The Federal Reserve's Discussion Paper on Central Bank Digital Currencies:

Seven Things To Know

The Board of Governors of the Federal Reserve System (the "Federal Reserve") released an important discussion paper on January 20, 2022 entitled "Money and Payments: The U.S. Dollar in the Age of Digital Transformation" (the "Discussion Paper"). The Discussion Paper examines the advantages and disadvantages of a potential U.S. central bank digital currency, or "CBDC". Although the Discussion Paper carefully avoids any commitment by the Federal Reserve to future development and issuance of a CBDC, it nonetheless identifies a number of key benefits that a CBDC could offer and provides a clear sense of how the Federal Reserve might approach key policy choices associated with developing a CBDC, should it decide to move forward. The Discussion Paper also seeks comment from the public on a number of related questions; comments are due by May 20, 2022.

1

The Federal Reserve characterizes the Discussion Paper as "the first step" in the conversation about whether it should issue a CBDC, but makes clear that it "is not intended to advance any specific policy outcome" and that no policy choices are imminent.

The Discussion Paper makes clear that the intent of the Paper is to foster a broad public dialogue between the Federal Reserve and stakeholders about CBDC, and importantly, "is not intended to signal that the Federal Reserve will make any imminent decisions about the appropriateness of issuing a U.S. CBDC." The Discussion Paper also makes clear that the Federal Reserve does not intend to proceed with a U.S. CBDC without "clear support" from the public, the executive branch, and from Congress, "ideally in the form of a specific authorizing law." The Discussion Paper takes the position that a potential U.S. CBDC would best serve the needs of the United States by being privacy-protected, intermediated, widely transferable, and identity-verified, and then examines the potential benefits and risks of a U.S. CBDC more generally.

2

The Discussion Paper highlights that one of the benefits of a CBDC is the potential for it to provide all consumers with access to central bank money, in the form of a CBDC that is a liability of the Federal Reserve and thus carries no credit or liquidity risk, as an alternative to digital forms of money provided by commercial banks and nonbank financial service providers.

The Discussion Paper notes that because a CBDC would be a direct liability of the central bank, it "would be the safest digital asset available to the general public, with no associated credit or liquidity risk." The Discussion Paper emphasizes that, for this reason, a potential U.S. CBDC would enable the public to make digital payments – just as the public does with commercial banks and nonbank financial services providers today – but because a CBDC would be a liability of the Federal Reserve, it would not require mechanisms like deposit insurance to protect holders of CBDC, nor would a CBDC depend on backing by an underlying asset pool to maintain its value (*e.g.*, like a stablecoin). A U.S. CBDC also could streamline cross-border payments, subject to the need for significant international coordination.

3

The Discussion Paper focuses on the potential issuance of an "intermediated" CBDC — that is, the Federal Reserve would not itself offer accounts to individuals to hold CBDC, but would instead rely on intermediaries (*e.g.*, banks and regulated nonbank financial services providers) to offer accounts or digital wallets to consumers to manage their CBDC holdings and payments.

Noting that the Federal Reserve Act does not authorize direct Federal Reserve accounts for individuals, the Discussion Paper focuses on a CBDC framework in which the private sector would act as intermediary, offering accounts or digital wallets to consumers to facilitate the management and payments of CBDC holdings. The Discussion Paper notes that such intermediaries could include both banks and regulated nonbank financial service providers, suggesting that the Federal Reserve might allow certain nonbanks to more directly participate in a future CBDC ecosystem in ways they are not currently permitted within the existing monetary framework.

4

Similarly, the Discussion Paper envisions that any CBDC would leverage the existing privacy and identification frameworks used by financial institutions, with CBDC intermediaries (*e.g.*, banks and nonbank financial services providers) performing these key functions rather than the Federal Reserve.

As another benefit, an intermediated model would facilitate the use of the private sector's existing privacy and identity-management frameworks. This suggests that the Federal Reserve would not engage directly in identity verification or BSA/AML activities, nor hold personally identifiable information of individuals holding CBDC. Thus it appears that the Federal Reserve would effectively deputize CBDC intermediaries to perform this function in a manner similar to the existing identity verification requirements in the BSA/AML framework for financial institutions. The Discussion Paper's emphasis on an "identity-verified" CBDC also makes clear that it does not contemplate establishing a CBDC in which anonymous payments are possible or permitted — in other words, a future CBDC would not function as digital "cash."

5

The Discussion Paper emphasizes the importance of any CBDC's transferability between and across intermediaries, noting its potential to meet future needs and demands for payment services and provide a "safe foundation for private-sector innovations."

The Discussion Paper notes that a CBDC could potentially serve as a new foundation for the payment system and a bridge between different payment services, that at the same time would maintain the centrality of safe and trusted central bank money. Emphasizing that a key component of that promise would be the increased efficiency of the payments system due to CBDC being readily transferrable between customers of different intermediaries, the Discussion Paper notes that such transferability of a CBDC would give entrepreneurs a platform on which to create new financial products and services, support faster and cheaper payments (including cross-border payments), and expand consumer access to the financial system.

6 The Discussion Paper also highlights several risks of a CBDC, including changes to financial-sector market structure and financial stability that might occur if CBDC were to become a substitute for bank deposits or other low-risk assets.

The Discussion Paper makes clear that a CBDC could also pose certain risks and would raise a variety of important policy questions, including how it might affect financial-sector market structure, the cost and availability of credit, the safety and stability of the financial system, and the efficacy of monetary policy. In particular, it notes the availability of CBDC to consumers could lead to substitution away from commercial bank deposits (and potentially other low-risk assets) in favor of a CBDC, which “could reduce the aggregate amount of deposits in the banking system, which could in turn increase bank funding expenses, and reduce credit availability or raise credit costs for households and businesses.” The Discussion Paper identifies several potential policy choices that could limit that risk, including (i) making the CBDC non-interest bearing and/or (ii) capping the amount of CBDC that an end user could hold.

7 The Discussion Paper seeks public comment on 22 questions, suggesting that substantial additional public input and deliberation is likely before any choice to issue a CBDC is made.

The Discussion Paper describes the wide range of research the Federal Reserve is currently undertaking and makes clear that it will only take further steps toward developing a CBDC if research points to benefits for households, businesses, and the economy overall that exceed the downside risks, indicating that CBDC is superior to alternative methods. To that end, the Discussion Paper states that the Federal Reserve will conduct targeted outreach and convene public forums to foster a broad dialogue about CBDC, and seeks public comment on 22 broad questions concerning CBDC benefits, risks, policy considerations, and design choices. Public comments are due by May 20, 2022.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Financial Services practice:

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