Institute of Economic Affairs

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IEA's Response to Call for Comments Questions

1. Which institution/group do you believe is responsible for tackling financial exclusion in any given domestic market? [Multiple answer question]

a. Central Bank
b. National Government
c. Commercial Banks
d. Non-Profits/Third Sector
e. The individual

All the listed institutions above bear different levels of responsibility for tackling financial exclusion in Kenya.

2. How important do you believe the topic of financial inclusion to be in relation to the development of domestic retail CBDC? [Only one answer]

a. Vital (It won't develop without it)
b. Important ✓
c. Somewhat important
d. Not important
e. Completely unrelated (no bearing whatsoever)

3. How would a CBDC impact financial inclusion, either as part of a wider strategy or in isolation?

The effect of CBDC on financial inclusion is not unambiguous. It depends on what infrastructure is required for the citizens to be able to use the facility with ease. For instance, if the chosen model of a CBDC requires the possession or ownership of a smartphone as with his processor capability, then that may be a gap owing to the costs of new gadgets and the taxes that increasingly make them unaffordable. This situation would defeat the attempt to raise financial inclusion via the adoption of CBDC.

Secondly, digitization in Kenya is constrained by the overall quality and reach iinfrastructure. There is a spatial infrastructure gap in Kenya with the effect that some parts of the country do not have access to reliable access to broad-band. An assessment of this infrastructure gap and its implications for the use of a CBDC should precede widespread adoption. This suggests that if the policy for adoption of CBDC was made, then for the foreseeable future, the currency must be supplementary to the use of paper currency for as long as the demand persists.

4. How would CBDC affect cross-border transactions, either as part of a wider strategy or in isolation?

CBDC would have different effects based on the volume of transactions by each country or jurisdiction. This effect would only be material at the retail level because the larger transactions are already undertaken through a cross-bank infrastructure.

5. How would a CBDC affect the financial sector? What tools could be considered to mitigate any adverse impact of CBDC on the financial sector?

CBDC could have positive or negative effects on the financial sector depending on several factors including the operational model undertaken, the design features adopted, the technical literacy of consumers and the legal foundations of a CBDC.

Key criteria to keep in mind for the success of CBDC would include:

(a) **The importance of a detailed market study along with attention to precedence**. It will be important that the launch of CBDC be undertaken against the background of an extensive knowledge of consumer preferences in connection with available design features and operational models. These should reflect consumer preferences with respect to trade-offs between anonymity and privacy, and how this fits into other non-technical aspects such as cultural tendencies in Kenya. It is helpful to conduct a global scan to understand what the early adopters of CBDC have learned.

(b) The importance of robust legal foundations. The uptake of CBDC will require that lawmakers redefine definitions of currency, electronic money or legal tender status so that currency is backed by laws that adequately reflect the operational models of the digital currency. Consumers will be comfortable with CBDC if there is a clear and practical regulatory framework that supports the adoption of CBDC.

(c) Collaboration with private intermediaries. In Kenya, CBDC would more likely be effective in an intermediated model because private intermediaries, more likely commercial banks, have more contact with banked consumers. However, the CBK must take cognizance of the fact that the cost of accounts establishment and maintenance preclude the exclusive use of this approach. This suggests that the CBK should consider a "competing model" where citizens have the choice of either intermediation or citizens should have a choice on when to move "electronic cash assets" to a conventional bank.

(d) The importance of cross-border payments. A key policy goal for CBDC would be to increase the efficiency of cross-border payments through decreased disruption and interoperability. Therefore, increased interaction across jurisdictions should inform the formal adoption of CBDC.

6. What factors would determine the level of adoption of CBDC as a means of payment in Kenya?

1. **Consumer literacy.** The design features and operational models adopted for CBDC will need to conform to the capacity of consumers to utilize the currency in day-to- day transactions.
2. **Technological development.** CBDC will only work if the government can acquire the needed technological support to launch and disseminate the currency. This will reduce systemic and operational problems.
3. **Regulatory and institutional framework.** CBDC will only remain an attractive currency if there is a robust regulatory framework that defines the operational model for the currency and the institutions that will be involved in making it effective.
4. **Interoperability.** It will be important that CBDC be effective in supporting cross-border transactions, and therefore interoperability with other CBDC models will be a key concern.
5. **Connection with private intermediaries.** As earlier stated, private intermediaries have closer contact with banked consumers. A CBDC model that works in consort with private intermediaries would therefore be more effective.

7. What advantages and disadvantages do you believe CBDC would introduce over the existing digital payments landscape in Kenya?

It bears highlighting at the outset that advantages and disadvantaged are dependent on how the CBDC is designed and disseminated. As such, there isn't one answer to this question. In any event, generally, a CBDC would come with the following advantages:

(a) **Efficiency of transactions.** CBDC can increase efficiency of transactions, especially in a direct operational model, due to the reduced need for financial intermediaries across payments. I addition, a CBDC would allow for a high divisibility of the retail payments to support micropayments or transactions for fractions of the Kenya shilling.

(b) **Broader taxation.** Considering digital transactions are easily traceable, more transactions will likely be brought within the tax net which would likely broaden the tax base and reduce tax evasion.

(c) **Reduced risk of money laundering and financing of terrorism.** This is tied to the fact that CBDC is likely to be a highly centralized and digitized currency which would make it easier to track transactions intended to launder money and finance terrorism.

(d) **Financial inclusion.** CBDC is likely to act as a gateway for the unbanked or under banked. Even with the availability of digital payment systems, CBDC provides features that are likely to reinforce access to financial services considering users would have more contact with financial institutions.

(e) **Support for private intermediaries.** CBDC would likely provide a backstop to private intermediaries in the event they would face operational or systemic inefficiencies.

On the other hand, CBDC would have the following disadvantages:

(a) **Disintermediation.** The adoption of CBDC would likely shift a considerable number of consumers to adopt the uptake of CBDC which would likely reduce the amount of funds deposited in private commercial banks. It is not clear to the Institute of Economic Affairs, but there is a claim that the reduction in disintermediation would affect the viability of commercial banks in Kenya.

(b) **Loss of privacy.** Physical cash brings with it the advantage of anonymity during the conclusion of transactions. Depending on the models and the architecture of the CBDC, there is a possibility that transactions history of users may be traced. Because of this, the loss of privacy is likely to be a huge trade-off during the uptake of the digital currency.

(c) **Technological vulnerabilities or entrenched design mistakes.** The CBDC will require considerable technological support to be effective. Without this, the currency would likely face technological inefficiencies that reduces its effectiveness within the financial sector and its demand for use by individuals for payments.

(d) **Risks connected to regulatory capacity.** Financial technology has the tendency to develop at a faster pace than regulatory frameworks. CBDC comes with the risk that Kenyan laws will continue to play 'catch up' and will not adequately reflect the desired design features and operational models of the system. It will therefore be important to define key legal issues in connection with the system and a mechanism for dispute resolution, before it is launched.

8. What additional potential opportunities, considerations, or risks of a CBDC may exist that have not been discussed in this paper?

The discussion paper on CBDC does not provide answers on whether it would be a complement or a substitute to physical cash. Physical cash has some advantages such as offering privacy that would be limited with CBDC. Income plays an important role in financial inclusion and if there is a reduction in the usage of cash such that CBDC substitutes physical cash, those without access to electronic forms of payment would be at a risk of transacting even at the retail level.

In addition to this, Central Bank of Kenya CBDC discussion paper did not comprehensively consider a number of risks such as the privacy question on how secure would the infrastructure around Central Bank Digital Currency be. The institute of Economic Affairs also notes that there is an overwhelming and disproportionate emphasis on the risks of money laundering and criminal uses of the CBDC. While crime and money laundering are serious felonies that should concern law enforcement authorities in Kenya, it is disingenuous to compel the monetary policy authorities to design the CBDC with this as the primary goal. Designing of the CBDC should be considered for its monetary and fitness for the payments systems, with the low but real risks of money laundering left to the criminal law enforcement arms of government to respond develop new forensic techniques to deter and prosecute crimes.

We emphasize this because the vast majority of cash transactions in Kenya are undertaken by citizens who are law abiding and so a design option that treats every transaction as suspect would be a bad tradeoff. Terming CBDC as the solution to money laundering, fails to question whether do they regard this as a political problem or a national payment systems question because trying to solve the problem of money laundering with CBDC is incorrect reasoning.

Finally, among the advantages of CBDC is avoiding the risks of new forms of private money creation. Here too, the rationale for the creation of the CBDC in Kenya should not be as a substitute to private forms of digital currency because their use is confined to niches and are unlikely to scale or provide broader transactional value to Kenyans. The development, design and deployment success of CBDC will depend on its own value as a medium of exchange, store of value and unit of account for Kenyans.

9. Are there additional ways to manage potential risks associated with CBDC that were not discussed in this paper?

The CBDC discussion paper did not sufficiently consider a number of risks such as the privacy of users. It will be important to factor in how privacy and data are protected in the CBDC system. Any CBDC system would have to comply with the data and privacy regulations, meaning that users have knowledge of and control over how their data is used and shared and no third-party intrusion without appropriate regulations.

CBDC might reduce financial inclusion due to technology barrier, according to an interview with the Nation Media, the CBK Governor stated that more than 50% of phones owned by Kenyans are basic feature phones. Given that CBDC has a minimum viable technology requirement, this means it will financially exclude those without smartphones.

10. Which model of CBDC do you believe would be the most suitable in Kenya and why?

Intermediated CBDC model that involves the Central Bank having a wholesale ledger of only payments between Payment Service Providers (PSP), not those between the individual users. Intermediaries or Payment Service Providers onboard clients and execute retail payments because it reduces central bank involvement and operational risks

11. Are there any additional design principles that should be considered that were not discussed in this paper?

The most significant issue that has not been sufficiently emphasized is in relation to the choice of an open-source software on which to build the infrastructure for the digital currency. The Institute of Economic Affairs (IEA-Kenya) argues that there will be a surfeit of proprietary software models and platforms upon which to build a BBDC. These will be made available by private firms using their proprietary standards, and provided as models to the Central Bank of Kenya to consider. A leading principle of the architecture must choose strong security standards that will ensure safety and privacy but this must be built on an open standard to allow for extensions, separate interfaces and to avoid the capture by a proprietary software platform.

Due to the various iterations that will emerge once a public sector digital currency is established, then the "ownership" of the foundation must be designed to limit exclusion.

12. How could a CBDC be designed to achieve maximum interoperability with the existing payment platforms in Kenya?

Interoperability is indispensable to ensure users that digital currency is the perfect substitute to papers currency and coinage. Thus, the insistence on an open-source software model upon which to build the digital currency facility cannot be over-emphasized.

Source: *https://www.centralbank.go.ke/uploads/discussion_papers/CentralBankDigitalCurrency.pdf*