January 23, 2022

Federal Reserve Discussion Paper on Central Bank Digital Currency

Paper Outlines "Pros and Cons" of a CBDC and Requests Comments from Stakeholders

SUMMARY

On January 20, 2022, the Board of Governors of the Federal Reserve System released a long-anticipated discussion paper regarding the potential development of a U.S. central bank digital currency, or "CBDC". The paper examines the uses and functions, and potential benefits and risks, of a CBDC and requests comment from stakeholders on all aspects of CBDCs, including policy considerations and design. The paper indicates, however, that the Federal Reserve does not intend to make any "imminent" decisions about the appropriateness of a U.S. CBDC—and does not intend to act without clear support from the executive branch and Congress.

THE DISCUSSION PAPER

1. Background and Overview

On January 20, 2022, the Federal Reserve released a discussion paper summarizing its current views regarding the potential adoption of a CBDC and the characteristics that would best serve the needs of the United States.[1] The paper defines CBDC as "a digital liability of a central bank that is widely available to the general public."[2]

The Federal Reserve notes that it intends the paper to "foster a broad and transparent public dialogue" regarding the potential benefits and risks of a CBDC. In considering these benefits and risks, the paper notes that any CBDC should:

- Provide benefits to households, businesses and the overall economy that exceed any costs and risks;
- Yield such benefits more effectively than alternative methods;
- Complement, rather than replace, current forms of money and methods for providing financial services;
- Protect consumer privacy;
- Protect against criminal activity; and
- Have broad support from key stakeholders.[3]

Taking these factors into account, the paper concludes that, if the U.S. were to create a CBDC, the CBDC would best serve the country's needs if it were (1) privacy-protected, (2) intermediated (*e.g.*, held or managed through a depository institution), (3) widely transferable, and (4) identity-verified.

The paper states that the Federal Reserve does not intend to proceed with the issuance of a CBDC without the clear support from the executive branch and Congress, "ideally in the form of a specific authorizing law."[4]

2. The Current State of Money and the U.S. Payment System

The paper first reviews current forms of money and the current state of the U.S. payment system.[5] Efforts toward making payments faster, cheaper, more accessible and more convenient, such as The Clearing House's RTP network and the Federal Reserve's FedNow Service (which is scheduled to "debut" in 2023) are noted as recent improvements in the system.[6] The paper also acknowledges the rise in consumer-focused digital payments services accessed through mobile devices. However, the paper highlights key challenges for these services, including that: (i) a significant percentage of the U.S. population lacks access to digital banking and payment services, and a portion do not have banking relationships at all, and (ii) cross-border payments often suffer from slow settlement, high fees and limited accessibility.[7] The paper requests comment on how a CBDC could affect the U.S. payment system and, in particular, how it could address these challenges.[8]

3. Considerations for a Central Bank Digital Currency

The paper then explores the potential design, uses, benefits, risks and policy considerations associated with a CBDC. A "crucial test" for a CBDC will be whether it "proves superior to other methods that might address issues of concern" outlined in the paper.

a. Design

The paper notes that, although the Federal Reserve continues to explore a wide range of design options for a CBDC, if a CBDC were to be created, it would "best serve the needs of the United States" if it were to include the following characteristics:

- **Privacy-protected:** A CBDC would need to strike an appropriate balance between safeguarding privacy and providing for the transparency necessary to deter criminal activity.
- **Intermediated:** The CBDC would need to be intermediated through digital wallets or accounts, offered by private sector participants to facilitate the management of CBDC holdings and payments. This approach would be necessary both to address existing limits on the authority of the Federal Reserve and other operational considerations. Under its current statutory authority, the Federal Reserve cannot offer direct Federal Reserve Accounts to individuals, and the paper notes that "such accounts would represent a significant expansion of the Federal Reserve's role in the financial system and the economy."
- **Transferable:** In order to serve as a widely accessible means of payment, a CBDC would need to be readily transferable between customers of different intermediaries.
- **Identity-verified:** A CBDC would need to be designed to comply with U.S. anti-money laundering and counter-terrorist financing rules. The paper notes that, in practice, a CBDC intermediary would need to verify the identify a person accessing a CBDC, similar to the way in which banks and other financial institutions currently verify their customers' identities.[9]

b. Uses and Functions

The paper notes that CBDC transactions would need to be final and completed in real time, in order to allow users to make payments for purchases using the CBDC. The government could likewise use a CBDC to collect taxes or make benefit payments. Finally, the paper notes that a CBDC could be programmed to have different functions, such as delivering payment at certain times rather than immediately.[10]

c. Potential Benefits

The paper highlights a number of potential benefits of a CBDC, including that it could "serve as a new foundation for the payment system and a bridge between different payment services, both legacy and new" and "maintain the centrality of safe and trusted central bank money in a rapidly digitizing economy."[11] The paper further notes the following potential benefits:

- **Safely Meeting the Future Needs and Demands for Payment Services:** Because a CBDC could offer the public broad access to digital money that is free from credit and liquidity risk, it could provide a "safe foundation for private-sector innovations" in the payment services sector. A CBDC could also level the playing field for smaller firms in payment innovation.
- **Improving Cross-Border Payments:** A CBDC could streamline cross-border payments through, among other measures, the use of new technologies—although the paper notes that realizing potential improvements in this area would require significant international coordination to address a variety of significant issues.
- **Supporting the Dollar's International Role:** A U.S.-issued CBDC could preserve the dominant international role of the U.S. dollar and its status as the world's reserve currency, especially if a U.S. CBDC were more attractive than CBDCs that could be issued by other countries.
- **Promoting Financial Inclusion:** Noting that financial inclusion, particularly for economically vulnerable communities, is a high priority for the Federal Reserve, the paper suggests that a CBDC could reduce barriers to financial inclusion and lower transaction costs.
- **Extending Public Access to Safe Central Bank Money:** Given that digital payments are rapidly supplanting cash payments in the U.S., the paper notes that U.S. consumers might

want the option of digitized central bank money in the form of a CBDC that, like cash, would have no credit or liquidity risk attached to it.

d. Potential Risks and Policy Considerations

The paper also sets out a number of potential risks that could accompany the introduction of a CBDC, including:

- **Changes to Financial-Sector Market Structure:** A CBDC could fundamentally alter the roles and responsibilities of the private sector and the central bank in the U.S. financial system. A CBDC that acts as a substitute for commercial bank money[12] could reduce the aggregate amount of deposits in the banking system, which could increase banking funding expenses and reduce the availability or increase the cost of credit to households and businesses. An interest-bearing CBDC could lead to a shift away from low-risk assets, such as Treasuries, shares in money market mutual funds or other short-term instruments, which could also reduce the availability or raise the costs of credit. The paper notes that these concerns could be mitigated by CBDC design choices, such as providing that the CBDC is non-interest bearing or limiting the amount of CBDC that an end user could hold.
- **Safety and Stability of the Financial System:** A widely accessible CBDC could be particularly attractive to risk-averse users, which could make runs on financial firms more likely or more severe during periods of stress. The paper notes that these concerns could be mitigated by CBDC design choices, such as paying no interest on CBDC, limiting the total amount of CBDC an end user could hold or limiting the amount of CBDC an end user could accumulate over short periods of time.[13]
- **Efficacy of Monetary Policy Implementation:** The introduction of a CBDC could affect monetary policy implementation and interest rate control by altering the supply of reserves in the banking system. The paper suggests that such effects would be "more pronounced and more complicated" if the CBDC is interest-bearing at levels comparable to the rate of return on other safe assets. The potential for significant foreign demand for a U.S. CBDC could also complicate monetary policy implementation.
- **Privacy and Data Protection and the Prevention of Financial Crimes:** A CBDC would need to balance the importance of safeguarding consumer privacy against affording the transparency necessary to deter criminal activity.
- **Operational Resilience and Cybersecurity:** Any dedicated infrastructure for a CBDC would need to be "extremely resilient" to threats to existing payment services, including operational disruptions and cybersecurity risks, particularly because a CBDC could have more entry points than existing payment services. The paper notes that a CBDC could enhance operational resilience of the payment system by being designed with offline capability.[14]

4. Request for Comment

The Federal Reserve requests comment from all stakeholders on a list of 22 questions that covers the entirety of the discussion paper.

The Federal Reserve is requesting that all comments be submitted by May 20, 2022 using the form available at https://www.federalreserve.gov/apps/forms/cbdc.

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ENDNOTES

1 Money and Payments: The U.S. Dollar in the Age of Digital Transformation, *Board of Governors of the Federal Reserve System* (January 20, 2022), *available at* https://www.federalreserve.gov/publications/files/money-and-payments-20220120.pdf. The Paper is the latest in a series of statements from various U.S. regulators regarding the development and regulation of digital assets, including: (1) the OCC's interpretive letter regarding the authority of banks to engage in cryptocurrency activities (*see* Sullivan & Cromwell, LLP, "OCC Issues Interpretive Letter Regarding the Authority of Banks to Engage in Cryptocurrency Activities" (December 21, 2021), *available at* https://www.sullcrom.com/files/upload/sc-publication-occ-issues-interpretive-letter-regarding-authority-of-banks-to-engage-in-cryptocurrency.pdf); (2) the federal banking regulators' joint statement on their crypto-asset "policy sprint" (*see* Sullivan & Cromwell LLP, "Federal Banking Agencies Release Joint Statement on Crypto-Asset 'Policy Sprint' Initiative" (November 24, 2021), *available at* https://www.sullcrom.com/files/upload/sc-publication-federal-banking-agencies-release-joint-statement-crypto-asset-policy-sprint-initiative.pdf); and (3) the President's Working Group on Financial Markets' Report on Stablecoins (*see* Sullivan & Cromwell LLP, "President's Working Group on Financial Markets Issues Report on Stablecoins" (November 5, 2021) (the "PWG Report"), *available at* https://www.sullcrom.com/files/upload/sc-publication-presidents-working-group-on-financial-markets-issues-report-on-stablecoins.pdf).

2 *Id*. at 1.

3 *Id.* at 1-2.

4 *Id.* at 3.

5 *Id.* at 7-9.

6 *Id*. at 7.

7 *Id.* at 8.

8 *Id.* at 21-22.

9 *Id.* at 13-14.

10 *Id.* at 14.

11 *Id.* "Central bank money" is a liability of the central bank. In the United States, central bank money comes in the form of physical currency issued by the Federal Reserve and digital balances held by commercial banks at the Federal Reserve. As noted in the paper, central bank money carries neither credit nor liquidity risk, and is therefore considered the safest form of money. Central bank money also serves as the "foundation of the financial system and the overall economy." *Id.* at 5.

12 "Commercial bank money" is the digital form of money that is most commonly used by the public. Commercial bank money is held in accounts at commercial banks and has very little credit or liquidity risk due to federal deposit insurance, the supervision and regulation of commercial banks, and commercial banks' access to central bank liquidity. *Id.* at 5.

13 The paper does not discuss how these issues might be affected by intermediation of a CBDC through banks, or by potential differences between the way in which customers could be treated in the event of the insolvency of a bank holding CBDC for the customer versus the treatment of a depositor holding "commercial bank money" for the customer.

14 *Id.* at 17-20.

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