



October 2022

Concept Note on Central Bank Digital Currency

The concept note on 'Central Bank Digital Currency' ("**Concept Note**") released by the FinTech department of the Reserve Bank of India ("**RBI**") on October 7, 2022 aims to; (a) promote awareness about the central bank digital currency ("**CBDC**" or "**Digital Rupee**"); (b) clarify the RBI's approach to the issue; and (c) describe the possible uses and features of the Digital Rupee.

Background

Noticing the recent rise in popularity of cryptocurrency, the RBI has been debating the merits and demerits of releasing a digital currency for some time and has recently indicated that a digital equivalent to the rupee may be rolled out in the financial year 2022-2023. The RBI has several times publicly expressed its concerns towards cryptocurrencies such as Bitcoin and Ethereum and has reiterated how cryptocurrencies do not have underlying value, making their value speculative in essence.

Contrary to cryptocurrency, the CBDC would have the advantage of being a sovereign currency and the RBI has stated that all CBDC transactions must be traceable.

RBI's Analysis of a Digital Rupee

The RBI has been exploring the introduction of CBDCs and is keen to implement a phased strategy to issue its own CBDC. The implementation strategy will progress from various stages of trials before the eventual launch and is hopeful of accomplishing this with minimal or no disruption to the financial system.

CBDC is defined by the RBI as legal tender issued by a central bank in a digital form. It is analogous to paper currency but takes a digital form. The RBI states that it will be exchangeable at par with the existing currency and will be accepted as a medium of payment and legal tender. The CBDCs would appear as a liability on the central bank's balance sheet.

The key incentives for the issuance of a CBDC in India, according to the RBI are : (i) reduction in operational costs involved in physical cash management; (ii) fostering innovation in the payments and settlement systems and; (iii) boosting innovation in cross-border payments space. A leading motivation was to provide the public with access to a digital currency and all the benefits a digital or virtual currency currencies can provide without the accompanying risks. The use of an 'offline feature' in the CBDC would also assist in remote locations and offer an alternative when mobile networks are not available.

The RBI analyses that private virtual currencies are not commodities or claims on commodities as they have no intrinsic value. Cryptocurrencies are being acclaimed for their role in moving towards a de-centralised financial

system. The regulatory arrangements that play an indispensable role in ensuring monetary integrity are sidestepped by cryptocurrencies which disrupts the financial eco-system. As the custodian of monetary policy framework in charge of ensuring financial stability in the country, the RBI has decided to introduce a digital currency in a phased manner to provide the benefits of cryptocurrencies without the burden of their risks.

The design and features of the CBDC should be in line with that of physical currency as it is an electronic form of the sovereign currency. The RBI notes that the design should be in accordance with the specific functions the CBDC may be expected to perform.

The RBI has stated in the Concept Note that there are 2 (two) forms of CBDCs which may be introduced:

1. a CBDC which is retail oriented, which would be able to be used by all for general retail transactions; and
2. a CBDC which is wholesale oriented, which would be able to be used by select financial institutions intended for interbank settlement of transfers.

Two models have been proposed by the RBI for the issuance and management of the CBDCs. The first is a single-tiered direct model which gives the central bank the entire responsibility of managing all aspects of the CBDC system and the second is a multi-tiered model where the central bank and other intermediaries (banks and similar service providers) play a role in managing the CBDC system. The multi-tiered system is similar to the system that is currently in place where banks and intermediaries are responsible for activities like distribution of notes and coins, verification of transactions and so forth.

The RBI has proposed that the CBDC could be structured as 'token-based' or 'account-based'. A token-based CBDC would be akin to a bearer-instrument where the holder of the token at any given point is the presumed owner. Alternatively, an account-based system would require a record of balances and transactions of all CBDC holders which would then signify the ownership status. Token-based CBDCs would require the bearer to verify the authenticity of their token whereas an account-based CBDC is verified by an intermediary. The RBI is of the view that a token-based CBDC is a preferred mode for the retail form of CBDCs as it resonates the features of bank notes, while an account-based CBDC would be considered more beneficial for the wholesale form of CBDCs.

The CBDCs would be able to function on a conventional centrally controlled database or on distributed ledger technology. Of the 2 (two) infrastructures, the technology to be finally used would need to be forward looking and have strong cybersecurity, technical stability, resilience and sound technical governance standards. For the CBDC to play a role as a medium of exchange, it would need to possess all the benefits that physical currency contains including anonymity, universality, and finality. The RBI acknowledges that ensuring anonymity for a digital currency is a challenge, as all digital transactions would leave some kind of trail. But the degree of anonymity which can be achieved is what remains to be seen.

The CBDC is aimed to complement, rather than replace, current forms of money and is envisaged to provide an additional payment avenue to users, not to replace the existing payment systems.

JSA Comment

This Concept Note while exploratory in nature, provides for an in-depth view of the requirements and benefits for the introduction of CBDC and focuses on explaining the RBI's rationale towards the design of the CBDC and the possible routes for its introduction. It analyses the possible effects of introducing a CBDC into the banking system and the knock-on effects it could have on monetary policy, financial stability and privacy issues. The Concept Note is analytical on the potential merits and demerits of the introduction of a CBDC.

The RBI has mentioned that it will soon launch a pilot of the Digital Rupee for specific uses only and it will no doubt be closely followed.

While 10 (ten) countries have already launched a CBDC, the first being the Bahamian Sand Dollar in 2020 and the latest being Jamaica's JAM-DEX, there are certain open points (amongst all the discussion points) which the RBI will need to analyse in detail as they may have a larger effect on the economy. These are broadly:

1. Anonymity of monetary transactions may be affected to a large extent;
2. Consensus whether CBDC should bear interest, as it will affect the saving patterns and result in reduction of the public deposits held with the commercial banks; and
3. As the CBDC will be a liability on the balance sheet of the RBI and not of the commercial banks, it will affect the book entries of both as it is expected that a sizeable percentage of the current currency will be converted to CBDCs.

While the introduction of the “digital rupee” is a welcome move, it is expected that the RBI will consult all stakeholders and evaluate all the concerns associated with CBDC and fine tune the final product. While it may take some time for glitches to be ironed out, the CBDC system will definitely have a positive impact on India’s digital economy by increasing the efficiency of the monetary and payment systems.

FinTech Practice

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

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

This Prism has been prepared by:



Dina Wadia
Partner



Abhishek Ray
Of Counsel



Zahan Kalyaniwalla
Associate



14 Practices and
23 Ranked Lawyers



15 Practices and
18 Ranked Lawyers



7 Practices and
2 Ranked Lawyers



IFLR1000 India Awards 2021

10 Practices and
34 Ranked Partners

Banking & Finance Team
of the Year

Fintech Team of the Year

Restructuring & Insolvency
Team of the Year



Among Top 7 Best Overall
Law Firms in India and
10 Ranked Practices

13 winning Deals in
IBLJ Deals of the Year

6 A List Lawyers in
IBLJ Top 100 Lawyer List



Banking & Financial Services
Law Firm of the Year 2022

Dispute Resolution Law
Firm of the Year 2022

Equity Market Deal of the
Year (Premium) 2022

Energy Law Firm of the Year 2021



Ranked #1
The Vahura Best Law Firms to
Work Report, 2022

Top 10 Best Law Firms for
Women in 2022

For more details, please contact km@jsalaw.com

www.jsalaw.com



Ahmedabad | Bengaluru | Chennai | Gurugram | Hyderabad | Mumbai | New Delhi



This prism is not an advertisement or any form of solicitation and should not be construed as such. This prism has been prepared for general information purposes only. Nothing in this prism constitutes professional advice or a legal opinion. You should obtain appropriate professional advice before making any business, legal or other decisions. JSA and the authors of this prism disclaim all and any liability to any person who takes any decision based on this publication.