Schulte Roth & Zabel

Alert

Federal Reserve Releases Report on Central Bank Digital Currency

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On Jan. 20, 2022, the Board of Governors of the Federal Reserve System ("Federal Reserve") released its report on central bank digital currency ("CBDC") ("Report").[1] The Report discusses and examines the potential benefits and risks of issuing a CBDC and identifies specific policy considerations. However, the Federal Reserve emphasizes they would not move forward with issuing a CBDC without congressional approval, stating "[t]he Federal Reserve does not intend to proceed with issuance of a CBDC without clear support from the executive branch and from Congress, ideally in the form of a specific authorizing law."[2]

What is a CBDC?

The Report defines a CBDC as a "digital liability of the Federal Reserve that is widely available to the general public."[3] Central bank money is generally a liability of the Federal Reserve. Specifically, in the United States, central bank money exists as either Federal Reserve-issued physical currency or as digital balances that are held by commercial banks at the Federal Reserve. Physical currency issued by the Federal Reserve is currently the only form of central bank money that the general public has available to use. Central bank money differs from digital money held in personal accounts at commercial banks (i.e., commercial bank money) and digital money held by non-bank financial service providers as balances (i.e., nonbank money) because central bank money does not need certain mechanisms in place (like deposit insurance for commercial bank money) for public confidence.[4] Further, unlike stablecoins,[5] a CBDC's value would not depend on an underlying asset pool for its backing. Therefore, a CBDC, simply put, would be a way for the general public to make digital payments using central bank money.

The Report outlines potential uses and functions of a CBDC. Individuals, businesses and governments could use a CBDC to purchase basic goods and services or pay bills.[6] Governments could use a CBDC to directly make benefit payments to citizens or to collect taxes. The Report also states that CBDC could potentially be programmed to deliver payments at specific, future times.

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[1] *Money and Payments: The U.S. Dollar in the Age of Digital Transformation*, Board of Governors of the Federal Reserve System (Jan. 2022), available here.

[2] *Id.* at 3.

[3] *Id.* at 13.

[4] *Id.*

[5] "Stablecoins are a more recent incarnation of cryptocurrency that peg their value to one or more assets, such as a sovereign currency or commodity." *Id.* at 11.

[6] *Id.* at 14.

Key Characteristics of a CBDC

The Report indicates that if a U.S. CBDC were to be created, such a CBDC would be optimal for the needs of the United States by being (i) privacy-protected, (ii) intermediated, (iii) widely transferable and (iv) identity-verified.[7] Below please find more information on how the Report describes these characteristics:

- *Privacy-Protected*. A CBDC would need to strike a balance between protecting the privacy rights of consumers and still being transparent enough to deter criminal activity with its use.
- *Intermediated*. If a CBDC were to be created, it would be best for the CBDC to be intermediated — i.e., the private sector would offer digital wallets or accounts for CBDC holdings and payments (and not involve individuals having direct accounts at the Federal Reserve, stating "such accounts would represent a significant expansion of the Federal Reserve's role in the financial system and the economy"). The Report states that such an intermediated approach would be optimal because it would not disrupt the current workings of the financial system and would allow reliance on the private sector's long-established and innovative ways of holding money properly and safely.
- *Transferable*. In order for a CBDC to be effective, a CBDC would need to be readily transferable between different intermediaries' customers, so that money can flow through the economy more easily.
- *Identity-Verified*. It would be important for a CBDC to be subject to anti-money laundering and counter-terrorism financing rules. Specifically, just like financial institutions that verify their customers' identities, a CBDC intermediary would need to verify the identity of a customer accessing a CBDC.

Potential Benefits of a CBDC

The Federal Reserve identifies and describes the following potential benefits of a CBDC in the Report[8]:

- *Safely Meet Future Needs and Demands for Payment Services:*
    - The proliferation of digital money relates to the need for fast and efficient payment delivery systems, but current digital money, like cryptocurrencies, carry many liquidity and credit risks. By creating a CBDC, the public could make fast digital payments while using an asset free from those risks.
    - Smaller businesses could gain access to a more level playing field by being able to use a CBDC because it is too cost-prohibitive for those smaller firms to create their own form of safe and private money. Thus, smaller businesses could focus on improving their offerings, instead of expending resources on making payments safely.
    - As noted above, a CBDC could make payments systems more efficient by generating new capabilities, like the ability to be programmed to make payments at specific times. Moreover, "microtransactions" (transactions involving a very small amount of money

[7] *Id.* at 13.

[8] *Id.* at 14-16.

that usually take place online) are not well-suited for traditional payments systems and a CBDC could facilitate those transactions more easily.

- *Improvements to Cross-Border Payments*. A CBDC could create improvements to cross-border payments by making such payments more efficient, creating opportunities for cross-border collaborations and potentially creating new technologies.
- *Support the Dollar's International Role*. A CBDC could potentially preserve the international dominance of the U.S. dollar (which benefits the United States by lowering international transaction costs for Americans and allows the United States to influence the global monetary system to its own benefit). If other countries were to create their own forms of CBDC, it would be paramount for the United States to have its own effective CBDC so those other forms of CBDC do not become so popular as to decrease the U.S. dollar's popularity.
- *Financial Inclusion*. Taking into account that many economically vulnerable households often lack access to rapid and cost-effective forms of payments (in order to receive wages, pay taxes and so forth), it is possible a CBDC would lower the transaction costs that lower-income households face when making and receiving payments.
- *Extend Public Access to Safe Central Bank Monkey*. Noting that cash is currently the only form of central bank money available to the general public and that the use of cash is rapidly declining in both the United States and other countries, the Federal Reserve is committed to ensuring the safety and availability of cash, while expanding safe payment options, like a CBDC, that do not carry the same liquidity and credit risks as commercial bank or nonbank money.

Potential Risks and Policy Considerations for a CBDC

The Federal Reserve identifies and describes the following potential risks and policy considerations of a CBDC in the Report[9]:

- *Changes to Financial-Sector Market Structure.* A CBDC (especially an interest-bearing one) could be so attractive to consumers that it ends up serving as a substitute for commercial bank money. In such a case, the deposits that banks are reliant on in order to give out loans would decrease and thus reduce credit availability for households and businesses. Moreover, such a CBDC could result in a shift away from other low-risk assets, like shares in money market mutual funds, and further raise credit costs or reduce credit availability for businesses and governments.

- *Safety and Stability of the Financial System.* A CBDC would be very attractive to risk-averse consumers and the ability to convert other forms of money into a CBDC could create an incentive for people to "make a run" on the money in financial institutions during times of financial stress and crisis. However, the Report states that this risk could be mitigated somewhat by design choices for a CBDC, like making sure banks do not pay interest on a CBDC or limiting the amount of a CBDC an end-user could have.

- *Efficacy of Monetary Policy Implementation.* The institution of a CBDC could greatly complicate Federal Reserve decisions over monetary policy. Currently, the Federal Reserve exercises control

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

over interest rates without actively managing the supply of reserves. By creating a CBDC, the amount of reserves in the financial system would change. As a result, the Federal Reserve would potentially need to increase the level of reserves to accommodate CBDC growth (particularly if the CBDC were interest-bearing), which, in turn, could increase interest rates.

- *Privacy and Data Protection and the Prevention of Financial Crimes.* It is paramount that a CBDC protect consumers' financial transaction data (using banks' existing tools), while still ensuring that CBDC intermediaries are identifying their customers and using other relevant tools (like recordkeeping) in order to prevent financial crime.

- *Operational Resilience and Cybersecurity.* Current threats to payment systems, like cybersecurity risks, would also apply to a CBDC. In fact, a CBDC could be more vulnerable to risks than current payment systems because a CBDC network would have more points of entry than a traditional payment system. However, if offline capability were developed for a CBDC (i.e., it could be used without the Internet), such risks could be mitigated (and a CBDC would be available to use in emergencies where Internet is not available, like in disaster zones).

Conclusion

While the Report does not commit the Federal Reserve to any action, the Report demonstrates the serious attention that financial government agencies and regulators are giving to digital payments (and the potential desire by the government to create its own form of digital payment).[10] The Federal Reserve is requesting public comment on more than 20 questions on the benefits, risks and policy considerations for CBDCs, as well as CBDC design. Comments are being accepted through May 20, 2022.[11]

Schulte Roth & Zabel's lawyers are available to assist you in preparing and submitting comments to the Report or addressing any questions you may have regarding these developments. Please contact the Schulte Roth & Zabel lawyer with whom you usually work or any of the following attorneys:

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[10] The Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency also recently conducted a series of interagency "policy sprints" focused on crypto-assets. *See* Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps (Nov. 23, 2021), available here. For more information about the "policy sprints," please refer to our prior *Alert*. The President's Working Group on Financial Markets also issued an interagency report on stablecoins. President's Working Group on Financial Markets, Federal Deposit Insurance Agency & Office of the Comptroller of the Currency, Report on Stablecoins (Nov. 2021), available here. For more information about the report, please refer to our prior Alert.

[11] *Id.* at 21.

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