Published on *The National Law Review* https://natlawreview.com

Federal Reserve System Takes First Step Toward Creating Its Own Digital Currency

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On Jan. 20, 2022, the Board of Governors of the Federal Reserve System (Fed) issued the Money and Payments: The U.S. Dollar in the Age of Digital Transformation paper (Paper) to discuss how a potential U.S. central bank digital currency (CBDC) could improve the U.S. domestic payments system. The Paper covers: (1) the existing forms of money in the United States; (2) the current state of the U.S. payment system and its relative strengths and challenges; (3) the various digital assets that have emerged in recent years, including stablecoins and other cryptocurrencies; and (4) the pros and cons of a U.S. CBDC. This GT Alert summarizes each of these items.

The Fed is welcoming comments in response to the Paper by issuing 20 questions covering the subject. Answers to such questions must be provided by **May 20, 2022,** on the Fed's CBDC Feedback Form. It is not a requirement that all questions be answered.

The Existing Forms of Money in the United States

As a means of payment, store of value, or unit of account, money takes multiple forms in the United States:

- **Central Bank Money**: A liability of the central bank that serves as the foundation of the financial system and the overall economy. In the United States, central bank money comes in the form of physical currency issued by the Fed and digital balances held by commercial banks at the Fed.
- **Commercial Bank Money**: The digital form of money most commonly used by the public. Commercial bank money is held in accounts at commercial banks.
- **Nonbank Money**: Digital money held as balances at nonbank financial service providers

(e.g., financial technology firms). These firms typically conduct balance transfers on their own books using a range of technologies, including mobile apps.

In the Paper, the Fed explains the downsides of Commercial Bank Money, which has little credit or liquidity risk due to (i) federal deposit insurance, (ii) the supervision and regulation of commercial banks, and (iii) commercial banks' access to central bank liquidity, and of nonbank money, which lacks the full range of protections of commercial bank money and therefore generally carries more credit and liquidity risk. Conversely, the Fed explains, central bank money carries neither credit nor liquidity risk of the other two forms of money and is therefore considered by the Fed the safest form of money.

Recent Improvements to the U.S. Payment System

The U.S. payment system connects a broad range of financial institutions, households, and businesses. Most payments in the United States rely on interbank payment services—such as the ACH network or wire-transfer systems—to move money from a sender's account at one bank to a recipient's account at another bank. Interbank payment systems may initially settle in commercial bank money, or in central bank money, depending on their design. However, because central bank money has no credit or liquidity risk, central bank payment systems tend to underpin interbank payments and serve as the backbone of the broader payment system.

Recent improvements to the U.S. payment system have focused on making payments faster, cheaper, more convenient, and more accessible. A host of consumer-focused services accessible through mobile devices have made digital payments faster and more convenient. However, some of these new payment services, the Fed explains, could pose financial stability, payment system integrity, and other risks. For example, if the growth of nonbank payment services were to cause a large-scale shift of money from commercial banks to nonbanks, it could introduce run risk or other instabilities to the financial system resulting from the lack of equivalent protections that come with commercial bank money.

The Innovations of Digital Assets

Following the recent improvements to the U.S. payment system summarized above, the Fed recognizes that technological innovation has ushered in a wave of digital assets with money-like characteristics (i.e., cryptocurrencies). Cryptocurrencies arose from a combination of cryptographic and distributed ledger technologies, which together provide a foundation for decentralized, peer-to-peer payments. As a more recent incarnation of cryptocurrencies, stablecoins (digital assets backed by other assets such as fiat currency) are emerging as the favored method used today to facilitate trading of other digital assets, and many firms are exploring ways to promote stablecoins as a widespread means of payment.

The Fed, along with other U.S. banking regulators, has expressed concerns and called for regulatory action with respect to cryptocurrencies, particularly stablecoins, in the President's Working Group on Financial Markets Report, covered in this November 2021 GT Alert.

Central Bank Digital Currency (CBDC)

In reacting to the rapidly changing landscape of digital assets in the United States, the Fed is

considering how a CBDC might fit into the U.S. money and payments landscape.

Today, Fed notes (i.e., physical currency) are the only type of central bank money available to the general public, but a U.S. CBDC would enable the general public to make digital payments without requiring mechanisms to maintain public confidence like deposit insurance, and it would not depend on backing by an underlying asset pool to maintain its value. According to the Fed, a CBDC would be the safest digital asset available to the general public, with no associated credit or liquidity risk.

In the Paper, the Fed states that a U.S. CBDC, if one were created, would best serve the needs of the United States by being:

- **Privacy-protected**: Any CBDC would need to strike an appropriate balance between safeguarding the privacy rights of consumers and affording the transparency necessary to deter criminal activity.

- **Intermediated**: Under an intermediated model, the private sector would offer accounts or digital wallets to facilitate the management of CBDC holdings and payments. Potential intermediaries could include commercial banks and regulated nonbank financial service providers and would operate in an open market for CBDC services. Although commercial banks and nonbanks would offer services to individuals to manage their CBDC holdings and payments, the CBDC itself would be a liability of the Fed. An intermediated model would facilitate the use of the private sector's existing privacy and identity-management frameworks; leverage the private sector's ability to innovate; and reduce the prospects for destabilizing disruptions to the well-functioning U.S. financial system.

- **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.

- **Identity-verified**: Financial institutions in the United States are subject to robust rules designed to combat money laundering and the financing of terrorism. A CBDC would need to be designed to comply with these rules. In practice, this would mean that a CBDC intermediary would need to verify the identity of a person accessing CBDC, just as banks and other financial institutions currently verify the identities of their customers.

The Fed intends a potential U.S. CBDC to be used in transactions that would be final and completed in real time, allowing users to make payments to one another using a risk-free asset. Moreover it is intended that individuals, businesses, and governments would potentially use a U.S. CBDC to make basic purchases of goods and services or pay bills, and the U.S. government could use a CBDC to collect taxes or make benefit payments directly to citizens.

Potential Benefits of a U.S. CBDC

As highlighted by the Fed, the potential benefits of a U.S. CBDC are:

- **Meeting future needs and demands for payment services**: According to the Fed, a U.S. CBDC would safely meet future needs and demands for payment services by offering the general public broad access to digital money free from credit risk and liquidity risk.

- **Improvements to cross-border payments**: In the Paper, the Fed explains that a U.S. CBDC

would improve cross-border payments by using new technologies, introducing simplified distribution channels, and creating additional opportunities for cross-jurisdictional collaboration and interoperability. However, realizing these potential improvements would require significant international coordination to address issues such as common standards and infrastructure, legal frameworks, preventing illicit transactions, and the cost and timing of implementation.

- **The dollar's international role**: The Fed expects that a U.S. CBDC would support the U.S. dollar's international role because, in a world where foreign countries and currency unions may have introduced their own CBDCs, which could lead to a decrease in the use of the U.S. dollar, a U.S. CBDC might help preserve the international role of the dollar.

- **Financial inclusion**: Promoting financial inclusion—particularly for economically vulnerable households and communities— by, among other benefits: (i) providing access to digital payments; (ii) enabling rapid and cost-effective payment of taxes; and (iii) enabling rapid and cost-effective delivery of wages, tax refunds, and other federal payments.

Potential Risks and Policy Considerations for a U.S. CBDC

Conversely, the potential risks and policies considerations of a U.S. CBDC are:

- **Financial-sector market structure**: A U.S. CBDC could fundamentally change the structure of the U.S. financial system, altering the roles and responsibilities of the private sector and the central bank. For example, a widely available U.S. CBDC would serve as a close substitute for commercial bank money. This substitution effect could reduce the aggregate amount of deposits in the banking system and potentially reduce credit availability or raise credit costs for households and businesses. Similarly, an interest-bearing CBDC could result in a shift away from other low-risk assets, such as shares in money market mutual funds, Treasury bills, and other short-term instruments. A shift away from these other low-risk assets could reduce credit availability or raise credit costs for businesses and governments.

- **Safety and stability of the financial system**: The safety and stability of the financial system could be affected by a U.S. CBDC because the ability to quickly convert other forms of money—including deposits at commercial banks—into CBDC could make runs on financial firms more likely or more severe. 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.

- **Consumer privacy**: A general-purpose CBDC would generate data about users' financial transactions in the same ways that commercial bank and nonbank money generates such data today. In the intermediated CBDC model that the Fed would consider, intermediaries would address privacy concerns by leveraging their existing tools.

- **Prevention of financial crimes**: Financial institutions must comply with a robust set of rules designed to combat money laundering and the financing of terrorism, including customer due diligence, recordkeeping, and reporting requirements. Any U.S. CBDC would need to be designed in a manner that facilitates compliance with these rules by involving private-sector partners with established programs to help ensure compliance with these rules.

- **Operational resilience and cybersecurity**: Threats to existing payment services—including operational disruptions and cybersecurity risks— would apply to a U.S. CBDC as well. Any dedicated infrastructure for a U.S. CBDC would need to be resilient to such threats, and the operators of the U.S. CBDC infrastructure would need to remain vigilant as bad actors employ ever more sophisticated methods and tactics. Many digital payments today cannot be executed during natural disasters or other large disruptions, and affected areas must rely on in-person cash transactions and central banks are currently researching whether offline CBDC payment options would be feasible.

- **Efficacy of monetary policy implementation**: Under the current "ample reserves" monetary policy regime, the Fed exercises control over the level of the federal funds rate and other short-term interest rates primarily through the setting of the Fed's administered rates. In this framework, the introduction of a U.S. CBDC could affect monetary policy implementation and interest rate control by altering the supply of reserves in the banking system. In the case of a noninterest-bearing U.S. CBDC, the level and volatility of the public's demand for U.S. CBDC might be comparable to other factors that currently affect the quantity of reserves in the banking system, such as changes in physical currency or overnight repurchase agreements. In this case, a decline in U.S. CBDC that resulted in a corresponding increase in reserves likely would only make reserves more ample and have little effect on the federal funds rate.

Conclusion

While the Paper examines the potential benefits and risks of a U.S. CBDC, it is not intended to advance any specific policy outcome, nor is it intended to signal that the Fed will make any imminent decisions about the appropriateness of issuing a U.S. CBDC. However, the Paper undoubtedly is the Fed's first step toward central bank digital currencies via a public discussion with its stakeholders.

As previously indicated, the FED is accepting comments in response to the Paper until May 20, 2022, through the FED's CBDC Feedback Form.

National Law Review, Volume XII, Number 39