

FINTECH FLYER

FEB-MAR 24

IN FOCUS : KYC

The RBI believes that the systemic strengthening of KYC compliance is essential to the future proofing of the Indian financial system

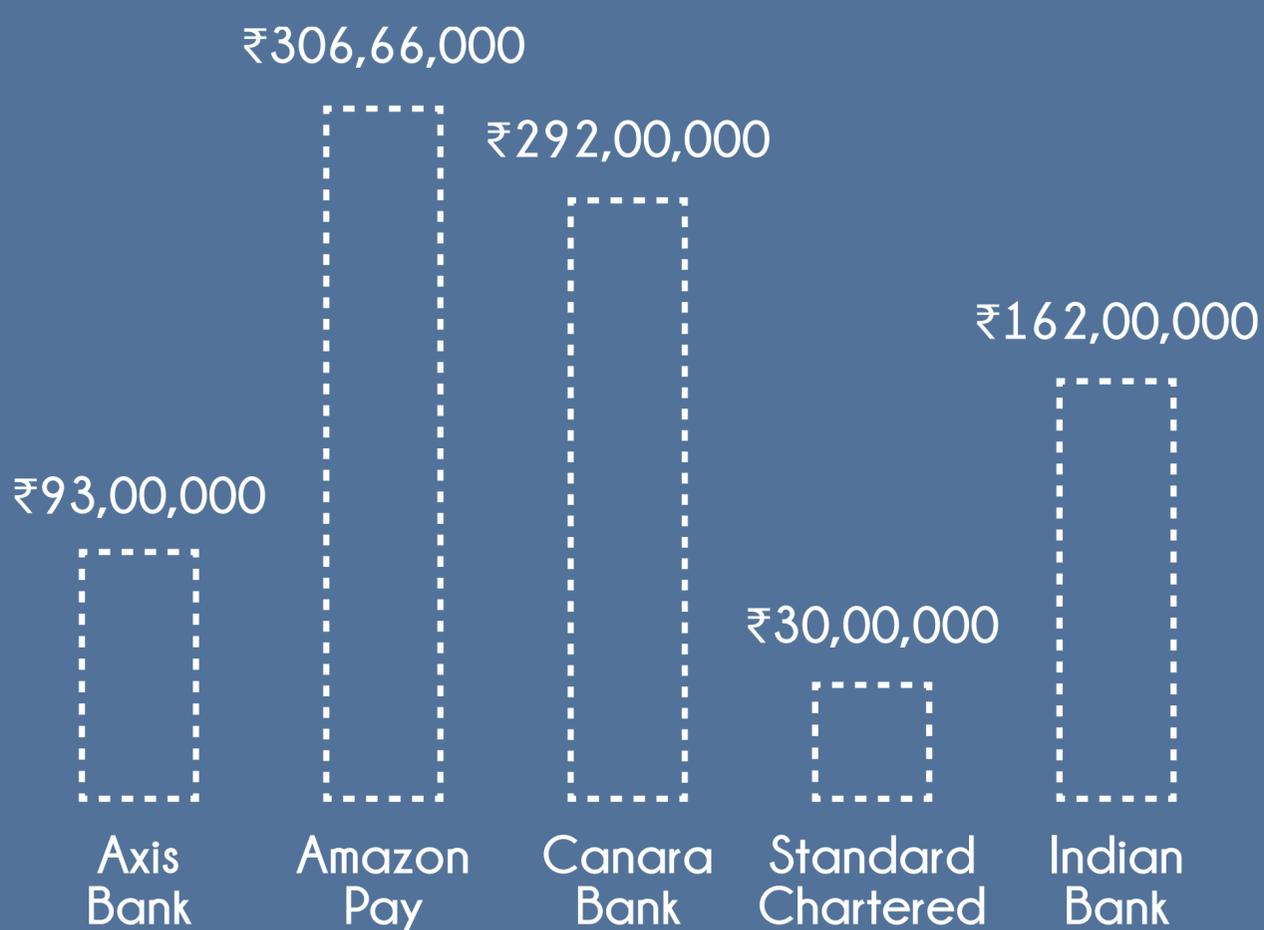
The exponential growth of the fintech industry and the paradigm shift in consumer behaviour from traditional financial solutions to a high dependency on fintech solutions has steadily but surely drawn the attention of the regulators. The latest data on orders from the Reserve Bank of India (**RBI**) shows a persistent push to encourage a culture of compliance, while prioritizing Know Your Customer (**KYC**) compliances.

CULTURE OF COMPLIANCE

LARGE AND DIVERSE FINANCIAL SYSTEM

FUTURE PROOFING THE FINANCIAL SYSTEM

Non-adherence to the Reserve Bank of India (Know Your Customer (KYC)) Directions, 2016, as amended from time to time, (**KYC Master Directions**) has been heavy on certain banks, in terms of the monetary penalty imposed by RBI, as is visible from RBI's orders, wherein RBI has penalized banks for not: (i) undertaking risk categorization of its customer and carrying out periodic updation of KYC for high risk customer; (ii) putting in place a system of periodic review of risk categorisation of accounts; (iii) reporting any frauds to RBI within stipulated timelines; (iv) periodically updating KYC as per risk categorization of customers; (v) undertaking ongoing customer due diligence and putting robust software in use for generating alerts when transactions were inconsistent with customer profile.



In the last couple of months, the RBI has not shied away from imposing stringent regulatory actions against some significant stakeholders in the industry, who have been non-compliant with the regulations, especially the compliances under the KYC Master Direction.

THOU SHALL KYC

SYSTEMATIC PROTECTION
TO FINANCIAL SYSTEM

ADDRESSES AML / CFT CONCERNS

ENSURES AUTHENTICITY OF
FINANCIAL TRANSACTIONS

ACCURACY OF CONSUMER
ACCOUNT INFORMATION

Considering that the regulatory environment surrounding fintech entities is still evolving, it is important for the fintech entities to ensure that the compliance team takes a principled and holistic approach to compliances prevalent in this industry. KYC measures not only helps the regulated entities in establishing customer account relationships or verification of identity, but it is also an operational means for combating money laundering, terrorist financing and other related threats to the integrity of the financial system.

RBI GUV SPEAKS

“We have about 90 banks and more than 900 NBFCs, our actions are against two NBFCs and one payment bank. So, to say spate of regulatory action would not be the correct way of describing the action.”

PART ONE

REALIGNING THE CREDIT CARD SYSTEM

The regulator continues with its open but conservative approach towards fintech, with the credit cards market receiving its attention over the last few days.

SUSPENSION OF UNAUTHORIZED PAYMENT ARRANGEMENTS: The RBI, through a press release dated 15 February 2024, informed that a card network had been issued directions to suspend payment arrangements that facilitate businesses to make card payments through intermediaries i.e., Business Payment Service Provider (BPSP) to non-card accepting recipients.

**CARD SYSTEM NOT FOR PAYMENTS
TO NON MERCHANTS**

POOLING AND KYC APPREHENSIONS

An arrangement as referred above is a card-based payment where the originator makes the payment to the beneficiary through a fintech intermediary, which pools large amounts of funds from such transactions into an account and pays out to non-card accepting recipients.

KEY OBSERVATIONS BY RBI: The RBI has raised the following concerns regarding such an arrangement.

(A) Non-compliance with Section 4 of the Payment and Settlement Systems Act, 2007 (Act): As per Section 4 of the Act, no person can operate or commence a payment system unless authorised by the RBI. However, in the present instance, a particular card network had transferred the funds to merchants through intermediaries, that was not authorized by the RBI to undertake such business. These intermediaries were found to be pooling large amounts of funds collected from corporates into accounts which are not designated under the Act. As per the RBI, the aforesaid arrangement is qualified as a 'payment system' which was operating without the authorisation of the RBI as per Section 4 of the Act

(B) Non-compliance with the KYC Master Directions: As per the KYC Master Directions, for an intermediary to engage in a wire transfer arrangement, information with respect to originator and beneficiary should be retained with the transfer. Such information includes the details of the originator and the beneficiary such as name of the originator/beneficiary, their account number, originator's address or date and place of birth, etc. RBI has raised concerns regarding the non-compliance with the aforementioned KYC requirements.

LEX | **ACTION LIMITED TO**
TAKEAWAY | **SPECIFIC USE CASE**

This move by the RBI is not to be considered as a ban on commercial cards, but a specific use case to freeze the usage of commercial cards to make payments to non-card accepting recipients, through a BPSP.

AMENDMENT TO THE CARD DIRECTIONS: The RBI has raised the following concerns regarding such an arrangement.

The RBI through an amendment dated 7 March 2024 (**Card Amendment**) to the Master Direction – Credit Card and Debit Card – Issuance and Conduct Directions, 2022 (**Card Directions**), introduced several key changes aimed at bolstering customer privacy, enhancing convenience, and enforcing transparency in co-branding arrangements. The key changes introduced by the Card Amendment are as follows:

(A) While co-branding partners (**CBPs**) were not privy to the transaction details under the Card Directions, the Card Amendment now provides the CBPs with access to encrypted transaction data for cardholder convenience, while ensuring strict security measures in place. Nevertheless, CBPs are not permitted to store or access this data.

(B) The Card Amendment mandates that co-branded cards should explicitly indicate their nature and display the name of the card issuer prominently. Further, CBPs are prohibited from advertising or marketing the cards as their products.

DATA SECURITY

CUSTOMER CONVENIENCE

CO-BRANDED FOR MARKETING NOT
DATA SHARING

(C) Previously, all Scheduled State Co-Operative Banks (SCBs) and Non-Banking Finance Companies (NBFCs) had to obtain prior approval from the RBI to enter into co-branding arrangements. However, the Card Amendment removes this requirement for all the RBI-registered banks and NBFCs, thereby simplifying the process and expanding participation.

(D) The Card Amendment prohibits card issuers from sharing transaction and card data with outsourcing partners unless necessary, and provided explicit consent from the cardholder is obtained beforehand.

These key changes aim to establish accountability mechanisms, particularly concerning the end use of funds by the card issuers.

LEX TAKEAWAY | IRREGULARITIES MAY FACE BUSINESS BLUNTING

The recent actions taken by the RBI against South Indian Bank and Federal Bank, to halt issuance of new credit cards, underscore the effective implementation of the principles behind policies such as the Card Amendment. Through a letter dated 12 March 2024, the RBI identified irregularities in the co-branding arrangements of these banks, leading to directives to cease onboarding new customers for such cards. This enforcement action signals the RBI's commitment to tightening regulatory oversight and ensuring compliance with the amended guidelines.

PART TWO

RBI's GREEN SIGNAL TO PPI IN THE MASS TRANSIT SYSTEM

This is yet another instance of the RBI's broader vision of advancing the digital payment infrastructure in India.

Maintaining its position in providing convenience to consumers, the RBI, through a notification dated 23 February 2024 (**Amendment**), has amended the Reserve Bank of India Master Directions on Prepaid Payment Instruments, 2021 (**PPI Master Directions**) by permitting authorized banks and non-banks to issue prepaid payment instruments (**PPI-MTS**) which were previously issued solely by mass transit operators (**MTS**) operators. While PPI-MTS cannot be used for any kind of withdrawal or refund, these PPIs can be replenished.

Keeping in mind the extensive numbers of daily commuters under the Indian public transport network, the RBI, vide this Amendment, envisions to provide to the users accessibility, ease and safety of the digital modes of payment.

PPI-MTS ISSUABLE BY REGULATED ENTITIES

These PPIs now contain the automated fare collection application facilitating the use of such PPT-MTS at transit services, toll collection and parking. Further, the usage for payments across various transit modes such as metro, buses, rail and waterways, tolls, and parking has now been enabled.

LEX TAKEAWAY | ADVANCING DIGITAL PAYMENTS

The Amendment aligns with the broader vision of RBI of advancing the digital payments infrastructure in India. In addition to embracing digital payment solutions, the RBI is encouraging inclusive and extensive growth in India's financial backdrop. In this regard, PPI-MTS paves the way for an efficient, convenient, and futuristic transportation experience for commuters. This is particularly so given the vast infrastructural push in the public transport segment that the country is witnessing.

Financial regulators are increasingly vigilant in ensuring financial institutions play by the book.

RBI's imposition of several stringent restrictions on Paytm Payments Bank Limited (PPBL), a subsidiary of One97 Communications Limited (Paytm), vide [press release](#) dated 31 January 2024, is being seen as a statement of intent by the RBI for fintech to reassess their regulatory compliance check mechanism.

THE FACTS

PPBL was issued a [license](#) under the guidelines for “Licensing of Payment Banks” and “Licensing of Small Banks” (**Guidelines**) in 2017 and has since then established itself as a significant player in the fintech industry. This is not the first time that the RBI has censured PPBL.

Less than 6 months ago, per a press release dated [12 October 2023](#), non-compliances under the Guidelines and the KYC norms cost PPBL a penalty of INR 5.39 crore.

The non-compliances arose in relation to identification of account owners, video based customer identification process infrastructure failing to prevent connections from internet protocol (IP) addresses outside India, non-compliance with PAN requirements and breach of minimum KYC pre-paid instrument limits.

PAST AND PERSISTENT NON-COMPLIANCE

In light of the persistent non-compliances by PPBL in the past, the RBI, on 31 January 2024, barred PPBL from accepting deposits, credit transactions, recharges or top-ups in wallets, FASTags, prepaid instruments and other cashbacks or refunds from 29 February 2024. The RBI further directed PPBL to settle all pipeline transactions and nodal accounts by 15 March 2024. On 16 February 2024, the RBI, after taking into account the interests of the consumers of PPBL, extended the earlier deadline provided to PPBL from 29 February 2024 to 15 March 2024. Subsequently, on 17 February 2024, the RBI released a list of Frequently Asked Questions (FAQs) clarifying the scope of restrictions on the functioning of PPBL vis-à-vis the different services offered by PPBL.

WHAT DOES THIS MEAN FOR PAYTM AND OTHER PLAYERS?

The regulatory action taken by the RBI against PPBL has a significant impact on the other players in the Indian fintech sector.

APP CONTINUES, ENABLER CHANGES

For Paytm, the imposition by the RBI has severely affected its wallet business. Since the restriction by the RBI is strictly against PPBL and not the Paytm Application (**App**) itself, while the bank cannot accept direct deposits, the App can still act as an intermediary and facilitate payments between non-Paytm bank accounts. All of the nodal accounts on the App have now been shifted to Axis Bank, its banking partner. This indicates a fresh start for PPBL in terms of complying with KYC norms.

CAREFUL OR YOU'RE NEXT?

Paytm's competitor apps have seen a significant increase in downloads. For other fintech players and competitors, the direction by the RBI may act as a wake-up call for their internal corporate governance compliance. The severity of the RBI's direction may act as a prevention mechanism for further irregularities in the fintech space. The RBI's regulatory action further emphasises that compliance with laws is not voluntary but mandatory.

HOW HAS PAYTM RESPONDED?

ALL IS WELL, ALL IS WELL.

To combat the criticisms against it and to instill confidence among merchants and consumers, PPBL has reassured players that it is exploring third-party banks to provide back-end banking support to merchants. In this regard, it has also shifted nodal accounts with Axis Bank. Further, as a precautionary measure, Paytm has released a list of FAQs on its App, clarifying its position with respect to the services offered by it. Paytm has assured its customers that its QR code, unified payment interface (**UPI**) payments, recharges, bill payments, wallet and other services remain unimpacted by the RBI's direction. It has further clarified that the existing balance in the wallet of customers will remain safe.

Paytm has also recently been granted the third party application provider (**TPAP**) license by National Payments Corporation of India (**NPCI**). This will help the users on Paytm to continue to use the App for UPI transactions and autopay mandates effectively, without any interruption in services to the users.

LEX | RBI KEHTA HAI KYC TAKEAWAY | ZAROORI HAI

Given the stated objective of future proofing the Indian financial system, there appears to be a dynamic shift in the regulatory oversight of the RBI in the fintech sector. Imposition of such actions on such significant players in the fintech industry, despite the potential disruptions that may be caused in the fintech sector, reflects RBI's will to ensure that all stakeholders, irrespective of their size, adhere to the regulations.

The RBI, through its impositions, envisions to prevent and resolve any further irregularities in the fintech sector and seeks to ensure a healthy functioning of the fintech industry in a regulated environment. This endeavour of RBI is also reflected through its efforts to establish a self-regulatory framework in the fintech industry, through the issuance of draft regulations for self-regulatory organisations dated 15 January 2024.

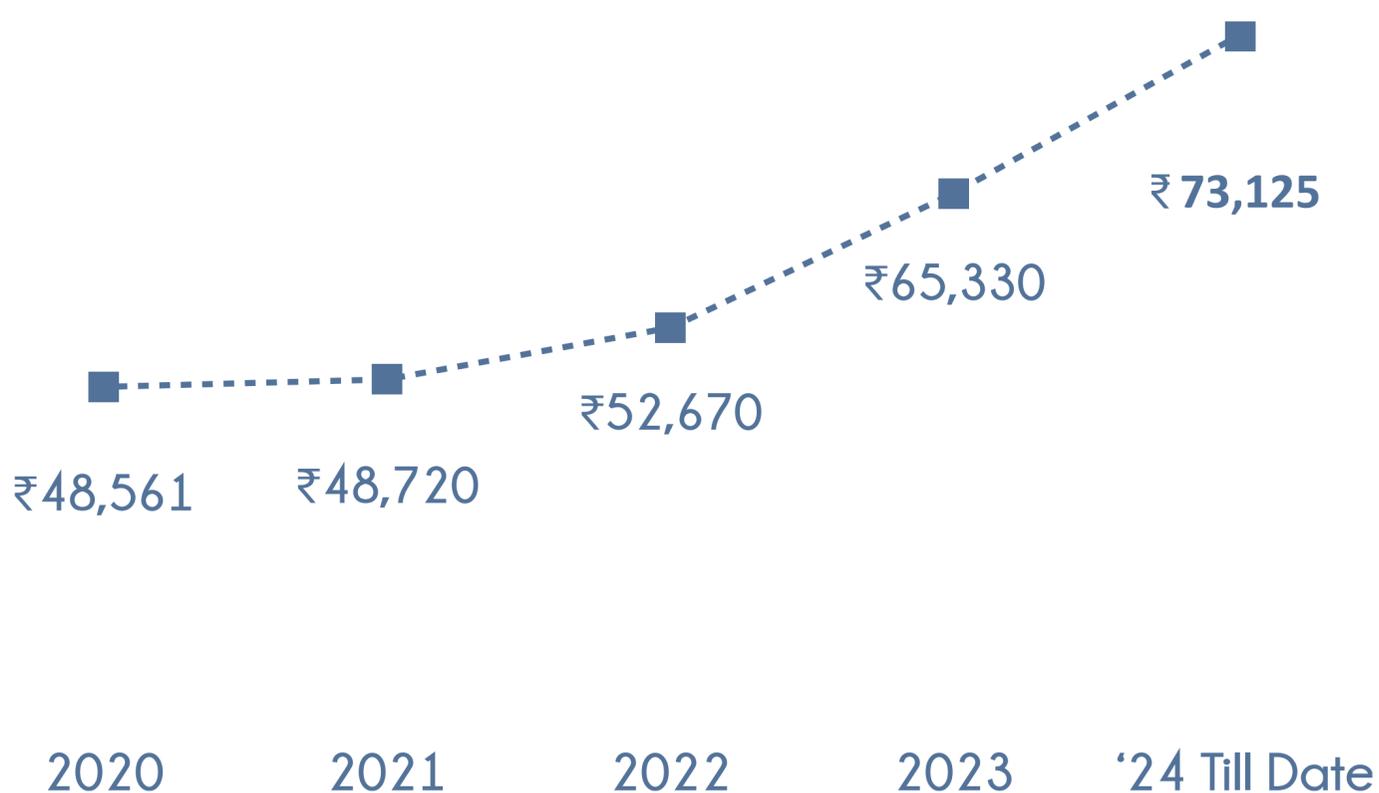
PART FOUR

GOLD LOAN MARKET UNDER REGULATORY SCRUTINY

The regulatory action highlights the need for compliance and transparency in a loan market that impacts the ordinary Indian

In recent times, a significant surge in the prices of gold can be observed and as a result of this surge, several NBFCs have swiftly expanded their gold loan portfolios to cater to the escalating market demand. Notably, IIFL Finance Limited (IIFL) has grown from third to second place in the gold loan market post-pandemic, exemplifying this trend.

HISTORICAL GOLD RATE TREND



INCREASE IN DEFAULTS

However, amidst this growth, concerns have arisen regarding compliance and transparency within the gold loan market. The surge in gold loan borrowing has led to an increase in default rates consequently triggering a rise in gold auctions. The fast pace of growth demonstrated by NBFCs and other developments have prompted regulatory bodies like the RBI to take notice.

DIRECTIVES BY THE DFS AND THE RBI: In response to the observed material non-compliances, the Department of Financial Services (**DFS**), an arm of the Finance Ministry of India, issued a directive dated 27 February 2024, mandating all state-run banks including the State Bank of India and Punjab National Bank to conduct audits of their gold loan processes. This directive, with a view to ensure transparency and accountability within the sector, requires banks to review all gold loan accounts issued after 1 January 2022.

PROLIFERATION OF NON-COMPLIANT DISBURSALS

As per information available in the public domain, the key concerns highlighted by the DFS include the disbursement of gold loans without adequate collateral, anomalies in the collection of fees and interest, non-compliance with loan-to-value limits, and closure of accounts.

Further, in March 2024, maintaining its stance on the protection of customer interests against adverse actions, the DFS directed the heads of public sector banks to conduct a comprehensive review of their gold loan portfolios.

In parallel to the DFS directive, the RBI through a [press release](#) dated 4 March 2024, took action against IIFL by directing it to cease and desist from sanctioning and disbursement of gold loans or assigning, securitizing, or selling any of its gold loans, with immediate effect, due to material supervisory concerns identified during inspections.

However, the RBI permitted IIFL to continue its existing gold loan portfolio through usual collection and recovery processes. These concerns ranged from deviations in gold purity certification to breaches in loan-to-value ratios, the disbursal and collection of loan amounts in cash exceeding statutory limits, and lack of transparency in fee structures.

LEX TAKEAWAY

FOSTERING GREATER ACCOUNTABILITY IN GOLD LOAN MARKET

The regulatory actions undertaken by both the RBI and the DFS underscore a commitment to transparency and compliance within the gold loan market.

The DFS directive serves as a preventive measure against further irregularities, emphasizing the severity of the observed concerns. In light of the multiple opportunities provided by the RBI to rectify its deficiencies, the action taken by the RBI appears to be aligned with its regulations and objectives.

Moving forward, these regulatory interventions are likely to foster greater accountability and adherence to regulatory standards within the gold loan market. By prioritizing customer interests and enforcing compliance with applicable laws, both regulatory bodies aim to safeguard the integrity of the financial system, and the interest of the common consumer.

Can the fintech sector buck the trend and implement a self-regulatory framework?

In an endeavour to enhance regulatory effectiveness and promote self-regulation, in light of the fast-growing and evolving regulated entities, the RBI, on 21 March 2024, issued an 'Omnibus Framework for recognition of Self-Regulatory Organisations (SROs) for Regulated Entities (REs) of the RBI (Framework)'. This Framework came as a finalization of the 'Draft Omnibus Framework' which was released by the RBI on 21 December, 2023.

The Framework prescribes the broad objectives, functions, eligibility criteria and governance standards for SROs, which shall be applicable to all the SROs for REs, irrespective of the sector, and SROs shall frame necessary best practices/standards/ codes in compliance with the Framework.

SROs TO BE A COLLECTIVE VOICE

TRANSPARENT, PROFESSIONAL AND INDEPENDENT

FOSTER ENGAGEMENT WITH RBI

The Framework clarified that the existing SROs already recognized by the RBI shall continue to be governed by the terms and conditions under which they were recognized, unless this Framework is specifically extended to such SROs. RBI may prescribe sector-specific additional conditionalities including membership criteria for SRO, if warranted, at the time of calling for applications for recognising SROs for a category/ class of REs.

Key features of the Framework highlight the following:

(A) SROs shall frame a code of conduct, establish grievance redressal and dispute resolution mechanisms, and promote knowledge exchange.

(B) SROs are tasked with promoting a culture of compliance, acting as the collective voice of their members, sharing sectoral information with the RBI, and encouraging research and development within the sector.

(C) SROs shall ensure their responsibilities towards the RBI by sharing relevant information and engaging in interactions with RBI for the promotion of the sector and its members and, ensure compliance with regulatory provisions by submitting annual report to RBI and inspection of books by RBI, if deemed necessary.

(D) Entities seeking recognition as an SRO must meet prescribed parameters and submit necessary documents as specified in the Framework. The RBI reserves the right to grant recognition based on a fit and proper status.

(E) SROs are expected to operate with transparency, professionalism, and independence.

LEX | NEW BEGINNINGS,
TAKEAWAY | NEW BENCHMARKS

The Framework sets a new standard for self-regulation by emphasizing the importance of governance, compliance, and industry best practices. Through the introduction of SROs, RBI seeks to ensure better compliance with the regulatory guidelines, development of the sector, protection of stakeholder interests, foster innovation and detection of early warning signals.

The SRO is also expected to act as a bridge between the REs and the Reserve Bank. In a step to promote self-regulation in the fintech industry, in particular, the RBI has also issued Draft Framework for SROs in the FinTech Sector dated 15 January, 2024 which seeks to maintain balance between maximising creative potential of fintechs while mitigation systematic risks arising out of the conduct of such players.

This move of the RBI to promote self-regulation would enable the stakeholders to efficiently communicate their grievances, ensure compliance and enable growth and innovation in the industry.

As we have maintained in our previous communications, RBI seeks to adopt a business-friendly approach and at the same takes into account systematic concerns and consumer and stakeholder interest. The Framework is considered to be a favourable move towards the long-term goal of RBI and with a view to enhance regulatory effectiveness, foster innovation, transparency, fair competition, and consumer protection. The Framework paves the way for a more robust and stable financial ecosystem.

PART SIX

INDIAN P2P ASSOCIATION HALTS INSTANT WITHDRAWAL PRODUCTS

The increasing scrutiny of the RBI in relation to products and promises made on P2P platforms may have necessitated this step

In the past decade, the Indian peer-to-peer (**P2P**) lending sector has undergone a significant evolution and growth. P2P lenders act as a conduit between investors and retail borrowers. They provide a hassle-free platform through which investors can lend money directly to the borrowers. The lending platforms aid with the loan disbursement and collection process.

Recently, as per information available in the public domain, in alignment with the principles of self-regulation of the RBI, an association of India's P2P lending platforms (**Association**) has taken an industry-level decision regarding instant withdrawal products.

With a view to increase risk awareness, the Association has directed its members including NDX P2P Private Limited (**Liquiloans**), Transactree Technologies Private Limited (**Lendbox**) and Fairassets Technologies India Private Limited (**Faircent**) to stop offering instant withdrawal products to customers after 31 March 2024. In furtherance to this decision, Liquiloans has informed its business partners that it would pause the liquid scheme option for all new lenders with effect from 31 March 2024.

UNDERPLAYING OF P2P PRODUCT RISKS CENSURED BY RBI

The rationale behind the Association's decision can be traced to the displeasure expressed by the RBI over such instant withdrawal products that offer attractive interest rates and instant liquidation options to investors. On 9 February 2024, the deputy governor of the RBI highlighted the breach of licensing conditions by such products. The deputy governor disapproved of the practices of NBFC – P2Ps vis-à-vis the underplaying of risks, promising high/assured returns and providing anytime fund recall facilities.

In addition to this, reports also suggest that a few P2P lending platforms also came under the radar of the RBI owing to certain irregularities in their functioning. In this regard, the RBI sought clarity on their onboarding process, agreements with lenders, customer profiles, etc. and suggested corrective measures that ought to be taken by the platforms.

LEX TAKEAWAY | SHORT-TERM PAIN FOR LONG-TERM GAIN

The decision by the Association may also impact other fintech companies which have partnerships with P2P lending platforms. While this decision by the Association may initially appear disadvantageous to the users of the P2P lending platforms, it is anticipated to help the users in the long run. By discontinuing these products, the Association appears to aim at safeguarding investors from engaging in volatile investments and foster a more resilient P2P lending ecosystem.

FINTECH FLYER

FEB-MAR 24

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