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DRAFT BANNING OF CRYPTOCURRENCY & REGULATION OF OFFICIAL DIGITAL CURRENCY BILL, 2019

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

Highlights of the Bill

- The draft Bill seeks to prohibit mining, holding, selling, trade, issuance, disposal or use of cryptocurrency in the country. Cryptocurrency is defined as any information, code, or token which has a digital representation of value and has utility in a business activity, or acts as a store of value, or a unit of account.
- Under the draft Bill, mining, holding, selling, issuing, transferring or use of cryptocurrency is punishable with a fine or imprisonment of up to 10 years, or both.
- A person must declare and dispose of any cryptocurrency in his possession, within 90 days from the commencement of the Act.
- The draft Bill permits the use of processes or technology underlying any cryptocurrency for experiment, research, or teaching.
- The central government, in consultation with the RBI, may issue digital rupee as legal tender. The RBI may also notify a digital currency recognised as legal tender in a foreign jurisdiction, as a foreign currency.

Key Issues and Analysis

- The draft Bill bans all cryptocurrencies based on the risks associated with them such as potential use for money-laundering, risks to consumers and threat to the country’s financial stability. However, cryptocurrencies also have potential benefits such as better record keeping and more efficient cross border payments. Several countries are trying to mitigate some of these risks through regulations.
- The Bill defines cryptocurrency to include information, code or token which has a digital representation of value and is generated through cryptographic means, or otherwise. This definition may be too broad and include various forms of digital tokens which have not been generated through cryptography. Such tokens may not pose the risks associated with cryptocurrencies.
- The penalties prescribed for certain offences under the Bill may be disproportionately higher compared to other similar economic offences in the country.

PART A: HIGHLIGHTS OF THE BILL

Context

Cryptocurrency emerged as a person-to-person electronic cash system that allows online payments to be sent directly from one party to another, without the need of a financial

institution.[1] In traditional currencies, a central authority issues currency that all parties are legally bound to accept as a mode of payment. This makes the issued currency a legal tender. Most cryptocurrencies are not backed by a sovereign guarantee, and therefore are not considered as legal tender. For a legal tender, transaction data is usually maintained centrally with financial institutions like banks. In contrast, cryptocurrency transactions are recorded and shared with all users on the network. Cryptocurrencies are used for payment if the receiver is willing to accept it. Since their values fluctuate in relation to other currencies such as the US Dollar, they are also traded. They are also used as utility tokens which provide the holder access to a company's goods and services. As of October 2019, there were more than 3,000 cryptocurrencies across the world, with daily global trading volume of around USD 50 billion.[2]

Over the years, several risks related to cryptocurrencies have emerged such as potential use for illicit activities, and lack of consumer protection. Countries have adopted different frameworks to regulate cryptocurrencies. Several countries (such as Japan, Canada, Switzerland) regulate cryptocurrencies under their anti-money laundering provisions.[3] Some countries, such as Japan, have accepted certain cryptocurrencies as a legal payment method. Other countries (such as China, Saudi Arabia) have prohibited their use as a currency.[3]

Between 2013 and 2017, the Reserve Bank of India (RBI) and the Ministry of Finance issued several advisories against the potential financial, customer protection and security risks pertaining to cryptocurrencies.[4] In April 2018, RBI prohibited entities regulated by it from dealing in, or providing services for dealing with virtual currencies.[5] An Inter-Ministerial Committee (IMC), constituted by the Ministry of Finance, studied the issues related with virtual currencies. It highlighted several risks associated with cryptocurrencies such as high volatility in price, vulnerability to money laundering and financial stability risks.[6] Considering these, it recommended that all cryptocurrencies, except those issued by the government, be banned in India. It also proposed a draft Bill to ban cryptocurrencies in the country and provide for an official digital currency.

Key Features

- **Cryptocurrency: The draft Bill defines cryptocurrency as any information, code, number or token, generated through cryptographic means or otherwise, which has a digital representation of value and has utility in a business activity, or acts as a store of value or a unit of account.**

Regulation of cryptocurrency

- **Ban on cryptocurrencies: The draft Bill bans the use of cryptocurrency as legal tender or currency. It also prohibits mining, buying, holding, selling, dealing in, issuance, disposal or use of cryptocurrency. Mining is an activity aimed at creating a cryptocurrency and/or validating cryptocurrency transactions between a buyer and seller.**

- In particular, the use of cryptocurrency is prohibited for: (i) use as a medium of exchange, store of value or unit of account, (ii) use as a payment system, (iii) providing services such as registering, trading, selling or clearing of cryptocurrency to individuals, (iv) trading it with other currencies, (v) issuing financial products related to it, (vi) using it as a basis of credit, (vii) issuing it as a means of raising funds, and (viii) issuing it as a means for investment.

- **Exemptions: The central government may exempt certain activities, if necessary in public interest. The use of technology or processes underlying cryptocurrency for**

experiment, research or teaching is permitted.

- **Digital Rupee: The central government may, in consultation with the central board of the RBI, approve digital rupee to be legal tender. The RBI may also notify a foreign digital currency as a foreign currency. Foreign digital currency means a digital currency recognised as legal tender in a foreign jurisdiction.**

Offences and Penalties

- Under the Bill, mining, holding, selling, issuing, transferring or using cryptocurrency is punishable with a fine or imprisonment of up to 10 years, or both.

- Issuing any advertisement, soliciting, assisting or inducing participation in use of cryptocurrency is punishable with a fine or imprisonment of up to seven years, or both. Acquiring, storing or disposing of cryptocurrency with the intent of using it for non-commercial purposes will be punishable with a fine.

- The Bill provides for a transition period of 90 days from the commencement of the Act, during which a person may dispose of any cryptocurrency in their possession, as per the rules notified by the government.

PART B: KEY ISSUES AND ANALYSIS

Rationale for the draft Bill

Working of cryptocurrencies

Money has three main attributes: it is used as a unit of account, as a medium of exchange, and as a store of value. In most countries, money is issued by a government backed authority (such as RBI in India) and carries sovereign guarantee. Entities authorised to hold money and enable payments (such as banks, credit cards and payment wallets) are licensed by a government agency. This means that there is a government-regulated centralised system of validating transactions and keeping track of money flow.

Cryptocurrencies differ from this system in several ways. First, they are only in digital form. Second, there is no central authority that validates and guarantees transactions. Instead, the transactions are validated by other users and then stored in a secure manner. We explain the process below.

Unlike a physical currency note, it is easy to copy a digital item. Therefore, a digital currency has an inherent challenge of ensuring that there is no double payment with the same currency. Cryptocurrencies address this problem using 'blockchains'. All users in the system have access to the account balance of all other users (code-names may be used to protect privacy). When a set of payments happen, they are bunched together in a "block". Other users verify the block by checking whether the person making the payment had sufficient balance. The block is considered valid if all transactions on it are validated by a majority of users. At this stage, the block is connected to the previous block using cryptography, and published on the system. A chain of such blocks of transactions is called a blockchain. As this ledger is available to all users and validated by them, it is a form of Distributed Ledger Technology (DLT). The cryptography method used makes it very difficult to change the transactions in a validated block. Further, a change in a block will necessitate change in all subsequent blocks, a near impossible task. Also, as multiple copies of the ledgers are kept, it would be very difficult to simultaneously tamper wih all of them. These properties help maintain trust in the system.

Benefits and risks associated with cryptocurrencies

The Inter-Ministerial Committee (2019) noted that the technology underlying cryptocurrencies i.e., DLT, could improve the efficiency and inclusiveness of the financial system.[6] It can help lower the costs of personal identification for KYC, and improve access to credit. Global regulators (such as IMF) have also noted benefits of cryptocurrencies. These currencies could provide cheaper, faster and more efficient transactions.[7],[8],[9] For example, they can be used for small value cross-border transfers where the cost of sending remittances remains high due to multiple intermediaries. Cryptocurrencies also provide for a more secure payment mechanism (as records cannot be manipulated by a single entity), transparency in transactions, and improved ease of auditing.[8]

However, several risks have also been associated with cryptocurrencies. First, they pose risks to consumers. Cryptocurrencies do not have any sovereign guarantee and hence are not legal tender. Their speculative nature also makes them highly volatile. For instance, the value of Bitcoin fell from USD 20,000 in December 2017 to USD 3,800 in November 2018. A user loses access to their cryptocurrency if they lose their private key (unlike traditional digital banking accounts, this password cannot be reset). In some cases, these private keys are stored by technical service providers (cryptocurrency exchanges or wallets), which are prone to malware or hacking.

Second, cryptocurrencies are more vulnerable to criminal activity and money laundering. They provide greater anonymity than other payment methods since the public keys engaging in a transaction cannot be directly linked to an individual. Third, central bank cannot regulate the supply of cryptocurrencies in the economy. This could pose a risk to the financial stability of the country if their use becomes widespread. Fourth, since validating transactions is energy intensive, it may have adverse consequences for the country's energy security (the total electricity use of bitcoin mining, in 2018, was equivalent to that of mid-sized economies such as Switzerland).[7]

Cryptocurrency regulation in other jurisdictions

Considering these benefits and risks, countries are regulating cryptocurrencies in various ways. In Canada, cryptocurrencies are regulated under the money laundering and terrorist financing laws.[10] Trading of digital currencies on an open exchange is permitted, and revenue generated from cryptocurrencies is subjected to income tax.[11] They can also be used to buy or sell goods and services. Japan permits the use of cryptocurrencies as a payment system.[12] Cryptocurrency exchanges are registered and regulated by the Financial Services Authority of Japan. In New York, use of cryptocurrency as a payment mechanism is permitted subject to licensing requirements.[13] Every licensee is required to comply with anti-fraud, anti-money laundering, cyber security and information security related regulations.

Several countries such as China, Thailand, Indonesia and Taiwan ban the use of cryptocurrency.[3] Many others, while permitting the use of cryprocurrencies, have issued warnings about their high risk. For example, the European regulators for securities, banking, and insurance and pension issued a joint statement cautioning that virtual currencies are highly risky and unsuitable as investment, savings or retirement planning products.[14]

Definition of cryptocurrency may be too broad

Definition of cryptocurrency may include tokens or value generated through non-cryptographic means

The draft Bill defines cryptocurrency as any information, code, number or token, generated through cryptographic means *or otherwise*, which has a digital representation of value and has utility in a business activity, or acts as a store of value, or a unit of account. It bans all such cryptocurrencies. It may be argued that this definition is too broad. It may include certain tokens which are not generated through cryptographic means, and hence do not pose the risks associated with cryptocurrencies. For example, this may include online discount coupons, gift cards, and loyalty reward points such as the frequent flyer miles as they provide a digital representation of value and act as a store of value. Note that under the draft Bill, the central government may exempt certain activities from the list of prohibited activities, if necessary in public interest.

Definition of cryptocurrency differs from international standards

Other jurisdictions define cryptocurrencies in a more precise manner. The Financial Action Task Force (an intergovernmental organisation to combat money laundering) defines it as a math-based decentralised, convertible virtual currency which is protected by cryptography.[9] A convertible virtual currency is one which has an equivalent value in real currency and can be exchanged for real currency. The state of New York defines virtual currency as any digital unit that is used as a medium of exchange, or a form of digitally stored value.[13] It excludes digital units that: (i) have no application outside the platform, and (ii) are part of rewards programs.

Penalties for certain offences may be disproportionate

Under the Bill, mining, holding, selling, issuing, transferring or using cryptocurrency is punishable with an imprisonment of up to 10 years. This may be disproportionate as compared to other similar economic offences. Table 1 provides a comparison of the penalties prescribed under the Bill with some other offences.

Table 1: Comparison of penalties prescribed under various economic offences

Offence	Maximum imprisonment
Mining, holding, selling, issuing, transfer or use of cryptocurrency in the country (draft Bill)	10 years
Proceeds of crime involved in money laundering related to offences under the Narcotic Drugs and Psychotropic Substances Act, 1985 (PMLA)	10 years
Involvement in activities connected with proceeds of crime including its concealment, possession, acquisition or use or projecting it as untainted property (PMLA)	7 years
Holding of foreign exchange of aggregate value exceeding one crore rupees (FEMA)	5 years

Sources: Draft Banning of Cryptocurrency & Regulation of Official Digital Currency Bill, 2019; Prevention of Money Laundering Act (PMLA), 2002; Foreign Exchange Management Act (FEMA), 1999; PRS.

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