CGAP | TECHNOLOGY PROGRAM

Notes on Regulation of Branchless Banking in India

January 2008

For decades, India's government and the country's central bank, the Reserve Bank of India (RBI), have made the establishment of an inclusive financial sector a key policy priority. In early 2005, RBI formed a high-level working group specifically to examine issues relating to rural credit and microfinance. One year later, following the written recommendations of the group, RBI issued a circular that for the first time allowed banks to use third-party "business correspondents" for the delivery of financial services outside bank branches. Unfortunately, the use of business correspondents is lagging behind expectations, largely due to RBI-imposed restrictions.

In 2005, RBI also substantially relaxed its anti-money laundering and combating the financing of terrorism requirements for banks—specifically, the identification and proof-of-residence requirements for small-value accounts. RBI has suggested the possibility of further "pro-outreach" adjustments. The current situation is favorable from the perspective of branchless banking.

The potential for payment and m-banking services to be provided by mobile network operators and other nonbanks has not yet been realized due to restrictions on nonbanks accepting funds from the public and the prohibition on any e-money issuance by nonbanks. There have been indications, however, 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. The reports include language suggesting RBI's willingness to consider the possible use of mobile phones and prepaid cards for these purposes.

India has all the ingredients for making 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. The business correspondent model is the first step to unleashing this potential.

These notes offer details on what the CGAP branchless banking diagnostic assessment found in India. CGAP has released **"Notes on Regulation of Branchless Banking"** detailing its findings and observations on this important topic in Pakistan and Kenya. Similar notes will be released for Brazil, Philippines, Russia, and South Africa.

BACKGROUND: CGAP, BRANCHLESS BANKING AND THIS SERIES OF POLICY DIAGNOSTICS

CGAP is a global resource center for microfinance standards, operational tools, training, and advisory services. Its members—bilateral, multilateral, and private donors—are committed to building more inclusive financial systems for the poor. The CGAP Technology Program is a multi-year initiative co-funded by the Bill and Melinda Gates Foundation to find and test promising technology solutions to improve access to finance.

CGAP defines branchless banking as the delivery of financial services outside conventional bank branches using information and communications technologies and nonbank retail agents. Because of their potential to radically reduce the cost of delivery and increase convenience for customers, branchless banking approaches can expand coverage to new, previously unserved segments of the population. Technology can help a range of market actors to push the boundaries of access to finance, including not only banks but also microfinance institutions (MFIs), mobile phone operators, and technology companies.

Two models of branchless banking – bank-based and nonbank-based – can be distinguished. Both make use of retail agents such as merchants, supermarkets or post offices to deliver financial services outside traditional bank branches. In the **bank-based model**, every customer has a direct contractual relationship with a prudentially licensed and supervised financial institution - whether account-based or involving a one-off transaction - even though the customer may deal exclusively with a retail agent who is equipped to communicate directly with the bank (typically using either a mobile phone or a point-of-sale (POS) terminal).

In the **nonbank-based model**, customers have no direct contractual relationship with a fully prudentially licensed and supervised financial institution. Instead, the customer exchanges cash at a retail agent (or otherwise transfers, or arranges for the transfer of, funds) in return for an electronic record of value. This virtual account is stored on the server of a nonbank, such as a mobile operator or an issuer of stored-value cards.[1] The balance in the account can be used for making payments, storing funds for future use, transferring funds or converting back to cash at agents. If the system relies on a POS network and plastic cards, customers must visit a participating retail agent to conduct a transaction. If the system is mobile phone-based, customers need to visit a retail agent only to add value or to convert stored value back into cash. A more limited version of the nonbank-based model can be found in payment networks, which involve a technology provider or other nonbank institution offering a network of "payment points" (for example, payment terminals, ATMs or retail agents equipped with POS devices) where a customer can make payments due to third parties or a governmental entity can make payments to beneficiaries.

India - Highlights

- Creating an inclusive financial sector is a top priority of the Government of India.
- As a result of the following limitations, branchless banking has yet to take off in a substantial fashion in India:
  1. The 2006 central bank circular permitting banks to use agents for the delivery of financial services includes two significant restrictions: only nonprofits, post offices, and cooperatives may serve as agents and agents are prohibited from charging clients fees.
  2. Banking regulations do not permit outsourcing of loan approval or KYC decisions.
  3. Mobile operators do not yet engage in the provision of financial services as they are prohibited both from accepting funds from the public and issuing e-money.
- RBI has made a series of adaptations on KYC standards to make it easier for low-income Indians to access service.
- RBI published two reports in 2007 suggesting a willingness to consider using mobile phones for payment services.

1 Introduction

From May 1 to 11, 2007, CGAP conducted a mission in India to analyze the policy, legal, and regulatory environment for branchless banking.[2] This document summarizes CGAP's initial findings.[3] It is based on an analysis of existing and upcoming legislation and regulation relevant to branchless banking approaches as well as 28 interviews with 60 representatives of a wide range of stakeholders. Interviews were conducted with RBI, the Ministry of Finance (MoF), the Ministry of Communications and Information Technology (MoCIT), the Telecom Regulatory Authority of India (TRAI), the Competition Commission of India (CCI), commercial banks, nonbanking financial companies (NBFCs), MFIs, the India Post, mobile network operators, technology firms, donor agencies, and other knowledgeable parties (a list of persons interviewed is appended to this document).

The Indian government and RBI have a strong financial inclusion agenda. In January 2006, RBI issued a circular permitting banks to use business correspondents as agents in the delivery of financial services outside bank branches. A few banks have launched pilots under this circular. Several mobile operators are interested in m-banking, and technology providers are also exploring business models using electronic channels to reach unbanked clients. However, as yet, there is no legal window for these mobile operators and technology providers to engage in the provision of financial services.

2 State of Play: Government Authorities

The Government of India and RBI have consistently shown a **strong interest in improving access to financial services for poor people**. Three areas of particular concern—access to finance, consumer protection, and banking sector stability—have shaped RBI thinking on branchless banking.

> *Access to finance.* India's regulators and policy makers tend to **focus on credit and savings services in rural areas and the existing gap between supply and demand**. This was the primary focus of a 2005 report (Khan Report) of an RBI working group (Internal Group to Examine Issues Relating to Rural Credit and Microfinance). The Khan Report proposed the use of third-party "**business correspondents**" to assist in the delivery of financial services. (One year later, RBI issued a circular permitting such outsourcing.) The report also highlighted information and communication technology (ICT) as a way to leapfrog the efforts to increase outreach by reducing costs of service delivery.
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> Notwithstanding RBI's focus on serving rural areas, fertile ground for branchless banking may also be found in the need for payment services for the several hundred million urban poor and remittances for India's 80 million migrant laborers from rural areas. According to some interviewees during the diagnostic mission, due to rapid urbanization, India may have as many urban as rural poor by 2020 (taking into account poverty lines adjusted to rural and urban standards of living).
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> *Consumer protection.* Indian financial sector policy makers and regulators also **place emphasis on protecting low-income consumers**, particularly with respect to high prices and the risk of being defrauded. RBI's initiatives to improve access to finance are shaped by its concern regarding the vulnerability of customers.
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> *Banking sector stability.* A third factor occupying RBI thinking is the critical role of financial-sector stability in underpinning economic growth, which has averaged 9 percent per annum GDP growth since 2003.[4] RBI sees its steadfast and vigilant effort to maintain banking stability as a key contributor to India's recent success story.

As noted above, in 2006, RBI issued a circular, "Financial Inclusion by Extension of Banking Services—Use of Business Facilitators and Correspondents" (**BC Circular**), that permits the use of business correspondents to carry out various banking functions, including, among others, the disbursal of small-value credit, collection of loan repayments, collection of small-value deposits, and receipt and delivery of small-value remittances and other payments.[5] The choice of agents is limited mostly to nonprofit entities, and agents are enjoined from charging customers for service. (These topics are discussed in more detail below in "Legal and Regulatory Framework for Branchless Banking.")

Officials at MoF and RBI have indicated potential **willingness to permit a wider set of agents** in the future. They describe the BC Circular as a first step and anticipate that banks' experiences using business correspondents may provide a basis for future adjustments. However, RBI appears to be constrained—particularly regarding the decision not to permit commercial entities to be agents—by the concern expressed among some in government about making a profit based on charges imposed on the poor (a concern that is not exclusive to policy makers in India). This factor also informed RBI's decision not to permit agents to charge clients for services.

The Khan Report mentions the use of ICT as an important component in expanding the poor's access to financial services, although it contemplates using mobile phones only as a transmitting device (and *not* for payments and transfers). This aligns with the general view of government authorities that the bank-based model is preferable to the nonbank-based model because the former involves well-regulated institutions. In addition, **e-money issuance by nonbanks is regarded as too risky** and therefore has not been permitted. However, two RBI reports published this year indicate that RBI may be changing its views. In June, RBI's Department of Information Technology issued a "vision" document that indicated that the 2008–2010 plans include providing standards for the use of mobile phones for "banking related transactions in general *and payment services in particular*" (italics added).[6] In October, RBI released a report acknowledging a need—as expressed in feedback sought by RBI from banks, consumer associations, trade, and industry—for "new payment modes," such as mobile payments and prepaid cards, because of the high cost of using credit cards and debit cards for micropayments.[7]

RBI has consistently worked toward **adjusting KYC rules for small-value transactions** in the interests of increasing access. These are discussed in “Legal and Regulatory Framework for Branchless Banking.”

MoCIT, as the telecommunications licensing authority, requires only notification from mobile network operators about new value-added services. Financial services would generally be regulated by RBI, with the primary concern of MoCIT being data security issues.

3 State of Play: Industry

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, lived below the national poverty line.[8] Of these, nearly 80 percent lack access to formal financial services.[9] 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.[10] 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 banks’ 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$4,900), commercial banks may not charge higher than the prime lending rate.[11] This requirement is related to RBI's priority-sector lending policies.[12]) Many regional rural banks have been suffering from weak performance.

NBFCs and NGO-MFIs have not been able to fill the gap, and only a few states have benefited from the tremendous growth of the self-help group (SHG)–bank linkage model.[13] Thus, many poorer customers, in particular in rural areas, lack access to suitable financial products.

Banking Activities

Banks. A few private- and public-sector banks—ICICI Bank and State Bank of India (SBI)—have shown considerable interest in the microfinance market. **ICICI Bank has been using what is known as the "ICICI partnership model**," in which the bank uses MFIs as agents in originating, disbursing, tracking, and collecting loans. Each loan agreement is signed by ICICI and the borrower, and each loan remains on ICICI's books. The use of this model slowed down considerably following imposition of the BC Circular's requirement that all transactions carried out via correspondents be “accounted for and reflected in the bank's books by end of day or next working day” as well as the circular's prohibition on agents charging fees.[14] To address the first problem, an ICICI subsidiary—FINO—is developing a solution combining the use of smartcards, biometrics, and electronic capability that will enable ICICI to see all transactions with partner MFIs within 24 hours, thus addressing the difficulty in complying with the KYC requirement. Smartcards also permit ICICI to perform a KYC check on a customer once and have that authenticated identity travel with the client via the card.

SBI is piloting a model operating under the BC Circular in which ZERO-MASS (a Section 25 nonprofit company formed under the Companies Act) operates as agent at various customer service points equipped with POS terminals. Clients hold contactless smart cards and access their SBI bank accounts at these customer service points. Some new-generation banks, like YES Bank and UTI, are making plans to do this as well. Other banks are considering using banking correspondents for the delivery of other financial services, in particular remittances and insurance.

NBFCs. Some large NBFCs, like SKS and Basix, are keen to use agents and technology to offer deposit and/or remittance services. (NBFCs licensed to take deposits may accept term deposits, but not demand deposits.) However, NBFCs are not able to meet the requirements required to engage in deposit taking (for example, minimum capital and a minimum investment grade rating of a qualified credit rating agency). Thus branchless banking is not currently of interest to NBFCs.

NGO MFIs*.* NGO MFIs registered as a Section 25 nonprofit company, society. or trust are not currently permitted to take deposits, but are very active in lending to poor clients. Many of them are interested in mobilizing deposits as an additional source of loan capital and might be allowed to under the Micro Financial Sector (Development and Regulation) Bill, 2007 (Microfinance Bill). **NGO MFIs can operate as business correspondent for banks, but they lack incentive to do so** because the BC Circular prohibits them from charging customers a fee for facilitating a microloan from a bank. (If the Microfinance Bill is passed, NGO MFIs could begin to collect deposits and will have even fewer reasons for act as agents for banks.)

The Post. The **India Post**, organized as the Department of Posts under MoCIT, cannot offer loan services to its clients. However, post offices are eligible to operate as business correspondents 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 business correspondent model.

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 from 185 countries to approximately 2,500 post offices in India of up to US$2,500 provided that the funds are for the recipient's personal use.

Mobile operators are just starting to enter the field.[15] In late September, ICICI Bank launched a facility with Reliance Communication (R-Com) that enables an ICICI Bank customer who also subscribes to R-Com's CDMA or GSM mobile services to send to and receive money from another ICICI Bank customer. (A customer may send a maximum of Rs 5,000 in any one day.) It is reported that there will also soon be a service provided by three banks (ICICI Bank, HDFC, and Corporation Bank), Visa International, and mCheck that will enable Visa customers to send and receive money through their cell phones. (The maximum daily "send" amount for a customer will be determined by her bank.) (Visa International currently has a card-to-card Visa Money Transfer service.)

Bharti Airtel is actively developing plans with SBI for domestic remittances through mobile phones, and RBI appears to have given a "nod" to the launch of this project as a section 25 nonprofit company.[16] Bharti has also entered into an arrangement with Western Union that will enable a person outside India (in one of the 200 countries served by Western Union) to send money via the person's mobile phone to a Bharti Airtel customer in India.[17] Thirty-five mobile operators have signed up with Western Union to provide this service, which is expected to be rolled out in the second quarter of 2008.

Another possible player in the payments arena is the mobile operator Hutch, purchased earlier this year by Vodafone. Vodafone's Kenya affiliate, Safaricom, garnered 700,000 registered users in the first seven operating months for its M-PESA mobile payment and transfer service.

Technology providers Oxigen, m-Check, Obopay, and A Little World have developed **m-payment platforms** and business models that are ready to be rolled out to unbanked customers via agents. The future of these depends on both the conclusion of partnerships with banks and MFIs as well as the sourcing of funds required to scale-up. Some of the models are card- and POS-based; at least one model involved an electronic payments service similar to PayPal, but was shut down by RBI. None has gone beyond the pilot stage as of now.

4 Legal and Regulatory Framework for Branchless Banking

In India, branchless banking has the potential to increase poor people's access to financial services if regulation (*a*) permits the use of a wide range of agents outside bank branches, thereby increasing the number of service points; (*b*) eases account opening (both on site and remotely) while maintaining adequate KYC standards; and (*c*) permits a range of players to provide payment services and issue e-money (or other similar stored-value instruments), thereby enabling innovation from market actors with motivation to do so.

4.1 Use of 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."[18] Until last year, banking could be conducted only by licensed banks.[19] Pursuant to the BC Circular issued by RBI in January 2006, **banks are now permitted to use business correspondents for a variety of services**: disbursal of small-value credit, recovery of principal and collection of interest, collection of small-value deposits, sale of microinsurance and other third-party products, and receipt and delivery of small-value remittances and other payment instruments. While the BC Circular can be seen as an important step in facilitating the bank-based model in branchless banking, it also places a number of restrictions on the model, including the following:

(a) limiting the institutions eligible to operate as business correspondents to nonprofit institutions, post offices, and cooperatives,[20]

(b) requiring that all transactions be reflected on the books of the bank by the next working day, and

(c) prohibiting a business correspondent from charging the customer for services rendered on behalf of the bank.

To address (and effectively get around) the first restriction, for-profit companies have founded section 25 companies for the sole purpose of operating as business correspondents. Such section 25 companies use customer service points as subagents—something that was not envisaged in the BC Circular. The section 25 company recruits SHG leaders, the wives of merchants, or other persons experienced with handling cash to run customer service points.

Banks are looking to technology to address the challenges posed by the second restriction. ICICI, for example, launched FINO, which provides an application to easily transfer transaction data to the bank with the help of smart cards and POS terminals.

The third restriction (on fees) is one of the main reasons for the slow up-take of the business correspondent model. Banks lending amounts below Rs. 200,000 (about US$4,900) can charge only up to their prime lending rate.[21] (As of November 2007, banks' prime lending rate ranged from 12.75 percent to13.25 percent.) Previously, under ICICI's partnership model, for example, MFIs would add on a service fee (typically 10 percent). As a result of the prohibition on agents charging for services, banks and agents must share the interest. Neither bank nor agent is accustomed to such a small margin and both may find it unprofitable to operate at this level.

The BC Circular also requires that the bank be liable to its customers for business correspondents' "acts of omission and commission."[22]

In November 2006, RBI issued **outsourcing guidelines for banks that prohibit banks from outsourcing core management functions**.[23] In particular, banks are prohibited from outsourcing loan approval and compliance with KYC norms for opening deposit accounts. The requirement that the bank conduct KYC can be costly and time-consuming. This creates an incentive for banks to be able to conduct KYC on a customer once and have the verified identity travel with the client via smart card, for example.

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."[24] 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.[25]

4.2 AML/CFT

Anti-money laundering (AML) and combating the financing of terrorism (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.[26] The guidelines advise banks to categorize customers[27] into low, medium, and high risk and to adjust identification requirements according to risk. According to the guidelines, low-value accounts with low turnover were low risk. 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$1,225) and maximum money deposit into the account per year of Rs. 100,000 (approximately US$2,450).[28] For such accounts, identity and address can be proven through (*a*) introduction by another account holder who (*i*) went through full KYC procedures and opened an account at least six months prior and (*ii*) can certify the applicant’s address and provide a photograph of the applicant **or** (*b*) 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 constitutes a problem for small-value transactions.

In October 2006, the governor of RBI announced that bank KYC procedures will 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$1,225) and total annual transactions up to Rs. 200,000 (approximately US$4,900), banks would need only a photograph of the account holder and self-certification of the account holder’s address.[29] However, RBI has not yet issued a circular implementing such proposed changes.

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

Regarding 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$1,225) below which only suspicious transactions require identification.[31] This would seem to be an important consideration for business models built around domestic person-to-person transfers via mobile or any other electronic device.

4.3 Payment Systems Regulation

Currently, India does not have a payment systems law. The Payment and Settlement Systems Bill was introduced in Parliament last year and passed by the Lok Sabha on 26 November 2007; however, it has not yet been passed by the Rajya Sabha (see "Areas of Opportunity"). In the meantime, applicable law permits only banks and financial institutions (both of which are registered with and regulated by RBI) to engage, as a primary activity, in **collecting moneys**. In other words, only banks and financial institutions may collect funds for payment to third parties. A nonbank may provide "payment services" only if these services do not categorize the provider as a bank or as a financial institution.[32] The broad definition of "financial institution" would capture nonbanks operating e-money schemes (if this were permitted, which it is not under current law) as well as other payment service providers, although it would not cover payment service providers that engage in limited front-end interface activities and route the payments through ordinary banking channels. It remains to be seen how the ICICI-R-com and Bharti Airtel arrangements with SBI and Western Union are being structured.

Today, **only banks and the India Post provide domestic payment services**.[33] **International money transfers into India** are dealt with under RBI's Money Transfer Service Scheme (MTTS).[34] MTTS permits the following institutions to receive international remittances: authorized dealers (primarily banks authorized to deal in foreign exchange under the Foreign Exchange Management Act 1999), RBI-licensed fully fledged money changers, NBFCs, and IATA-approved travel agents with a minimum net worth of Rs. 250,000. RBI, however, seems to be indicating flexibility in permitting banks to partner with mobile phone companies to provide remittances.

Most banks in India have their own ATM switch. In addition, the Institute for Development & Research in Banking Technology has set up a National Financial Switch, but uptake so far is only limited. RBI does not require interconnectivity of ATM switches nor does it regulate interconnection charges. (Some banks have bilateral contracts; in all other cases, customers must go through the Visa or MasterCard switch.) The Fair Practices Code issued by RBI requires all banks operating ATMs to display the service charges being levied.[35]

4.4 Regulation of e-Money and Other Similar Stored-Value Instruments

In 2002, RBI set up a working group on e-money that concluded that liabilities accepted under prepaid cards are in the nature of demand liabilities, and therefore, banks are the "preferred" issuer of e-money.[36] This was followed by a 2004 circular announcing that only banks were permitted to issue smart cards, debit cards, stored-value cards, and value-added cards. [37] The circular also reminded banks of an earlier circular advising banks not to issue smart cards or debit cards in "tie-up" with any nonbank entity. In 2006, responding to the cropping-up of "internet based electronic purse schemes," 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.[38] RBI also 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.[39]

4.5 Other Issues Relevant to Branchless Banking

Taxation can potentially be a problem for mobile network operators offering m-payment services (in addition to the restrictions on the use of agents mentioned above). Operators are subject to a license fee of 6 percent to 12 percent (depending on the area of operation) levied as a percentage of gross revenue. If the tax is levied on the full amount of funds passing through (as a remittance, utility bill payment, etc.), this would result in an uneven playing field between mobile phone branchless banking providers and those relying on other ICT and could ultimately deter mobile operators from entering the field.

Data security in e-commerce, important for many branchless banking models making use of ICT, is dealt with under the Information Technology Act 2000. Electronic records can be authenticated through digital signatures. The Institute for Development & Research in Banking Technology is a licensed certifying authority that issues and administers digital certificates that are trustworthy and legally valid (and revokes digital certificates as well).

Competition regulation in India is currently in a transitional phase. A new Competition Commission of India was set up after the passage of the Competition Act (2002). However, the law was successfully challenged in the Supreme Court, which left CCI in limbo and with only a small skeletal staff. Once fully operational, CCI will theoretically cover all sectors, including the financial and telecommunication sector. Even now, CCI has already expressed concern regarding "overregulation" of the banking sector (i.e., barriers to entry and the high costs of regulatory compliance) and the negative implications for market competition. It remains to be seen whether CCI's objections will have any impact on RBI.

Consumer protection issues in the banking sector are dealt with both by statutory regulation and by voluntary membership bodies. The Banking Codes and Standards Board of India, an independent and autonomous watchdog, developed the Banking Code Rules with which all member banks must comply. RBI's BC Circular requires each bank working through business correspondents to establish "grievance redressal machinery" within the bank for complaints about the business correspondents and to publicize these mechanisms “widely” through electronic and print media. If the bank fails to respond to a customer's complaint filed through grievance redressal machinery, the customer may approach the banking ombudsman.

In addition, there is a Consumer Protection Act (1986) that established the Central Consumer Protection Council and the State and District Consumer Protection Councils.

5 Areas of Opportunity

5.1 Use of Agents

The BC Circular can be regarded as an important first step to allow banks' use of agents for the delivery of financial services. Policy makers and regulators are pursuing a strategy of opening up space gradually. A **further relaxation on the range of permitted business correspondents and a relaxation of pricing restrictions**—either by exempting lending under the business correspondent model from interest rate limits in line with the exemption for loans given by banks to microcredit organizations[40] or by lifting the ban on charges by business correspondents to the end-client—will likely unleash the potential of the bank-based model. Technology solutions, such as those being developed by ICICI Bank's subsidiary FINO, can help ensure transactions are reported on the books of the bank by the end of next day. Such technology can also help the bank get all necessary information for KYC compliance and to underwrite loans. (As noted, neither loan approval nor KYC compliance for opening deposit accounts may be outsourced.)

With regard to deposit-taking services offered via business correspondents, not much has happened apart from the start of some limited pilots. An important determinant for the future growth of this model is whether NGO MFIs will be permitted to mobilize deposits on their own behalf. This is envisaged under the Microfinance Bill, even though it might be subject to certain restrictions and permitted for only certain NGO MFIs. If NGO MFIs can collect deposits and use such funds as their own source of funding, then they will have even less incentive to collect deposits for banks.

5.2 AML/CFT

The Government of India should be commended for its awareness about the access-constraining effects of KYC norms. RBI has gradually lifted KYC norms for small-value accounts. If it implements its stated position that identification requirements for small accounts would be reduced to self-certification of addresses and a photograph, it would remove any barriers for low-income customers while at the same time addressing risks of money laundering and financing of terrorism through strict maximum balance and transaction limits.

5.3 Payment Systems Regulation

In its 2005 report "Payment Systems in India—Vision 2005–08," RBI acknowledged the "rapidly changing payments landscape" worldwide and "the shift towards electronic modes of payments, [which has] has revealed inadequacies in [India's] present legal structure." [41] As stated in the report, the goals for 2005–08 include a new institutional structure for retail payment systems and a sound legal base for payment systems. The report further detailed RBI's plans, which include (*i*) the retail clearing function being entrusted to a national legal entity separate from RBI and (*ii*) RBI serving as regulator and supervisor of the payment systems and providing settlement services for all clearing systems. RBI's regulatory goals for the period include enactment of the Payment and Settlement Systems Bill (which has as of the date of writing been passed only by the Lok Sabha), development of regulations thereunder for authorized payment and settlement systems, and drafting of legislation for "credit transfer transactions" (i.e., instruction-based payments). Furthermore, in a June 2007 report, RBI's Department of Information

Technology indicated that 2008–10 plans include establishing standards for the use of mobile phones to provide financial services including, in particular, payment services.

The future potential of nonbank-based models will very much depend on the Payment and Settlement Systems Bill and relevant rules and regulations thereunder. The bill suggests that a nonbank may be a payment system provider and transact payments without the involvement of a bank. However, the bill limits electronic fund transfers to the electronic authorization of debits and credits of bank accounts, thus not covering fund transfers between e-money accounts. This is not surprising because the current government policy does not permit the issuing of e-money by nonbanks. However, if the e-money policy changes, it would be preferable if the definition of electronic fund transfers were sufficiently broad to permit transfers between accounts held with nonbanks.

5.4 Regulation of e-Money and Other Similar Stored-Value Instruments

The current government's policy on e-money clearly does not permit issuance of e-money (or other similar stored-value instruments) by nonbanks. As a result, nonbanks that are interested in branchless banking have resorted to operating through banks or are struggling to find a mode of operation that would be in compliance with current regulations. It appears, however, from recent RBI statements, that there is a willingness to reconsider the absolute prohibition on nonbanks issuing e-money in light of the possibilities of using such a route to expand access to the poor. Specifically, in its October 2007 report "Review of Payment and Settlement Systems in India," RBI took stock of feedback from various stakeholders (banks, trade and industry, consumer associations) and appeared to acknowledge the need, as expressed by such stakeholders, to permit mobile payments and prepaid cards for micropayments. In light of this, RBI acknowledged that permitting customers' accounts to be maintained at mobile phone companies and pooled at banks would require regulatory changes. RBI also reported that the feedback indicated that widespread use of these mechanisms and instruments would require cash-in/cash-out at merchant and mobile phone service locations and specifically referred to this arrangement being permitted in Kenya and the Philippines.

International experience suggests that it is not necessary to subject nonbank e-money issuers to the panoply of licensing and prudential requirements applicable to banks. An issuer of e-money used only by a limited number of merchants or by members of a corporate family (a “closed” network) may not require *any* financial regulation or supervision. (For example, in the United Kingdom, a closed-network e-money issuer can be exempt from regulation by FSA if the “purse size”—the e-money balance—is limited to €150.) However, an issuer of e-money that can be used in multiple places (an “open” network) does warrant appropriate regulation and supervision. The risks of nonbanks issuing e-money can be minimized by stipulating certain specific regulatory requirements, such as per-customer transaction and maximum e-money balance. In addition, to minimize risk of loss of customers' funds, operators can be subjected to minimum security standards and required (*i*) to put e-money proceeds in a segregated bank account held in trust for the benefit of the customers and (*ii*) to hold a sufficient proportion of funds in liquid forms to mitigate liquidity risk. To minimize AML/CFT risk, there can be transaction limits for individual accounts. To address consumer protection issues, providers can be required to offer customer grievance redress mechanisms.

6. Conclusion

The table below provides a summary of the barriers to branchless banking observed, via CGAP's branchless banking diagnostic assessment, and recommendations for resolving them.

Barriers	Recommendations
1. Limitation on institutions permitted to be **business correspondents** and prohibition on business correspondents charging fees	Permit commercial entities to act as business correspondents, subject to specific criteria. Either exempt business correspondent model from interest rate limits (in line with the exemption for loans given by banks to microcredit organizations) or lift the ban on charges to the customer, subject to adequate consumer protection measures ensuring transparency and customer understanding.
2. Prohibition on nonbanks providing **payment services**	Ensure that the Payment and Settlement Systems Bill permits the nonbank-based model (i.e., where a nonbank is permitted to engage in electronic fund transfers without bank involvement).
3. Prohibition on nonbanks issuing **e-money**	Permit nonbanks to engage in e-money issuance subject to certain requirements, including minimum capital and liquidity requirements, reporting requirements, AML/CFT compliance, and rules on appropriate investment of funds and security of funds held.

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[1] The stored-value card, like other stored-value instruments, is often referred to as "e-money." There are various definitions of e-money, including the following from the European Union's Electronic Money Institutions Directive (2000): "monetary value as represented by a claim on the issuer which is: (i) stored on an electronic device; (ii) issued on receipt of funds of an amount not less in value than the monetary value issued; (iii) accepted as a means of payment by undertakings other than the issuer."

[2] CGAP Policy Advisory Consultants Stefan Staschen and Stephen Rasmussen, CGAP staff member Mark Pickens, and consultant Marina Solin conducted the field portion of the mission to India, with logistical support from Neumech's Shilpa Kalucha. Staschen and Pickens and CGAP Policy Advisory Consultant Kate Lauer authored the Notes. The Indian law firm of Trilegal provided advice on the interpretation of various laws, regulations, and bills mentioned.

[3] This document summarizes results from a rapid analysis of the policy environment for branchless banking in India conducted in May 2007 with follow-up through November 2007 and is subject to the limitations of such an approach.

[4] World Bank Development Indicators Database, http://go.worldbank.org/3JU2HA60D0 (accessed 12 November 2007).

[5] 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.

[6] RBI Department of Information Technology, "Financial Sector Technology Vision," ¶ 4.9.12, http://rbidocs.rbi.org.in/rdocs/Content/PDFs/80799.pdf.

[7] RBI, “Review of Payment & Settlement Systems in India 2006–2007,” Executive Summary, p. 3, http://www.rbi.org.in/scripts/PublicationReportDetails.aspx?FromDate=11/2/2007&SECID=22&SUBSECID=0.

[8] World Bank Development Indicators Database, http://go.worldbank.org/3JU2HA60D0 (accessed 12 November 2007).

[9] Malcolm Harper and Marie Kirsten, “ICICI Bank and Microfinance Linkages in India,” *Small Enterprise Development* 17, no. 1 (2006).

[10] RBI, “Technical Paper on Differentiated Bank Licenses” (19 October 2007), § IV.A, ¶ 4.2.

[11] 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.

[12] 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.

[13] The SHG–Bank Linkage Program is not insignificant in its outreach. In 2006–07, it had lent to an additional 9.6 million persons, approximately 50 percent of whom were poor. As of mid-2007, the total reached through the program was 41 million persons. *Ibid*., p. 11.

[14] BC Circular, § 5.2(b).

[15] India has currently more than 206.7 million GSM mobile phone subscribers, adding about 6 million per month, according to Wireless Intelligence. Ninety percent of new clients are from peri-urban and rural areas.

[16] http://www.telegraphindia.com/1071029/asp/business/story_8485964.asp. According to the article, mobile operators do not know how the revenue from the service will be treated for tax purposes (i.e., the telecommunications license fee).

[17] http://economictimes.indiatimes.com/Bharti__Western_Union_sign_deal_to_offer_mobile_money_transfer/articleshow/2483572.cms

[18] Banking Regulation Act (1949), § 5(b).

[19] *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.

[20] The Khan Report proposed a wider range of institutions to be permitted to act as business correspondents, 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 business correspondents; 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 business correspondents.

[21] RBI, Circular DBOD No.Dir.BC.6/13.03.00/2007-08, Master Circular “Interest Rates on Advances” (2 July 2007), ¶ 2.2.

[22] BC Circular, § 5.2(b).

[23] 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 Commission, and International Association of Insurance Supervisors).

[24] *Ibid*., Annex, §1.5.

[25] *Ibid*., Annex, §§ 4.1, 4.3, 5.5.1.

[26] 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 business correspondents for banks.

[27] 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.58/14.01.001/2004-05, “Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards” (29 November 2004), ¶ 1.

[28] RBI, Circular DBOD.No.AML.BC.28/14.01.001/2005-06, “Know Your Customer' (KYC) Guidelines – Anti Money Laundering Standards” (23 August 2005).

[29] RBI, “Mid-Term Review of Annual Policy Statement for the Year 2006–07” (31 October 2006), ¶ 127.

[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.

[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] Under the RBI Act, a "financial institution" is an institution "collecting, for any purpose or under any scheme or arrangement by whatever name called, monies … by way of subscription … *or in any other manner* …." RBI Act, § 45I (c)(vi).

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

[34] Money Transfer Service Scheme, 2003, http://www.rbi.org.in/scripts/NotificationUser.aspx?Mode=0&Id=1217

[35] RBI, Circular RPCD.BOS./81/13.33.01/2005-06, “Fair Practices Code—Display of Bank Charges” (16 May 2006).

[36] RBI, “Report of the Working Group on Electronic Money” (11 July 2002), ¶ 36

[37] RBI, Circular DBODNo.FSC.BC.106/24.01.019/2003-04, “Issue of Smart / Debit Cards” (30 June 2004).

[38] RBI, Circular DBODNo.BP.BC22/08.12.01/2006-2007, “Providing Clearing and Settment

Services for internet-based electronic purse schemes" (14 July 2006).

[39] 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).

[40] RBI, Circular RPCD.MFFI.BC.No.08/12.01.001/2007-08, Master Circular "Micro Credit" (2 July 2007), ¶ 4.

[41] RBI, "Payment Systems in India—Vision 2005–08" (May 2005), pp. 2, 11.

List of Persons Interviewed-India[1]

Arnold, R. K., Secretary, TRAI

Ayitam, Gopala Krishna, Project Coordinator, Cooperatives, BASIX

Baijal, Vinay, Chief General Manager, Reserve Bank of India (RBI)

Bajaj, Tarun, Director, Ministry of Finance

Bhaskar, P. Vijaya, Chief General Manager, Reserve Bank of India (RBI)

Black, Rebecca, Director Office of Economic Growth, U.S. Agency for International Development (USAID)

Bondre, Sarika, Project Director, ZERO MASS

Chadha, Maneesha, Manager, ABN AMRO Bank

Challu, U. N., Chief General Manager (New Businesses), State Bank of India

Ehrbeck, Tilman, Partner, McKinsey & Company

Gunaranjan, P. S., Head, Insurance Business, BASIX

Gupta, Anurag, Funder and Chief Executive Officer, ZERO MASS

Gupta, Manish, Chief Business Development, Oxigen

Haberberger, Marie-Luise, Program Director, GTZ

Handa, Rameshwari, Postmaster General, Kolkata Region, Post Office-India Post

Hegde, Brahmanand, Joint General Manager, ICICI Bank Ltd.

Jha, Ashok, Financial Sector Reform Program, U.S. Agency for International Development (USAID)

Juneja, Ashok, Corporate Director, Airtel

Kanitkar, Ajit N., Program Officer, Development Finance and Economic Security, The Ford Foundation

Khandge, Ameya, Senior Associate, TriLegal

Krishnamurthy, N., Vice President, Indian Banks' Association

Kulkarni, Sunil, President, Corporate, Oxigen

Kumar, Manish, Company Secretary, SKS

Kumar, Soundara, Chief General Manager, State Bank of India

1 Persons listed alphabetically by surname. Titles reflect position held at the time of the diagnostic mission.

Landi, Christina, Second Secretary (Economics), Embassy of the United States of America

Mahajan, Vijay, Chairman, BASIX

Marti, Adrian, Deputy Country Director, Swiss Cooperation Office-India

Meissner, Jan, Expert, GTZ

Mittal, Rajesh, Group Chief Financial Officer, Oxigen

Mohan, C. P., Deputy General Manager & Member of Faculty, Reserve Bank of India (RBI)

Peter, Augustine, Economic Advisor, Competition Commission of India

Prasad, S. Vishwanatha, Fund Manager, Bellwether Microfinance Fund

Ramesh, S., Chief Operating Office Designate PNG PML-Port Moresby, BASIX

Rao, M. R., Chief Operating Officer, SKS

Rao, Sitaram, Director, SKS

Regy, Prasanth V., Senior Executive, BASIX

Rukmini Parthasarathy, Project Manager, Financial Sector, KFW

Salim, K. A., Deputy General Manager, State Bank of India

Saran, Prashant, Chief General Manager-in-Charge, Reserve Bank of India (RBI)

Savyasachi, Achla, Policy Team Leader, Sa-Dhan

Sawhney, A. K., Member, TRAI

Sekar, V. G., Deputy General Manager & Member of Faculty, Reserve Bank of India (RBI)

Shankar, Ravi, Country Head, Direct Banking, Yes Bank

Sharma, Dr. Anil Kr., Assistant Director, Research, Competition Commission of India

Sharma, Moumita Sen, Vice President, Head-Microfinance and Sustainable Development, ABN AMRO Bank

Sharma, Santosh, Senior Program Executive, Sa-Dhan

Shrivastava, Shashi, Manager, ABN AMRO Bank

Siddiqui, Faisal, Senior Vice President, Content and Services, Airtel

Sinha, Sanjay, Co-Founder, EDA Rural

Sinha, Frances, Executive Director and Co-Founder, EDA Rural

Sinor, H. N., Chief Executive, Indian Banks' Association

Sridhara, K., Member (Technology) & Ex-Officio Secretary to the Govt. of India,

Ministry of Communication and Information Technology
Sudhakar, Kaza, Chief General Manager, Reserve Bank of India (RBI)
Swamy, Sanjay, Chief Executive Officer, MChek
Thorat, Y. S. P., Chairman, NABARD
Titus, Mathew, Executive Director, Sa-Dhan
Varghese, Reji, Manager, Information Technology, BASIX
Verma, Amitabh, Joint Secretary, Ministry of Finance
Verma, Niraj, Financial Specialist, World Bank
Virwani, Ravi, Senior Officer, Credit & Operations, Rural Micro Banking and Agri Business Group, ICICI Bank Ltd.
Wright, Graham, Program Director, Micro Save