



Discussion Paper on
Payment & Settlement Systems Act 2007

By

Internet & Mobile Association of India

A: Executive Summary

1. Payments Systems in India:

Payment Systems in India has come a long way from Cash based systems to Card based and in future moving towards virtual accounts and e-payments. Indian Payment Systems has been largely controlled and managed by its Central Bank, the 'Reserve Bank of India' and other Banks like in most of the countries. At the macro level the Payment Systems can be classified as follows:

- **Traditional Payments Systems:** some of the key examples of payment instruments which are basis of these systems are Cash, Bank Accounts like Saving/Current Accounts, Cheque, Demand Drafts, EFT, Credit Cards, ATM Cards, Debit Cards.
- **Extension of Traditional Systems:** Market Demand led by Information technology and innovation have seen the Traditional Payments Systems launching new services in form of Internet Banking, Mobile Banking, ECS, RTGS, NEFT, Store Value Prepaid, Smart or Contact less Cards linked to Bank Accounts, No Frills Account. Most of these are extension of Traditional Payments Systems.
- **New Payments Systems:** Market Opportunities, Advancement of Technology and Innovation has resulted in new payments systems by non-traditional players launching new payments instruments like Internet Accounts, Internet or Mobile Wallets or Purse, Mobile Based Accounts, Internet or Mobile based remittance services, Prepaid Cards.

Globally services like Paypal, Obopay, Green Dot are mainstream and are already growing at an accelerated rate contributing a great deal to areas of Internet Commerce, Mobile Commerce, Financial Inclusion, International Remittance, Mobile Banking, Micro Transactions Processing delivering speed and economy to payer and payee at the same time ensuring appropriate level of safety and security. 'Committee on Payment and Settlement Systems of Bank For International Settlement' has published a report on Non-traditional and New Payment systems in their report on 'Survey of developments in electronic money and internet and mobile payments' in March 2004 covering about 90 plus countries across the globe. 'Financial Action Task Force: Groupe d'action financière' also published their report on Non Traditional and New Payments Systems titled 'REPORT ON NEW PAYMENT METHODS' dated '13 October 2006'. While the focus was primary the Risk Assessment and suggestions for Mitigating these Risks but it has also evaluated various Non-traditional and New Payments Systems across the globe [*FATF has issued a draft topology report that acknowledges that alternative payment methods may be low risk, if proper processes for risk mitigation are in place (see FATF Report attached separately)*].

'Department of Payments and Settlement' of Reserve Bank of India which was set up in Year 2005 with a view to Oversight on Payments and Settlement Systems in India has published various white papers and reports on Indian Payments System and Reserve Bank of India's vision for 'Safe, Secure, Sound and Efficient Payments and Settlement System' for the country.

2. The Payments and Settlement Systems Bill 2007

- **Key Features of The Payment and Settlement Systems Bill 2007**

The Government of India introduced 'The Payment and Settlement Systems Bill 2006' in Year 2006 to facilitate the Oversight of Payments and Settlement Systems in the Country by Reserve Bank of India. The Bill has been reviewed by Parliamentary Committee and introduced in Lok Sabha and Rajya Sabha of Parliament of India for approval. The Earlier Bill amended as Bill No. 50-C of 2007 and now called 'The Payment and Settlement Systems Bill 2007 (The Bill)' as passed by Lok Sabha on 26th November 2007 and became an Act.

The Act has 8 (eight) chapters and 38 (thirty eight) clauses and various sub clauses covering various matters like definitions, authority and its committee to regulate the payment systems in the country, authorization of payment systems in the country, regulation and supervision by the Reserve Banks of Payment System like they already do for Banks and certain other entities, rights and duties of a payment system, settlement of disputes, offences and penalties, miscellaneous dealing with matters like power of RBI to make rules etc and specifically exempting Stock Exchanges and Clearing Corporations of Stock Exchanges. These chapter and clauses are designed:

“to provide for the regulation and supervision of payment systems in India and to designate the Reserve Bank of India as the authority for that purpose and for matters connected therewith or incidental thereto.”

- **IAMAI Members' Understanding of the Bill:**

Based on the Historical Background of The Payment and Settlement Systems Bill 2007 our understanding is that the objective of RBI and BIS has been to have all Central Banks empowered for **Oversight on Systemically Important Systems (SIPS)** or at Best System of System Wide Importance (as mentioned in RBI report on Oversight of Payments System 2006-07), However the current Bill does not specify nor provide adequate classification to oversight the payment systems based on their Systemically Important criterion. This may not be the objective of the Reserve Bank and would bring all Non-traditional and New Payments System whether or not they are Systemically Important.

3. Payments and settlement Systems: Global Scenario

In most developed countries where the regulations are being provided for the Payments Systems these have been on the basis of the Risk. These possible risk categories have also been defined as Open Payment Systems, Closed Payment Systems and Semi Open/Close Systems. These systems have been classified based on risk parameters like Identification, Value Limits, Geography, Funding in, Funding out, Usage Limits, Currency Denomination.

Risk Parameters	Open-ended	Close-ended	Semi-Open/Close ended
Identification	Anonymous	Identity available in form of KYC	Basic KYC available directly or indirectly
Value Limits	Generally no limit	Specified limit	Limits May or may not be specified, but for specified usages
Geography	International Transactions	Clear Geographic usage mostly pure Domestic	May have Geographic Details but for specific usages within Geographic boundaries specified
Funding-in Options	All options including cash	primarily bank accounts or bank instruments	Pre specified and Bank instruments
Funding-out Options	Globally anywhere in all forms including ATM Cash withdrawals	Not possible or only in bank account	Possible but with additional formalities and for specified purposes
Usage Limits	No Limits	Prefixed annual and periodic limits	May or may not be specified but for specific usage only
Currency Denomination	Local currency but highly liquid like USD and easily convertible in other currencies	Only Local currency non liquid and non convertible	Local Currency but strong currency like USD, Euro

Most of the New Payment Systems and Branchless Banking Systems are also classified as following options which can again be in nature of Open, close or semi open/close:

- Prepaid Cards
- Internet Accounts/Wallet/Purse
- Mobile Accounts/Wallet/Purse
- Remittance (Domestic or International)

New Payments Systems	Open-ended	Close-ended	Semi-Open/Close ended
Prepaid Cards	Bank Prepaid Cards with ATM withdrawal domestic as well as International	Limited Usage prepaid cards without Cash withdrawal Options	Prepaid Cards like No Frills Account Cards for branchless banking with KYC and pre-specified limits
Internet Accounts/Wallets/ Purse	Internet Bank Accounts, Internet Virtual Accounts with Cash Withdrawal across the globe	Internet Accounts / Wallets/Purse for specific usages with no cash withdrawal	Internet Accounts / Wallets/Purse for specific usages with cash withdrawal in to specified bank accounts etc.

Mobile Accounts/ Wallets/ Purse	Mobile Banking Account with all features of traditional banking and cash	Mobile Accounts / Wallets/Purse for specific usages with no cash withdrawal	Mobile Accounts / Wallets/Purse for specific usages with cash withdrawal in to specified bank accounts etc.
Remittance	Across the globe; no limits	Pure Domestic	Domestic or International but with specified value for specific transaction and total during the year

In a few countries where ‘New Payment Systems’ are regulated the regulations are generally of three Levels i.e.;

Level I: Basic Registration and Information for the Central Banks to have direct access on the growth and information which may be required from time to time in their function as Monetary Authority. Such regulation is primary for the Payment Systems which are low risk and primary close ended systems.

Level II: At Level II certain Payment Systems may be regulated based on the different payment instrument and services they deliver in their respective country and they may have different requirement for different payment systems for different instrument they run. Some of them may require specific licensing subject to certain terms and conditions, some specific identity related regulation like KYC, Certain limits on value of transactions or reporting in case of transactions above certain specified values.

Level III: Non-traditional or New Payment Systems which has elements of ‘Systemically Important Systems’ as specified by CSPP may be regulated at Level III which may be more close to current banking system compliances, however while regulating such payments systems only specific services and products that qualify as nature of ‘Systemically Important’ should be regulated as Level III and other services which are not of the same risk or criticality should be regulated at appropriate level.

Countries like Singapore and the European Union where New Payments systems are popular and have a high adoption rate have been able to provide adequate detailed guidelines to differentiate and regulate the Payment Systems based on their ‘Systemically Important’ nature and ‘Possible Risks’.

4. IAMI submissions on Payments and Settlement Systems Act 2007

The proposed Payments and Settlements Act is a document that is difficult to critique as it merely places the overall payment and settlements regime in India within the ambit of the Reserve Bank of India [RBI]. The RBI has not yet explicitly laid out its position on the various options that are likely to be available. But what is clear is that there is a need for a framework to be developed which clarifies the status of Non-traditional and New Payments Systems.

This paper, therefore, calls for building a framework that explicitly states what the regulatory system that oversees the Non-traditional and New Payment Systems should be like. It suggests certain important characteristics that ensure:

- (a) Stability
- (b) Innovation, entry and competition
- (c) Entry of small players into e-payment services
- (d) Secure and safe e-payment system

We are therefore able to answer some important questions that are not addressed adequately by the proposed Act. These issues will need to be decided by the regulator while framing the Rules and Guidelines for the Payments and Settlement Systems Bill:

1. Whether Non Systemically Important Payments Systems like Non-traditional Payments System and New Payments System fit into the definition of System Providers is not clear; but since the flexibility of defining such providers has been given to the RBI in the proposed bill, it will only become clear what route the RBI will take.
2. Should this segment that is at such a nascent stage of development be regulated? Regulation will impose costs with little immediate benefits at this point and therefore some may prefer regulation to be delayed. However, if regulations ensure entry with safety and security, they will only accelerate the spread of the New payments systems. This should be a critical element for developing a legal framework for emerging transaction technologies.
3. Who should provide such services and who should not? The question of entry is important, as undue regulation will prevent entry and therefore competition from the non-bank sector. Here it is essential that all segments, not just the Banking sector, should be able to provide such payment system services. Moreover explicit mention should be made on facilitating the entry of small players.
4. How should issues of safety and security be addressed? Fears such as money laundering or use in illegal cross border trade are quite unfounded as there are other much easier means to undertake these tasks. However, as long as basic monitoring and reporting systems are being followed, these can be directly addressed. With electronic payments it would be easier to trace as well as identify both activities as well as persons indulging in such activities.

In conclusion, the Rules and Guidelines for the current bill should be framed to include broad principles that would be followed. The Regulator needs to specifically mention the broad vision that will then translate into broad principles related to entry, competition, innovation, equity and growth. The reason is, if the regulator focuses more on maintaining security and stability and not give enough weight to the fact that a growing and inclusive economy needs many different types of providers to meet the demands of the different types of potential users, the purpose of regulation would be diluted to a great degree. The poor and rural users, the un-banked population, small groups, payment over the Internet, etc. all need to be facilitated and coverage growth needs to be accelerated.

In most of the countries the Regulation is for the specific product/service and in proportion to specific risk and the same is not on the entity or business. And in line with best global practices RBI should provide for the Rules and Guidelines which is based on three tier principle and provide regulation in proportion to the risk associated with different type of Payment Systems especially New Payment Systems. Industry proposal at the macro level is as follows:

Open-ended New Payment Systems	Close-ended New Payment Systems	Semi-Open/Close ended New Payment Systems
Level III Regulation: Registration; Licensing; AML/CFT; Transaction Reporting; Capitalization; Fund Utilisation Norms	Level I Regulation: Registration and Authorization Only with time to time information sharing on need to know basis by regulator	Level II Regulation: Registration and Authorization, Specific Guidelines in terms of Value and Funding Limits and Reporting; Guidelines for utilizing Funds

- ⇒ Technology vendors /Partners/service providers to Organizations/players who run Payment Systems should not be subject to RBI authorization as the compliance responsibility is on the Payment System Service Provider.
- ⇒ RBI may at best provide technology guidelines /standards to be followed by all these vendors/partners to ensure security, safety and interoperability of system.

New and Nontraditional payments system may take mitigating steps which will help lower overall risk in the system:

- Service providers could implement ISO 27001 certification to ensure that the relevant controls are in place. While this is not mandatory it may be a recommended guideline.
- Service providers that deal with Card information in any way should adopt the Payment Card Industry DSS 1.1 certification (PCI compliance)
- Vulnerability and Penetration Testing by appointing widely recognized agencies.
- Concrete steps by Payment Service Providers should be taken to ensure privacy and confidentiality of customer data.

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B: Complete Paper

5. Payments Systems in India

The Payments System in any country would have following key elements:

- **Payment Parties:** Payer and Payee
- **Payment Instruments:** Instrument which is used to settle the values between Payer and Payee depending upon the type of transactions (commercial, money transfer, domestic, international, settlement etc) value of transaction (micro to macro) etc.
- **Payments Infrastructure:** Infrastructure would include Payments Instrument Generation and Management System, Transaction System, Clearing and Settlement System
- **Others:** Independent entities supporting the systems, technology and various processes either as vendors or outsourcing partners
- **Environment:** Social, Market, Regulatory, Operating etc

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- **New Payments Systems:** Market Opportunities, Advancement of Technology and Innovation has resulted in new payments systems by non- traditional players launching new payments instruments like Internet Accounts, Internet or Mobile Wallets or Purse, Mobile Based Accounts, Internet or Mobile based remittance services, Prepaid Cards

Reserve Bank of India has been continuously working with Payments System Players to bring technology advances and innovation to provide wide range of options for Payers and Payees to conveniently facilitate their transactions. This has seen major growth in Extension of Traditional services in last 5-7years. Reserve Bank of India has been continuously stressing on need for 'Financial Inclusion' to increase the reach of Banking and Financial services to common man as large population of the country still is unbanked, underbanked or underserved.

Unprecedented growth in mobile penetration and Internet Access in the country is opening new opportunities for Indian Economy to delivery various goods and services and settle their payments in unconventional way. These disruptive technologies have created new business models and also wiped out some of the old business model. Digital Convergence is moving towards Sales Channel

Convergence and the key challenge in the economy is the “Payments Convergence”. Does our country have sufficient options of payment instruments for Payer and Payee to use in all kinds of transactions on all sales channels seamlessly? Most of the traditional payment instrument can not support new sales channels like Mobile, Internet, Digital Kiosks and in future TV Commerce and any such developments. This has created an opportunity for newer players to enter the market with specific offerings that satisfy the market need and to explore future potential of eCommerce, mCommerce and TV Commerce.

Globally services like Paypal, Obopay, Green Dot are mainstream and are already growing at an accelerated rate contributing a great deal in areas of Internet Commerce, Mobile Commerce, Financial Inclusion, International Remittance, Mobile Banking, Micro Transactions Processing delivering speed and economy to payer and payee at the same time appropriate level of safety and security. ‘Committee on Payment and Settlement Systems of Bank For International Settlement’ has published a report on Non-traditional and New Payment systems in their report on ‘Survey of developments in electronic money and internet and mobile payments’ in March 2004 covering about 90+ countries across the globe. ‘Financial Action Task Force: Groupe d’action financière’ also published their report on Non Traditional and New Payments Systems titled ‘REPORT ON NEW PAYMENT METHODS’ dated ‘13 October 2006’. While the focus was primarily the Risk Assessment and suggestions for Mitigating these Risks, it has also evaluated various Non-traditional and New Payments Systems across the globe.

‘Department of Payments and Settlement’ of Reserve Bank of India which was set up in Year 2005 with a view to Oversight on Payments and Settlement Systems in India has published various white papers and reports on Indian Payments System and Reserve Bank of India’s vision for ‘Safe, Secure, Sound and Efficient Payments and Settlement System’ for the country.

6. The Payments and Settlement Systems Bill 2007

- **Historical Background**

There are a few large value payment systems functioning in every country. Some of these are the Inter-Bank Cheques Clearing Systems, the Government Securities Clearing System, the Securities Clearing and Settlement Systems (run by Stock Exchanges), the Foreign Exchange Clearing System, the Commodities Clearing and Settlement Systems (run by Commodities Exchanges). All these systems may be physical or electronic based systems. These mostly relate to inter-bank, inter-financial institutional transactions All these are deemed to be Systemically Important Payment Systems (SIPS).

The Committee on Payments and Settlement Systems (CPSS) of the Bank for International Settlement (BIS) established a task force on Payment System Principles and Practices in May 1998 to consider ‘what principles should govern the design and operation of payment systems in all countries?’ It comprised representatives not only from G10 central banks and the European Central Bank but also from 11 other national central banks of countries in different stages of economic development from all over the world and representatives from the International Monetary Fund

and the World Bank. In undertaking its work it also consulted a group of central banks in Africa, the Americas, Asia, Pacific rim and Europe.

CPSS suggested the following Ten Core Principles to be used by Central Banks across the globe in exercising their Oversight on Systemically Important Payments:

1. The system should have a well-founded legal basis under all relevant jurisdictions.
 2. The system's rules and procedures should enable participants to have a clear understanding of the system's impact on each of the financial risks they incur through participation in it.
 3. The system should have clearly defined procedures for the management of credit risks and liquidity risks, which specify the respective responsibilities of the system operator and the participants and which provide appropriate incentives to manage and contain those risks.
 4. The system should provide prompt final settlement on the day of value, preferably during the day and at a minimum at the end of the day.
 5. A system, in which multilateral netting takes place should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single settlement obligation.
 6. Assets used for settlement should preferably be a claim on the central bank; where other assets are used, they should carry little or no credit risk and little or no liquidity risk.
 7. The system should ensure a high degree of security and operational reliability and should have contingency arrangements for timely completion of daily processing.
 8. The system should provide a means of making payments, which is practical for its users and efficient for the economy.
 9. The system should have objective and publicly disclosed criteria for participation, which permit fair and open access.
 10. The system's governance arrangements should be effective, accountable and transparent.
- * Systems should seek to exceed the minima included in these two core principles.

The core principles apply to systemically important payment systems - that is, systems which could trigger or transmit systemic disruptions in the financial area because of the size or nature of individual payments which they handle or because of the aggregate value of the payments processed. A systemically important system does not necessarily handle only high-value payments; the term can include a system which handles payments of various values, but which has the capacity to trigger or transmit systemic disruption by virtue of certain segments of its traffic.

CPSS also has identified Key Risks that needs to be controlled or mitigated by the Central Banks in their respective countries while exercising the Oversight. These risks are classified as below for SIPS:

- **Credit Risk:** the risk that a party within the system will be unable fully to meet its financial obligations within the system currently or at any time in the future;
- **Liquidity Risk:** the risk that a party within the system will have insufficient funds to meet financial obligations within the system as and when expected, although it may be able to do so at some time in the future;
- **Legal Risk:** the risk that a poor legal framework or legal uncertainties will cause or exacerbate credit or liquidity risks; operational risk: the risk that operational factors

- such as technical malfunctions or operational mistakes will cause or exacerbate credit or liquidity risks; and
- **Systemic Risk:** in the context of payment systems this is the risk that the inability of one of the participants to meet its obligations, or a disruption in the system itself, could result in the inability of other system participants or of financial institutions in other parts of the financial system to meet their obligations as they become due. Such a failure could cause widespread liquidity or credit problems and, as a result, could threaten the stability of the system or of financial markets.

In India, Reserve Bank set up 'The Department of Payment and Settlement Systems (DPSS)', which was operational with effect from March 2005. The Department is responsible for regulation and oversight on the Payment and Settlement Systems which encompass the cheque-based clearing systems managed by the Reserve Bank and other commercial banks, Electronic Clearing Service (ECS), Electronic Funds Transfer (EFT) System, the inter-institutional Government Securities clearing, the inter-bank foreign exchange clearing as also the RTGS.

The functions of the Department include the following:

- Formulation of Payment and Settlement Systems policies.
- Regulation of Payment and Settlement Systems.
- Supervision of Payment and Settlement Systems.
- **Implementation of the Core Principles relating to payment systems (as enunciated by the Bank for International Settlements).**
- Laying down standards for payment and settlement systems.
- **Designing, developing and integrating Systemically Important Payment System (SIPS) projects and / or facilitating such implementation.**
- Monitoring the operations of payment and settlement systems.

DPSS based on the above functions has time to time come up with various reports, policies and white papers for 'Systemically Important Payment Systems (SIPS)'. The approach to be followed for payment and settlement systems is best captured in the Mission Statement which encompasses Safety, Security, Soundness and Efficiency (the **Triple-S and E**) as its vital components. Thus the payment system policy goals will continue to be "to foster a safe, secure, sound and efficient payment systems for the country".

DPSS in one of its report on Payments System has identified Systemically Important Payments as follows:

"There are a few large value payment systems functioning in the country. These are the Inter-Bank Cheques Clearing Systems (the Inter-bank Clearing), the High Value Cheques Clearing System (the High Value Clearing), the Government Securities Clearing System (the

G-Sec Clearing), the Foreign Exchange Clearing System (the Forex Clearing) and the Real Time Gross Settlement (RTGS) System. All these systems except the High Value Clearings are electronic based systems. These mostly relate to inter-bank / inter-financial institutional transactions except the High Value Clearing where high value customer cheques are cleared. The Inter-bank Clearing functions in 7 places and the High Value Clearing in 15 places - both are managed by the Reserve Bank. The G-Sec Clearing and the Forex Clearing are managed by the Clearing Corporation of India Limited (CCIL). The RTGS System is operated by the Reserve Bank. All these are deemed to be Systemically Important Payment Systems (SIPS) and therefore the Reserve Bank has, in line with the international best practices in this regard, moved them (except the Inter-bank Clearings at places other than Mumbai and the High Value Clearings) to either secure and guaranteed systems or the RTGS System.

DPSS in its report titled 'Report on Oversight of Payment Systems in India 2006-07) has identified the SIPS and System of System Wide Importance stated as below:

“The need for oversight

1.2 The Committee on Payment and Settlement Systems (CPSS - which is the international standard setting body for Payment Systems) in its report on 'Central Bank Oversight of Payment and Settlement Systems' has highlighted the importance of oversight of payment and settlement systems comprising large-value, retail, and securities settlement systems. Large-value payments involve large transfer of bank deposits usually reflecting the settlement of transactions relating to financial markets. The enormity of such transactions can be gauged by the fact that total turnover in several large value payment systems and securities settlement systems over a period of 2 / 3 days is often found to be equivalent to the annual GDP of a country. Consequently, most Central banks classify such large-value systems as Systemically Important Payment Systems (SIPS) (in India the turnover in the SIPS segment constituted more than four-fifths of the total turnover - Rs.3,51,16,277 crore of the total of Rs.4,23,74,063 crore - in 2006-07), as any disruption in such systems will have serious systemic consequences effecting the financial markets and thereby the financial stability of the country. Thus, it becomes imperative that oversight of the entire payments system infrastructure (institutions, instruments, rules, procedures, standards and technical means) is central to the establishment and existence of an efficient, stable and reliable payments and settlement system in a country.”

“What does oversight involve?

1.3 The payments system infrastructure, typically involves the provision of payment and settlement services by both private and public sector providers using common infrastructure, to market participants following various market practices and processes. **Overseeing payment systems would thus involve putting in place systems and procedures that (a) ensure the smooth and efficient provision of payment services to**

all participants and users in a fair manner, (b) minimize and control the risk of transmitting shocks through the economy caused by failures of individual participants to settle their payment obligations, and (c) ensure development of technical and institutional infrastructure to meet growing payment system needs of the country.”

The same report further specifies:

“1.12 Large value payment systems are no doubt an integral part of a country's payment systems, but equally important are the retail payment systems which settle a large volume of retail (public) transactions with comparatively low values. Some typical examples of retail payment systems are the automated clearing houses, card schemes and cheque clearing which are used to make bulk payments and also settle a range of transactions in goods and services. Thus, any disruption in retail payment services also impacts the public confidence in payment services in general. As such these systems can be called as Systems of system-wide importance if not as SIPS.

- **Key Features of The Payment and Settlement Systems Bill 2007**

The Government of India introduced ‘The Payment and Settlement Systems Bill 2006’ in Year 2006 to facilitate the Oversight of Payments and Settlement Systems in the Country by Reserve Bank of India. The Bill has been reviewed by Parliamentary Committee and introduced in Lok Sabha and Rajya Sabha of Parliament of India for approval. The Earlier Bill amended as Bill No. 50-C of 2007 and now called ‘The Payment and Settlement Systems Bill 2007 (The Bill)’ as passed by Lok Sabha on 26th November 2007.

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“to provide for the regulation and supervision of payment systems in India and to designate the Reserve Bank of India as the authority for that purpose and for matters connected therewith or incidental thereto.”

- **Clarifications/Concerns of the IAMAI Members**

CPSS report on Core Principles for Systematically Important Payments System also provides various sections on Central Bank’s responsibility in implementing the core principles as well as section on ‘The Public Policy Objectives’ to be kept in mind while making any policy and regulating Payment Systems:

“Responsibilities of the central bank in applying the core principles

- A.** The central bank should define clearly its payment system objectives and should disclose publicly its role and major policies **with respect to systemically important payment systems.**
- B.** The central bank should ensure that the systems it operates comply with the core principles.
- C.** The central bank should oversee compliance with the core principles by systems it does not operate and it should have the ability to carry out this oversight.
- D.** The central bank, in promoting payment system safety and efficiency through the core principles, should cooperate with other central banks and with any other relevant domestic or foreign authorities.

Section 2: The public policy objectives

2.1 Systemically important payment systems are an essential mechanism supporting the effectiveness of financial markets. They can also transmit financial shocks. Poorly designed systems may contribute to systemic crises if risks are not adequately contained, with the result that financial shocks are passed from one participant to another. The effects of such disruption could extend beyond the system and its participants, threatening the stability of money markets and of other domestic and international financial markets. Systemically important payment systems are therefore crucial for the economy, and their safety and efficiency should be objectives of public policy.

2.2 Market forces alone, however, will not necessarily achieve the objectives of safety and efficiency sufficiently, since operators and participants do not necessarily bear all the risks and costs. They may not have adequate incentives to minimise the risk of their own failure or the failure of a participant or the costs they impose on other participants. In addition, the institutional structure of the payment system may not provide strong incentives or mechanisms for efficient design and operation. **Economic factors such as economies of scale and barriers to entry may limit competition in the provision of payment systems and services.** In practice, in many countries there are a very limited number of payment system providers or a single provider, usually the central bank.

2.3 To pursue the objective of safety in a payment system, it is necessary first to identify and understand how risks of various types may arise or be transmitted within the system and to determine where they are borne. Once these risks are properly analysed and assessed, appropriate and effective mechanisms must be devised to monitor, manage and control them.

2.4 Payment systems consume substantial resources. Accordingly, it is important that the designers and operators of payment systems are conscious of the resource costs of their systems and the charges they will need to pass on to users if resources are to be used efficiently. Cost constraints are likely to require choices to be made about a system’s design which will have an impact on the system’s functionality and safety. The functionality required will vary from one system to another according to the demands of participants and users. **Systemically important payment systems must always achieve a high level of safety appropriate to their potential for triggering or transmitting systemic risk. Little, however, would be gained if a payment system were designed with such**

extensive safety features that it became so difficult, slow or costly to use that no-one was prepared to do so. System operators should keep their choices under review, as financial markets and the local economy develop and as technological and economic advances improve the range of solutions available.

2.5 Safety and efficiency are not the only public policy objectives for payment system design and operation. Other objectives, however, such as crime prevention, competition policy and consumer protection, can play a role in the design of systemically important payment systems, but these issues are beyond the scope of this report.

2.6 Different aspects of the safety and efficiency objectives may be pursued by a variety of different public sector agencies. Central banks have a leading role, particularly because of their strong interest in financial stability, their role in providing settlement accounts for payment system participants, and their concerns with the functioning of money markets for the implementation of monetary policy and with maintaining confidence in the domestic currency both in normal circumstances and in a crisis. The expertise they have developed through carrying out these functions means that central banks have a leading role to play in respect of systemically important payment systems; in many cases they have been given explicit responsibilities in this area.”

Based on the Historical Background of The Payment and Settlement Systems Bill 2007 our understanding is that the objective of RBI and BIS has been to have all Central Banks empowered for Oversight on Systemically Important Systems (SIPS) or at Best System of System Wide Importance (as mentioned in RBI report on Oversight of Payments System 2006-07), However the current Bill does not specify nor provide adequate classification to oversight the payment systems based on their Systemically Important criterion. This may not be the objective of the Reserve Bank and would bring all Non-traditional and New Payments System whether or not they are Systemically Important.

7. Payments and settlement Systems: Global Scenario

Globally Payments and Settlement Systems are monitored, controlled and regulated by the Central Bank of the country. However most of these Regulation and Controls are specified for the Payments System classified as Traditional Banking Payments System or Non Traditional Extension of Banking Payments System. In some cases where the settlement or clearing systems which are of Systemic Important like Stock Exchange Clearing or Commodities/Forex Clearing such systems have been brought under control. Very few countries have specified Regulations for monitoring and controlling the New Payment Systems as these systems are at early stage of introduction and are yet to have clear business model. These models actually are paving way for future innovation around ‘Digital and Sales Channel Convergence’.

Most of the developed countries where the regulations are being provided for the Payments Systems has been on the basis of the Risk. These possible risk categories have also been defined as Open Payment Systems, Closed Payment Systems and Semi Open/Close Systems. These systems have been classified based on risk parameters like Identification, Value Limits, Geography, Funding in, Funding out, Usage Limits, Currency Denomination.

Risk Parameters	Open-ended	Close-ended	Semi-Open/Close ended
Identification	Anonymous	Identity available in form	Basic KYC available

		of KYC	directly or indirectly
Value Limits	Generally no limit	Specified limit	Limits May or may not be specified, but for specified usages
Geography	International Transactions	Clear Geographic usage mostly pure Domestic	May have Geographic Details but for specific usages within Geographic boundaries specified
Funding-in Options	All options including cash	primarily bank accounts or bank instruments	Pre specified and Bank instruments
Funding-out Options	Globally anywhere in all forms including ATM Cash withdrawals	Not possible or only in bank account	Possible but with additional formalities and for specified purposes
Usage Limits	No Limits	Prefixed annual and periodic limits	May or may not be specified but for specific usage only
Currency Denomination	Local currency but highly liquid like USD and easily convertible in other currencies	Only Local currency non liquid and non convertible	Local Currency but strong currency like USD, Euro

Most of the New Payment Systems and Branchless Banking Systems are also classified as following options which can again be in nature of Open, close or semi open/close:

- Prepaid Cards
- Internet Accounts/Wallet/Purse
- Mobile Accounts/Wallet/Purse
- Remittance (Domestic or International)

New Payments Systems	Open-ended	Close-ended	Semi-Open/Close ended
Prepaid Cards	Bank Prepaid Cards with ATM withdrawal domestic as well as International	Limited Usage prepaid cards without Cash withdrawal Options	Prepaid Cards like NoFrills Account Cards for branchless banking with KYC and prespecified limits
Internet Accounts/Wallets/ Purse	Internet Bank Accounts, Internet Virtual Accounts with Cash Withdrawal across the globe	Internet Accounts / Wallets/Purse for specific usages with no cash withdrawal	Internet Accounts / Wallets/Purse for specific usages with cash withdrawal in to specified bank accounts etc.
Mobile Accounts/Wallets/ Purse	Mobile Banking Account with all features of traditional banking and	Mobile Accounts / Wallets/Purse for specific usages with no	Mobile Accounts / Wallets/Purse for specific usages with cash

	cash	cash withdrawal	withdrawal in to specified bank accounts etc.
Remittance	Across the globe; no limits	Pure Domestic	Domestic or International but with specified value for specific transaction and total during the year

In few countries where ‘New Payment Systems’ are regulated the regulations are generally of Three Levels i.e.:

Level I: Basic Registration and Information for the Central Banks to have direct access on the growth and information which may be required from time to time in their function as Monetary Authority. Such regulation is primary for the Payment Systems which are low risk and primary close ended systems.

Level II: At Level II certain Payment Systems may be regulated based on the different payment instrument and services they deliver in their respective country and they may have different requirement for different payment systems for different instrument they run. Some of them may require specific licensing subject to certain terms and conditions, some specific identity related regulation like KYC, Certain limits on value of transactions or reporting in case of transactions above certain specified values.

Level III: Non-traditional or New Payment Systems which has elements of ‘Systemically Important Systems’ as specified by CSPP may be regulated at Level III which may be more close to current banking system compliances, however while regulating such payments systems only specific services and products that qualify as nature of ‘Systemically Important’ should be regulated as Level III and other services which are not of the same risk or criticality should be regulated at appropriate level.

Countries like Singapore and the European Union where New Payments systems are popular and have a high adoption rate have been able to provide adequate detailed guidelines to differentiate and regulate the Payment Systems based on their ‘Systemically Important’ nature and ‘Possible Risks’.

Committee on Payment and Settlement Systems of Bank For International Settlement’ has published a report on Non-traditional and New Payment systems in their report on ‘Survey of developments in electronic money and internet and mobile payments’ in March 2004 covering about 90+ countries across the globe. ‘Financial Action Task Force: Groupe d’action financière’ also published their report on Non Traditional and New Payments Systems titled ‘REPORT ON NEW PAYMENT METHODS’ dated ‘13 October 2006 and most recently a preliminary report entitled ‘MONEY LAUNDERING AND TERRORISM FINANCING VULNERABILITIES OF COMMERCIAL WEBSITES AND OF INTERNET PAYMENT SYSTEMS- INTERIM REPORT’’. These reports also cover the regulatory environment for New and Non Traditional Payments Systems and provide for Differentiating the type of regulation or compliance requirements based on the type of the Payment Systems and the Possible Risks that they may pose. In addition, the Interim report clarifies that, “as long as the sector understands the potential vulnerabilities associated to commercial websites and Internet

payment systems and as long as appropriate measures with regard to the risk-based approach are taken, the [AML] issues should not constitute a higher risk for the online sector than for the offline sector.”

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8. IAMI Suggestions on Payments and Settlement Systems Act 2007

The Payment and Settlement Systems Bill 2007, is an empowering one. It will enable the RBI to set up a comprehensive regime that would bring together various types of ‘payment systems’ under a single regulatory framework. But what should be the overall vision of such payment systems, who should it include, what should be provided greater weight - competition, innovation, and growth of coverage, or financial security? These issues are missing from the law and therefore needs to be kept in mind while framing the Rules and Guidelines for implementing the Bill.

As this is brought out quite clearly “The Bill, *inter alia*, seeks to provide for the following matters, namely,...to designate the Reserve Bank of India as the designated authority for the regulation and supervision of payment systems in India for their smooth operations...”

The BIS 10 core principles are important as they form the basis of much of the future regulations and procedures governing the financial sector. There is nothing in the principles that one could argue against. Indeed the key requirement for the success is a part of the core principles as well: **“The system should provide a means of making payments which is practical for its users and efficient for the economy.”** There are following important issues that need to be addressed related to this point.

The first is applicability. By design of its framers, the principles are limited to high value Systemically Important Payment Systems. There is a reason for limiting this applicability, and that is recognition that there are significant costs of regulations. A related issue is that of what is systemically important. **If a payment system is not a large enough component of the financial framework of an economy, then it cannot be considered to be systemically important, and therefore the regulatory oversight would need to be on the basis of proportionality.**

In other words, regulatory oversight should not be at the cost of growth of Nontraditional and New Payments Systems. And payment systems which are at nascent stage of their development in India and are therefore unlikely to create larger risks should not be included under its aegis.

This is essential, as it will ensure that regulation does not stifle the growth of low cost, convenient and efficient but technologically advanced systems that are currently not systemically important *inter-alia* like prepaid cards, Online Person to Person Payment Facilitation & Processing services for underlying eCommerce transactions, Online Remittance services etc.(generally referred as Nontraditional or New Payments Systems).; these Payment Systems are breaking new ground and are still at a nascent stage of growth. This would ensure that the Bill is in line with internationally accepted norms of regulation of Systemically Important Payment Systems as also

achieve the policy goal objective of the RBI by continuing “to foster a safe, secure, sound & efficient payment system for the country” as set out in their Vision 2005-08 Payment Systems in India document of May 2005.)

India has a large segment of its population that is currently deprived of accessing banks. This un-banked population earns, spends and saves in large numbers. It’s per household earning, spending, or saving capacities however tends to be quite low. Despite intensive efforts a large part of this population remains un-banked. This un-banked population remains in urban as well as rural areas and has been deprived of many of the services. As e-governance and other efforts of the government accelerate, we need to bring such groups rapidly into the banking fold. However, it is well known that this would be difficult if not impossible for many reasons, three of the most important being - high levels of illiteracy and lack of access to the banking system; problem of access especially in the rural hinterland, and high cost of servicing remotely located customers. New and emerging Payment Systems are actively trying to solve for this very problem and if placed within the same regulatory structure as SIPS with the same level of regulatory oversight, these un-serviced and un-banked population will remain un-serviced. Moreover Internet and other electronic modes of interaction are rapidly becoming more and more important as a source of information on professional as well as personal fronts. It is the governments desire to ensure that such or other payments systems are able to empower the masses in a short enough period of time. For this purpose the regulator would aim at ensuring greatest spread through low transaction costs, higher safety and security.

The proposed Payments and Settlements Bill is a document that is difficult to critique as it merely places the overall payment and settlements regime in India within the ambit of the RBI’s powers. The RBI itself has not yet explicitly laid out its position on the various options that are likely to be available. But what is clear is that there is a greater need for a framework to be developed which clarifies the status of Nontraditional and New Payments Systems.

Where the regulator is concerned, this paper therefore calls for building a framework that explicitly states what the regulatory system that oversees the Nontraditional and New Payment Systems should be like. It suggests certain important characteristics that ensure:

- (e) Stability
- (f) Innovation, entry and competition
- (g) Entry of small players into e-payment services
- (h) Secure and safe e-payment system

We are therefore able to answer some important questions that are not addressed adequately by the proposed bill. These issues will need to be decided by the regulator while framing the Rules and Guidelines for the Payments and Settlement Systems Bill:

5. Whether Non Systemically Important Payments Systems like Nontraditional Payments System and New Payments System fit into the definition of System Providers is not clear;

but as that flexibility of defining such providers has been given to the RBI in the proposed bill it will only become clear what route the RBI will take.

6. Should this segment that is at such a nascent stage be regulated? Regulation will impose costs with little immediate benefits at this point and therefore some may prefer regulation to be delayed. However, if regulations ensure entry with safety and security, they will only accelerate the spread of the New payments systems. This should be a critical element for developing a legal framework for emerging transaction technologies.
7. Who should provide such services and who should not? The question of entry is important, as undue regulation will prevent entry and therefore competition from the non-bank sector. Here it is essential that all segments, not just the Bank sector, should be able to provide such payment system services. Moreover explicit mention should be made on facilitating the entry of small players.
8. How should issues of safety and security be addressed? Fears such as money laundering or use in illegal cross border trade are quite unfounded as there are other much easier means to undertake these tasks. However, as long as basic monitoring and reporting systems are being followed, these can be directly addressed. With electronic payments it would be easier to trace as well as identify both activities as well as persons indulging in such activities.

In conclusion, the Rules and Guidelines for the current bill should be framed to include broad principles that would be followed by the regulatory entity. The regulator needs to specifically mention the broad vision that will then translate into broad principles related to entry, competition, innovation, equity and growth. The reason is if the regulator focus more on maintaining security and stability and may not give enough weight to the fact that a growing and inclusive economy needs many different types of providers to meet the demands of the different types of potential users. The poor and rural users, the un-banked population, small groups, payment over the Internet, etc. all need to be facilitated and coverage growth needs to be accelerated.

In most of the countries the Regulation is for the specific product/service and in proportion to specific risk and the same is not on the entity or business. And in line with best global practices RBI should provide for the Rules and Guidelines which is based on three tier principle and provide regulation in proportion to the risk associated with different type of Payment Systems especially New Payment Systems. Industry proposal at the macro level is as follows:

Open-ended New Payment Systems	Close-ended New Payment Systems	Semi-Open/Close ended New Payment Systems
Level III Regulation: Registration; Licensing; AML/CFT; Transaction Reporting; Capitalization; Fund Utilisation Norms	Level I Regulation: Registration and Authorization Only with time to time information sharing on need to know basis by regulator	Level II Regulation: Registration and Authorization, Specific Guidelines in terms of Value and Funding Limits and Reporting; Guidelines for utilizing Funds

- ⇒ **Technology vendors /Partners/service providers to Organizations/players who run Payment Systems should not be subject to RBI authorization as the compliance responsibility is on the Payment System Service Provider.**
- ⇒ **RBI may at best provide technology guidelines /standards to be followed by all these vendors/partners to ensure security, safety and interoperability of system.**

New and Nontraditional payments system may take mitigation steps which will help to lower overall risk in the system:

- Service providers could implement ISO 27001 certification to ensure that the relevant controls are in place. While this is not mandatory it may be a recommended guideline.
 - Service providers that deal with Card information in any way should adopt the Payment Card Industry DSS 1.1 certification (PCI compliance)
 - Vulnerability and Penetration Testing by appointing widely recognized agencies.
 - Concrete steps by Payment Service Providers should be taken to ensure privacy and confidentiality of customer data.
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Internet and Mobile Association of India (IAMAI)

The Internet & Mobile Association of India (IAMAI) is a not-for-profit industry body registered under the Societies Act, 1896. Its mandate is to expand and enhance the online and mobile value added services sectors. It is dedicated to presenting a unified voice of the businesses it represents to the government, investors, consumers and other stakeholders. The association addresses the issues, concerns and challenges of the Internet and Mobile economy and takes a leading role in its development.

The association's activities include promoting the inherent strengths of the digital economy, evaluating and recommending standards and practices to the industry, conducting research, creating platforms for its members, communicating on behalf of the industry and creating a favorable business environment for the industry.

Founded in January 2004 by leading portals in India, IAMAI is the only specialized industry body in India representing the interests of online and mobile value added services industry.

9. IAMAI: Payments Committee

The national committee on Digital Payments at IAMAI focuses on regulation, industry norms and business facilitation for digital payments. Current members of IAMAI Digital Payments committee are:

- Vishwas Patel, Founder and CEO, Avenues (Convenor)
- Navin Surya, Executive Director, ITZ Cash
- Rajan Mehra, Country Manager, eBay India
- Sanjay Agarwal, IRCTC
- Aditya Menon, CTO, OboPay
- Ravi Shankar, Head Direct Banking, Yes Bank