Regulation of payments and settlements in India – Updated

November 30, 2018

UPDATED

Manifest Pedagogy

In our earlier articles on MANIFEST-11 we had explicitly mentioned that it is an integrated endeavor to collect all current affairs related to a topic at one place. RBI autonomy as an issue has already been dealt in our Payments and Settlements Regulation article. Now that the same issue certain developments have happened it doesn't make any sense to make a separate article. We do not want to burden you and waste your time. We want to make your preparation WISE

In news

The government – RBI differences came to a head after the financial markets were squeezed when mutual funds halted buying commercial papers of NBFCs and Housing Finance Companies.

RBI government meeting

- RBI set up a committee to discuss the controversial issue of transfer of surplus reserves to the government (ToR to be announced with consultation later)
- Committee to decide on relaxation of lending norms for banks under the Prompt Corrective Action regime
- Banks would also get a breather in meeting the capital adequacy goals under the Basel norms

- Restructuring loans for MSMEs (up to Rs.25 crores)
- Relaxation of CRAR norms under BASEL III
- Next board meet on December 14

1. Fixing a capital framework could free up RBI’s surplus reserves for transfer to the central government. The government is struggling to meet its fiscal deficit target of 3.3% of gross domestic product in the face of lackluster tax collections, and a massive surplus transfer will help it in bridging the gap.
2. The central bank contends that the reserves are crucial for it to ring fence the country at the time of a crisis.
3. Further, the board did not yield to demands of bringing down the capital adequacy ratio in line with bare minimum levels prescribed by Basel III norms. However, it has yielded and provided another year for implementation of the capital conservation buffers.
4. The Board, while deciding to retain the CRAR (capital to risk weighted asset ratio) at 9%, agreed to extend the transition period for implementing the last tranche of 0.625% under the Capital Conservation Buffer (CCB), by one year, i.e., up to March 31, 2020.
5. The issue of easing the prompt corrective action (PCA) framework for weak banks has also been referred to a committee, with the government pushing for a review to allow a few state-run banks out of this framework. Eleven of the 21 state-run banks are under RBI’s PCA framework, which the government believes is restricting credit flow to key sectors of the economy, including MSMEs.
6. However, there seems to be no consensus on addressing the liquidity shortage faced by NBFCs flagged by the union government. Instead, RBI announced that it would inject Rs.8,000 crore liquidity through open market operations on 22 November.
7. To ease the liquidity crunch faced by NBFCs, State Bank

of India had in October announced that it would buy loans worth Rs.45,000 crore from non-banks. In addition, to ease the liquidity squeeze faced by housing financiers, the refinance window of National Housing Bank was increased to Rs.30,000 crore.

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(EARLIER POST)

In news

Payments Regulator & RBI autonomy and section 7

Placing in the syllabus

Paper 3- EFFECTS OF LIBERALIZATION ON THE ECONOMY-Financial Sector Reforms

Static Dimensions

1. Payments and settlements systems Act ,2007
2. Instruments-UPI,QR codes, mobile wallets etc
3. Cashless Economy or Digital Economy
4. Functions of RBI
5. Regulatory bodies in Financial Sector-SEBI,FSLRC etc
6. Vision for Payments ecosystem by RBI

Current Dimensions

1. Payment regulation
2. RBI vs Government

(a) Autonomy of RBI with respect to Payments

(b) Contingency Reserves of RBI

(c) Section 7

3. Prompt Corrective action
4. Issue of RBI autonomy in General

Content

The major issues of debate which emerged in the recent times with respect to RBI are

The finance ministry sent three different letters to the RBI in the past few weeks on issues of

1. Prompt Corrective Action (PCA) dilution in general and withdrawal of PCA for Public Sector Banks (PSB)
2. The second point of friction is governments insistence that RBI go soft on power companies defaulting on loan repayments
3. The governor’s opinion on RBI’s capital reserves for providing liquidity (siegniorage)

Payments Regulation

The **Payment and Settlement Systems Act 2007**, set up by the RBI, provides for the regulation and supervision of payment systems in India and designates the apex institution (RBI) as the authority for that purpose and all related matters. To exercise its powers and perform its functions and discharge its duties, the RBI is authorized under the Act to constitute a committee of its central board, which is known as the **Board for Regulation and Supervision of Payment and Settlement Systems (BPSS).**

RBI Vision for Payments

Vision-2018 focuses on four strategic initiatives viz., responsive regulation, robust infrastructure, effective supervision and customer centricity.

- **Responsive Regulation**
- **Robust Infrastructure**
- **Effective Supervision**.
- **Customer Centricity**

The broad contours of Vision-2018 revolve around the 5 Cs:

- **Coverage** – by enabling wider access to a variety of electronic payment services
- **Convenience** – by enhancing user experience through ease of use and of products and processes
- **Confidence** – by promoting integrity of systems, security of operations and customer protection
- **Convergence** – by ensuring interoperability across service providers
- **Cost** – by making services cost effective for users as well as service providers

Payments Regulation: RBI Vs Government

Case against RBI

- **Regulation must maintain a level playing field within the payments industry between the public sector and the private sector, and between bank and non-bank players.**
- **Regulation should encourage independent payment system providers, which are not linked to payment participants, thereby minimising moral hazard through conflict of interest.** It is important that the payments regulator does not run any payment systems. Presently, RBI runs real time gross settlement (RTGS) and National Electronic Fund Transfer (NEFT), which are payment

systems. It is therefore necessary that RTGS and NEFT be spun off from RBI.

- **Encourage innovation in payments regulation and supervision, by recognising that this is a fast-changing technology enabled business. Bring in relevant expertise into the regulatory body in order to improve the regulation and supervision of this industry.** Instead, it would be desirable to draw the majority membership of the Board from people who have had direct familiarity with payment processes or allied businesses such as BPOs, technology companies or banks.
- RBI representation on this Board should be confined to the Governor (as Chairman) and the Deputy Governor in charge of Payments.
- **The Payments Regulator would need actively to sponsor the constitution of a Payments Council, a body which would be representative of payment system providers and users of payment systems. Regulations would be issued by the Payments Regulator which would define the role which the Council would play in advising the payments regulator on industry standards and other related matters.**

For example, the UK government formed the UK Payments Council in 2007, which represents payment systems providers and user groups. The Council thereby constitutes a consultative mechanism engaging all stakeholders with an interest in payment systems. The European Payments Council operates in a similar manner.

- **All payment system providers should be governed by one consistent legislative framework.** (Stock exchanges and clearing houses are presently outside the ambit of Payments in India).
- **A system of 'proportionate regulation' would be helpful, allowing nascent businesses to adapt technology solutions without undue regulatory intervention, while**

requiring systemically important businesses to submit to stronger regulatory oversight.

Case for RBI

Payments should remain with RBI. As the very nature of payments is completely integrated with money market and payments being

- **Sub-set of currency**
- **Underlying bank account for payment systems**
- **Dual regulation over such instruments will not be desirable.**
- **Payment system is bank-dominated**

The Payments Regulatory Board (PRB) must remain with the Reserve Bank and headed by the Governor, Reserve Bank of India. It may comprise 3 members nominated by the Government and RBI respectively, with a casting vote for the Governor to ensure smooth operations of the Board.

Debates on RBI Autonomy

Traditionally, it is quite natural for the government and the central bank to be at loggerheads with each other. This can be explained by the inflation growth dynamics. Here, the former is concerned with high growth and the latter is concerned with controlling inflation.

However, in India these issues took an ugly turn with the government demanding certain privileges from the RBI over and above its mandate:

1) Request for higher dividend from RBI to cover up fiscal deficit will lead to balance sheet maintenance concerns.

2) Governments insist that public sector banks lend more to NBFCs to manage their liquidity crisis.

3) Dilution demand for the current framework of Prompt

Corrective Action standards for recovery of NAPs.

4) The lack of regulatory mechanism for Public Sector Banks and Powers vested with RBI in this regard including appointment decisions of board members and chairpersons.

5) Leaving out key aspects of financial intermediation such as payments ecosystem outside the ambit of the RBI.

6) Dictating orders to RBI as under section 7 which is over bearing on the inference of the RBI.

Contingency reserves

The RBI keeps a large reserve of cash in its money jar **(contingency reserves and surplus with RBI)**, which the government is looking to dip its fingers into, financial analysts and economists say. The government may be of the view that the RBI’s large reserve cash, if it is sitting idle, may be put into use. But the RBI is called the “lender of last resort” for a reason – it may need its reserves to step in if a crisis threatens to bring down the entire financial system.

SECTION 7

The central government for the first time in 83 years have issued RBI Section 7 Act, 1934.

1. Section 7(1) of the RBI Act says: “The Central Government may from time to time give such directions to the Bank as it may, after consultation with the Governor of the Bank, consider necessary in the public interest.”
2. Section 7(2) gives the government powers to entrust the running of the RBI to its board of directors.

Recently the government has issued statements on section 7 of RBI act showing that it has the power of veto over RBI decisions. Thus underlining that the RBI’s autonomy is tempered by its accountability to government. Section 7 is certainly available to the more powerful side; but just as the weapon is a deterrent never to be used, so is Section 7. The need of the hour is to settle the differences through deliberation.

Manifest pedagogy

In prelims UPSC may focus on conceptual issues such as Contingency Reserves, dividend payments to government, Section 7, Prompt Corrective Action and functions of RBI in general. In Mains, questions regarding autonomy and independence of the institutions and desired changes which are a cause of conflict may be touched upon.

Test yourself: Mould your thoughts

Briefly explain the rise of alternative payment instruments in India. Also, highlight the key issues involved in governing the Payments Regulation in India.