ADB

ASIA-PACIFIC
FINANCIAL INCLUSION FORUM

The Role of Central Bank Digital Currencies in Financial Inclusion

Proposed Actions for Policymakers and Regulators

In partnership with

ADBInstitute

APEC Asia-Pacific Economic Cooperation

ABAC APEC Business Advisory Council

INTRODUCTION

The Asia-Pacific Financial Inclusion Forum (APFIF) is a policy initiative established in 2010 under the APEC Finance Ministers' Process, housed within the APEC Business Advisory Council (ABAC). The primary purpose of the Forum is to identify concrete actions policymakers and regulators can take to expand the reach of financial services to the underserved. The annual APFIF Policy Dialogue provides a platform for policymakers, regulators, development experts and industry leaders to take an active role in validating and refining the proposed actions developed through the APFIF initiative and achieve consensus for effective pathways for progress. These proposed actions are distributed through official APEC channels to support the work of the APEC Finance Ministers' Process.

A distinctive feature of the Forum is its broad view of financial inclusion as an enabler of inclusive growth and development in all its manifestations – financial, economic and social - and its strong focus on those at the base of the economy and the potential for financial inclusion to have a positive impact on the poor. This approach aligns with the priorities of APEC including:

- Priority areas established by the APEC Host (Thailand) under the theme "*Open. Connect. Balance.*"
- The APEC Putrajaya Vision 2040
- The Cebu Action Plan, 2015 (i.e. promoting domestic strategies for financial inclusion and literacy) as well as its revised implementation strategy endorsed by APEC's Finance Minister's in 2021

To support these priorities, and recognizing the important role technology and innovation has in driving greater financial inclusion, in 2022 APFIF adopted the theme "*The Role of Central Bank Digital Currencies in Financial Inclusion*". Under this theme, the APFIF initiative has examined this emerging technology and developed a series of proposed actions to support APEC's policymakers and regulators currently exploring or interested in designing a CBDC to advance financial inclusion. Specific issues explored through the APFIF initiative in 2022 include:

- Understanding a central bank digital currency and its applications
- The opportunities and challenges associated with central bank digital currencies as a driver for financial inclusion
- Connecting central bank digital currencies to the existing financial system to enable financial inclusion

The 2022 Asia Pacific Financial Inclusion Forum is led by the Asian Development Bank (ADB) and co-organized with the Asian Development Bank Institute (ADBI) and the APEC Business Advisory Council (ABAC).; and supported by the Griffith Asia Institute (GAI).

PROPOSED ACTIONS FOR POLICYMAKERS AND REGULATORS

As interest in CBDCs grows globally, the findings from ongoing research and pilot programs will contribute to the collective understanding of the potential challenges and opportunities they represent. These findings will also provide greater clarity on how impactful a CBDC may be as a mechanism to enhance the reach and value of formal financial products and services to the unbanked. Based primarily on the experiences of the Asia-Pacific region, the following proposed actions intend to provide guidance to policymakers and regulators on ways they might prepare for and develop a CBDC that can be successful in achieving greater financial inclusion.

Proposed Action 1: Consider which design features of a CBDC will be most effective for financial inclusion

There is no one-size-fits-all model when it comes to CBDC design. Economies need to carefully consider what specific design features will result in the best financial inclusion gains in terms of both expanding access to formal financial products and services as well as enhancing the financial health of individuals or businesses through effective usage. Achieving this requires determining the key constraints for financial inclusion within the local economy and mapping these constraints to specific CBDC design features that can play a role in overcoming them. As part of this process, policymakers and regulators should consider the following points:

- *Determine how CBDC design features would be recognized and impacted by current policies and regulations*. How an economy chooses to design its CBDC may result in various unforeseen policy or regulatory challenges which could have a significant impact on its viability to address financial inclusion.

Certain design features, such as whether the CBDC is wholesale or retail, account-based or token-based, may be treated differently according to established legal frameworks. In the context of cross-border CBDC transactions, this issue also highlights the importance of assessing and standardizing regulatory and legal frameworks between economies.

- *Weigh the costs and benefits of a CBDC against other potential solutions for addressing financial inclusion.* While the prospect of implementing a CBDC to accelerate financial inclusion gains is appealing, it's important that governments and other stakeholders consider if it is indeed the most appropriate solution, or if this solution can complement already existing initiatives by Central Banks to advance financial inclusion. With technology evolving at such a rapid pace, so too are opportunities to develop new innovative solutions to address financial inclusion constraints. Implementing a CBDC is a significant challenge and requires a high level of expertise, financial resources, and reliable infrastructure to operate effectively. Before committing to such a major investment, governments should consider the specific financial inclusion barriers most prominent in their economy and assess whether alternative technology solutions may actually be more effective or cost efficient.

- *Pursue collaborations with other governments in the region to understand and address cross-border implications*. Joint assessments through cross-border collaborations can be a useful strategy to understand how a CBDC may be recognized in different jurisdictions. This may be especially important for transactions involving CBDCs to operate effectively between economies, including implications for international remittances. For example, high remittance receiving economies may need to consider regulatory reforms to address the potential for currency substitution when a CBDC is transferred from another economy and used in local markets.

Proposed Action 2: Prioritize addressing the required pre-conditions for successful digital financial inclusion

As a digital product, a CBDC will encounter the same challenges currently experienced by service providers attempting to introduce digital financial services to the financially excluded. This includes persistent constraints such as limited trust in technology, reliance on the cash economy, or inadequate financial and digital literacy. These issues are exacerbated in developing economies where significant portions of the population also lack access to affordable or reliable infrastructure necessary for participating in the digital economy such as internet connectivity or even stable electricity networks. For a CBDC to be a viable solution for these disadvantaged groups, efforts must be made to create an environment where all consumers are both capable and comfortable using digital products and services. Examples of critical areas governments may need to consider for a CBDC to be a successful driver of financial inclusion include:

- *Leverage the existing system of regulated financial intermediaries to distribute a CBDC and provide access channels*. The inclusion of non-bank services providers is especially important for meeting financial inclusion objectives, as it ensures access channels for those who are less connected with the formal financial system or the digital economy (i.e. those in remote areas). The use of existing networks can also support offline functionality of a CBDC, which is critical for remote communities which often have limited internet coverage or reliable access to electricity.

- *Address onerous identification and KYC requirements*. Identification requirements, especially for small transactions, are a critical barrier for financial inclusion. Integrating a CBDC with a national digital identification system, simplifying due diligence requirements through reforms, and promoting remote onboarding or eKYC methods, such as tiered eKYC based on transaction amounts, can strengthen a CBDC's impact on financial inclusion.

- *Address financial and digital literacy needs*. Governments can play a major role in building awareness, level of skills, and trust in digital financial services through campaigns and public-private partnerships targeting disadvantaged segments of the population. Building trust in a CBDC will be of particular importance as many segments of the population may be resistant to moving beyond cash as the preferred medium of exchange. Society will need to have confidence in not only the CBDC, but also the technology systems used to facilitate it within the economy.

- *Foster interoperability among multiple dimensions*. For a CBDC to become a viable currency option for all members of society it will need to have broad adoption and integration throughout the economy. This requires ensuring interoperability across digital payment and settlement systems, including credit transfers, payment cards and mobile money as well as cross-border CBDC systems for international remittances. Data portability is also an important aspect of interoperability as it enables users to use their credit history to access other financial products and services.

Proposed Action 3: Recognize and manage the risks associated with introducing a CBDC

A CBDC creates the unique prospect of putting central bank money in the hands of individuals and businesses, bringing new and potentially serious risks. One of the most significant risks associated with introducing a CBDC is the prospect of it directly competing against present day fiat currencies, commercial banks and the financial services sector, in general. The resulting impact on financial sector stability could have detrimental effects on financial inclusion. Examples of specific actions governments may need to take to ensure the safety and effectiveness of a CBDC include:

- *Establish safeguards to mitigate the prospect of CBDCs' crowding out or directly competing with the commercial banking sector and financial services industry*. Depending on how CBDC is designed, it can have different impact on banking and the finance sector. Some examples of measures which could help reduce potential negative impacts on financial sector stability include ensuring that a CBDC is not interest bearing or implementing a two-tiered system for CBDC distribution. Conducting CBDC pilot programs and introducing the currency in a staged and progressive adoption plan can help to better identify and understand potential risks and support the development of appropriate mitigation measures.

- *Invest in enhancing cybersecurity technology and capabilities*. Every individual or business using a CBDC will be exposed to potential risks including fraud, privacy breaches, human error, and others. Without adequate consumer protection policies combined with and education programs (i.e. financial and digital literacy) in place to combat these issues the perceived value of CBDC among potential users could be compromised. This issue may present a good opportunity for central banks to collaborate with the private sector to, for example, boost cybersecurity knowledge and capabilities or to undertake pilot programs with the aim of testing and reforming policy and regulatory frameworks as needed.