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9th GES GLOBAL ECONOMIC SUMMIT ON

FINTECH: ACCELERATING THE DIGITAL REVOLUTION

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White Paper

MVIRDC

M. Visvesvaraya Industrial Research and Development Centre

Bharat Ratna Sir M. Visvesvaraya

(September 15, 1860 - April 14, 1962)

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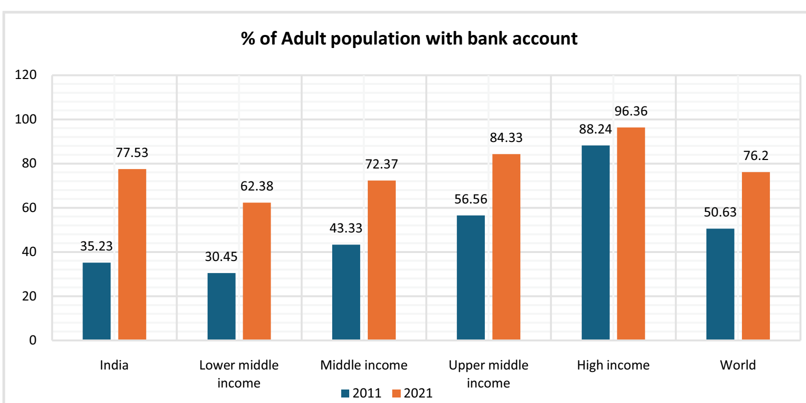
White Paper

Overview of fintech in India

India has set an ambitious goal of becoming a developed economy by 2047. To achieve this, its economy will need to expand from its current size of USD 3.3 trillion to between USD 30 to 35 trillion—an increase of 10 to 12 times. Such growth requires a robust and dynamic financial ecosystem that can meet the needs of all economic participants.

Historically, India has grappled with significant challenges in financial inclusion, with a large segment of its population remaining unbanked or underbanked. Recognizing this, the government has implemented a series of initiatives under the policy trinity known as JAM—Jan Dhan Yojana, Aadhaar, and the widespread availability of affordable mobile phones and internet access. The Jan Dhan Yojana, in particular, has been instrumental in expanding financial access. Till 2011, only 35.23% of India's adult population (aged 15 and above) had a bank account. However, over the past decade, more than 500 million individuals have been brought into the financial system through newly opened bank accounts. By 2021, 77.5% of India's adult population had a bank account, exceeding the middle-income country average of 72.37%.



Source: World Bank, compiled by MVIRDC WTC Mumbai

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The widespread access to finance laid the foundation for India's fintech sector, which has now emerged as the third largest globally, encompassing over 10,244 entities across diverse sectors. The sector is expanding at a CAGR of 14% and is currently valued at approximately USD 110 billion. Projections indicate that it could reach USD 420 billion by 2029, with a CAGR of 31%. India also boasts of the highest fintech adoption rate of 87% which is much higher than the global average of 67%[1]. At a regional level, the southern states are at the forefront of this fintech growth, with Karnataka leading in the number of fintech startups, followed by Maharashtra and Tamil Nadu.

The country's Digital Public Infrastructure, spearheaded by initiatives like Aadhaar, UPI, and API Setu, has been instrumental in facilitating fintech expansion. These initiatives have streamlined company incorporation, enabled the recognition of peer-to-peer lenders as Non-Banking Financial Companies (NBFCs). The RBI has also introduced regulatory frameworks such as sandboxes, fintech repositories, and self-regulatory organization (SRO) frameworks, fostering innovation and regulatory compliance. Some of these have been highlighted in the table below.

Sr. No	Policy Initiatives	Year	Purpose
1	Regulatory Sandbox	2019	To foster innovation in the fintech sector by providing a controlled environment for testing new products and services.
2	Guidelines for Payment Aggregators (PAs) and Payment Gateways (PGs)	2020	To regulate these entities and provide customer protection and secure transactions.
3	Account Aggregator (AA) Framework	2021	To enable secure and consent-based data sharing among financial institutions, empowering customers with control over their financial data.
4	Prepaid Payment Instruments (PPI) Guidelines	2021	To provide clarity and guidelines on the issuance and operation of prepaid payment instruments like mobile wallets.
5	Establishment of Digital Banking Units	2022	To accelerate and widen the reach of digital banking services
6	Framework for Digital Lending	2022	To regulate and standardize digital lending practices, ensuring transparency and reducing the risk of exploitation.
7	Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023	2023	To introduce a tiered framework for categorisation of NBFCs based on their perceived risk to the financial ecosystem.
8	Direction on Regulation of Payment Aggregator – Cross Border (PA - Cross Border)	2023	To introduce a new regulatory regime for cross-border payments.
9	Master Directions on Cyber Resilience and Digital Payment Security Controls for non-bank Payment System Operators	2024	To strengthen the cybersecurity infrastructure of digital payment systems.

[1]As per Global FinTech Adoption Index

Sr. No	Policy Initiatives	Year	Purpose
10	Framework on Self-Regulatory Organisations for fintech	2024	To encourage proactive adherence to industry standards and best practices in the absence of formal regulation.
11	Fintech Repository	2024	To streamline policy-making by collecting data on fintech activities and technologies.

At the state level, Maharashtra pioneered the implementation of a dedicated Fintech Policy in 2018, with the objective of positioning Mumbai among the top five global fintech centers. The state also launched a fintech corpus fund of INR 250 crores and established the "Mumbai Fintech Hub" to promote fintech startups and ecosystem growth.

In 2021, Tamil Nadu introduced its own five-year Fintech Policy aimed at establishing Chennai as a leading global fintech hub by 2025. The policy outlines plans for a Digital Payment Zone to enable seamless digital transactions within a 5 km radius, further supporting the state's fintech ambitions. There also exist fintech parks in Rajasthan and West Bengal.

Despite its leadership in the fintech ecosystem, Karnataka has yet to implement a dedicated fintech policy, though the state government has proposed an integrated fintech startup program. Notably, Andhra Pradesh, in collaboration with the Fintech Association of Hong Kong aims to transform Vishakhapatnam into "Fintech Valley Vizag," a key entry point for fintech startups and knowledge transfer.

Other states such as Gujarat and Uttar Pradesh also propose to set up fintech parks and hubs to nurture fintech ecosystems. These efforts collectively underpin India's growing prominence in the global fintech landscape, with a diverse range of state-led initiatives and policies fostering innovation and entrepreneurship across the country.

India's fintech sector growth has been driven mostly by its payments. Over the last eight years, volume of retail digital transactions has witnessed a sharp rise. Digital payments on the whole account for 99% of total volume and 89% of total value of retail transactions. This rise is majorly driven by the sharp increase in transactions through the Unified Payments Interface (UPI) framework. In FY23, UPI accounted for 73% of the total retail transaction volume and 21% of value indicating its predominant use for smaller retail payments[2].

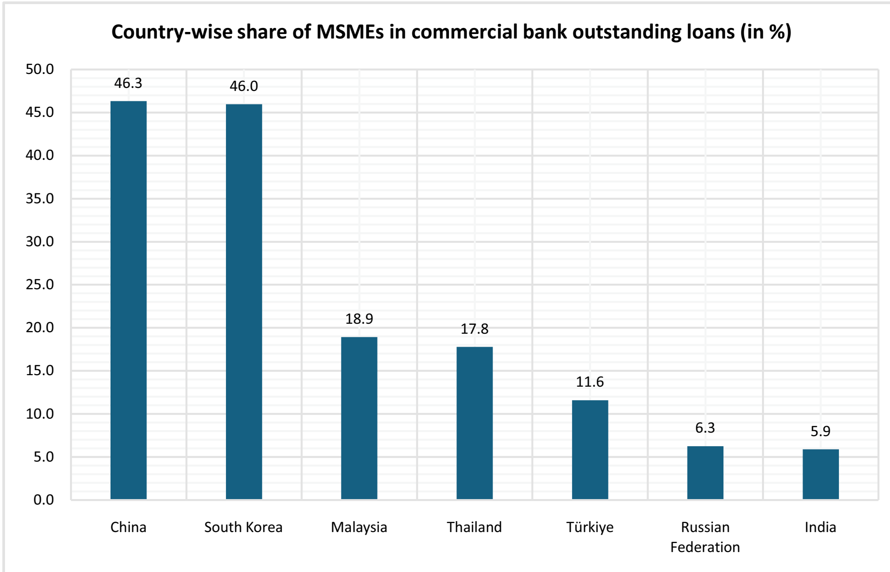
India's fintech companies are also transforming the digital lending space with Indian digital lending market growing from USD 270 billion in 2022 to USD 350 billion in 2023. Driven by retail investors, India's WealthTech market is estimated to reach USD 237 billion by 2030. Insurtech is also an upcoming area for India. India is the 2nd largest Insurtech market in Asia-Pacific and is expected to reach USD 88.4 billion by 2030[3].

The fintech sector also plays an important role in bridging the MSME credit gap. MSMEs are integral to the Indian economy, contributing 30% to GDP and accounting for 45% of total exports and employ 45% of the total workforce of the country. Despite its significance, the Indian MSME sector is faced with numerous challenges, primarily in accessing cost-effective finance.

As per the RBI, the MSME sector faces a credit gap estimated at INR 25-30 trillion (approximately USD 20-25 billion). Data from the IMF financial inclusion database indicates that in India, MSMEs account for only 6% of outstanding loans from commercial banks. Though this share has more than doubled over the past two decades, it is significantly lower than that of peer economies such as China and South Korea.

In the absence of funding from formal financial channels, Indian MSMEs have to rely on informal sources of credit where they are charged significantly higher interest rates. This adversely affects their profitability and reduces their competitiveness. The lack of access to credit at competitive rates also deters MSMEs from pursuing capital expansion, thereby limiting their capacity. Addressing these financial constraints is crucial for the sustained growth and development of the MSME sector in India.

[2]RBI Payment System Data
[3]As per Invest India



Source: IMF, compiled by MVIRDC WTC Mumbai

Road ahead for fintech sector

Leveraging Digital Public Infrastructure **("DPIs")**, the fintech sector in India has made remarkable progress over the past decade. The identity layer of India Stack has facilitated e-KYC, making customer identification and verification more robust and cost-effective. The payment layer, powered by UPI and Aadhaar-based frameworks, has completely revolutionized the country's payment system. The Open Network for Digital Commerce (ONDC) is expected to further democratize India's digital economy, creating additional opportunities for fintech companies to offer innovative and cost-efficient solutions.

However, to date, the success of fintech in India has been concentrated within a few segments of the overall financial industry. While payments and transactions have benefited the most from technological advancements, other areas such as deposits, lending—particularly MSME lending—and loan collections have seen slower adoption of technology. The upcoming Open Credit Enablement Network (OCEN), based on the Account Aggregator (AA) platform, is expected to transform the lending space. Nevertheless, lack of cooperation among financial players within the AA framework remains a significant challenge.

The recent announcement of the Unified Lending Interface (ULI), an expansion of the Public Debt Platform, aims to provide frictionless credit by integrating fintech lenders and focusing on sectors like agriculture and MSME loans. This initiative could be a pivotal step in revolutionizing the MSME lending space. Additionally, India's vast and largely untapped rural financial market presents significant potential across all segments of the fintech industry.

As one of the fastest-growing emerging markets, India is expected to become the world's third-largest economy by the end of this decade. The country's expanding economy, coupled with a tech-savvy population, offers immense opportunities for fintech companies to broaden their reach across various financial sectors.

The following section, based on discussions from the 9th Global Economic Summit (GES), outlines a future roadmap for the fintech industry in India and provides key policy recommendations for regulators, along with best practices for the industry to consider.

Policy recommendations

1. Enhancing the scope of financial inclusion from 'Access to finance' to 'Use of finance' through financial literacy

Through the JAM Trinity, India has successfully brought over 500 million previously unbanked individuals into the formal banking system by opening accounts under the Pradhan Mantri Jan Dhan Yojana (PMJDY). Notably, 66% of these accounts were from rural and semi-urban areas, and 55% of the beneficiaries were women. While the Jan Dhan Yojana has been highly successful in connecting the unbanked population to the formal banking sector, it has not yet translated into widespread usage of those accounts for accessing financial services.

According to the World Bank, India had the highest rate of inactive bank accounts globally, with 27.44% of accounts inactive in 2021. **Now that India has successfully provided access to banking for a large section of the population, the focus must shift toward promoting the use of banking and financial services among these newly connected individuals.**

The lack of financial knowledge in rural areas contributes to a high volume of business transactions being conducted in cash. Cash management costs in India account for approximately 7% of its GDP, which is around USD 210 billion. This is a significant amount, and even if a small fraction of it were allocated toward promoting financial literacy in rural populations, the reliance on cash could decrease substantially.

Government may consider running an educational program targeting to train at least ten women form each village in usage of financial services and digital finance.
Although financial literacy is fundamentally a public good and will require policy intervention from the government, there is an opportunity for public-private partnership in this domain. Increasing financial literacy will help fintech companies further penetrate rural areas, expanding their market reach.

2. Promoting fintech companies in rural areas

Despite the fintech industry making great strides in promoting financial inclusivity, the permeation of fintech operations into rural India is still an enigma that needs unravelling. The socio-economic demographics of urban and rural India differ significantly which has posed a challenge as tried and tested models adopted by fintechs in urban areas do not translate with the same efficacy to rural and semi-urban areas. In rural areas, the population is relatively dispersed, and the per capita income is, on average, half that of urban regions. Additionally, rural areas tend to have lower literacy rates and less tech-savvy populations. These factors make rural and semi-urban areas less attractive for fintech companies, as operating margins are thinner and customer acquisition costs higher, rendering the revenue model unsustainable in the long run.

This is further exemplified by data in relation to the fintech industry, such as the top ten cities in India being the source of 85% of insurance premiums, with urban centers like Delhi, Mumbai, and Bengaluru contributing significantly to the total volume of digital transactions.

To encourage fintech operations in rural and semi-urban areas, the government could consider offering tax incentives to fintech companies operating in these regions. Relaxing certain compliance requirements, such as Know Your Customer (KYC) protocols, may also help reduce operational costs for fintech firms in these underserved areas.

A fund could also be established to provide capital support at lower interest rates to fintech companies operating in Tier-2 and Tier-3 cities.

3. Digital Personal Data Protection Act (DPDP)

The DPDP Act, which has been passed in the Parliament, and awaiting implementation, is expected to bring substantial changes to data collection and management frameworks in the fintech industry, making data governance increasingly important. However, the Act may lead to higher compliance costs for fintech companies. A key feature of the Act is the requirement for obtaining explicit consent from customers, which could slow down operations and increase costs.

To mitigate the impact on fintech companies operating on thin margins, the government may implement the DPDP Act in phases.

Additionally, a centralized agency should be established to manage customer consent records, ensuring smoother operations and compliance. This agency could also handle customer redressal in the event of any breach of privacy. To address this concern, the DPDP Act provides for a concept of "consent managers". However, the rules relating to consent managers have not been provided yet, and it would be good to ensure the proposed rules also factor detailed guidelines for authorization and standards of operation of consent managers.

4. Promoting ease of doing business in the fintech sector

Fintech is a broad term that describes the integration of technology with banking, financial services, and related domains, covering various aspects of finance such as banking, insurance, investments, pension funds, regulatory technology, and cross-border transactions. As a result, the sector is regulated by multiple authorities, including the RBI (Reserve Bank of India), SEBI (Securities and Exchange Board of India), IRDAI (Insurance Regulatory and Development Authority of India), and the Ministries of Finance, IT, and Electronics and Information Technology.

The involvement of so many regulatory bodies can lead to unnecessary complications and overlaps. Therefore, it is recommended that the government consider a separate, formal policy framework to streamline governance in the fintech sector.

Additionally, a nodal agency formed from a consortium of existing regulatory bodies could be established to oversee matters specific to fintech.

The fintech industry is subject to complex regulations and compliance requirements. In certain areas, such as KYC (Know Your Customer), fintech companies are held to the same standards as commercial banks and NBFCs (Non-Banking Financial Companies). While a robust regulatory framework is essential to ensure a secure, sustainable and inclusive financial ecosystem, there is room for relaxation in certain compliance and regulatory requirements to attract more investment into the sector.

Certain fintech companies, such as super apps, offer a wide range of unrelated financial services, including insurance, stockbroking, and banking. **These companies are often subject to identical compliance requirements, such as KYC (Know Your Customer), from multiple regulatory bodies, leading to unnecessary repetition and pressure on their operating margins. Therefore, there is a need to harmonize overlapping compliance requirements from different regulators to enhance ease of doing business in the sector.**

Additionally, a central agency could be established to manage customer KYC records, reducing the compliance burden on fintech companies and streamlining the KYC process.

5. Reforms in Account Aggregator (AA) framework

India's digital ecosystem has successfully leveraged the DPIs to generate significant volumes of valuable data with crucial implications for financial decision-making. The Account Aggregator (AA) framework was developed to harness this data and facilitate the secure sharing of financial data across regulated institutions, with explicit user consent and controls over utilization of the data. It is a key pillar of India's financial ecosystem, aimed at enhancing data portability and promoting financial inclusion. However, a few reforms are recommended to broaden the scope of the AA framework and expand its user base.

It is suggested that the types of data recorded within the AA framework be expanded to include new data sources such as provident fund records, income tax returns, land records, and DigiLocker documents.

While the AA framework has been instrumental in fostering a data-driven digital financial ecosystem, access to this data is currently limited to regulated financial entities. However, small fintech companies play a vital role in driving innovation within India's fintech sector. **To support their contributions, a data licensing framework is recommended. This would allow fintech companies and startups to access the AA framework on a licensing basis, with eligibility determined by criteria such as corporate governance and data governance policies.**

This reform would not only expand the user base of the AA framework but also pave the way for an open finance or open banking model in the country.

6. Potential for global collaboration

Driven by its robust DPIs, India has emerged as a global leader in the digital economy and fintech. Leveraging the payment stack of its DPI, the Unified Payments Interface (UPI) has become the largest payment settlement system in the world. The successful proliferation of the UPI ecosystem has generated a growing global demand for India's DPI. Currently, UPI-like systems are accepted in over seven countries, including Sri Lanka, Mauritius, France, the United Arab Emirates (UAE), Singapore, Bhutan, and Nepal. With the right policy support and cross-country cooperation, the UPI payment system has the potential to evolve into an alternative global payment settlement mechanism.

India's large and tech-savvy workforce also creates opportunities for various cross-border collaborations in the fintech space. For example, Japan, with its well-established traditional banking system, could collaborate with India's dynamic fintech industry to develop innovative financial products for the Japanese market. Similarly, India's fintech ecosystem can play a pivotal role in fostering fintech ecosystems in other emerging economies across Asia, Africa, and Latin America through knowledge and technology sharing. **Additionally, India could take the lead in establishing a global fund to promote financial inclusion initiatives in emerging and underdeveloped economies.**

As one of the world's largest recipient of remittances, India also has significant potential in the cross-border transaction segment, presenting further opportunities for exploration.

Some of the key policy suggestions with regards to fostering global collaboration are as follows:

- **Cross-country regulatory harmonization, particularly around KYC norms and Anti-Money Laundering (AML) regulations, is essential to reduce compliance barriers for fintech companies.**
- **Additionally, there is a need to establish a framework that ensures data protection while allowing seamless data sharing between regulatory authorities in different jurisdictions to prevent misuse of the system for illegal activities.**
- **In the case of foreign exchange transfers, a common point of acceptance among regulators is necessary to prevent, detect, and investigate any illegal transactions effectively.**
- **A cross-country regulatory sandbox could also be established to promote innovation by fostering knowledge and idea sharing among fintech companies and regulators.**

7. Best practices suggested for the FinTech industry

The fintech industry, known for its reliance on advanced technology, depends heavily on a skilled and tech-savvy workforce. As technology continues to advance in areas such as AI/ML, IoT, blockchain, robotics, and big data analytics, the industry is becoming increasingly competitive. While these technological advancements can help companies reduce their dependence on manual labor, they also create a high demand for skilled professionals capable of developing and managing these technologies.

Despite India emerging as a global tech hub, fintech companies are facing a dual challenge in talent acquisition: high costs and intense competition from other industries for top talent. Consequently, the cost of acquiring talent may consume 60%-70% of a fintech company's funding, which is not sustainable in the long run. This issue is exacerbated in urban areas where competition is fierce and the workforce is highly aspirational.

To address this, fintech companies should consider establishing talent acquisition hubs in tier-two and tier-three cities. These locations offer a relatively lower cost of talent and can be a source of skilled individuals. Additionally, investing in training programs to equip the local workforce with advanced technological skills could be beneficial, allowing companies to develop and integrate talent more effectively.

The fintech sector is playing an increasingly crucial role in the country's financial system. Its innovations and risk-taking have the potential to facilitate access to formal credit for the new-to-credit consumers. Consequently, more people are placing their trust on fintech companies. However, the decisions made by these companies can profoundly impact their customers' livelihoods and financial health. Additionally, fintech firms often have access to highly personal data, and any mismanagement or excessive risk-taking could not only erode customer trust but also jeopardize the entire financial system.

Therefore, it is recommended that fintech companies voluntarily adopt self-regulation and robust data governance policies to ensure the sustainability and stability of the system.

Fintech companies should also actively engage in promoting financial literacy in tier-two and tier-three cities through various educational programs. By increasing financial literacy, they can cultivate a larger, more informed market for their products and services and potentially improve their penetration into rural areas.

Industry Perspective

FINANCIAL SERVICES ECOSYSTEM ASKS

Mr. Devendra Damle, Vice President – Policy, ONDC & Mr. Hrushikesh Mehta, Senior Vice President - Financial Services, ONDC

ONDC is an initiative under the Ministry of Commerce and Industry, Government of India. ONDC has been established to facilitate an open, interoperable network for digital commerce. E-commerce based on open networks is fundamentally different from the prevalent platform-centric model of e-commerce, both in its technical architecture and the legal relationships between stakeholders. ONDC, as an idea, evolved to address the challenges associated with platform-centric models such as market-concentration, anti-competitive behaviour etc.

ONDC enables buyers and sellers to discover each other and enter into commercial transactions, using an open protocol, irrespective of the platform which either of them uses. ONDC, thus, aims to democratise digital commerce, by increasing access to and participation in digital commerce in India. It aims to enable small businesses, traders, artisans, weavers, farmers, small retailers etc to sell their products and services digitally, on their own terms, to consumers across India. The benefits of ONDC are expected to spread across sectors, domains, socio-economic strata, and geographic locations promoting the Hon'ble Prime Minister's mission of Digital India.

As ONDC Network expands, the discovery and trade of financial products and services, such as loans, mutual funds and insurance, is also being enabled through the Network. This is expected to hugely improve financial inclusion among the digitally underserved population.

While the ONDC Network provides the technology enablers to MSMEs, the un-digitised businesses and underserved populations, it is necessary to supplement it with an enabling policy environment. To that end, we are requesting certain interventions from the Ministry of Finance to create a conducive regulatory environment to ease this process of digital inclusion.

1. RBI - Increase Aadhaar-based eKYC limit for individuals

In 2016, the RBI permitted the use of Aadhar OTP based e-KYC in non-face-to-face mode to align the KYC architecture with the technological developments. However, the directions impose a cap of INR 60,000 (sixty thousand rupees) on the aggregate amount of term loans that can be sanctioned through this method. While the economy has grown and technology has evolved since 2016, the limit has remained unchanged for the past 7 years.

In light of evolving economic dynamics and the expanding scope of digital financial services, there is a compelling case for an upward revision of the Aadhaar-based KYC limit. The current cap of ₹60,000 cap can be restrictive, and limit the full potential of Aadhaar-based KYC. An upward revision would not only align with the contemporary demands of a rapidly-digitising economy but also facilitate greater financial inclusion and ease of access for individuals seeking to engage with digital financial platforms. As policymakers and regulatory bodies assess the changing financial landscape, a revision of the Aadhaar-based KYC limit will contribute to a more robust and adaptable framework that meets the evolving needs of both consumers and the financial industry.

Suggested Amendments:

RBI may revise clause 17 (v) of Master Direction - Know Your Customer (KYC) Direction, 2016. The upper limit for the loan amount for which solely Aadhar-based eKYC may be permitted should be increased to INR 3 lac from the existing 60,000. Further, the limit should be reviewed every 2 years, to take into account inflation, credit access, technological evolution and other salient factors.

2. RBI - Sole Proprietor KYC Revamp

There is a need to revisit the extant regulations to foster a more conducive environment for sole proprietorship firms seeking financial services. Part II (clause 27, 28, and 29) of the Master Direction - Know Your Customer (KYC) Direction, 2016 issued by the RBI mandates the regulated entities to obtain three documents—identity proof, entity proof, and proof of activity—for undertaking customer due diligence of a sole proprietary firm.

While the introduction of Aadhar eKYC has streamlined the process for identity proof, challenges persist in obtaining digitally signed entity proof directly from the source. Currently, GST certificates, a common entity proof, are not digitally signed and require manual download from the GST portal before being uploaded to the lender. Furthermore, the recently notified Udyam Aadhar as an Officially Valid Document offers a solution for identity proof but does not comprehensively address the regulatory requirements of obtaining all three types of documents.

The Directions acknowledge the challenges faced in obtaining two documents for proof of business/activity. The discretion given to REs to accept only one document in such cases reflects an understanding of the practical constraints. However, the regulations cast the burden of proving that two documents cannot be furnished on REs, as a result, the discretion is rarely exercised in practice.

In light of the above, we recommend that the RBI reevaluate the necessity for three distinct documents under the 2016 Directions. We also suggest a push for the digitization and inclusion of all relevant documents in DigiLocker. The latter would significantly ease the transfer of necessary documents to lenders, promoting efficiency and compliance simultaneously.

Suggested intervention:

RBI may revise Part II of Master Direction - Know Your Customer (KYC) Direction, 2016 to the effect that any two documents that prove identity, entity and activity should be deemed sufficient KYC for sole proprietorship.

3. RBI - CKYC reforms

RBI indicated in a clarification letter to banks that post the use of CKYC, in-person verification is required. As a consequence, the usage of CKYC has presented challenges, particularly for MSMEs with small ticket sizes. For individuals, the simpler option of Aadhaar eKYC outweighs completing CKYC plus an additional in-person verification. While non-sole proprietors with large ticket sizes may find KYC less burdensome, the additional in-person verification poses a significant hurdle for smaller entities, hindering their seamless integration into the financial ecosystem.

Several operational challenges undermine the effectiveness of CKYC, ranging from financial deterrents such as upload fees to issues with data quality, deduplication, and scan legibility. We propose a comprehensive approach to address these challenges, including a review and streamlining of data submission requirements, strengthened data validation, and the introduction of user authentication. Additionally, the removal of upload fees, reduction of mandatory fields to the essential minimum, and aligning the CKYC process with the product type for which KYC was conducted would significantly enhance the user experience.

Suggested intervention:

To enhance the effectiveness of CKYC, we recommend a product improvement initiative encompassing the streamlining of data submission requirements and strengthening data validation. User authentication should be introduced to ensure the accuracy of submitted data. Additionally, aligning CKYC processes with the product type, eliminating the need for scanned documents where Aadhaar eKYC has been performed, and removing upload fees will contribute to a more user-friendly and efficient system.

We propose a policy change that, once these enhancements are implemented, CKYC may be deemed acceptable by the RBI without the necessity of in-person verification, provided all other regulatory requirements are met, for a maximum ticket size of INR 5 lac, to be reviewed from time to time. We believe that this will not only alleviate current challenges but also contribute to a more inclusive and streamlined KYC process for entities of all sizes.

4. Ministry of Finance - Foundational Client Due Diligence - Amendment to PML Rules - Disbursals to accounts received via AA should require no KYC

The Account Aggregator flow authenticates a borrower as they link their bank account to their handle and then authenticates the consent again before sharing the data to a lender. If a lender disburses a loan to the account number provided in the AA data packet then the lender should not be required to do KYC given that the bank account has already been through a stringent KYC process during the time of its opening. A parallel can be drawn where we don't KYC the recipient bank account holder while sending them money over UPI. There should be a separation between KYC risk and Credit risk which is currently bundled.

Suggested intervention:

PML Rules will have to be amended to allow disbursals to accounts received via AA without further KYC. In addition, the AA framework would have to provide an unmasked account number to facilitate this.

<u>REVIEW OF RECENT POLICY MEASURES BY FINANCIAL SECTOR REGULATORS</u>

Ms. Smita Jha, Partner (Banking & Finance, Fintech), Khaitan& Co.

1. SEBI's proposal to introduce a New Asset Class

Through a recent Consultation Paper dated 16 July 2024, SEBI proposed an introduction of a New Asset Class ("**NAC**") as a new investment product with the objective of filling the vacuum between mutual funds ("**MF**") and portfolio management services ("**PMS**"). Under the current regime, risky investment products such as PMS and Alternative Investment Funds ("AIF") can only be subscribed by high-net-worth individuals given the minimum ticket size of INR 50 lakhs and INR 1 crore respectively.

Additionally, MFs are subject to a number of restrictions regarding the types of instruments in which they are permitted to invest. Thus, individuals with a capital of less than INR 50 lakhs and a high-risk appetite often subscribed to unregistered investment advisory/portfolio management services. With a view to prevent retail investors from becoming vulnerable to such unauthorized investment products, the Paper proposes NAC as a customized investment product offering greater flexibility and a higher risk-taking capability to meet the needs of risk-taking investors.

Under the proposed NAC framework, managers will be allowed to invest in derivatives to a greater extent allowing investment strategies which were otherwise impermissible under the current framework such as long-short equity funds and inverse funds. However, it is relevant to note that the NAC can only be offered by certain Asset Management Companies ("**AMC**") who meet the specified criteria and the regulatory framework applicable to MFs shall also be made applicable to the NAC, unless otherwise specified. This restricts the offering of NAC's to a limited number of AMCs, as registering and functioning as an AMC requires significant regulatory compliance.

Recommendation:

Given the nature of the investment products, SEBI may consider allowing registered Portfolio Managers to offer NACs and prescribe additional obligations to be followed by the Portfolio Manager in this regard.

Overall, the proposal to introduce a new asset class in the Indian market is a welcome move and represents a significant development in providing risk taking investors with more customized and flexible investment options, while also ensuing necessary regulatory safeguards to protect retail investors.

2. Changes in the regulatory framework pertaining to Investment Advisers (IA) and Research Analysts (RA)

On 6 August 2024, SEBI released a Consultation Paper ("**Paper**") with a view to enhance, simplify and reduce the compliance requirements applicable to IAs and RAs under the current framework. SEBI noted that the current ratio of IAs and RAs to investors is sufficient, with a growing number of unregistered entities offering advisory services, often outside the regulatory framework. With an objective of addressing this gap, SEBI has proposed reducing barriers to entry for seeking and IA/RA registration thereby encouraging more professionals to enter the field.

Among the key proposals, SEBI has proposed relaxing the eligibility criteria from registration as an IA/RA. This includes reducing the minimum qualification from a post graduate degree to a graduate degree and removing the need for prior experience. SEBI has also proposed a shift from the annual NISM certification process to one that required a certification on incremental changes in the IA/RA framework every 3 years. Furthermore, the current net worth requirement is proposed to be replaced with a deposit requirement commensurate with the number of clients which will be lien marked to the stock exchanges.
One of the proposals in the Paper provide for the recognition of "Model Portfolios" as a permissible research service and detailed guidelines have been provided in this regard. Further, SEBI has also proposed to tighten the scope of "Investment Advice" particularly in relation to unregulated asset classes such as real estate and gold. Non-individual IAs providing advice on these classes will need to do so through a separate legal entity, while individual IAs will be entirely prohibited from offering such advice. Additionally, SEBI has addressed a longstanding ambiguity by clarifying that advisory or research services on global securities offered to Indian residents or persons of Indian origin will not require IA/RA registration, except when dealing with Indian securities. Additionally, a new part-time registration option is proposed for professionals engaged in other non-securities businesses, enabling them to offer advisory services with additional compliance obligations. SEBI has also proposed a client-level segregation of research and distribution services for RAs, mirroring the existing restrictions on IAs.

Recommendation:

The Paper is a welcome measure that provides much needed clarity in the regulatory framework applicable to IAs and RAs. The proposals outlined in the Paper not only reduced compliance burden but also open the doors for more professionals to enter the field with the objective of ensuring quality research and advisory services for investors. However, certain proposals may need reconsideration such as the requirement for non-individual IAs to establish a separate legal entity for advising on products or services related to asset classes not regulated by SEBI.

This restriction, along with the complete prohibition on individual IAs from offering such advice may need a relook as investors would always prefer to receive advice on multiple classes from a single source regardless of whether the product is regulated by SEBI or any other regulator. SEBI may also reconsider its stance on restricting IAs from advising on asset classes which do not fall within the domain of 'securities'. It is also unclear as to why KYC related requirements are proposed to be introduced for RAs as they neither handle their client's funds nor give client specific personalised advice. Nevertheless, the proposals, if implemented, will definitely improve access to investment advice and research services for retail investors whilst ensuring that such services are aligned with regulatory expectations.

3. Proposed amendment in the Securities Contracts (Regulation) Rules, 1957

The Ministry of Finance issued a Consultation Paper ("**Paper**") on 11 September 2024, proposing amendments to Rule 8 of the Securities Contracts (Regulation) Rules, 1957 (“**SCRR**”) which outlines the qualifications required for a person to become a stockbroker or a member of a recognized stock exchange. Rule 8(1)(f) and 8(3)(f) of the SCRR prohibits stockbrokers fromh engaging in any business other than securities unless they serve only as broker or agents without personal financial liability. In furtherance of Rule 8, both the National Stock Exchange and the Bombay Stock Exchange issued circulars reiterating that brokers should not engage in non-securities businesses such as entering loan agreements with clients or investing in non-securities entities which led to the identification of a number of brokers in violation of Rule 8 of the SCRR.

Thus, under the current framework, stockbrokers are restricted from investing in companies, including group companies, that engage in non-securities businesses. As a result, brokers find themselves with fewer avenues to invest the profits earned from their broking activities. For instance, if a broker wants to invest these profits in a group company or any non-securities business, they would have to transfer the funds from the broking company to its parent company or its promoter, often through dividends or buybacks. This practice results in a significant tax liability, making it inefficient for brokers to deploy their surplus capital effectively.

Against this backdrop, the Paper proposes an amendment to Rule 8 to provide clarity on what constitutes as “business.” Specifically, it suggests that investments made by brokers using their own funds should not be treated as business unless they involve client funds or create financial liabilities for the broker. The proposed amendment would allow brokers more flexibility to invest their profits without violating Rule 8, subject to the condition that client funds remain protected. Further, this proposal is also relevant from a group structuring point of view as it would allow brokers to incorporate subsidiaries who may engage in other business such as banking, insurance, etc.

Recommendation:

The Paper is a welcome move for the broking industry and this proposed amendment has been long overdue. Since stockbrokers are already subject to stringent regulations by SEBI concerning their client funds, restricting them to invest in group companies or any other company engaged in non-securities business seemed unnecessary. The proposed amendment would provide brokers with more flexibility to utilize their own funds without being in violation of Rule 8 of the SCRR.

4. Alternative Authentication Mechanisms for Digital Payment Transactions

The adoption and utilization of digital payments amongst the population has consistently grown year on year. However, the growth in adoption of digital payments has also precipitated in the growth of frauds perpetrated through means such as phishing, vishing, brute force attacks etc., in relation to digital payments[4] .

To address this worrying trend and protect segments of the population new to the digital payments ecosystem, the RBI released the ‘Draft Framework hernative Authentication Mechanisms for Digital Payment Transactions’ (“Draft Framework”) for public comments on 31 July 2024, proposing to create a uniform framework applicable to all Payment System Operators (“PSO”) and Payment System Participants (“PSP”) to enable the adoption of robust and dynamic multi-factor authentication methods.

The RBI has taken cognizance of the fact that developments in technology has created a stage for secure alternate mechanisms to be introduced to a system which is heavily reliant on the SMS-based one-time password (“OTP”) as the primary mode of additional factor authentications (“AFA”). To facilitate innovation, the Draft Framework proposes overarching guidelines which PSOs and PSPs must adhere to in creating their authentication framework for payment instructions, without prescribing a specific mode of authentication to be adopted.

The Draft Framework proposes to classify the factors utilized for authentication into separate categories viz.,

( ) factors the individuals have knowledge of such as PIN, password etc.,

(ii) factors which are tangible and will be in possession of the individual such as card hardware and software tokens, and

(iii) factors which are unique to the individual such as biometrics. PSOs and PSPs are required to create AFA based mechanisms for all digital payment transactions which involve one factor which is dynamically generated after initiation of a payment transaction and is specific to the transaction and further require both factors utilized under the AFA mechanism to be from distinct categories.

4. Reserve Bank of India - Payment System Indicators (rbi.org.in)

The Draft Framework also provides for risk-based use of AFA mechanisms and also provides flexibility to customers to de-register from certain authentication modes. The Draft Framework also exempts certain transactions from its ambit such as E-mandates for recurring transactions, small value digital payments in offline mode, small value contactless card payments etc.

The Draft Framework also creates a conundrum regarding practical implications once it is implemented. In case of devices with limited features (without face ID detectors, or fingerprint scanners), the viable modes of AFA become limited as one of the proposed categories of factors cannot be utilized. Further where an individual de-registers from any specific forms of authentication, there may once again be limitations on the factors that can be utilized for the AFA. The PSOs and PSPs in implementation of AFA must also take into account technological savviness of its target customers.

Regardless, the Draft Framework represents a significant step towards strengthening the digital payments ecosystem by enabling further adoption of digital payments by the population at large as a safe and secure means of undertaking payment transactions.

Recommendations:

As the Draft Framework is still under discussion, the final framework implemented by the RBI should consider the challenges to implementation of the framework and provide further clarity which addresses concerns on practical implications.

5. Changes to P2P NBFC Ecosystem

The RBI amended the Master Direction - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017 dated 4 October 2017 ("**Master Directions**") through the Review of Master Direction - Non-Banking Financial Company – Peer to Peer Lending Platform (Reserve Bank) Directions, 2017 on 16 August 2024 ("**P2P Review**") and brought about sweeping changes to the Peer-to-Peer ("**P2P**") lending ecosystem. At its inception, the Master Directions were brought in to regulate P2P-NBFCs which were seen as an alternative to the traditional bank and NBFC led lending sector by offering a digital platform-based crowdfunding model that facilitated unsecured loans between lenders and borrowers. The P2P lending platform provided services such as credit assessment and risk profiling, undertaking loan documentation, assistance in disbursement and loan repayment collection, etc. and generated revenue through platform fees charged to participants on the platform.

However, varied interpretations of the intent of the Master Directions led to P2P-NBFCs positioning their products as investments and pooling funds from multiple lenders and offering quasi-deposit linked products with the allure of high fixed returns. This led to many P2P-NBFCs acting as intermediaries offering investment returns and liquidity options, as well as taking up credit risk to ensure fixed returns to lenders on their platforms. Many P2P-NBFCs also tied up with fin-techs to create a closed loop of borrowers and lenders from the fin-techs customer base.

The P2P Review was brought in to clarify the RBI's stance on the role of P2P-NBFCs in ecosystem as mere facilitators of direct lending transactions between lenders and borrowers on their digital platform and barred them from assuming credit risk directly or indirectly. Further, the P2P Review imposed a timeline of T+1 on the settlement of funds deposited in the escrow accounts maintained by P2P-NBFCs for disbursals and repayments, which was absent in earlier iteration of the Master Directions thereby preventing the practice of pooling and re-distribution of funds to generate returns akin to a mutual fund. Mandates such as barring the utilization of funds of a lender as replacement of any other lender were imposed to further establish the P2P-NBFCs role as a mere facilitator and to highlight that the risk in relation to loans disbursed on P2P platform shall only be borne by the lenders.

The prohibition of matching/ mapping the participants within a closed user group further seeks to align the P2P ecosystem with its intended role as a genuine alternative form of finance offering a path to credit to underserved borrowers.

The Master Directions were further amended on 9 September 2024 which brought in further compliance requirements such as adoption of practices specified in the Master Direction on Information Technology Governance, Risk, Controls and Assurance Practices dated 7 November 2023 which are only applicable to NBFCs in the top, upper and middle layers while P2P-NBFCs are considered as part of the base layer. When considered alongside the other requirements such as disclosure requirements specified in the Master Direction – Reserve Bank of India (Non-Banking Financial Company – Scale Based Regulation) Directions, 2023 and compliance with the Guidance Note on Operational Risk Management and Operational Resilience dated 30 April 2024 brought about in the amendment on 9 September 2024, demonstrate that the RBI is seeking to increase monitoring of P2P-NBFCs.

By overhauling the status-quo of the P2P ecosystem, and imposing greater regulatory oversight, the RBI seeks to re-establish P2P-NBFCs as an alternate avenue for credit. While this introduces new challenges and requires many players in the P2P ecosystem to reevaluate their approach to P2P lending, the amendments brought about by the RBI also bring clarity to the P2P ecosystem and opens the floor for creation of new products that can bring value to both lenders and borrowers in the long term and creates a trustworthy alternate avenue of credit for underserved sections of borrowers.

Recommendations:

At present, it is noted that various P2P platforms display detailed information in relation to borrowers which may cause conflict as lenders may directly approach borrowers in case of delinquencies as P2P platforms are no longer taking any credit risk and are only providing support in recoveries. In such a scenario, the RBI should consider, further regulating the extent of information that may be displayed to the lender to prevent harassment of borrowers.

6. Sectoral data localisation mandates and the DPDP Act.

The RBI mandated authorised payment system operators (such as banks and payment aggregators) to store all payments data within systems located in India through a circular on 'Storage of Payments System Data' dated 6 April 2018 ("**Data Localisation Directive**"). This payments data includes end-to-end transaction details, customer data, payment sensitive data, and transaction data, and the obligation extends to all entities in the payments ecosystem, including third-party vendors and service providers that are involved in the processing payments.

The RBI has also clarified in the context of cross-border payment transactions that there is no bar on processing of payment transactions outside of India but the end-to-end payments data should be deleted from systems located outside India and brought back to India within one business day or 24 hours from payment processing, whichever is earlier. Additionally, for cross border transaction data, a copy of the domestic component may also be stored abroad, if required. The RBI has not clarified on whether 'if required' would be satisfied by the offshore entity's internal process requirements or local law applicable to that entity. The RBI has also maintained a firm stance with respect to localisation of all payments data since the issuance of the Data Localisation Directive.

On 11 August 2023, India passed the Digital Personal Data Protection Act 2023 ("**DPDP Act**"), its first law on protection of personal data. The DPDP Act deals with the digital personal data of data principals, placing restrictions and obligations on data fiduciaries and data processors. However, the DPDP Act does not principally place restrictions on cross-border transfers of data. Instead, it provides for the Indian Central Government to restrict the transfer of personal data to specific countries or territories outside India.

The DPDP Act also clarifies that in the event of conflict with any other law, the DPDP Act would prevail to the extent of the conflict. This may be harmoniously interpreted to mean that stricter compliance obligations under the DPDP Act would take precedence over data protection stipulations in sectoral regulations (or vice versa).

Recommendations:

Given the interplay between the Data Localisation Directive and the DPDP Act on account of overlapping subject matter, it would be helpful if the RBI provides further guidance in relation to cross-border data transfers and storage, and whether the threshold of 'if require' is only met by local regulations applicable to offshore entities. This would provide much-needed clarity to regulated entities and other stakeholders in the payments ecosystem.

7. Clarity for cross-border payment aggregators.

The RBI introduced a new regulatory regime for cross-border payments last year through a circular titled 'Regulation of Payment Aggregator – Cross Border (PA - Cross Border' issued on 31 October 2023 ("**PA-CB Directions**"). The PA-CB Directions require payment aggregators – cross border ("**PA-CBs**") refer to the Guidelines on Regulation of Payment Aggregators and Payment Gateways dated 17 March 2020 ("PA Guidelines") which govern domestic payment aggregators ("PAs") for compliance with aspects such as governance, merchant onboarding, baseline technology recommendations, etc. where the PA-CB Directions are silent. While the PA-CB Directions aim to amplify India's increasing global expansion in the payments space (with relaxations for certain categories of entities classified as existing PA-CBs), there may be teething troubles with operationalising certain processes for market players on account of ambiguities or contradictions between the PA-CB Directions and existing applicable directions which the RBI has not yet clarified on.

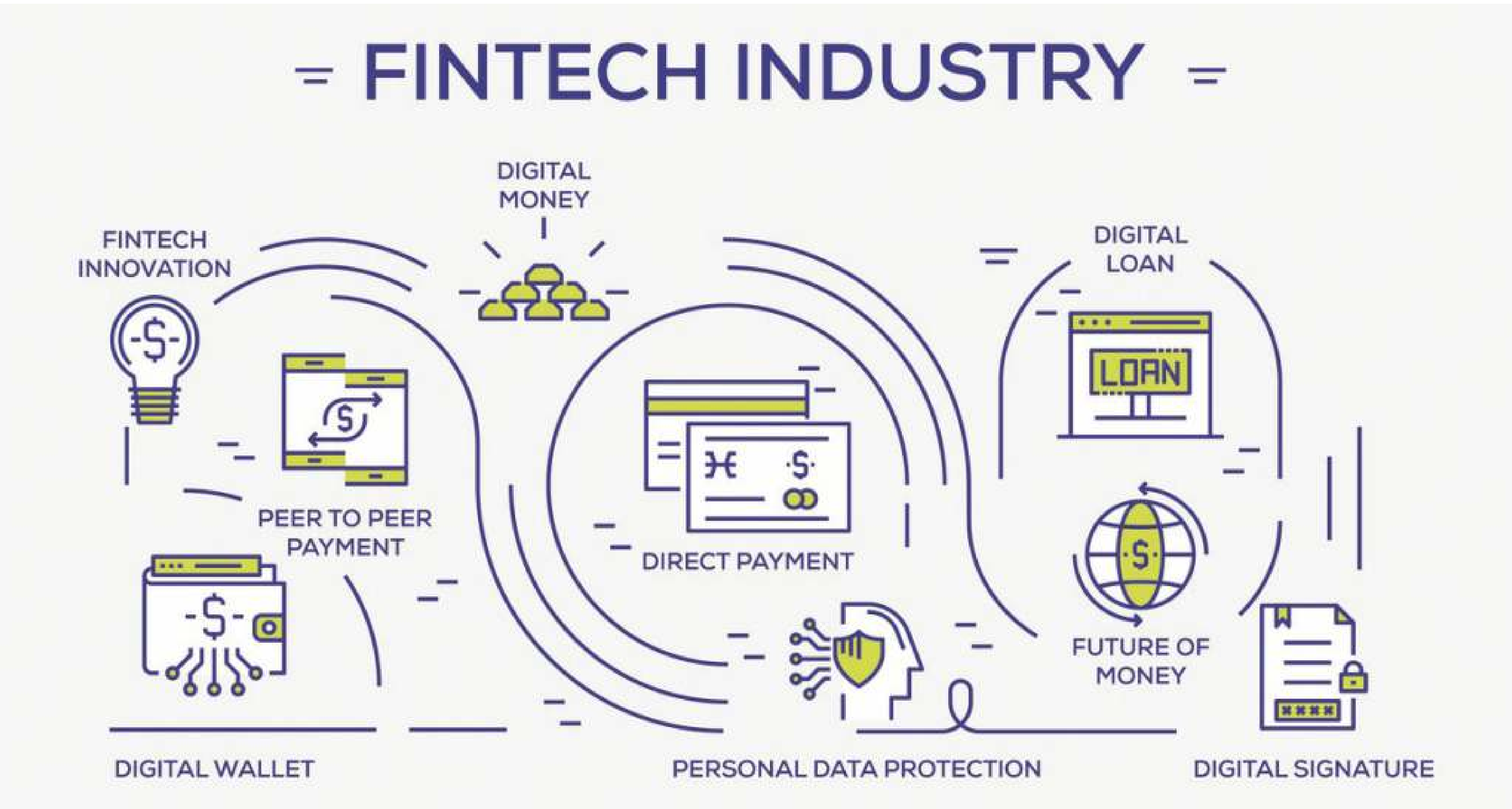
The PA Guidelines prescribe strict settlement timelines within which PAs are required to ensure final settlement with merchants, while the PA-CB Directions do not specify any timelines, in which case market players may be expected to adhere to the settlement timelines under the PA Guidelines. However, settlement timelines for cross-border payments are dependent on authorised dealer category I banks ("**AD Banks**"), who are not obligated to adhere to the settlement timelines provided under the PA Guidelines.

Further, while the PA-CB Directions state that permissible debits and credits from PA escrow accounts may be done in line with the PA Guidelines (which allow settlements into any account as directed by merchants), they also require PA-CBs to ensure that proceeds from Export Collection Accounts ("**ECAs**") are settled only into the account of the merchant.

Additionally, with reference to overseas entities providing payment aggregation services abroad, it may be relevant for the RBI to clarify whether they would be required to adhere to the Data Localisation Directive and if payments data must be stored in India only.

Recommendations:

There exist several open questions on interpretation of the RBI's instructions with respect to the operationalisation of PA-CB arrangements, such as how data localisation would be implemented for offshore entities, as well as the manner of settlement of funds to merchants. Accordingly, it would be helpful if the RBI were to issue FAQs with respect to the PA-CB Directions so that entities looking to enter the cross-border payments space can set up arrangements that are compliant with the RBI's expectations from the get-go.



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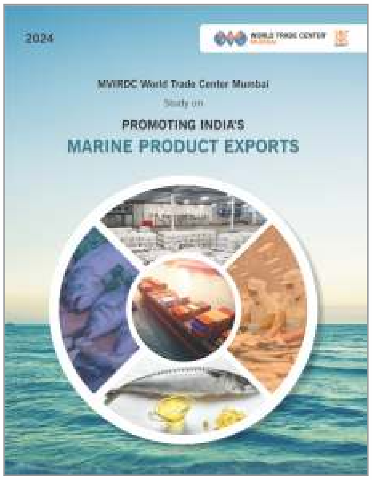

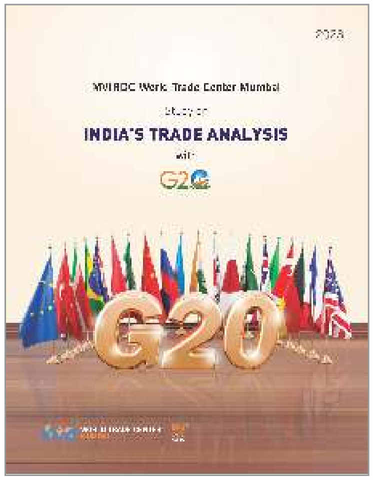

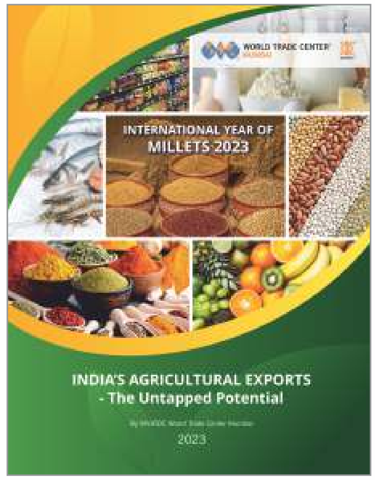

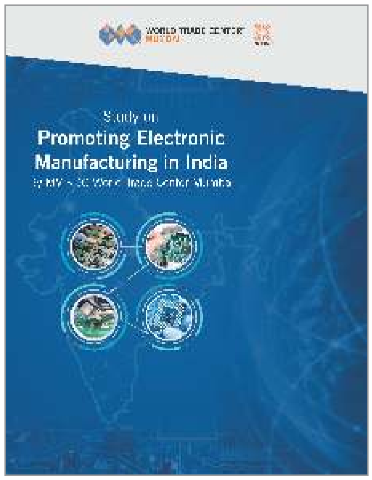

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