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CBDCs: The fate of commercial banking rests with the State

The RBI's concept note makes it clear that CBDCs can disrupt commercial banking and the choice of CBDC-type will determine the future of commercial banks, their role and even their existence

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Representative image

In two articles (**here** and **here**) written earlier this year, I had raised concerns over the impact of central bank digital currencies (CBDCs) on commercial banking. Interestingly and pertinently, this aspect, largely overlooked by economists and commentators, has been extensively raised by the Reserve Bank of India (RBI) in a **concept note** released on October 7, 2022.

The concept note has unequivocally acknowledged that CBDCs like the e-Rupee (e₹), in particular, retail-remunerated (interest bearing) CBDCs, which essentially allow opening of deposit accounts by the non-bank private sector (NBPS) directly with the RBI, can potentially 'lead to a massive disintermediation in the financial system resulting from loss of deposits by commercial banks.'

Given the fact that any deposit held by the NBPS at the RBI is risk-free while those at a commercial bank are insured only up to Rs.5 lakhs, there would be a substantial outflow of deposits from commercial banks to the RBI. Large volumes of money held in current accounts at commercial banks are likely to move to the RBI even if the deposits held at the RBI are non-remunerative. The RBI, therefore, has even raised a concern over possible bank-runs.

In spite of the risks involved in holding deposit accounts in a commercial bank people do so presently because first, they are legal tender, i.e., they can be used to settle obligations owed to the state by the NBPS and second, the NBPS cannot open accounts at the RBI. With CBDC deposits, these reasons to hold deposits at commercial banks become redundant. Consequently, deposits at commercial banks that are widely used as money (M1) can be replaced by deposits held at the RBI.

What then will be the implications of CBDCs on commercial banks? Without deposits, commercial banks will be drained of a major source of reserve money or balances in their account held at the central bank, commonly referred to as liquidity. And without adequate financial liabilities of the RBI to settle inter-bank transactions, commercial banks will have to source liquidity from the RBI or borrow/loan money from the NBPS. The latter — market funding — could result in the payment of substantially higher rates by commercial banks as opposed to present deposit rates thereby increasing the cost of bank credit as well as its availability, the latter constrained by how much funds a commercial bank can raise in the market. In effect, banks would essentially be reduced to the status of non-banking financial companies (NBFCs). This may have an adverse effect on credit creation by commercial banks and consequently on economic growth.

These impacts have been discussed in the RBI's concept note. The potential disruptions to commercial banking will, however, depend on the final design of the e₹. Retail CBDCs (CBDC-R) that are non-remunerated with further caps on transaction amounts can inhibit the likely disruption to commercial banking. The RBI is therefore considering the possibility of introducing CBDCs only at the wholesale level — CBDC-W — as, for instance, in the case of reserve money transactions between commercial banks and the RBI.

Another alternative articulated by the RBI to prevent a major disruption in commercial banking is to introduce e₹ as 'tokens' wherein the bearer of a token is considered its owner. The transactions between agents are not recorded by the RBI and responsibility to verify the authenticity of the token rests with the receiver. This is closer to replacement of physical cash or currency notes by e₹. At the same time, CBDCs as deposits can be restricted to the wholesale level.

While the deposit-taking role of the commercial banking system has been elaborately deliberated upon in the concept note, the RBI has not delved into an essential function of commercial banking — as the creator of money. Commercial banks, as it is now widely acknowledged, are not mere financial intermediaries: they are, by design, the creators of credit or money. The decentralization of credit creation through commercial banks was 'allowed' in the nineteenth century because credit-risks could be better assessed in a competitive environment (amongst commercial banks) and at the same time, when banks had closer relationships with their clients or borrowers.

The introduction of CBDCs as deposits could effectively mean the direct disbursement of credit by the central bank. The more fundamental question is not the ability of the central bank to do so but whether a centralized and monopolistic institution will be able to assess credit risk as well or as soundly as a decentralized, competitive commercial banking system. The advancement of technology or fintech — data analytics and artificial intelligence — could, however, mean the of displacement personal relationships in credit-risk assessment in the near future, thereby overcoming a major limitation of centralization in credit disbursement.

While some economists believe that further decentralization in commercial banking is more appropriate — as for instance, in Germany — there are others who think that it is the state which should direct the flow of credit in an economy to achieve its developmental goals rather than by commercial banks who are motivated by profitability in taking decisions on who gets credit and how much.

All-in-all, the RBI's concept note makes it clear that CBDCs can disrupt commercial banking and the choice of CBDC-type will determine the future of commercial banks, their role and even their existence. The technology for such a disruption is advancing rapidly and just as the state legitimised the development of commercial banking the way we know it, it can also, if it so desires, disrupt it.

It is ultimately a matter of political choice.

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