

Bank of Namibia



Position on Distributed Ledger Technologies and Virtual Currencies in Namibia

September 2017

1. Executive Summary

1.1. **The Bank's understanding of virtual currency is a type of digital currency that is unregulated with no legal tender status or relations to any central bank or public authority of a particular jurisdiction.** Rather, its value is derived from the common acceptance among a group of natural or legal persons as a means of payment that can be transferred, stored, or traded electronically. It should be noted that there is a difference between virtual currency and electronic money, even though they are both presented in digital form. The main difference between the two is that electronic money is a digital form of a country's legal tender currency backed and issued by a central authority, while virtual currencies are not backed by any legal tender currency or central authority. The Bank does not consider virtual currencies to be legal tender or payment instruments in Namibia and users should be aware and cautious of the risks involved. The Bank notes the presence and potential benefits of distributed ledger technologies to the financial system.

2. Purpose

2.1. **This position paper aims to educate the Namibian public and state the Bank of Namibia's understanding and position concerning distributed ledger technologies and digital currencies, with a specific focus on virtual currencies.**

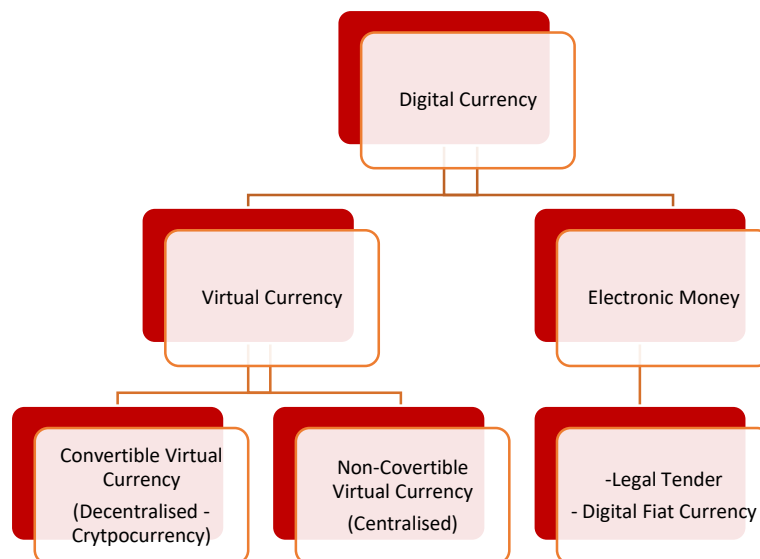
3. Background

3.1. **The creation and issuance of currency in a sovereign state is widely considered to be the role of a central authority i.e. central bank or central government.** To this effect, central banks / reserve banks are normally entrusted to fulfil this mandate by issuing currency and ensuring that the value of the currency is intact through monetary policy interventions. In this regard, the Bank of Namibia Act (Act 15 of 1997) as amended (the BoN Act) provides the Bank with the sole mandate to serve as the state's instrument to control money supply and to create and issue currency. Section 17 (Monetary units and symbols) of the BoN Act states:

“The President may by proclamation in the Gazette determine the monetary units and the symbols to be used for such units which shall, with effect from the date specified in such proclamation, be the currency of Namibia.”

Additionally, Section 20 of the BoN Act states that notes and coins issued by the Bank shall be regarded as legal tender in Namibia and the same section declares the Namibia Dollar as legal tender in Namibia. The same Act further recognizes the South African Rand as a legal tender in Namibia and as such, the two currencies (NAD and ZAR) also known as “fiat currencies” are considered as the only two legal tender currencies in Namibia.

- 3.2. The FATF¹ makes a distinction between virtual currencies and electronic money (e-money) by stating that e-money is a digital representation of legal tender currency, which is also referred to as fiat currency.** In its digital form, e-money still carries its original value equivalent to that of its legal tender currency. Another notable distinction is that the supply of e-money depends on the fiat money in circulation, which is controlled by the central bank, whilst the supply of virtual currencies solely depends on the issuer’s decision or the community that uses or controls the specific virtual currency.



¹ The Financial Action Task Force (FATF) published a report in June 2014 on Virtual Currencies: Key Definitions and Potential AML/CFT Risks

- 3.3. In Namibia, institutions that issue e-money are regulated by the Bank of Namibia and are bound to regulatory and operational conditions while this is not the case for virtual currencies.**
- 3.4. According to the FATF², virtual currency can be divided between two basic types namely convertible and non-convertible virtual currency.** Convertible currency is seen to have an equivalence with real (legal tender) currency and can be exchanged back and forth for real currency. The example of such currency is Bitcoin – which can be used to buy physical goods and services on the internet from merchants that accept them as a means of payment, and it can be exchanged for real “legal tender” currency. Non-convertible currency on the other hand is intended to be specific to a particular domain or virtual world, such as online gaming gold rewards. These cannot be exchanged for fiat currency or used to buy physical goods and services outside of their virtual world in which they exist.
- 3.5. Virtual currency can be classified as centralised and Decentralised virtual currency.** The FATF describes non-convertible virtual currency as centralised, meaning that a central authority has autonomous control of the issuance, operational rules and power to withdraw such a currency from circulation. Decentralised currency, also referred to as cryptocurrency, is convertible and has no central administrative authority and no regulatory oversight.
- 3.6. According to the IMF³, a distributed ledger provides history of transactions associated with the use of a particular unit of decentralised virtual currency.** It provides a secure permanent record of transactions that cannot be manipulated by a single entity and do not require a central point of registration. A distributed ledger can also be described as a database that keeps track of who owns a specific physical or electronic asset. Examples are diamonds, real estate, land, shares, currency etc. An essential feature of the distributed ledger is that it is distributed, meaning that every participant of the distributed ledger can keep a copy of the ledger, which is updated automatically when new transactions occur.

²² The Financial Action Task Force (FATF) published a report in June 2014 on Virtual Currencies: Key Definitions and Potential AML/CFT Risks

³ <https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Virtual-Currencies-and-Beyond-Initial-Considerations-43618>

3.7. The best known example of a distributed ledger is the *Blockchain*, which is a type of distributed ledger that provides a way for information to be recorded and shared by a community. In this community, each member maintains their own copy of the information and all members must validate any updates collectively. The information could represent transactions, contracts, assets, identities, or practically anything else that can be described in digital form. Entries are permanent, transparent and searchable, which makes it possible for community members to view transaction histories in their entirety. Each update is a new “block” added to the end of the “chain”, and hence the term *Blockchain*. A protocol manages how new edits or entries are initiated, validated, recorded, and distributed. It should be noted that distributed ledger technologies such as the blockchain can also be used for other activities and not necessarily just payment related activities.

3.8. Position on the Impact of the Role of Bank of Namibia

3.8.1. The Bank does not consider the creation of virtual currencies to be similar to the function entrusted to the Bank under section 17 of the BoN Act. Given the current state of virtual currencies in the country, it is the view of the Bank that the current impact on the Bank’s role as the sole custodian of money creation and supply in Namibia, is minimal.

3.8.2. The Currency and Exchanges Act 9 of 1933 read in conjunction with the Exchange Control Regulations 1961 (Excon Act), does not make provision for the establishment of virtual currency exchanges or bureaus in Namibia. In this regard, the Excon Act does not make provision for Authorised Dealers (ADs), Authorised Dealers with Limited Authority (ADLAs) and natural persons to establish virtual currency exchanges or engage in activities that provide or facilitate the conversion or exchanging of virtual currencies in Namibia. A virtual currency exchange or bureau can be referred to as an entity that converts or exchanges legal tender currency / fiat currency into virtual currency or *vice versa*. In addition to the Bank not recognising virtual currencies as legal tender in Namibia, it also does not recognise it to be a foreign currency that can be exchanged for local currency. This is because virtual currencies are neither issued nor guaranteed by a central bank nor backed by any commodity.

The Bank however understands that virtual currencies, when exchanged for legal tender / fiat currency can be used to facilitate payment transactions, remittances and many other financial services. However, due to the lack of a legal premise, the Bank is unable to endorse such activities in Namibia at the moment.

3.8.3. According to the FATF⁴, virtual currencies that can be exchanged for real money or other virtual currencies are potentially vulnerable to money laundering and terrorist financing abuse for various reasons. These potential risks include exposure to greater anonymity or anonymous funding and transfers through virtual exchangers that do not properly identify the funding source, if the sender and recipient are not adequately identified. Decentralised systems are prone to greater anonymity risks as a result of how they are designed and function. For instance, Bitcoin addresses, which function as accounts, do not have names or other customer identification attached. Furthermore, Bitcoin protocol does not require or provide identification or verification of participants. Generation of historical records which can be tied back to an individual's true identity is also a challenge. Virtual currency systems can be accessed via the internet and can be used to make cross-border payments and funds transfers also increase potential AML / CFT risks. Virtual currencies commonly rely on complex infrastructures that involve several entities, often spread across several countries, to transfer funds or execute payments. This segmentation of services means that responsibility for AML/CFT compliance and supervision/enforcement may be unclear. Moreover, customer and transaction records may be held by different entities, often in different jurisdictions, making it more difficult for law enforcement and regulators to access them. Components of a virtual currency system may be spread across various jurisdictions which may not necessarily have adequate AML / CFT controls.

⁴ The Financial Action Task Force (FATF) published a report in June 2014 on Virtual Currencies: Key Definitions and Potential AML/CFT Risks

- 3.8.4. Currently in Namibia, the use of virtual currencies to buy goods or services is not prominent enough to affect monetary policy, price stability or the demand for money.** Its interaction with the real economy is somewhat low and mostly limited to the internet and online foreign-merchants that accept such currencies in exchange for goods and services. As such, it is the current position of the Bank that virtual currencies do not pose any significant threat to the financial stability or monetary policy of Namibia, given its limited presence in the Namibian financial system, at the moment.
- 3.8.5. The Bank notes that distributed ledger technologies could introduce efficiencies and less costly methods in the financial market space.** Such technologies, however, normally come with undue risks and thus require deeper understanding. In this regard, further studies will be required to fully understand the possible uses of distributed ledger technologies, the possible impact they might have on other sectors of the economy and how their functionalities can be harnessed to improve efficiencies in the financial sector.
- 3.8.6. The Bank does not consider virtual currencies as payment instruments, even though they can be used in the provision of payment services and the facilitation of payment transactions.** Virtual currencies are neither owned nor issued by a known authority or institution, and as such, lack the legal tender status (even though they have the characteristics of money i.e. measure of value etc.). Like the Namibia Dollar or the South African Rand, virtual currencies cannot be used to pay for goods and services in Namibia. For example, a local shop is not allowed to price or accept virtual currencies in exchange for goods and services. Users of virtual currencies should therefore exercise caution when dealing in this type of currencies or when comparing it to e-money. Transactions performed in e-money normally include various parties i.e. the licensed issuers and the user, whereas in the case of virtual currencies, there is no entity licensed to run the virtual currency system, meaning that the user bears the responsibility and the entire risks for transacting in virtual currency.
- 3.8.7. Virtual currency transactions are not interoperable meaning they do not necessarily interact with payment instruments of system participants in the National Payment System (NPS).** In this regard, users of virtual currencies

somewhat operate outside the NPS and thus have no effect on the smooth operations of the NPS. The Bank notes that this situation might change in the future considering the similarities that exist between virtual currencies and e-money, in that they can both be considered as prepaid instruments and they both operate in the digital space. The Bank will continue to monitor these developments and assess whether there is a need to intervene from a regulatory perspective.

3.9. Risks to Users

3.9.1. Users of virtual currencies should understand and be aware of the risks associated with the use of virtual currencies. The European Central Bank⁵ has highlighted typical risks that are associated with virtual currencies which users should be aware of:

- a) **Credit risk:** Users are exposed to credit risk in relation to any funds held on the virtual accounts, as it cannot be guaranteed that the settlement institution is able to fully meet its financial obligations when these are due or at any time in the future.
- b) **Liquidity risk:** Users are also exposed to liquidity risks if the settlement institution fails to meet any commitments it has made to provide liquidity to the participants as and when expected. In this regard, virtual currency schemes are very illiquid because of the low volumes traded. In the event of security incidents, the conversion of users' funds into real money would probably not occur quickly without a significant material loss in value.
- c) **Operational risk:** Both payer and payee need to have accounts with the settlement institution and are therefore reliant on the soundness of its operational and business continuity.
- d) **Legal risk:** There are many legal uncertainties regarding virtual currency schemes. In virtual currency schemes, the lack of a proper legal framework substantially exacerbates the other risks.

3.9.2. Users of virtual currencies should be aware of risks related to Money Laundering (ML) and the Financing of Terrorism (FT) when engaging in the

⁵ <https://www.ecb.europa.eu/pub/pdf/other/virtualcurrencyschemes201210en.pdf>

trading of virtual currencies. The ML and FT risk is mainly concentrated at platforms where virtual currencies intersect or are exchanged for regulated fiat currency and vice versa.

3.10. Overall Position on Virtual Currencies and Distributed Ledger Technologies

3.10.1. Virtual currencies are not legal tender and are considered unsafe to users that are unaware of the risks it possesses. The Bank does not consider virtual currencies to be the equivalent to the Namibian currency despite there being similarities from the functions of money and measure of value perspective. Additionally, **the trading of virtual currencies in Namibia is not currently regulated and individuals that engage in such trading would be doing so at their own risk and should exercise caution.** Virtual currencies are known to fluctuate when exchanged with recognized legal tender currencies, and as a result, the yields may not be known at all times.

3.10.2. The Currency and Exchanges Act 9 of 1933 read in conjunction with the Exchange Control Regulations 1961, does not make provision for the establishment of virtual currency exchanges or bureaus in Namibia and definition of foreign currency does not extend nor apply to virtual currency exchanges or bureaus.

3.10.3. The Bank recognizes the potential impact distributed ledger technologies might have in Namibia. Distributed ledger technologies have attracted interest from market and industry players such as financial market participants, venture capitalists and regulators, concerning their potential application in trading activities in financial markets. Although the potential risks and implications are not entirely clear and fully understood, these technologies are seen to have the potential of transforming financial sector infrastructure and consequently, the operations. The Bank intends to conduct further research on the plausible uses distributed ledger technologies and establish a position accordingly.

3.10.4. The current position of the Bank may be amended and / or supplemented, should a need arise.