Federal Reserve Releases Paper on U.S. Central Bank Digital Currency

February 3, 2022

On January 20, 2022, the Board of Governors of the Federal Reserve System ("Federal Reserve") released a long-awaited paper on U.S. central bank digital currency ("CBDC"), *Money and Payments: The U.S. Dollar in the Age of Digital Transformation*.[1] Although not a rulemaking in any formal sense, the paper characterizes itself as "the first step in a public discussion between the Federal Reserve and stakeholders about CBDC," and requests comments on a wide range of questions, seeking to foster a broad dialogue about CBDC. Comments on the questions included in the paper, which focus on benefits, risks, related policy considerations as well as design of CBDC, are due by May 20, 2022.

The Federal Reserve makes clear that it is not yet prepared to embrace any particular policy outcome, and the paper is not intended to signal that decisions about CBDC are imminent. Rather, the Federal Reserve commits only to take further steps toward developing a CBDC if research suggests that the benefits of CBDC for households, businesses and the economy overall would exceed the downside risks and that CBDC is superior to alternative approaches to payments. In particular, it is clear that the Federal Reserve does not intend to proceed with issuance of a CBDC without guidance from the executive branch and from Congress, preferably in the form of specific authorizing legislation.

Background

The paper starts with an overview of the existing forms of money used in the United States and the current state of the U.S. payment system, including its relative strengths and challenges. While concluding that the existing U.S. payment system is generally effective and efficient, the paper recognizes persistent shortcomings, including (i) the lack of access by the disadvantaged to digital banking and payment services and (ii) slow and costly cross-border payments that might be ameliorated by the adoption of CBDC,

[1] Board of Governors of the Federal Reserve System, *Money and Payments: The U.S. Dollar in the Age of Digital Transformation* (Jan. 2022) ("CBDC Paper" or "paper"), available at **https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf**. For purposes of the paper, CBDC is defined as a digital liability of the Federal Reserve that is widely available to the general public. *Id.* at 3.

ensuring faster, more efficient and more inclusive payments. Articulating an argument that has been characterized by some as "preserving public money in a digital world,"[2] the paper observes that, although emerging alternatives, such as stablecoins, could potentially mitigate some of these concerns, they also threaten the potential for destabilizing runs, disruptions in the payment system and concentration of economic power.

The Federal Reserve acknowledges that the introduction of a CBDC could significantly expand the Federal Reserve's role in the financial system and the economy, fundamentally affecting financial-sector market structure, the role of commercial banks, the cost and availability of credit, the safety and stability of the financial system and the efficacy of monetary policy. This concern will likely be a key political issue in an environment in which central banks and similar institutions have been viewed as suspect by many proponents of digital assets (a sentiment that has been consistently present in political discourse in the U.S. since the founding of the Republic). At the same time, some have questioned whether the possible threat to the role of traditional commercial banks should be a concern that influences the debate over adoption of a central bank digital currency.[3]

Amplifying the virtues of public money, the paper also notes that, unlike existing forms of commercial bank money and nonbank money,[4] CBDC would not require mechanisms like deposit insurance to maintain public confidence and would not depend on backing by an underlying asset pool to maintain its value. Thus, a CBDC would be the safest digital asset available to the general public, with no associated credit or liquidity risk.

Key Features of a CBDC

Unsurprisingly, the Federal Reserve does not share the libertarian sentiments that characterize many advocates of digital assets, observing that a crucial test for a potential CBDC is whether it would prove superior to other methods that might address issues outlined in the paper and that its analysis to date suggests that a potential CBDC would best serve the needs of the United States by having the following features:[5]

---

2 *See, e.g.,* Brunnermeier, M.K. and Landau, JP., *The Digital Euro: Policy Implications and Perspectives*, Publication for the Committee on Economic and Monetary Affairs, Policy Department for Economic, Scientific and Quality of Life Policies, European Parliament, Luxembourg (Jan. 2022) ("ECON Committee Study"), pp. 19-23, available at **https://www.europarl.europa.eu/RegData/etudes/STUD/2022/703337/IPOL_STU(2022)703337_EN.pdf**. *See also* Agustín Carstens, General Manager, Bank for International Settlements, *Digital Currencies and the Soul of Money* (Jan. 18, 2022), Remarks at the Goethe University's Institute for Law and Finance Conference on "Data, Digitalization, the New Finance and Central Bank Digital Currencies: the Future of Banking and Money," available at **https://www.bis.org/speeches/sp220118.htm** (noting that "[t]he soul of money belongs neither to a big tech nor to an anonymous ledger. The soul of money is trust. … [C]entral banks have been and continue to be the institutions best placed to provide trust in the digital age. This is also the best way to ensure an efficient and inclusive financial system to the benefit of all.").

3 For example, in the ECON Committee Study, the authors observed that:

> it is not obvious why [deposit taking and lending] activities should be bundled together and offered by the same institution. One could easily envision an arrangement in which banks specialise. Some specialise in lending activity, funding themselves on funding markets, while other [sic] focus on payments and deposit/money creation. The latter are often referred to as "narrow banks"; they could also be payment platforms operated by fintech companies.

ECON Committee Study at 29. It is somewhat speculative at this stage to anticipate either the form of any institutional adoption of CBDC or its impact on the banking sector, but it is likely that these questions will be prominent in the public debate of the issue.

4 "Commercial bank money" is described in the paper as the digital form of money that is held in accounts at commercial banks and is most commonly used by the public. "Nonbank money" is described as digital money held as balances at nonbank financial service providers, which typically conduct balance transfers on their own books using a range of technologies, including mobile apps. *See* CBDC Paper at 5.

5 CBDC Paper at 13-14.

- Privacy-protected: CBDC would strike an appropriate balance between safeguarding the privacy rights of consumers[6] and affording the public transparency necessary to deter criminal activity.
- Intermediated: Under the Federal Reserve Act, the Federal Reserve currently lacks the legal authority to offer accounts to most private counterparties other than banks and key market participants. Consequently, in the intermediated model for CBDC that the Federal Reserve evidently views as the likely policy choice, commercial banks and regulated nonbank financial services providers would offer accounts or digital wallets to facilitate the management of CBDC holdings and payments. The CBDC itself would be a liability of the Federal Reserve, with the safety and liquidity associated with central bank money.[7]
- Widely transferable: For a CBDC to serve as a widely accessible means of payment, it would need to be readily transferable between customers of different intermediaries, making the payment system more efficient by allowing money to move freely throughout the economy.
- Identity-verified: While it is contemplated that CBDC would differ materially from cash in that it would not enable anonymous transactions and would be designed to conform to the objectives of anti-money laundering and counter terrorist financing laws, there would be continued reliance on the gatekeeper role of CBDC intermediaries, which would be responsible for verification of the identity of a person accessing CBDC, just as banks and other financial institutions currently verify the identities of their customers.

Uses, Functions and Potential Benefits of a CBDC

The Federal Reserve observes in the paper that CBDC transactions would need to be final and completed in real time, allowing users to make payments to one another using a risk-free asset. Potential benefits of CBDC would include:[8]

- Safely Meet Future Needs and Demands for Payment Services: Unlike options for private digital money, such as stablecoins and other cryptocurrencies, CBDC would be free from credit and liquidity risks and could potentially serve as a new and safe foundation for private sector innovations in payment services.
- Improvements to Cross-Border Payments: CBDC has the potential to streamline cross-border payments by using new technologies, introducing simplified distribution channels and creating additional opportunities for cross-jurisdictional collaboration and interoperability. The Federal

---

6 Privacy is likely to be another key theme in the discussion of the role of CBDC as opposed to tech-driven digital assets. Part of the discussion is likely to focus on the distinction between commercial privacy and governmental privacy. In the EU, at least, there is a suggestion that governmental privacy is only of minor concern. *See* ECON Committee Study at 25 (noting that "[p]rivacy will certainly be a major driver of the attractiveness of a digital euro. … Amongst all the providers of payment services, the central bank is the only one which has no interest in exploiting personal data for profit purposes. It can provide citizens with a 'privacy safe haven' which mirrors and parallels the monetary safe haven that public money brings.").

It remains unclear whether the choice will be so straightforward, as the Federal Reserve contemplates an intermediated system in which banks and regulated non-bank institutions share key gatekeeper functions which, although regulated, are unlikely to constitute "privacy safe havens." In contrast, the Federal Reserve observes that, in the intermediated model that it contemplates in the paper, "intermediaries would address privacy concerns by leveraging existing tools." CBDC Paper at 19.

7 The Federal Reserve discusses little about technology design, a subject that would profoundly affect the nature and implications of any intermediation. For a useful discussion of this subject, see Bank for International Settlements, *Central Bank Digital Currencies: Foundational Principles and Core Features* (Oct. 9, 2020), at pp. 12-15, available at https://www.bis.org/publ/othp33.pdf, where the authors note that "[i]n designing a [central bank digital currency] ledger, there are five key factors: (i) structure; (ii) payment authentication; (iii) functionality; (iv) access; and (v) governance. Each design factor will have a bearing on how a [central bank digital currency] system meets the core features" of a central bank digital currency.

8 CBDC Paper at 14-16.

Reserve warns that the realization of such potential improvements would require significant international coordination to address numerous legal and operational issues.

- Support the Dollar's International Role: CBDC could potentially help preserve the dominant international role of the U.S. dollar, thus addressing concerns about potential decrease in the global use of the dollar due to the introduction of central bank digital currencies by foreign countries and currency unions.

- Financial Inclusion: CBDC could potentially reduce common barriers to financial inclusion and lower transaction costs, which would particularly benefit lower-income households. The Federal Reserve notes that further study would be helpful to assess the potential for CBDC to expand financial inclusion, including cases targeted to underserved and lower income households.

- Extend Public Access to Safe Central Bank Money: The Federal Reserve is committed to ensuring the continued safety and availability of cash and is considering CBDC as a means to expand safe payment options, not to reduce or replace them.

Potential Risks of a CBDC

The Federal Reserve recognizes that the introduction of a CBDC would raise complex policy issues and risks requiring additional research and analysis, including the following:[9]

- Changes to Financial-Sector Market Structure: CBDC could fundamentally change the structure of the U.S. financial system by serving as a substitute for commercial bank money and reducing the aggregate amount of deposits in the banking system, which could increase bank funding expenses and reduce credit availability or raise credit costs for households and businesses. The Federal Reserve notes that, even in the absence of a CBDC, households and businesses might shift deposits away from banks by increasingly using nonbank money, including stablecoins, as a substitute for bank deposits.

- Safety and Stability of the Financial System: The ability to quickly convert other forms of money, including commercial bank deposits, into CBDC could make runs on financial institutions more likely or more severe. The Federal Reserve cautions that traditional measures such as prudential supervision, government deposit insurance and access to central bank liquidity may be insufficient to stave off large outflows of commercial bank deposits into CBDC in the event of financial panic.

- Efficacy of Monetary Policy Implementation: The introduction of CBDC could affect monetary policy implementation and interest rate control by altering the supply of reserves in the banking system. Interactions between CBDC and monetary policy implementation would be more pronounced and more complicated if the CBDC were interest-bearing at levels that are comparable to rates of return on other safe assets, in which case the level and volatility of public demand for CBDC could be substantial. In addition, monetary policy implementation could be further complicated in the case of significant foreign demand for CBDC.

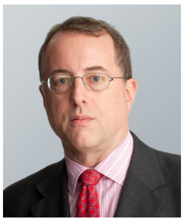
- Privacy and Data Protection and Prevention of Financial Crimes: CBDC would need to strike an appropriate balance between safeguarding consumer privacy and affording the transparency necessary to deter criminal activity. In the intermediated CBDC model that the Federal Reserve would consider, financial institution intermediaries would address privacy concerns by leveraging existing tools. Moreover, CBDC would need to be designed in a

[9] *Id*. at 17-20.

manner that facilitates compliance by financial institution intermediaries with customer due diligence, recordkeeping and reporting requirements.

- Operational Resiliency and Cybersecurity: CBDC would be potentially vulnerable to operational disruptions and cybersecurity risks, and any dedicated infrastructure for CBDC would need to be extremely resilient to such threats. The Federal Reserve notes that designing appropriate defenses for CBDC could be particularly difficult because a CBDC network could potentially have more entry points than existing payment services. On the other hand, CBDC could potentially enhance the operational resilience of the payment system if it were designed with offline capability, allowing some payments to be made without internet access.

Contacts



Bill Satchell
Partner
Tel +1 202 683 3860
bill.satchell@allenovery.com

Lena Kiely
Senior Counsel
Tel +1 212 756 1112
lena.kiely@allenovery.com

Barbara Stettner
Partner
Tel +1 202 683 3850
barbara.stettner@allenovery.com

Hilary Sunghee Seo
Senior Counsel
Tel +1 212 756 1155
hilary sunghee.seo@allenovery.com