CGAP

Update on Regulation of Branchless Banking in India

January 2010

Note: This update of CGAP's 2008 "Notes on Regulation of Branchless Banking in India" incorporates research conducted by CGAP in January 2010 regarding relevant legal and policy changes through the end of 2009. It is one of 11 similar country updates produced by CGAP as a part of the work plan of the Access through Innovation Sub-Group of the G-20 Financial Inclusion Experts Group. However, CGAP alone is responsible for its content. Corrections may be forwarded to yseltzer@cgap.org.

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1. Introduction

India has all the ingredients to make branchless banking work: a government committed to increasing access; a central bank cognizant of the potential *and* the risks posed by branchless banking models; a large, sophisticated banking sector; a dynamic and competitive mobile phone industry; and no lack of cutting-edge technology providers.

In 2006, RBI issued a circular that—for the first time—allowed banks to use third-party business correspondents (BCs) to deliver financial services outside bank branches. However, early experiments by banks have failed to reach significant scale, and more generally, banks' interest in using BCs has been limited due in part to restrictions imposed by the circular. A 2009 revision to the circular removed some of the key restrictions, although it is not clear that banks see BCs as offering a compelling opportunity to grow their businesses.

In 2005, RBI substantially relaxed its anti-money laundering and combating the financing of terrorism (AML/CFT) requirements for banks—specifically, the identification and proof-of-residence requirements for small-value accounts. The current situation is favorable from the perspective of branchless banking.

The potential for payment and mobile banking (m-banking) services to be provided by mobile network operators (MNOs) and other nonbanks has not yet been fully realized due to restrictions on nonbanks accepting funds from the public and the past prohibition on any electronic money (e-money) issuance and transfer by nonbanks. However, recent changes have removed some of these barriers, and there have been other indications that change is on the horizon. In 2007, RBI issued two reports that revealed a keen awareness of the need to lower the costs of delivering payment and banking services. Then, in 2008, a comprehensive Payment and Settlement System Act went into effect pursuant to which RBI issued guidelines for the issuance of "prepaid payment instruments." These guidelines ostensibly enable MNOs to offer "mobile wallets" in partnership with banks, with the important restriction that MNOs may not intermediate or earn interest on the funds collected (except on a certain defined "core portion" as explained below). In a recent speech at a telecommunications industry event, an RBI Deputy General urged MNOs to

[1] The 2008 "Notes on Regulation of Branchless Banking in India" was based on an analysis of existing legislation and regulations relevant to branchless banking approaches and on the CGAP research team's insights from interviews with a range of stakeholders. The original diagnostic assessment was carried out under the auspices of CGAP's Technology Program, which is co-funded by the Bill & Melinda Gates Foundation. The Indian diagnostic assessment was one of seven that provided evidence for CGAP & DFID's Focus Note 43, *Lyman, Timothy, Mark Pickens, and David Porteous. 2008. "Regulating Transformational Branchless Banking: Mobile Phones and Other Technology to Increase Access to Finance."* Washington, D.C.: CGAP & DFID, January."

[2] In September 2009, the G-20 called for the establishment of a Financial Inclusion Experts Group with two sub-groups, one of which is the ATI Sub-Group. CGAP is a member of an experts group assembled to assist the ATI Sub-Group in its work, which includes updating information previously published on the policy and regulatory framework for branchless banking in various developing countries.

consider the new opportunities posed by these guidelines, and hinted at a possible future role for MNOs if banks failed to make progress toward financial inclusion targets through the BC model.[3]

2. Sector Overview

In spite of numerous government initiatives and a burgeoning microfinance sector, lack of access to formal financial services remains a problem in India to date. As of 2006, an estimated 29 percent, or 321 million Indians, were below the national poverty line.[4] Of these, nearly 80 percent lack access to formal financial services.[5] Less than 59 percent of the adult population has access to a bank account, and less than 14 percent of the adult population has a loan with a bank.[6] With more than 30,000 bank branches, 110,000 cooperatives (one in every five villages), and 150,000 post offices, financial sector policy makers and regulators do not believe the number of service points is a major problem.

In fact, most banks lack the appetite to serve the lower end of the market. The productivity of commercial bank rural branches has declined since the 1990s, not least because of the caps on interest rates charged on small loans, which banks say make it difficult for them to lend directly to microentrepreneurs and still make a profit. For loans below Rs. 200,000 (approximately US$4,400), commercial banks may not charge higher than their prime lending rate.[7] This requirement is related to RBI's priority-sector lending policies.[8] Regional rural banks have marginally improved their performance in recent years but the large majority still suffers from weak performance. Microfinance institutions (MFIs) have expanded rapidly over the last five years, though their reach remains concentrated in three states in South India. The self-help group (SHG)–bank linkage model continues to be important, although its rate of growth has slowed over the last two fiscal years.[9] Thus, many poorer customers, in particular in rural areas, lack access to suitable financial products.

2.1 Banking Activities

2.1.1 Banks. Few banks attempt to enter the microfinance lending business directly, instead preferring to lend through various microfinance channels. Bank interest is driven by Priority Sector Lending requirements that allow banks to include lending to microfinance activities in their quota. The larger lenders to MFIs include ICICI Bank, HDFC, ABN-AMRO (now RBS), and CitiBank. The government-owned Small Industries Development Bank of India (SIDBI) is the single largest lender to MFIs. Other public sector banks focus more of their lending toward the SHG–bank linkage model.

The introduction of BCs has led to experimentation with new branchless banking channels. Banks have used BCs (many of which have been established by technology companies) to open no-frills accounts and to process National Rural Employment

[3] Address by Dr. K. C. Chakrabarty, deputy governor, RBI, "Mobile Commerce, Mobile Banking—The Emerging Paradigm," delivered at the India Telecom Conference 2009, 4 December 2009. (http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=451).
[4] World Bank Development Indicators Database. http://go.worldbank.org/3JU2HA60D0 (accessed 12 November 2007).
[5] Malcolm Harper and Marie Kirsten, "ICICI Bank and Microfinance Linkages in India," *Small Enterprise Development* 17, no. 1 (2006).
[6] RBI, "Technical Paper on Differentiated Bank Licenses" (19 October 2007), § IV.A, ¶ 4.2.
[7] RBI, Circular DBOD.Dir.BC. 6/13.03.00/2007-08, Master Circular "Interest Rates on Advances" (2 July 2007), § 2.1. This requirement applies to commercial banks, not to regional rural banks or district central cooperative banks.
[8] Prabu Ghate, Sai Gunarajan, Vijay Mahajan, Prasanth Regy, Frances Sinha, and Sanjay Sinha, "Microfinance in India: A State of the Sector Report, 2007," pp. 24, 84,184.
[9] The SHG–Bank linkage program, introduced by NABARD (National Bank for Agriculture and Rural Development) in 1992, is not insignificant in its outreach. As of mid-2007, it had lent to 41 million persons. *Ibid*., p. 11.

Guarantee (NREGA) payments. As discussed in Section 2.2, banks have also worked with BCs to offer payment services.

Some additive use of mobile phones by banks has enabled banked customers to perform some functions (e.g., account inquiry, check ordering) remotely. However, partnerships between banks and mobile operators aiming to offer services to the unbanked at a large-scale have not yet materialized.

2.1.2 Nonbanking Financial Companies (NBFCs). Some large NBFCs (e.g., SKS and Basix) are keen to use agents and technology to offer deposit and/or remittance services. However, NBFCs are not able to meet the requirements required to engage in deposit taking (e.g., minimum capital and a minimum investment grade rating of a qualified credit rating agency). Even if they did qualify, they could offer only term deposits and not demand deposits considered essential to meet the poor people's need for product flexibility. Some NBFC MFIs have considered using related nongovernmental organizations (NGOs) to act as nonprofit BCs that operate in parallel to their for-profit operations, but early efforts have not gone as hoped, and several programs have been shelved.

2.1.3 NGO MFIs*.* NGO MFIs, whether registered as a Section 25 nonprofit company, society, or trust, are not currently permitted to take deposits, but they are active in lending to poor clients. NGO MFIs can operate as BCs for banks although banks have lacked the incentive to engage BCs because of the prohibition (removed under the most recent RBI circular regarding BCs adopted in 2009) on banks charging customers a fee for the use of a BC. It is possible that banks will now be more interested in working with BCs, given the cost-recovery possibilities; however, few NGO programs have a large enough presence to attract significant attention as potential BCs.

2.1.4 SHGs. There has been little discussion of using large SHGs as BCs, though the circular released November 2009 specifically opened up this possibility. One large SHG program in Andhra Pradesh State (Society for Elimination of Rural Poverty) will be launching a BC service in one district using its network of SHG organizations.

2.1.5 The Post. The India Post cannot offer loan services to its clients. However, post offices are eligible to operate as BCs for banks and could offer loans in such capacity, making use of the Post's significant infrastructure. In fact, several banks have started using post offices for lending under the BC model.

2.2 Payment Services

The Post has a dominant role in domestic money transfers through money orders delivered at the doorstep of the client, even though it can take seven or more days to remit the money. Recently, India Post launched a Web-based money transfer service called iMO (instant money order) that enables residents to send and receive money at more than 400 post offices countrywide. India Post is also collaborating with Western Union to provide international money transfers of up to US$2,500 from 185 countries to approximately 2,500 post offices in India, provided that the funds are for the recipient's personal use.

Mobile operators have been examining opportunities to offer payments services, but until late 2009, RBI discouraged their entry. Nevertheless, the picture is shifting due to the November 2009 RBI circular that expanded the possibilities of banks using BCs as well as greater attention to the potential of m-banking at the federal government level. There is a sense that mobile operators could be allowed to enter into this area at the not too distant future, though serving only as the front end of a bank-based service.

Airtel had been actively looking at an opportunity to use its distribution network to support the m-banking efforts of Eko under an SBI BC program. However, this has not materialized and Airtel appears to be waiting like other mobile operators to enter the business if and when regulation becomes more permissive. Telenor (under the Uninor brand) and Vodafone, both multinational mobile operators in India, have m-banking offerings in other countries and would likely be interested to do the same in India, given the right regulatory and market conditions.

Several technology firms have made initial forays into the payments space. To address a restriction in the BC circular regarding who may act as a BC—initially limited to nonprofits, the post office, and cooperatives—for-profit companies founded affiliated Section 25 nonprofit companies for the sole purpose of operating as BCs. FINO, a technology firm, working together with its nonprofit partner Fintech Foundation, which acts as the BC network manager, has opened 10 million accounts on behalf of 14 banks, the post office, and nine government agencies. A Little World (ALW) and its nonprofit partner, Zero Mass Foundation, have opened several million on their own. These two initiatives focus on providing services to banks to open no-frills accounts, to process NREGA payments and to extend insurance services. One of the early challenges is that it takes time to increase average account balances and to encourage users to transact more frequently over their services. FINO reports that account balances on average are increasing but only just surpassed Rs.100 and that users transact about 1.5 times per month. The banks who work with ALW report that the account balances and transactions need to increase for ALW as well. Eko is a similar technology-focused company with a parallel nonprofit, Eko Aspire Foundation, operating as BC. Eko, however, is using the mobile phone as the transacting device and focuses on person-to-person transactions as its central business. Eko is trying to grow its business through a partnership with SBI. There is a range of other technology-focused BC efforts, and some may expand considerably in time. However, few at this juncture have achieved the level of scale for which the promoters of the BC model had originally hoped.

Punjab National Bank (PNB), with the government of the State of Rajasthan, initiated the Bhamashah program to process large-scale social payments and succeeded in signing up more than 4 million clients in only two months. The Bhamashah program has been frozen due to a change in state government, but it could be restarted. PNB has broader aspirations to deploy its own in-house technology in many other states. Despite these investments, there is still skepticism that the level of investment and appetite for banks is sufficient to drive scale.

RBI along with some banks is also investing in a new national payments switch (NPCI). There is some desire to use NPCI as the platform to enable a growing number of BCs to access a wider number of banks.

3. Current Legal Framework for Branchless Banking

3.1 Agents

“Banking” in India is defined as “the accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft, order or otherwise."[10] Until 2006, banking activities could be conducted only by licensed banks and could not be outsourced.[11]

Pursuant to the BC Circular issued by RBI in January 2006,[12] banks were permitted to use BCs for a variety of services: (*i*) identification of borrowers, (*ii*) collection and preliminary processing of loan applications including verification of primary information/data, (*iii*) creating awareness about savings and other products and education and advice about managing money and debt counseling, (*iv*) processing and submission of applications to banks, (*v*) post-sanction monitoring,[13] (*vi*) disbursal of small-value credit, (*vii*) recovery of principal and collection of interest, (*vii*) collection of small-value deposits, (*viii*) sale of microinsurance and other third-party products, and (*ix*) receipt and delivery of small-value remittances and other payment instruments. Pursuant to the BC Circular, banks are liable to their customers for their BCs' "acts of omission and commission."[14]

While the BC Circular was an important step in facilitating bank-based branchless banking models, it also placed restrictions on the model, including (*i*) limiting the institutions eligible to operate as BCs to nonprofit institutions, post offices, and cooperatives[15] and (*ii*) prohibiting banks from charging customers for services rendered by BCs,[16] thereby preventing cost recovery and limiting available funds for fees to BCs.[17] These restrictions stymied initial product offerings and uptake, leading RBI to form a working group to assess the BC regulatory landscape and recommend suitable changes. The working group's August 2009 report recommended that (*i*) a broader range of entities be allowed to serve as BCs; (*ii*) banks engage BCs to offer a fuller range of banking services, beyond merely opening and administering no-frills accounts; (*iii*) banks be permitted to charge fees to customers for using BCs; and (*iv*) banks provide more incentives for BCs (including better compensation, temporary overdraft facilities without charging interest, and funds for initial set-up expenses).[18]

On 30 November 2009, largely based on the recommendations in the report of the working group, RBI issued significant revisions to the 2006 Circular. First, the revisions permit banks to charge customers "reasonable fees" for using BCs under Board-approved policies, a change that improves the business case for banks and should enable better compensation for BCs, particularly as they expand the range of services offered. Second, the revisions expand the scope of permissible BCs to include individual "kirana",[19] medical, and fair price

[10] Banking Regulation Act (1949), § 5(b).
[11] Ibid., §§ 5(b), 22. The law makes clear that a manufacturing or trading business that accepts deposits from the public to finance its business is not deemed to be engaged in banking.
[12] RBI, Circular DBOD.No.BL.BC.58/22.01.001/2005-2006, "Financial Inclusion by Extension of Banking Services—Use of Business Facilitators and Correspondents" (hereinafter BC Circular), 25 January 2006. Business facilitators can provide only nonfinancial services and are therefore not a focus of this paper.
[13] These first five listed services may also be performed by "business facilitators," which may be NGOs, post offices, IT-enabled rural outlets of corporate entities, cooperatives, insurance agents and others. RBI approval is not required for the use of business facilitators.
[14] BC Circular, § 5.2(b).
[15] The Khan Report proposed a wider range of institutions to be permitted to act as BCs, including for-profit institutions. The list included NBFCs and "government/corporate supported IT enabled outlets which already conduct cash transactions on behalf of the corporate entities." The BC Circular initially permitted nondepository NBFCs to be BCs; two months after the issuance of the BC Circular, RBI issued a new circular providing that only NBFCs formed as a Section 25 nonprofit company could operate as BCs.
[16] BCs were also prohibited from charging customers any fee directly.
[17] The BC Circular also required that all transactions be reflected on the books of the bank by the next working day. Banks have been relatively successful leveraging technology to address this requirement. ICICI, for example, launched FINO, which provides an application to easily transfer transaction data to the bank with the help of smart cards and point-of-sale terminals.
[18] Report of the Working Group to Review the Business Correspondent Model, 19 August 2009.
[19] Kirana shops are small, owner-staffed shops used by the majority of Indians (particularly rural) for basic groceries and fast moving consumer goods.

shop owners; individual Public Call Office (PCO) operators; individuals who are petrol pump owners; agents of small savings/insurance schemes; retired teachers; and functionaries of well-run SHGs linked to banks.[20] NBFCs were notably absent from the new list of permissible BCs, despite being recommended for inclusion by the working group. Many believe that MFI NBFCs would be well poised to reach underserved customers on behalf of banks, given their extensive existing physical infrastructure and customer relationships. However, RBI appears to be concerned about commercial entities making a profit based on charges imposed on the poor, and consequently opted against NBFCs as BCs. Third, the revisions make allowances for reaching the highly underserved northeastern regions, including exemption processes for permissible BC entities and from certain accounting standards.

Also, earlier in April 2009, RBI had increased the maximum distance permitted between the place of business of a BC and the bank branch, from 15 kms to 30 kms, further facilitating the expansion of BCs.[21]

Regarding outsourcing generally, in November 2006, RBI issued outsourcing guidelines ("Outsourcing Guidelines") for banks that prohibit banks from outsourcing core management functions,[22] including internal audit and decision-making functions (such as loan approval and determining compliance with know your customer (KYC) norms for opening deposit accounts). The Outsourcing Guidelines articulate “necessary safeguards” for addressing the risks inherent in outsourcing financial services, with the objective being that “the regulated entity should ensure that outsourcing arrangements neither diminish its ability to fulfill its obligations to customers and RBI nor impede effective supervision by RBI.”[23] The guidelines specifically provide that outsourcing should not affect the rights of a customer against the bank and that the bank remains responsible for the actions of its agents. In addition, bank contracts with agents are required by the guidelines to provide RBI with the right (*i*) to inspect the agent and (*ii*) to review agents’ information and records that are relevant to the outsourced activities.[24]

3.2 AML/CFT

AML/CFT issues are regulated under the Prevention of Money Laundering Act 2002. The law applies to banks and financial institutions. For banks, RBI has issued KYC guidelines and AML standards.[25] The guidelines advise banks to categorize customers[26] into low, medium, and high risk and to adjust identification requirements according to such risk category. According to the guidelines, low-value accounts with low turnover were low risk.

[20] RBI, DBOD.No.BL.BC. 63 /22.01.009/2009-10, 30 November 2009.
[21] RBI, DBOD.No.BL.BC.129 /22.01.009/2008-2009, 24 April 2009.
[22] RBI, Circular DBOD.No.BP.40/21.04.158/2006-2007, “Guidelines on Managing Risks and Code of Conduct in Outsourcing of Financial Services by Banks,” 3 November 2006. As stated in the guidelines, RBI incorporated the Guiding Principles on outsourcing financial services (February 2005) issued by the Joint Forum (a tripartite body comprised of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions, and International Association of Insurance Supervisors).
[23] *Ibid*., Annex, §1.5.
[24] *Ibid.,* Annex, §§ 4.1, 4.3, 5.5.1.
[25] Only the AML/CFT requirements applicable to banks are discussed because currently there are no NBFCs taking deposits, and NBFCs (other than those formed as Section 25 nonprofit companies) are not permitted to act as BCs for banks.
[26] For purposes of KYC requirements, the term “customer” includes any person with a bank account or other relationship with the bank, any beneficial owner of an account, and any person connected with a financial transaction that can pose a significant reputational or other risk to the bank (the guidelines give as an example a wire transfer). RBI, Circular DBOD.No.AML.BC.58/1 4.01.001/2004-05, “Know Your Customer (KYC) Guidelines—Anti Money Laundering Standards,” 29 November 2004.

Notwithstanding this, banks reported that the KYC procedures remained a challenge for many low-income clients.

In response, RBI issued a circular substantially relaxing the identification and proof of residence requirements for small-value accounts with a maximum account balance of Rs. 50,000 (approximately US$1,100) and maximum money deposit into the account per year of Rs. 100,000 (approximately US$2,200).[27] For such accounts, identity and address can be proven through

> (*i*) introduction by another account holder who (*a*) went through full KYC procedures and opened an account at least six months prior and (*b*) can certify the applicant's address and provide a photograph of the applicant, or
>
> (*ii*) production of any other evidence as to the identity and address of the customer to the satisfaction of the bank.

Under this KYC regime it is unlikely that customer identification and address verification constitute a problem for small-value transactions.

In October 2006, the RBI Governor announced that bank KYC procedures would be further simplified in the interest of financial inclusion. According to this announcement, for opening small accounts with outstanding balances up to Rs. 50,000 (approximately US$1,100) and total annual transactions up to Rs. 200,000 (approximately US$4,400), banks would need only a photograph of the account holder and self-certification of the account holder's address.[28] Unfortunately, changes have since been stalled, and it is not clear when or even if such proposed changes will be made.

However, the RBI's 2009 "Policy Guidelines for Issuance and Operation of Prepaid Payment Instruments in India"[29] provide further relaxed standards for certain prepaid payment instruments. Specifically, (i) semi-closed instruments (as defined in the Guidelines and discussed in Section 3.3 below) of Rs. 1,000 or less may be issued against any identity document (provided that an issuer must insure that a customer holds only one such active instrument at any time), (ii) any prepaid instrument of Rs. 5,000 or less may be issued against any officially valid document defined as such under the Prevention of Money Laundering Act, (iii) semi-closed instruments used only for payment of utility bills or essential services up to Rs. 10,000 can be issued without any KYC by the issuer (provided that the institutions receiving payments maintain the full identity of their customers), and (iv) semi-closed instruments of up to Rs. 5,000 may be issued to companies which then may issue the instruments to their employees or other beneficiaries, provided that such companies maintain full details of their employees or other beneficiaries. Aside from these specified exceptions, the guidelines provide that all prepaid instrument issuers comply with existing AML/CFT rules. In addition, issuers must maintain a log of all transactions undertaken using prepaid instruments, which should be available for review by RBI.

RBI also allows for nonface-to-face customer identification, but only if there are specific and adequate procedures to mitigate the higher risk involved.[30] The guidelines'

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[27] RBI, Circular DBOD.No.AML.BC.28/14.01.001/2005-06, "Know Your Customer' (KYC) Guidelines—Anti Money Laundering Standards," 23 August 2005.
[28] RBI, "Mid-Term Review of Annual Policy Statement for the Year 2006–07," 31 October 2006, ¶ 127.
[29] RBI, Circular DPSS.CO.PD.No.1873/02.14.06/2008-2009, "Policy Guidelines for Issuance and Operation of Prepaid Payment Instruments in India," 27 April 2009 (hereinafter Prepaid Instrument Guidelines).
[30] RBI, Circular UBD.BPD(PCB)MC.No.9/13.01.00/2005-06, Master Circular "Maintenance of Deposit Accounts," 11 August 2005, Annex A to Annexure III.

recommendations—certification of all documents presented and requiring the first payment to be effected through the customer's account with another bank—are likely to create high barriers for remote account opening.

Except as noted below, for international transfers of funds, banks are required to include accurate and meaningful originator information (name, address, and account number). The information must be preserved for at least 10 years. For domestic transfers, the same applies except that there is a threshold of Rs. 50,000 (approximately US$1,100) below which only suspicious transactions require identification.[31] This is an important consideration for business models built around domestic person-to-person transfers via mobile or any other electronic device.

In a promising development, the Government of India launched in 2009 a new initiative to provide all Indians with a unique identification (UID) number. The initiative, headed by Nandan Nilekani, an Indian Minister of State and one of the founders of the technology firm Infosys, is still in its initial stages and is seeking broader support throughout the government. It is expected that UIDs will voluntarily offer residents of India a unique identifying number that can be verified electronically via a biometrically read finger print. This effort could have positive implications for branchless banking efforts by removing identification risks associated with remote account opening and transactions—though there will undoubtedly be challenges posed by the expense involved in developing biometric reading infrastructure.

3.3 Regulation of E-Money and Other Similar Stored-Value Instruments

Until 2009, only banks and financial institutions were permitted to issue e-money and collect funds for payment to third parties.[32] In April 2009, RBI issued its Prepayment Instrument Guidelines pursuant to the 2007 Payment and Settlement Systems Act. The Guidelines identify three categories of prepaid instruments, which term includes smart cards, magnetic stripe cards, Internet wallets, and mobile accounts and wallets, paper vouchers. The three categories are: (*i*) "closed" system payment instruments, which may be used only for the purchase of goods and services from the issuer itself and therefore, as explicitly stated, are not classified as payment systems;[33] (*ii*) "semi-closed" payment instruments, which may be used at a group of clearly identified merchant locations and/or establishments that have contracted to accept such instruments, but which may not be used for cash withdrawal or redemption; and (*iii*) "open" system

[31] RBI, Circular DBOD.AML.BC. No.77/14.01.001/2006-07, "Know Your Customer (KYC) Norms/Anti Money Laundering (AML) Standards/Combating of Financing of Terrorism (CFT)—Wire Transfers," 13 April 2007.

[32] In 2004, RBI issued a circular announcing that only banks were permitted to issue smart cards, debit cards, stored-value cards, and value-added cards. RBI, Circular DBODNo.FSC.BC.106/24.01.019/2003-04, "Issue of Smart / Debit Cards," 30 June 2004. Two years later, responding to the "internet based electronic purse schemes" that were cropping up, RBI announced that such schemes were "in the nature of acceptance of deposits" and therefore companies engaged in such activities were in violation of the RBI Act governing registration of deposit-taking NBFCs. RBI, Circular DBODNo.BP.BC22/08.12.01/2006-2007, "Providing Clearing and Settlement Services for internet-based electronic purse schemes," 14 July 2006. RBI explicitly advised banks not to associate themselves with such schemes. One month later, RBI issued guidelines for cards issued by banks, including prepaid/stored-value cards RBI, Circular DBOD.FSD.BC.9/24.01.001/2006-07, Master Circular "Para-banking," 1 July 2006, ¶ 9, Annexure 1 (also included in the more recently issued RBI, Circular DBOD.FSD.BC.18/24.01.001/2007-08, Master Circular "Para-banking," 2 July 2007, ¶ 9, Annexure 1).

[33] Under the PSS Act, a payment system (defined as a system that enables payments to be effected between a payer and beneficiary and involves clearly, payment and/or settlement services but excluding a stock exchange) must be authorized by RBI. The Act specifically provides that such authorization is not required for payment agents, any company accepting payments from its holding company, any subsidiary thereof or any subsidiary of the receiving company, or any other company specifically exempted by RBI.

payment instruments, which may be used at any point-of-sale (POS) enabled merchant and for cash withdrawal at automatic teller machines (ATMs).

Only banks may issue all three types of instruments (and only those banks which have been permitted by RBI to provide mobile banking transactions may launch mobile accounts and wallets). NBFCs and "other persons" may issue only semi-closed or closed instruments. There are a variety of rules regarding the issuance of these instruments, including minimum capital requirements, special AML/CFT policies (see Section 3.2), maximum value (Rs. 50,000), minimum validity period (six months), and guidelines for how they can be issued and reloaded. There are also limits on how the collected funds can be used. For example, nonbanks must keep the funds collected in a noninterest-bearing escrow account with a scheduled commercial bank, and can collect interest on only a portion of these amounts, and only if other conditions are met.[34] This practice ensures that banks largely continue to control and benefit from the float, and encourages nonbanks to focus only on fee-based (rather than float-based) business models.

In August 2009, RBI amended the guidelines to permit "Other Persons" to issue mobile phone-based semi-closed prepaid instruments, although such instruments are restricted to a maximum of Rs. 5,000 (approximately US $110) value, cannot be purchased or recharged with mobile phone airtime, and can be used only for the purchase of goods and services (i.e., no person-to-person transfers).[35] RBI has since suggested that these revisions were intended in part to provide MNOs a way to offer customers a "mobile wallet" through banks, thus ensuring that the float would remain with banks, a clear objective of RBI.

3.4 Payment Systems

Until late 2007, India did not have a payment systems law. The 2007 Payment and Settlement Systems (PSS) Act, which came into force 12 August 2008, provides for the regulation and supervision of payment systems in India and establishes RBI as the authority for payment systems. Under the Act, a payment system (defined as a system that enables payments to be effected between a payer and beneficiary and involves clearly, payment and/or settlement services but excluding a stock exchange) must be authorized by RBI. Such authorization is not required, however, for payment agents, any company accepting payments from its holding company, any subsidiary thereof or any subsidiary of the receiving company, or any other company specifically exempted by RBI.

The RBI may prescribe and adopt regulations on the format of payment instructions, the standards for payment systems, the conditions for system participants participating in fund transfers, and procedures for the appointment and operation of a Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) within RBI to exercise its powers and discharge its duties under the Act.

Today, only banks and the India Post may provide domestic money transfer services.[36] (Although, as noted below, banks may offer mobile services as a channel for existing

[34] While nonbanks cannot earn interest on collected funds deposited into an escrow account, nonbanks are permitted to move a "core portion" of the funds into a separate interest-earning account subject to certain additional considerations, such as continued operation for at least one year and linkage of the separate account to the escrow account to satisfy any shortfalls. The "core portion" is determined with reference to the lowest daily outstanding balance of an escrow account over a year, and it is intended to be sure that a nonbank collects interest only on stable funds not subject to the characteristic high turnover of a payments transaction account. See Prepaid Instrument Guidelines, Section 7.

[35] RBI, Circular DPSS.CO.PD.No.344/02.14.06/ 2009-10, 14 August 2009.

[36] Indian Post Office Act (1898), Chapter IX, authorizes post offices to engage in money transfer services through money orders.

customers.) International money transfers into India are addressed by RBI's Money Transfer Service Scheme,[37] which permits the following institutions to receive international remittances: authorized dealers (primarily banks authorized to deal in foreign exchange under the Foreign Exchange Management Act [FEMA] 1999), RBI-licensed fully fledged money changers, NBFCs, and IATA-approved travel agents with a minimum net worth of Rs. 250,000 (approximately US$ 5,500). Prepaid instruments may be used for cross-border transactions only if the issuer is authorized under FEMA and is a participant in a payment system.[38]

In October 2008, RBI issued the Operative Guidelines for Mobile Banking Transactions in India pursuant to the PSS Act in acknowledgment of the growing opportunity to use mobile phones as an alternative channel for banking services.[39] In summary, these guidelines provided that

(a) Only banks licensed and supervised in India *and* with a physical presence in India can offer mobile banking to customers (i.e., MNOs and nonbanks cannot offer mobile banking services)
(b) Mobile banking services are limited to existing customers of banks
(c) Cross-border and foreign currency remittances are not allowed
(d) Services must be interoperable across MNOs within six months of offering
(e) Daily transactions are limited to a value of Rs. 5,000 (approximately US$110) for transfers and Rs. 10,000 (approximately US$220) for purchases involving goods and services
(f) Banks offering mobile banking services must obtain a one-time prior approval of RBI

These guidelines also required a two-factor authentication (including mPIN) and suggested end-to-end encryption. In late December 2009, these guidelines were updated to increase the transaction limit to Rs. 50,000 (approximately US$1,100) on all forms of transactions and remove encryption requirements for transactions below Rs. 1,000 (approximately US$22).[40]

[37] Money Transfer Service Scheme, 2003, http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=1217.
[38] The Prepaid Instrument Guidelines, Art. 6.2.
[39] RBI, Circular DPSS.CO.No.619/02.23.02/ 2008-09**,** 8 October 2008 (hereinafter Mobile Banking Guidelines).
[40] RBI, Circular No. DPSS.CO.No.1357/02.23.02/2009-10, 24 December 2009.