 days.
- Is this a viable business model for credit on UPI?

ILLUSTRATION #2

- YestPay (Pseudonym) - Another BNPL platform that offers credit products.
- YesPay decides to link UPI to its BNPL options.
    - YesPay issues a PPI to its customers.
    - The PPI is loaded with a credit line from a partner bank or NBFC.
    - The customers make online and offline payments through UPI ID linked to the PPI.
- What makes YestPay's model problematic?

CONCERNS

- RBI and NPCI have permitted the three modes of credit disbursal through UPI, i.e., (i) linking RuPay credit cards with UPI, (ii) linking bank overdraft account to UPI, and (iii) linking bank-sanctioned credit lines to UPI.
- Previously, NPCI had asked Jupiter, Freo Pay, LazyPay – apps offering credit linkage with UPI through different business models - to either (a) stop providing services, or (b) restructure their products.
- In a UPI transaction, a user's bank account is the underlying layer – over which UPI’s technical layer enables transactions (to and from the bank account).
  - The user’s identity is linked to her bank account. The bank is responsible for KYC.
  - Some business models (like illustration #1) require the customer to initiate the transaction while allowing payment through its partner NBFC's account. This goes against the KYC standards set for UPI transactions.
- Increased risk of unverified transactions as the user is not in complete control of the transaction.

QUESTION HOUR

THANK YOU!