



An Article

CENTRAL BANK DIGITAL CURRENCY: *GROWTH AND RELEVANCE*



1.0 INTRODUCTION

One of the most successful innovations of Blockchain technology is the introduction of cryptocurrency, which emanated as a result of the financial crisis of 2008 which caused severe shrinkage of liquidity in global financial markets and threatened to destabilize and possibly destroy the international financial system, thereby exposing the weakness of a centralized financial system.

Cryptocurrency is a form of digital currency or asset that is based on a network secured by cryptography,¹ and distributed across a large number of computers. This decentralized structure allows assets or digital currencies to operate outside the control of a central authority. Cryptocurrencies are digitally mined, unlike traditional currencies that are tangible, seen and touched.

A key and endearing feature of cryptocurrency is the fact that it is mostly decentralized. The activities and viability of the coin are not governed by any central authority, such as any financial institution or any agency of the government. They are largely controlled by the users of the currency (coin) instead, which illustrates the powerful capabilities of today's technologies, and also underlies the dissent it gets from various quarters.

Cryptocurrencies are not without their challenges however, for instance, they have exhibited periods of extreme volatility, which limits an asset's ability to fulfill two of the classic functions of money to wit; to act as a stable store of value that people can hold and use predictably in the future, and to serve as a meaningful unit of account that can be used to assign a comparable value of goods and services.

Furthermore, it does not have legal backing in most countries, and this lack of legal backing make consumers vulnerable, as they may not have a legal recourse in the events of mistakes, theft, and security breaches. And although the cryptographic technology prevents certain breaches, such as the fraudulent double spending of the same units of the cryptocurrency, the large number of breaches at some cryptocurrency exchanges and wallet providers suggest that significant vulnerabilities may remain, concerning security protections around customers' accounts². These potential lapses inform us that relying solely on cryptography within the transfer technology is not enough. A more holistic approach to the security of cryptocurrencies is crucial, if it is to be widely adopted.

Some cryptocurrencies also appear vulnerable to money-laundering (AML: Anti-Money Laundering) schemes, as many cryptocurrencies store little to no information about the identity of the owners in their ledger. This ensures

anonymity of cross-border transactions. For example, electronic instruments of large amounts can be easily transferred and stored, and peer-to-peer transactions outside of a particular country could be very hard to prevent and detect. Such instruments appear to have proven susceptible for use to facilitate payments of illicit funds.

Overall, the relatively small adoption of cryptocurrencies in relation to our broader financial system and its limited connection to our banking sector suggests that they do not immediately pose a threat to financial stability. If cryptocurrencies were to gain wide-scale use, or their impact greatly magnified through leverage, the effects would be broader. In particular, adverse developments and shifts in sentiment could cause a global rush to exit this market. As we have seen in other speculative activities in the past, rush-for-the-exits behavior can aggravate price fluctuations, create trading difficulties, and even induce market breakdowns.³

Given some of the inherent issues and challenges that cryptocurrencies pose for investor and consumer protection and the aiding of money laundering among other concerns, many have advocated that central banks should create their digital forms of currency as stable and reliable alternatives to cryptocurrencies. After all, a central bank digital currency could overcome the volatility risks associated with an unbacked asset with no intrinsic value by substituting a digital instrument that is the direct liability of the central bank. Moreover, advocates suggest a central bank would be able to develop a transfer mechanism that has robust governance.

2.0 THE SECURITY AND EXCHANGE COMMISSION (SEC) POSITION

The Security and Exchange Commission of Nigeria ("the Commission") established a Fintech Roadmap Committee ("committee") in November 2018 to explore the impact of Fintech on investments and securities in Nigeria and to properly classify and regulate cryptocurrencies and virtual assets. The committee recommended cryptocurrencies to be classed as securities or commodities, amidst other recommendations. Consequent upon the Committee's recommendations, the Commission started putting in place a framework for virtual currency in Nigeria and the recently released Statement is the first step towards cryptocurrency regulations.

The year 2020 witnessed the invasion of Covid -19, which caused myriads of economic harm to individuals, families, companies, and nations alike. Most Nigerians opted to trade cryptocurrencies because of their volatility, in a bid to make profits from same. According to Paxful, an average of



1.1million (One Million, One Hundred Thousand) cryptocurrency related trades were conducted on their platform per month in 2020, with an average of Sixty-Five Million Dollars exchanging hands in a month. Nigeria was ranked 3rd after the US and Russia, generating the sum of \$400 Million .

On 14th September 2020, the Commission released a Statement on Digital Assets Treatment (“the Statement”) classifying digital assets, pursuant to the powers conferred on it by section 13 of the Investment and Securities Act 2007 (“ISA”).

The Statement characterized virtual assets into four categories:

Crypto Assets

Crypto Assets will be treated as commodities If they are traded on a Recognized Investment Exchange and issued as an investment pursuant to Part E of the SEC Rules and Regulations 2013 (the “Regulations”) and any other relevant rules Issued In the future.

Utility Tokens or Non-Security Tokens

Utility Tokens have functionalities that can be used to access a product or service built on a blockchain and can be exchanged with the use of the virtual currency native to the blockchain. Utility Tokens will be treated as commodities as well, but spot trading (Over the Counter) of Utility Tokens will not fall under the scope of SEC unless It is conducted on a Recognized Investment Exchange compliant with part E of the Regulations.

Security Tokens

Security Tokens” (e.g., virtual tokens that have the features and characteristics of a security) represent assets such as participations in tangible underlyings, companies, or earnings streams, or an entitlement to dividends or interest payments. In terms of their economic function, the tokens are analogous to equities, bonds, etc. The Commission will treat these types of crypto assets as securities pursuant to Section 315 of the ISA.

Derivatives and Collective Investment Funds of Crypto Assets, Security Tokens and Utility Tokens

A Derivative is a contract between parties whose value is backed by an agreed underlying financial asset. Section 153 of the ISA defines Collective Investment Schemes as a scheme in whatever form, including an open-ended investment company, in pursuance of which members of the public are invited or permitted to invest money or other assets in a portfolio.

Derivatives and Collective Investment Funds involving

crypto assets would be regulated as Specified Investments under the ISA and the Regulations.

Capital Market Operators dealing with the aforementioned, need to be approved by the Commission.

3.0 THE CENTRAL BANK OF NIGERIA ON DIGITAL CURRENCY

The Central Bank of Nigeria issued a circular in February of 2021, ordering all banks and other financial institutions to cease their dealings with any cryptocurrency exchanges⁵. The Order directed banks and other financial institutions to immediately close the bank accounts of persons involved in digital asset transactions. Defaulting banks are to face serious regulatory sanctions. The ban also prohibits banks from processing remittances for cryptocurrency exchanges. This prompted the Commission to halt its plans to regulate cryptocurrencies as securities under its scope.

Most nations are starting to see cryptocurrency either as a welcome development or a threat to their economy. Many have echoed that crypto currencies are not valid legal tenders, and warned their citizen not to engage in cryptocurrency transactions for the same reasons earlier mentioned.

Bitcoin⁶ for example, is over 10 years old, yet, many countries do not have explicit systems that restrict, regulate, or ban the cryptocurrency. The decentralized and anonymous nature of bitcoin has challenged many governments on how to allow legal use while preventing criminal transactions. Many countries are still analyzing ways to regulate cryptocurrency. Overall, bitcoin regulation remains obscure in many countries, and that also goes for all other cryptocurrencies.

It is safe to say that the issue most governments have with cryptocurrency is its existence outside of a central authority, as it is powered by Blockchain technology. Fiat currency or traditional currency are controlled by the central banks. They have the sole responsibility to print, and issue the fiat currency⁷. Since government controls the fiat currency, they intentionally increase or restrict the amount of money circulating in an economy to stimulate investment and spending, generate jobs, or avoid out-of-control inflation and recession.

CENTRAL BANK DIGITAL CURRENCIES (CBDCS)

Central Bank Digital Currencies (“CBDCs”) are still novel as no country has fully implemented the use of CBDC. The Bank of England (BOE) was the first to propose CBDCs in England.

Central banks of other nations like China's People's Bank of China (PBoC), Bank of Canada (BoC), central banks of Uruguay, Singapore⁸, and the Central Bank of Nigeria, are similarly exploring the possibilities of introducing a central bank digital currency.

At the 279th Monetary Policy Rate meeting of the Central Bank of Nigeria, Governor, Godwin Emefiele assured Nigerians that digital currencies will have a place in the country.

CBDCs are central banks' attempts to keep control of the monetary and payments system. They would be reserve-backed currencies.⁹ CBDC is different from virtual currency and cryptocurrency, which are not issued by a state and lack the legal tender status declared by the government. CBDC implementations may likely not need or use any sort of distributed ledger such as a blockchain¹⁰. Although, the central bank's digital currencies may at first glance appear to address a number of challenges associated with the current crop of cryptocurrencies, this appeal may not withstand closer scrutiny.

Firstly, there are serious technical and operational challenges that would need to be overcome, such as the risk of creating a global target for cyberattacks or a ready means of money laundering. For starters, with regard to money laundering risks, unless there is the technological capability for effective identity authentication, a central bank digital currency would provide no improvement over physical notes and could be worse than current noncash funds transfer systems, especially for a digital currency that could circulate worldwide. In addition, putting a central bank currency in digital form could make it a very attractive target for cyberattacks by giving threat actors a prominent platform on which to focus their efforts. Any implementation would need to adequately deal with a variety of cyber threats.

Secondly, the issuance of central bank digital currency could have implications for retail banking beyond payments. If a central bank digital currency were to become widely used, it could become a substitute for retail banking deposits. This could restrict banks' ability to make loans for productive economic activities and have broader macroeconomic consequences. Moreover, the parallel coexistence of central bank digital currency with retail banking deposits could raise the risk of runs on the banking system in times of stress and so have adverse implications for financial stability.

POTENTIAL BENEFITS RELATED TO CBDC IMPLEMENTATION

Competing with digital/crypto currencies:

One of the reasons for the potential issuance of the CBDC is

to compete favorably with the privately issued digital/crypto currencies which may be denominated in foreign currencies. These central banks believe a domestically issued digital currency backed by the government, denominated in the domestic unit of account, would help reduce or prevent the adoption of privately issued currencies, which are difficult to regulate.

Monetary policy:

Most economists believe that CBDC will be highly instrumental to boost the transmission of monetary policy. One of their arguments is that it has the potential to increase the economy's response to changes in the policy rate. CBDC could be used to charge negative interest rate in times of prolonged crisis. Negative interest rate means that banks and other financial institutions have to pay to keep their excess reserves stored at the central bank, rather than receiving positive interest income.

Financial Inclusion:

In most emerging economies, the central banks have released several circulars and welcomed private financial technology firms to ensure that the individuals and businesses can access appropriate, affordable, and timely financial products and services. The issuance of CBDC will be essential in a digital world where banking sector penetration is low.

Stability of The Payment System:

Some central banks are concerned with the increasing concentration of the payment system in the hands of few very large companies. In this context, some central banks view CBDC as a means to enhance the resilience of their payment system.

Support Distributed Ledger Technology (DLT):

Some central banks see the virtue of DLT-based CBDC to pay for DLT-based assets. If these assets proliferate, DLT-based currency would facilitate automatic payments when assets are delivered (so-called "payment-versus-delivery," or "payment-versus-payment," which could be automated using smart contracts). Some central banks are considering the option of providing CBDC only to institutional market participants in order to develop DLT-based asset markets.

CHALLENGES AFFECTING IMPLEMENTATION OF CBDC

Despite these potential benefits, various challenges could emerge. Some of these can be attenuated by the appropriate design of CBDC.

Threat to the reputation of the central bank:

Issuing a full-fledged CBDC can be costly and may put the central bank's reputation at risk because it requires the active participation of the central bank along several steps of the payments value chain, potentially including

interfacing with customers, building front-end wallets, picking and maintaining technology, monitoring transactions, and being responsible for anti-money laundering and countering the financing of terrorism. Failure to satisfy any of these functions, due to technological glitches, cyber- attacks, or simply human error, could undermine the central bank's reputation.

Disintermediation of the commercial banks:

This is the reality in some economies where the commercial banks have been instructed by the governing bank to desist from and block accounts that transacts in cryptocurrency.

Disintermediation is the process of bypassing middlemen in a transaction. Deposits could be withdrawn from commercial banks, should people decide to hold CBDC in significant volume. Banks would have to raise more expensive and runnable wholesale funding, or raise interest rates on deposits to retain customers. As a result, banks would either experience a compression of margins, or would have to charge higher interest rates on loans. The extent to which CBDC will compete with commercial bank deposits in normal times will depend in part on interest rates paid on CBDC, if at all. A non-interest bearing CBDC would come closest to simply replacing cash.

International Implications:

CBDC of emerging economies available across borders could increase the usage of foreign currency in lieu of, or in addition to, domestic currency, primarily due to the greater stability of that foreign currency. Currency substitution is also known as dollarization when the U.S. dollar (USD) is the currency that is being used as a substitute. Currency substitution ("dollarization") is most likely to occur in countries with high inflation and volatile exchange rates.

Legality of CBDC

The legal status of central governing traditional banking system under public and private law in most countries is well developed and understood. The concept of digital currency or central bank digital currency, in contrast, have a very short history and unclear legal status.

To legally qualify as currency, a means of payment must be considered as such by the country's laws and be denominated in its official monetary unit. A currency typically enjoys legal tender status, meaning debtors can pay their obligations by transferring it to creditors¹¹. Therefore, legal tender status is usually only given to means of payment that can be easily received and used by the majority of the population.

Digital currencies can take different forms. That is, they could be "account-based" or "token-based." The first means digitalizing the balances currently held on accounts in a central banks' books; while the second refers to designing a

new digital token not connected to the existing accounts that commercial banks hold with a central bank. The overlapping of these and other design features can create very complex legal challenges and could well influence the decisions made by each monetary authority.

The creation of central bank digital currencies will also raise legal issues in many other areas, including tax, property, contracts, and insolvency laws; payments systems; privacy and data protection; most fundamentally, preventing money laundering and terrorism financing. If they are to be "the next milestone in the evolution of money," central bank digital currencies need robust legal foundations that ensure smooth integration to the financial system, credibility and broad acceptance by countries' citizens and economic agents.¹²

CONCLUSION

Emerging economies may consider going through the route of Private Public Partnership in implementing CBDC. This would potentially reduce central bank's involvement and operational risks. The International Monetary Fund has coined this model "synthetic CBDC"¹³.

The synthetic CBDC model recommends that private sector firms should issue digital coins to the public (which can either be accounts or tokens leveraging DLT). They will be responsible for innovating and interfacing with customers. The central bank, on the other hand, will be responsible for infusing and supervising the coin issuers.

This arrangement preserves the comparative advantage of each participant, whether it is a private-sector firm or a central bank and induces competition among private-sector firms to offer attractive coins and interfaces. At the same time, it limits costs to the central bank, as well as some of the risks.¹⁴

It is important to have a solid legal framework for issuing and regulating the activities of CBDC to avoid economic and reputational risk to the central bank. This also ensure that the innovation will be in line with the intent of the central bank. Otherwise, the door is open to potential legal and economic risks.

END NOTES

1. Cryptography is a method of protecting information and communications through the use of codes, so that only those for whom the information is intended can read and process it.
2. For instance, Mt. Gox, A Tokyo-based cryptocurrency exchange was hacked in 2014. Also, Coincheck, a cryptocurrency exchange was hacked in 2018.
3. For example, Elon Musk's tweet was reported to have influenced many investors to sell off their Bitcoin out of speculative fear of massive drop in the price of Bitcoin which caused the downturn of the crypto market in early May, 2021
5. These exchanges are platforms where cryptocurrencies are traded. Think of an electronic stock exchange, but for digital currencies.
6. Arguably the most popular cryptocurrency today, and the first to be produced.
7. See Section 2 of the Central Bank of Nigeria Act 2007
8. Shobhit Seth 'Central Bank Digital Currency', < <https://www.investopedia.com/terms/c/central-bank-digital-currency-cbdc.asp> > date accessed: 16th June, 2021
9. Eva Szalay and Siddharth Venkataramakrishnan, 'What are cryptocurrencies and stablecoins and how do they work?', <https://www.ft.com/content/424b29c4-07bf-4612-b7d6-76aecf8e1528>, date accessed: 16th June 2021
10. Yang, Yuan; Lockett, Hudson. "What is China's digital currency plan?"; www.ft.com <date accessed: 24th June 2021
11. For example, Bitcoin enjoyed this status when Laszlo Hanyecz purchased papa John Pizza pie with 10,000 Bitcoins in 2010.
12. by Catalina Margulis and Arthur Rossi, IMFBlog.' Legally Speaking, is Digital Money Really Money?' < <https://www.proshareng.com/news/World%20Bank%20IM-F%20and%20Dev%20Agencies/Legally-Speaking-is-Digital-Money-Really-Money/55196> > Date accessed:
13. Tobias Adrian and Tommaso Mancini Griffoli, 'Rise of Digital Money' 'Washington, D.C.: International Monetary Fund, 2019. | FinTech notes | July 2019, Pg. 14
14. Tobias Adrian and Tommaso Mancini-Griffoli of IMFBlog 'Central Bank Digital Currencies: 4 Questions and Answers' < <https://www.proshareng.com/news/WORLD%20BANK%20IM-F%20AND%20DEV%20AGENCIES/Central-Bank-Digital-Currencies-4-Questions-and-Answers/48407> > Date accessed:

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