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INDIA'S QUEST TO FIX ITS PAYMENTS PUZZLE

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

BENGALURU : The debate around how to regulate internet businesses in India is being increasingly defined by worries over national sovereignty. And because of the phenomenon of network effects—and sheer money power—many internet spaces in India, including email, messaging, social networking, video streaming and e-commerce, are dominated by American platforms, chiefly Amazon, Facebook and Google.

The scale and speed at which these American companies (and a few Chinese firms, now banned) have established dominance in so many businesses troubles politicians and regulators who have tried to address their fears by calling for data localisation, applying operational restrictions and undertaking ambitious antitrust investigations.

In early November, National Payments Corporation of India (NPCI), which runs the unified payments interface (UPI), RuPay and other digital payments infrastructure, went further than most regulators have dared. NPCI announced market share caps on third-party UPI apps, the largest of which are owned by two large American firms, Walmart and Google. NPCI also finally allowed WhatsApp Pay, which had been barred from expanding its pilot for nearly three years, to launch its service but to less than 5% of its users in the country for now.

NPCI was evidently attempting a balancing act—of meeting politicians' desire to rein in the burgeoning presence of foreign players in the sensitive sector of financial services and reducing systemic risk to UPI without demolishing its existing playing field, which has come about as a result of NPCI's own framework and policies.

In doing so, however, NPCI has evoked analogies with licence raj era regulators and proved how vexatious internet regulation in India is becoming. Critics say that the 30% market share cap on third-party apps is arbitrary and introduces operational distortions that will limit the ability of UPI apps to expand and potentially hurt customer experience on UPI—and still leave UPI dominated by the American third-party apps.

They also question how will a 30% cap, large as it is, address concerns about systemic risk to UPI? And, by stopping WhatsApp from making a full launch, which was expected to bring tens of millions of new users to UPI, NPCI may have hurt its own mission of promoting the payment network, according to entrepreneurs and fintech executives that Mint spoke to.

Catch-22 for NPCI

NPCI has landed in this difficult situation mostly as a result of its own success. It was formed in December 2008 as a not-for-profit entity owned by India's biggest private sector and public sector banks. Its mandate was to create and manage state of the art infrastructure to enable payments with a focus on the digital space. Its biggest and most impactful innovation has been UPI, which was launched in April 2016 and went live in August that year.

Since then, UPI has emerged as the fastest-growing payment mechanism in the country. It processed more than 2 billion monthly transactions in October and November, with its growth having been boosted during the pandemic as cash usage declined. When UPI was launched, few expected such explosive expansion.

At that time, NPCI executives believed that the UPI ecosystem would comprise of a combination of banks, local startups and international platforms. But UPI has largely been dominated by two third-party apps, Walmart-owned PhonePe and Google Pay, which together account for roughly 80% of all UPI transactions and are far bigger than Paytm, Amazon Pay and others in the fray. Apps by traditional banks as well as BHIM, which was launched by NPCI in the wake of demonetisation, have been walloped by PhonePe and Google Pay.

This chafes at NPCI's promoters, and more so at the government, which is leery of international platforms dominating an emerging medium within financial services, which is considered an especially sensitive sector. In addition, NPCI believes that the systemic risk to UPI increases when so much of it is dominated by one or two third-party apps.

To address these concerns, for at least two years, NPCI has been considering capping the market share that a single third-party UPI app can accumulate. Its resolve was strengthened after the Yes Bank-PhonePe fiasco earlier this year. In March, PhonePe, which had partnered with Yes Bank (entities without a banking license need tie-ups with banks to offer UPI services) suffered a service outage after the Reserve Bank of India issue a moratorium on the latter. It caused a crisis not just for PhonePe but for NPCI, too, as a large part of UPI collapsed instantly. Though PhonePe resumed its service within 36 hours after promptly finalizing a partnership with ICICI Bank, NPCI's fears about systemic risk were realised.

On 5 November, NPCI said that from January 1, 2021, it would cap the share of a single third-party app at 30%, which is to be determined on the basis of transaction volume processed during the preceding three months. PhonePe, Google Pay and other existing third-party apps have been given an additional two years to comply with the cap.

However, experts said that the 30% cap doesn't necessarily reduce the dominance of American platforms nor does it address systemic risk concerns in a meaningful manner.

Fintech licence raj

To start with, though the collective share of PhonePe and Google Pay will be capped at 60% from its current level of 80%, the slack is likely to be picked up by WhatsApp Pay or even Amazon Pay, both of which are American firms.

NPCI is obviously thinking: Let's get a handle on the situation before any player becomes too big because it's much more difficult to restrain them afterwards, according to Subramanya SV, co-founder and CEO of Fisdom, a wealth management startup.

"But on any platform like UPI, which has standardized protocols, the critical success factors are capital and managing scale of technology and data, which favour Big Tech rather than startups or non-tech companies. This is the dilemma for NPCI. On the one hand, UPI has resulted in massive adoption and value for customers and has brought millions to online payments. On the other, UPI-like platforms favour Big Tech at the expense of startups and the banks," he said.

Others said that applying a 30% cap doesn't remove systemic risks to UPI.

"I don't understand how a 30% cap will solve the problem," a veteran fintech entrepreneur said, on condition of anonymity. "It's not that much lower than 40% (the rough market shares of PhonePe and Google Pay each currently). Tomorrow, if PhonePe or Google Pay goes down, 30% of the system will still be gone. So how does putting a 30% restriction solve for systemic risk?"

Another potential problem with the 30% cap is that it may put off users, especially if there are glitches in the execution of the cap. Mint learns that NPCI is still working out the final details of the implementation of the cap and consulting with payment companies and banks. It currently favours restrictions on adding new users if apps have exceeded the 30% cap, rather than putting limits on transactions by existing users.

“The 30% cap is a throwback to the licence raj," said a second fintech entrepreneur, who was privy to NPCI discussions on the restriction. “The restrictions will affect either existing UPI users or delay onboarding of new users. So it will affect customer experience in some form, which could slow down UPI adoption, and that’s ironically not something that NPCI wants."

One recent regulatory change has already hit banks and payment apps on UPI. Last December, the government removed the merchant discount rate on UPI transactions, making it less lucrative for traditional banks to invest more in UPI. MDR was a processing fee charged by banks to merchants, an important source of income in a space with scanty margins. By removing MDR, the government wanted to incentivize merchants to adopt UPI. But while UPI usage has increased because of the pandemic, transaction failure rates have soared, some say, partly because banks aren’t investing enough.

Restrictions on WhatsApp

On the same day that NPCI announced the 30% cap, it also gave approval to WhatsApp to launch on UPI. NPCI said that WhatsApp could expand its UPI user base in a “graded manner" starting with 20 million, ending a nearly three-year wait for the American firm. (WhatsApp’s launch was delayed because of legal troubles, lobbying by existing payment companies and others, and demands that the company comply with data localization requirements and other reasons).

The timing of the two NPCI announcements wasn’t a coincidence.

Ever since Facebook-owned WhatsApp piloted its payment service in early 2018, many entrepreneurs, fintech executives and investors have predicted that it would lead to a dramatic expansion in India’s digital payments market. For all its success, UPI is estimated to have around 100 million regular users, a minority of the more than 600 million internet users. WhatsApp, with its easy-to-use interface, spending power and, most importantly, its large and sticky user base of more than 400 million, was expected to attract hordes of new users to UPI, which would turbocharge its growth.

Unlike PhonePe and Google Pay, which are pure payment apps that started from scratch, WhatsApp offers its payment service as a feature within its messaging app. The fact that many WhatsApp users log on to the app dozens of times every day is likely to provide a formidable advantage to the messaging app in its efforts to cross-sell its payments service. Its interface has already wowed users in the pilot.

For NPCI, however, the attraction of seeing rapid growth in new UPI users is overshadowed by the possibility that WhatsApp could rapidly establish dominance.

“When there are already concerns about MNCs like PhonePe and Google Pay having such a large share in UPI, NPCI didn’t want to take the risk of allowing a full WhatsApp launch," a person familiar with NPCI’s thinking said. “WhatsApp can realistically become a very large No.1 quickly, and that would be an even bigger concentration of power than the current situation with PhonePe and Google Pay."

NPCI is also unsure if the present [UPI infrastructure]() is equipped to handle a deluge of new users that a full WhatsApp launch may have brought, the person quoted above said. NPCI will monitor how the infrastructure holds up once WhatsApp launches to 20 million users, and decide on letting the messaging app expand accordingly, the person said.

NPCI has said that 30% cap is only for third-party apps, not for firms that own a banking license. So, the cap doesn't apply to apps by SBI or Paytm. But that qualification is unlikely to affect the existing order of UPI for now as other apps are unlikely to splurge on marketing and cashbacks, which are seen as necessary to attract users away from the market leaders, PhonePe and Google Pay.

The two American firms are nevertheless unhappy with the 30% cap, and believe that they have been short-changed by NPCI. The 30% cap has "implications for millions who use UPI for their daily payments and could impact the further adoption of UPI and the end goal of financial inclusion," said Sajith Sivanandan, business head, Google Pay and Next Billion User initiatives, India.

On a long-term basis, however, PhonePe and Google Pay may come to view the NPCI as a blessing. With both companies netting a share of about 40%, they will certainly lose some business. But given the wild popularity of WhatsApp and the expected success of its payment service, the market share cap may end up putting a floor on the downside for the PhonePe and Google Pay by curbing WhatsApp's market share.

Meanwhile, PhonePe, Google Pay and other digital payment companies are attempting to wield more influence with NPCI. Last week, NPCI announced that it had added 19 new shareholders including PhonePe, Google Pay, Paytm Payments Bank and Amazon Pay, selling 4.63% of its equity shares. Though these companies presently have a much smaller stake than the banks, their rising clout—and popularity with users—will present a regulatory headache for NPCI for many years to come. In effect, the battle over who gets to process India's payments may have only just begun.

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