G Padmanabhan: Random payment system issues of systemic relevance for the new year

Keynote address by Mr G Padmanabhan, Executive Director of the Reserve Bank of India, to the Bankers' Club, Thiruvanathapuram, 2 January 2013.

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It is always a pleasure to be in God's own country to welcome the New Year. I am thankful to the Bankers Club of Thiruvanathapuram for affording this opportunity by inviting me over. I also deem it a privilege to be addressing the Bankers of the state which recently captured the imagination of the nation when one of the districts – Ernakulam – was declared as the first financially included district in the country. I am aware of the enormous efforts put in by the bankers in the State under the stewardship of our Regional Director Shri. Salim Gangadharan. Congratulations to the entire banking community of the State.

The year that went by was quite challenging for the financial sector. The worsening of the sovereign debt crisis in Europe and the unsteady recovery in the USA had posed significant risks to emerging markets like India, with domestic factors playing a major role-perhaps in balance a more decisive role in shaping the course of Indian financial markets which remained volatile. As current account deficit burgeoned and reached a record high, debate on the contributory role of gold imports intensified. Without getting into the thick of the debate, let me state two things. First, the argument that a central bank which had diversified its own assets into gold has no moral right to preach against investment/import of gold is missing an important point. A central bank diversifying its dollar reserves into gold is entirely different from private agents in a country having capital controls investing in gold as it has the same effect of allowing such assets to be held in foreign currency! It has to be clearly recognised that the Central bank undertakes the onerous responsibility of managing the forex reserves of the country with the objectives of safety, liquidity and return in that order and investment in gold is in pursuit of these objectives! In the case of private savers, by stashing away his savings in gold, the economy stands to lose the benefit of accumulated savings which can go a long way in adding to the GDP of the country. Second, given the insatiable lure for gold in the country, it is imperative that we introduce gold linked products which results in the existing gold in bank lockers getting converted as financial products rather than unabated import of gold, if we are to find a sustainable solution for our current account problems.

Moving on, as we welcome what appears to be another year of turbulence for the markets, and when the Indian banking system is readying to adopt Basel III norms even in the face of growing NPAs, I thought it fit to discuss certain important issues relating to payment systems. You will appreciate that the payment systems all over the world including in our country functioned efficiently even while the crisis was crippling the markets. The issues that I propose to flag are of relevance to all stake holders using the Indian payment system.

Decline of cheques – a myth or a must?

The growth in electronic payments (in volume terms), in recent years is quite heartening when one sees that the share of electronic payments as a percentage of total payments have grown from 15% in 2003–04 to 48% in 2011–12. Despite this, in absolute terms cheque volume continues to be high (52% of total payments), even though the growth is showing a declining trend. While this high cheque volume could be attributed to overall growth in the economy and the consequent growth in financial transactions, it is nonetheless desirable that transactions in electronic form increases at an increasing rate rather than being contended with transactions through cheques increasing at a decreasing rate. It would also be desirable to migrate the existing cheque usage to an electronic form in view of the benefit which would accrue to both the payer and payee of the cheque which in turn has a positive impact on the economy as a whole.

In fact, the "Payment Systems in India – Vision 2012–15" talks about drawing up a strategy for disincentivising usage of cheques above a certain threshold limit by customers and corporates which may include prescribing a cut off limit for cheques cleared through clearing house arrangements. As announced in the "Second Quarter Review of Monetary Policy" we are in the process of preparing a Discussion Paper on the methods aimed at disincentivising the issuance and usage of cheques in India and placing this paper in the public domain for comments.

Before coming to the challenges and strategies for moving paper based transactions to electronic mode, let me touch upon the need for doing so. As we all know, cheques when compared to electronic payments are less efficient for various reasons – it has high printing and processing costs, requires manual interventions in the form of encoding and keying in cheque details, poses significant reconciliation challenges in terms of payables and receivables, needs to be preserved for longer period as per legal and regulatory requirements, has longer clearing and processing cycle etc., in addition to having inherent liquidity and credit risks. In contrast, electronic payments eliminate these inefficiencies and provide a faster, efficient, secured mode of transactions at a fraction of the cost. Electronic payments, where they are "credit-push" based imply that credit, liquidity and systemic risks are substantially reduced, and there is also adequate certainty on funds availability to the beneficiary. Despite these perceived virtues, physical instruments are still preferred by people as they can be "seen" and therefore more "trustworthy" as compared to unseen electronic transactions happening in seconds! Here the challenge for the bankers is to change this mindset through training and education of customers.

Several studies have been undertaken on the cost and benefits of cheques vis-à-vis electronic payments. A study undertaken by the Reserve Bank of Australia in 2007–08 pegged the average payment cost of cheques (for consumers, merchants and financial institutions) at AUD7.69, as compared to AUD1.21 for credit cards and AUD 0.67 for EFTPOS.[1] The UK Payment Council in its report "The Future of Cheques in UK" (2009) has indicated that the costs of electronic alternatives are at least one third lower than the cost of cheques. The report also estimates that the closure of the cheque clearing could lead to cost savings for the UK (for financial institutions and corporates) up to £1 billion per annum by 2018.Studies by Humphrey, Willesson, Bergandahl & Lindblom (2003)[2] found that migration away from paper-based payment methods was one of the key factor that contributed towards reduction in bank operating costs (a 24 per cent reduction, accounting for $32bn) across Europe from 1987–1999. Back home, studies by the Indian Banks' Association have also revealed that the costs relating to paper based instruments are relatively higher than electronic modes although the former is less efficient as well. To summarise, the key conclusion from several studies[3] is that there is a social business case for moving away from paper based instruments. That's why several jurisdictions such as UK, Canada, Ireland and Australia have drawn or are in the process of drawing the roadmaps for managing declining cheque usage in their jurisdictions.

However, this is easier said than done. Consumer habits which have been ingrained over the years do not change as quickly as changes in technology take place. So, even if newer

[1] Reserve Bank of Australia – "Payments Costs In Australia" (page 117).

[2] Quoted in "Cheques Working Group Report" November 2006, Office of Fair Trading, UK.

[3] Some of the studies have been quoted in the report "Target 2013: Modernising Payments in Ireland" prepared by National Irish Bank.

electronic forms of payments are introduced, widespread adoption of such modes takes time. Many users – including the Government – may also be apprehensive of using a “new” mode of payment and as such may resist the movement from their “comfort zone” (of using cheques).Issuing of cheques does not cost money (most banks offer some number of cheques leaves free of cost), whereas some charges have to be paid for initiating electronic payments. Given the lack of awareness, cost considerations may override safety and speed considerations.

Recognising the complexity of the challenge, any strategy to discourage the use of cheques by individuals as well as institutional users has to have a multi-pronged approach encompassing cost and time considerations, incentives for use of electronic modes of transactions and disincentives for the use of paper-based instruments. However, the decline of cheque usage has to be carefully managed so that the unwarranted ramifications such as slippage to cash based transactions and inconvenience to vulnerable segments of the customers having no access to alternative electronic modes of payments are avoided.

Why expand CTS if cheques are to be discontinued?

As you may be aware, gird CTS in Chennai now covers 43 clearing locations encompassing the states of Tamilnadu, Kerala, Karnataka, Andhra Pradesh, West Bengal and the Union Territories of Puducherry and Chandigarh. Pan-India roll out of CTS is expected to be completed by December 2013. Questions are being raised on the need for expansion of grid CTS for improving the efficiency of paper based clearing given the focus of the Vision Document towards electronic payments. Let me try to address these questions.

First, the paper-based clearing continues to be the dominant mode of retail payments in the country constituting 52% in terms of volume. It is also widely accepted that consumer behaviour does not change as quickly as changes in technology. This being the case, despite our objective of electronification of payments, requirements for safety and efficiency enhancements in paper-based clearing cannot be ignored.

Second, even though Speed clearing hastens the process of cheque collection as compared to outstation cheque collection, it pre-supposes the presence of the drawee bank (at least one branch) in the clearing house location which could be a limitation. In comparison, grid-based CTS, is a superior system as it encompasses a larger geographical area and the chances of drawee bank not having presence in the grid location is significantly reduced.

Third, grid CTS would provide significant cost savings both to the system operators as well as the system participants. From a systemic perspective consolidation of clearing locations into a few grids would minimise the cost of replacement of aging MICR machines and the related AMC costs. Banks will benefit from economies of scale as the grid CTS obviates the need for establishing inward cheque processing infrastructure at various clearing locations. Further, once local clearing houses are subsumed into the grid, the settlements which are now spread across clearing locations would be subsumed into a single settlement, thereby significantly reducing the liquidity requirements (opportunity cost included) for the banks. The CTS will also result in other benefits in terms of reduction in the cheque processing fee, reduction in operational overhead, elimination of clearing differences and reconciliation issues etc.

Fourth, as long as physical instruments cannot be realistically wished away even in the medium term scenario, it is economically sensible to leverage on technology to reduce the recurring processing costs, though it might involve a onetime capital expenditure.

There are a few challenges as well. The CTS implementation and the model adopted in India do not have a parallel elsewhere in the world and the features aimed at security and safety need to be addressed optimally. This is the reason behind the directive to all banks to migrate to the use of a uniform standard for the CTS cheques. Further, there is an increase in the responsibilities of the collecting banker when compared to the non-CTS scenario. A change in the mindset of the staff of banks is also a vital necessity, and this would transcend to the ultimate customer too. While it is heartening to note the positive outcomes in all these areas, we must recognize that full scale achievement of these would take time.

Entry of non-banks in payment system – a mirage or a threat?

It is quite discernible in many payment services that non-banks have made in-roads into an area that was once considered the exclusive domain of banks. Traditionally, banks alone played an important role in holding deposit funds (store of value) and providing payment services (medium of exchange). With significant developments in technology going hand-in-hand with the growing demand for faster and more efficient payment services by users, banks no longer find it possible, viable or even necessary to offer the whole range of payment services (end-to-end) by themselves, when the same could be outsourced and offered more cost-effectively. These reasons coupled with the growth potential have led to the entry of non-banks into the payment services area.

Some of the reasons for the almost ubiquitous presence of non-banks in the payment services area could be (a) the changing consumer behaviour with increasing demand for more efficient and faster systems (b) advancements in technology which has greatly facilitated innovations in payment services (c) trend for out-sourcing – possibly due to objectives of reduction in capital investment by banks when the same task can be outsourced on a fee-basis (d) financial inclusion drives where non-banks are also playing a significant role especially in the field of mobile banking etc.

Given the fact that this trend is gaining strength, particularly in retail payments, the role of banks vis-a-vis non-banks merits some closer examination. Especially, the aspect of cooperation between the two or the lack of it needs some introspection. In India, despite the poster-product of M-pesa in Kenya and other African country models led by MNOs, we have consciously chosen the path of a bank-led model. Further, it would also be interesting to debate whether outsourcing is in itself a type of cooperation or is it just a paid service? Is there a level-playing field or is one partner the dominant one? And how would systemic risk be addressed when there are players whose core business may only be relating to the payment system offered by them and any misdemeanor in this area may well affect the entire customer base of the entity concerned?

I am raising these issues here because they are very pertinent for the future and also raise concerns for regulation. While healthy competition between banks and non-banks could have positive repercussions on the provision of cost-effective and efficient payment services to users, it could also have negative impact in case of non-transparent processes and charges structure as well as issues pertaining to the continued sustenance of the services offered. Further, increased risks, if any, due to presence of non-banks in payments area also needs to be better understood and managed.

Is the time ripe to review the role of the payment intermediaries?

RBI has been aware of the critical role played by the “intermediaries” in the e-commerce arena. The intermediaries provide “platform” for acceptance and processing of payments across multiple electronic payment channels. They offer payment aggregation services to a large number of businesses (small to large), governments, utilities, banks, insurance companies, etc. They act as payment aggregators by obviating the need for a merchant/ organization to set-up and manage a multiplicity of relationships with different financial institutions – viz. banks, networks, wallets, prepaid issuers, etc. for accepting payments. Over the years the volume and value of transactions handled by the intermediaries have grown manifold. Reportedly, there are the intermediaries who handle daily volumes of 6–7 lakh transactions for values Rs 150 to Rs.200 crore.

Though these entities at present are not authorised, they have been advised to follow directions on protection of customer funds. The growing importance of intermediaries warrants a review of the extant oversight mechanism. Some of the areas which need attention are the need for intermediaries to provide complete and transparent information to the customers on the success/failure of transactions; uniform and standard practice for refunds to the customers for failed/cancelled transactions and related customer service issues. Another area of concern is the operational risk that such entities may pose. As the customers, merchants and financial institutions depend on the intermediaries for payments/ collections any disruption can negatively impact the payment system. While some of the big merchants have "substitutability" or "interoperability" arrangement in the form of payment gateway switching system, others fully depend on one intermediary. This underscores the importance of the operational risk being effectively addressed by the intermediaries.

Given the above, the need to continue with the existing light touch regulations vis-a-vis a focused oversight including authorisation for such of those entities which have a significant presence in the market would need to be explored. Further, the intermediaries perform certain niche functions which may not qualify to be part of the core businesses of banks. When specialization and efficiency are existent, it would be appropriate to allow such intermediaries to play their roles, but with the added covenants relating to safety, business continuity, risk reduction and sustenance.

Do we need a payment industry council / association encompassing all stakeholders?

The payment landscape in India was for long primarily dominated by banks. Legislation of Payment and Settlement Systems Act, 2007 paved the way for entry of non-bank payment system operators. The payment system milieu covers an entire gamut of stakeholders like banks, non-bank payment system operators, technology providers, outsourcing agencies, network providers, intermediaries, customers, government etc. The increasing complexities in payment system demands that all the stakeholders work in tandem and collaborate. In the Indian scenario, the co-operation and co-ordination among stakeholders is more critical considering the fact that a significant section of the society is under-banked or unbanked. For example for mobile banking to leapfrog it is essential that banks and MNOs co-operate. Similarly, growth of PoS transactions would require co-ordination among merchants, banks, card networks etc.

Against this backdrop the need for an industry-level association open to all stakeholders needs to be evaluated. There are several such association/payment councils like European Payment Council (EPC), UK Payment Council, Australian Payments Clearing Association (APCA) Payments Association of South Africa (PASA), to name a few, which provide the necessary platform for partnerships, collaboration, advocacy, and awareness around payments eco-system in their respective domains. In the Indian context, the Indian Banks Association represents the banks but does not have representations from non-banks and other stakeholders. It is true that there are small associations such as in the cards sector, but these are not all-pervasive across payment systems as a whole.

Industry-wide payments council/association will provide an excellent platform to brainstorm, collaborate and drive new technology proliferation, and thereby bring forth innovative solutions to create a robust payments infrastructure. The need for such a co-operative platform was touched upon in the "Payment Systems Vision 2012–15" which stated that the feasibility of forming a standard setting body under the overall guidance of RBI with representation from IBA, IDRBT and other stakeholders would be examined and taken forward.

How will the White Label ATM (WLA) scheme help expand ATM network in India?

Deployment of ATMs in India is witnessing a 30% y-on-y growth in the last few years. However, the deployment is largely restricted to the urban/metro areas while locations in

Tier III to VI areas have not witnessed much ATM presence. Further, when compared to other countries the per capita ATM deployment in India continues to lag. Given the recent policy initiatives in Financial Inclusion, it is expected that a large number of bank accounts would be opened in Tier III to VI centres triggering a demand for basic banking services including convenience banking through ATMs. Thus, there is a need for expanding deployment of ATMs to increase availability and access especially in the rural areas.

Some of the reasons that were being attributed to the low deployment as indicated above were high cost of deployment and operation, inadequate support infrastructure, large requirement of human resources etc. The WLA concept exemplifies the benefits of partnership between banks and non-banks in building the payment infrastructure. The banks need not lock their funds since the capital investment is undertaken by the WLA operator and the operator gets a fee plus other charges for every transaction from the bank which has issued the card. RBI is in the process of authorising the first set of non-bank entities for operating WLAs.

WLA scheme is a watershed initiative for bank and non-bank partnership in payment space. However, the success would depend on how well the banks and non-bank entities complement each other. The efforts of non-banks to create ATM infrastructures need to be complemented by banks by bringing the financially excluded into the ambit of banking and issuing them cards, besides providing a mutually beneficial cash management and settlement of transactions services. Further, banks and non-banks need to act in tandem in redressing customer grievances relating to failed transactions. RBI would be closely monitoring the progress and proactively intervening when warranted.

Consumer protection in electronic payments – a peek through the looking glass or a Pandora's Box?

Having raised the issues of discouraging the use of cheques, moving to electronic platforms of payments, and the entry of non-banks into the payment domain, I also need to discuss one other important issue regarding "consumer protection and rights" in payments. Just as it is well-understood that consumer behaviour does not change easily or quickly, it is also a moot point that some of the main underlying factors influencing customer choice relates to how transparent and secure the system is and how confident the customer is about getting a fair treatment in case of complaints / grievances. Often, the doubts the customer has about getting a "raw deal" tilts the scale towards traditional payments – cash or cheque – just so that the customer wants to "avoid the hassles" about failed transactions occurring in a media (online, electronic) that is unfamiliar to him/her.

Consumer protection issues mainly revolve around fraudulent and/or unauthorised transactions, unauthorised or excessive charges, failed transactions – non-delivery and rejections, late delivery of transactions, and disputes arising out of any or all of the above and complaint redressal. The catch is, as any banker would vouch for, while good consumer experience may not necessarily make for a second or repetitive use of the medium, bad consumer experience certainly creates a bitter feeling.

Even globally, it can be said that the need for and the discussion about consumer protection in electronic payments is a relatively new phenomenon as compared to cheques. Under cheques, consumer protection is provided by the nature of the banker-customer contract, which is not imposed by either of the parties but has been historically defined by "practice" as a series of common law cases (which is true in most countries). However, with the introduction of electronic funds transfer systems and also the entry of non-bank entities, many contractual terms and conditions began to be imposed on consumers who often ended up bearing all the losses for unauthorised transactions. Gradually, many regulatory developments have taken place with the objective of enhancing consumer trust in online payments including addressing the issue of disproportionate charges for services rendered, limiting consumer liability etc. For instance, the Dodd-Frank Wall Street Reform and

Consumer Protection Act, 2010 requires the Federal Reserve to establish standards for interchange fees that are reasonable and proportional to the cost of processing debit card transactions, the EU Directive on Payment services in the internal market (Directive 2007) provides rules on transparency, timing of payments and information requirements (including rights and obligations of users and providers of payment services, liability rules etc.), EU Directive on Consumer Rights 2011 (to be implemented by December 2013 by all member states) aims to harmonise consumer protection in particular relating to purchase of digital content products and in cross border transactions.

How are we placed in terms of consumer protection and responsibilities of banks and customers in an electronic banking environment where physical transaction is replaced by electronic transaction, physical trail is replaced by electronic trail, and a physical signature is replaced with a digital one? How can we define the roles and responsibilities of banks and customers in such an environment to achieve a win-win situation for all? Is the customer really aware of his/her rights and responsibilities, or does the "fine print" put all the liability on the customer? Does the regulatory requirement of "authorisation" provide a sufficient safeguard for users of electronic payments? Are the existing Consumer Protection Act, Banking Ombudsman Act, and other grievance redressal mechanisms really up to handling issues arising out of payments systems arena which is increasingly getting electronic? Or does the law need to be strengthened further while focussing exclusively on consumer protection issues arising out of electronic transactions? Is there a need to dovetail Consumer protection with Consumer awareness as well since there is a lot of synergy between these two requirements? For instance, even as the RBI is taking steps to make Card Present transactions more secure, customer awareness can go a long way in enhancing customer protection while using Magstripe cards at a POS terminal. A simple case in point is how many of us really pay attention to the fact whether the merchant is checking the signature on the card during a transaction at the POS terminal? Today, matching the signature on charge-slip with that on the card is perfunctory. Should not this become a more serious exercise? I would encourage the Bankers' Club to arrange a Round Table to debate on these issues and come up with a technical paper.

As I conclude, let me also take this opportunity to provide some inputs on two other areas which will see vast improvements in large value payments as well as bring in additional messaging avenues – I am referring to the Next-Gen RTGS and the proposed entry of SWIFT for domestic messaging in India.

The existing RTGS system was commissioned in 2004. The volume of RTGS transactions have grown over the years and currently settles approximately a volume of around 3 lakh transactions a day. This raised issues of scalability of the existing RTGS system which was developed to handle a volume of 50,000 per day. Further, it is a well known fact that RTGS, being a gross settlement system, is liquidity intensive system.

The next generation RTGS (NG-RTGS) is structured to be equipped with liquidity saving features, an advanced gridlock resolution mechanism, increased security measures, operational reliability, business continuity and be compliant with international standards. It would encourage inter-operability with alternative systems. The new system would endorse (a) the latest technology; (b) high scalability and flexibility to adapt to changes in the financial environment and other requirements; and (c) enhance accessibility to cope with changes in the financial environment, such as globalisation of financial transactions and networking of settlement infrastructures. It has been decided to adopt ISO 20022 message formats in the NG-RTGS system.

Currently, there is only one messaging solution – SFMS available for domestic messaging. In order to have an alternate messaging infrastructure, SWIFT has been accorded an in-principle approval for domestic messaging with specific terms and conditions. The participants would have the option to choose multiple channels to route the transactions to the central server in the Bank. The multiple channels are INFINET / SFMS, SWIFT and the Internet.

One must recognise that payment systems have become a dominant factor affecting our day to day lives and has the potential to spur economic growth as well. Coupled with its capability to be omnipresent and have a plethora of players with varied backgrounds and interests, the need to ensure safe, secure and efficient payment systems gains importance. It is this task which the Reserve Bank is now concentrating upon. Like effective teams which achieve success in their efforts, the various players in the payment systems space also need to work in unison, with the ultimate objective of ensuring customer satisfaction. It may be good to pause and examine in an unbiased manner whether this has been achieved or not. If the level of achievement is not substantial enough, then we need to work out strategies for ensuring that they are achieved. For instance, how do we move away from cash transactions? Can we for instance try this at petrol bunks across the country? Can we implement wireless POS/mobile POS across the country for replacing all cash-on-delivery payments to electronic payments, be it cooking gas or pizza delivery? I recall that more than two decades ago, it was this state which witnessed the introduction of new players in transferring payments from the Gulf – the private exchange houses which played a very specific role which was required at that point of time. Today, as the country is looking with great expectations for innovations in payment systems, can we look forward to an encore from the southernmost state of the country? Can the payment system operations in the God's own country function qualitatively and in terms of customer delight invoke even God's envy?

Thank you for your attention. Once again, wish you all a wonderful New Year.