August 2022

Discussion Paper on 'Charges in Payment Systems'

The discussion paper on 'Charges in Payment Systems' ("**Discussion Paper**") was released by the Department of Payment and Settlement Systems of the Reserve Bank of India ("**RBI**"). The RBI has invited public comments on the Discussion Paper, and comments can be submitted by October 3, 2022.

Background

The Indian Government's policy on the charges and commercial incentives applicable to digital payments has been a controversial topic for some time. Companies in the Indian payments ecosystem, including banks, have been engaged in prolonged discussions with the RBI regarding these policies and have, for several months, called for a rationalisation of this framework.

In response to these demands, the RBI published the Discussion Paper wherein it has acknowledged the need to assess and identify changes required to the way charges are levied by payment systems and payment intermediaries. The RBI has sought feedback from industry stakeholders on these matters and has raised several questions regarding the commercial arrangements and regimes applicable to specific payment systems.

Existing Regulations

1. **Types of Payments Systems and their Charges**

   The RBI has listed the types of payment systems in India and explained that the charges of payment systems are based on the role they play in the payment flow, and the ownership structure of the payment system.

   (a) In case of a funds transfer payment system (such as real time gross settlement ("**RTGS**"), national electronic funds transfer ("**NEFT**") and immediate payment service ("**IMPS**")), charges are usually recovered from the initiator of the payment instruction as an add-on to the amount to be remitted as per the instruction. This is usually charged uniformly on a per transaction basis and does not change based on the amount remitted.

   (b) In case of a merchant payment system (such as card networks and prepaid payment instrument ("**PPIs**"), the merchant is charged a fee, generally through a deduction (or discount) from the amount receivable by the merchant through the transaction. The charges of a merchant payment system may differ based on the channel used for the transaction. For instance, payments made online are often charged higher than offline / physical transactions.

   The RBI notes that the most preferred method for recovering such charge is *via* a merchant discount rate ("**MDR**"). MDR collected by acquirers is used to compensate payment service provider and intermediaries in the payment system – and the split of MDR is commercially agreed between the parties. The RBI also notes the various other charges or commercials involved in a payment transaction, including:

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(a) interchange (portion carved out from MDR to share with issuer of payment instrument),

(b) convenience fee for use of payment system's platform (for online payments; this may be agnostic to the type of payment instrument) or

(c) a surcharge (imposed by a merchant on customer; usually, merchants attempt to offset their MDR against this customer surcharge).

Unified Payments Interface ("**UPI**") is seen as both a funds transfer payment system as well as a merchant payment system.

2. **Regulatory Aspects**

The charges levied for a payment system are generally governed by the payment system operator ("**PSO**") for both fund transfer payment systems and merchant payment systems. The distribution to intermediaries is determined based on the mutual commercial arrangement with the acquirers.

The RBI has, however, noted its own attempts to cap such charges for certain payment methods (including debit cards) to promote digital payments. For instance, the RBI noted its previous efforts to set (and modify) the maximum MDR chargeable on debit card payments since 2012, with a view to encourage smaller merchants to accept debit card payments. The Discussion Paper also acknowledges the Government's initiative in this regard, and specifically notes the Government's decision to mandate zero MDR on UPI and RuPay transactions.

RBI's Questions

Under Part B of the Discussion Paper, the RBI has examined the payment systems on a product-wise basis to determine if they each need to be regulated differently or in a more expansive manner. While assessing the current regulation of charges, the RBI recognised the costs involved in setting up and managing the infrastructure for each of these payment systems.

Key highlights are as follows, with focus on the payments systems most relevant:

1. **RTGS and NEFT**: For RTGS and NEFT, RBI is the owner, operator and regulator. Therefore, there is steady regulation of these payment systems and maximum charges (for outward transactions) that may be levied, based on the value of the transactions. The RBI has now sought feedback on whether RBI can charge member banks for these transactions and if customers should be charged by banks on an ad hoc / market driven basis.

2. **IMPS**: Operated by National Payments Corporation of India ("**NPCI**"), this payment system works at all times, and charges for its use are imposed on the originator by the participating bank. NPCI in turn imposes a transaction fee on the participant banks to recover its cost of operations. RBI has asked if there should be a ceiling on the charges that may be imposed and whether it should regulate these transactions.

3. **Debit Cards:** The RBI stated that this is the only form of payment where the RBI has intervened to reduce merchant costs by prescribing limits on MDR that may be charged. In the Discussion Paper, the RBI has asked if there needs to be further regulation on debit card transactions, including:

   (a) regulation of interchange (which is the portion of MDR payable to the issuer entity by the acquirer, as determined by the PSO) as the MDR that may be recovered by the acquirer, may be reduced due to the issuer receiving a high interchange (given the current limits on MDR); and

   (b) mandating per-transaction fees, as debit card transactions do not lead to high infrastructure costs unlike credit card transactions (which involve recovery-linked infrastructure requirements). In relation to this point (b), the RBI noted that debit card transactions may have charges similar to other funds transfer transactions.

   The RBI also discussed whether MDR should be uniform (which may poorly impact merchants receiving small value transactions) or split on a tiered basis depending on the stakeholders in the payment chain. Interestingly, in contrast to the preceding points, the RBI also asked if it should 'deregulate' debit card MDR and allow stakeholders to determine the appropriate MDR and interchange.

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4. **Credit Cards:** The RBI acknowledged that credit card transactions may require a higher MDR than debit cards, given the infrastructure costs. While the use of the card for digital payments may involve an infrastructure like debit cards, the cost of interest foregone (including credit risk) by the issuer is an additional cost for credit card issuers. The RBI commented that charges on merchants in a credit card transaction should consider the movement in interest rates in the market, but PSOs / participants do not currently have transparent mechanisms which allows such self-regulation or adjustment to market changes. Therefore, the RBI has asked for feedback on whether it should delink the cost of the digital transactions and the credit risk related costs – enabling it to limit MDR on credit card transactions. It noted that charges for certain credit cards are 'exorbitant' and if they do not decrease / change based on reduction in interest rates, the RBI must step in to regulate such charges.

   One recommendation of the RBI is to equalize MDR for credit card and debit card transactions to the extent of the digital payments costs, and then allow an additional MDR for credit card transactions which is calculated at an average rate for 30 (thirty) days' credit for certain large banks. Such MDR may be reset for the entire industry, once in a year, at the beginning of a financial year based on the average lending rate of such large banks during the last financial year. As in the case of debit cards, the RBI has considered the regulation of interchange due to the same concerns as in the case of debit cards – although interchange on credit cards (with an unregulated MDR) only means that there are significantly higher charges for using credit cards.

5. **PPIs**: Since PPIs are issued by banks and non-banks, the costs incurred by the issuers may vary. Currently, the MDR on PPIs is similar to that of credit cards – and PSOs determine the MDR. There are no limits imposed by the RBI on MDR / charges for PPIs. The RBI is now looking for views on whether it should regulate MDR for PPI transactions. It has further discussed the concern that since no credit can be used to fund a PPI, it may not be reasonable to charge a high MDR for PPI transactions on the same footing as MDR on credit card transactions. In addition, the RBI has asked if the charges for cash withdrawal using PPIs should be regulated.

6. **UPI**: The NPCI / RBI have continued to promote UPI transactions in India and therefore, have introduced a zero-charge policy for UPI transactions (for both customers and merchants). The RBI noted the distinction in the settlement infrastructure of UPI players and card players, as UPI allows real time movement of funds and there is less of a settlement risk. The simplicity of UPI payments which allows merchants to accept payments *via* a QR code or a mobile number allows merchants an inexpensive process of setting up a form of payment. That being said, the RBI discussed an alternative to the zero-charges principle and asked if subsidizing costs may be more effective. It further asked if a charge on UPI transactions should be fixed or a percentage of the transaction value; and if they must be regulated by the RBI or market driven.

7. **Intermediaries**: Payment aggregators and payment gateways are currently the most relevant intermediaries that are supporting most digital payment processes in India. Intermediaries provide payment acquiring services either as an outsourced service provider or direct acquirer of merchants. In case of the former, they apply a bank or PSO mandated MDR and charge the banks or PSO a service fee. In case of the latter, they may charge additional fees over the applicable MDR – for 'value added services' they provide – which are added to the total MDR in such case. This total MDR is typically discounted / deducted in the payment flow before the payment is settled to the merchant. The RBI noted the lack of transparency for merchants in such payment flows where MDR is deducted – leading to high MDRs being charged by intermediaries. The RBI has recommended that charges must be clearly specified to the merchants by intermediaries and any separate charges (not the MDR) should be separately levied. The RBI has asked for thoughts on this recommendation.

8. **Surcharging and Convenience Fee**: These are additional charges levied (usually on customers) for digital transactions such as platform fees. As these are not very transparent and are charged on an ad hoc basis due to the commercial nature of such fees (i.e., based on the contractual terms between user and merchant), the RBI does not regulate such charges. The RBI has asked for inputs on whether it should begin to regulate such surcharges and convenience fees.

Separately, the RBI also asked for feedback on whether digital payment transactions should be charged based on value or if they should be value-neutral (*as the same process for digital payment would be followed regardless of the value of the transaction*). An alternate perspective laid out by the RBI is if large value users to subsidize cost of usage of small

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value users. The RBI also raised concerns on whether it should be capping charges where there currently are no limits as the general trends is for all players to attempt to equalize MDR in such case to align with the limit (even if their infrastructure costs may not be as expensive as other players). The determination of whether these charges can be regulated is also important, as the market keeps shifting based on demand and supply, and therefore, may need to be determined by the payment chain stakeholders.

JSA Comment

The systematic regulation of charges in payment systems has been long overdue, as most restrictions and guidelines have been issued on an ad hoc basis in the past (such as the zero-MDR policy for UPI transactions). The Discussion Paper is descriptive and analytical on current practices and asks for views of the public without fully revealing their position on each matter. The approach appears to be sensitive and open to the needs of the industry and indicative of the tight rope that the RBI will have to walk to strike a balance between the interest of payments companies with the Government's or public's demand for inexpensive / free payment infrastructure.

Notably, the Ministry of Finance has commented (in a Twitter thread) that it does not intent to change the zero-MDR policy for UPI transactions. The Ministry also expressed that it would continue to show its unequivocal commitment and support to encourage the adoption of electronic payments in India by making them user-friendly and providing financial support for cost recovery to the service providers.

FinTech Practice

JSA is one of India's pioneering law firms in the FinTech space. JSA's FinTech group brings together an integrated multi-practice team to support clients with transactions, disputes and regulatory matters at the intersection of financial services and technology. Our practice leverages the experience and in-depth technology expertise of attorneys across practice areas and allows us to offer clients access to time-tested strategies and holistic advice. Our experienced attorneys are well positioned to assist clients navigate through the complex legal, regulatory and compliance landscape within which these businesses and their technologies operate. Our strong relationships with regulators, banks, insurers, funds, large technology companies and infrastructure and service providers mean that we understand the issues that affect every area of the financial technology ecosystem. This enables us to deliver incisive, informed and innovative advice across the FinTech spectrum. We work with financial institutions, as they adapt and transform, FinTech start-ups, from inception through to all rounds of funding, to IPO and beyond, large technology companies diversifying into FinTech and Investors and strategic acquirers as they identify and secure strategic opportunities in the FinTech space.

Our areas of expertise inter alia include: (a) Prepaid payment instruments and variations thereof, (b) Remittance (person-to-person and person-to-merchant) models and services, (c) Central treasury arrangements and collection agency models, (d) Artificial Intelligence (AI) and Machine Learning (ML) enabled payment systems, (e) Alternative lending and payment platforms, (f) blockchain enabled service offerings, including smart contracts, (g) crowdfunding and crowdsourced investments, (h) Cryptocurrencies, including initial coin offerings, (i) InsurTech products and business models, (j) investments, including PE/VC financing into fintech and financial services companies, (k) Invoice trading and receivable discounting platforms, (l) Payment services and solutions (both cross-border and domestic).

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