

The Federal Reserve starts a U.S. CBDC discussion

January 31, 2022 | Client Update | 9-minute read

The Federal Reserve released a paper to start a public discussion on the pros and cons of a potential U.S. central bank digital currency. Here are our five key takeaways.

The paper, [Money and Payments: The U.S. Dollar in the Age of Digital Transformation](#), is intended to start a public discussion about whether the Federal Reserve should design, develop and launch a U.S. CBDC—and under what conditions it would be appropriate to do so. The paper starts with the premise that a U.S. CBDC would be digital USD money, issued by the Federal Reserve, and available to the general public. Today, the only USD money that is legal tender and available to the general public takes the form of paper Federal Reserve notes and metallic coins.

The paper does not commit the Federal Reserve to any policy or design choices. It does, however, signal the Federal Reserve's views on several essential design features of a CBDC that Federal Reserve principals have previously telegraphed.¹ Most importantly, the Federal Reserve's initial analysis suggests that a U.S. CBDC “would best serve the needs of the United States” by being “privacy-protected, intermediated, widely transferable, and identity-verified.”

The Federal Reserve is not convinced that it should develop a CBDC. It states that it will take further steps to develop a CBDC only if “research points to benefits for households, businesses, and the economy overall that exceed the downside risks” and that research would need to indicate that a CBDC is better than alternatives. Accordingly, the paper solicits comments on 22 questions and provides stakeholders four months, until May 20, 2022, to provide input. The paper makes clear that the Federal Reserve intends to proceed cautiously, and we agree with Isaac Boltansky's assessment: “The paper provides a thoughtful framing of the options and key considerations, but it is light on conclusions and reinforces our view that a Fed-backed CBDC is – at best – years away from launch.”²

The most persuasive case made for CBDC so far has been made by Sir Jon Cunliffe of the Bank of England. Noting that public money in the form of paper money and metallic coins is becoming an anachronism as more and more people substitute various forms of electronic private money for more and more of their payments, a CBDC may be necessary so that the public will continue to have an option for a viable form of public money.³ Indeed, based on the figures for circulating cash and commercial bank deposits on page 25 of the paper, as of November 2021, around 90% of the USD funds that consumers and non-bank businesses held that could be used to make payments for goods and services were held in the form of USD deposit claims against commercial banks (i.e., private money) rather than as public money in the form of Federal Reserve notes or coins.

Our five key takeaways on the paper are as follows:

1. This paper is the first step on a long road.
2. The Federal Reserve is unlikely to launch a U.S. CBDC without legislation.
3. The Federal Reserve is open to both banks and nonbanks to provide access to the U.S. CBDC.
4. Further steps will depend on whether a U.S. CBDC's potential risks to the financial system can be sufficiently mitigated through design choices.
5. Big policy and design questions are left wide open.

1. This paper is the first step on a long road.

The Federal Reserve characterizes its release as a “discussion paper,” and it is clear that, for the near future, the emphasis is on *discussion*. It is only “the first step in a broad consultation that will also include targeted outreach and public forums.” The Federal Reserve will publish all responses received by the comment deadline. It will also be seeking input in targeted outreach and through public forums.

Given the potential wide-ranging monetary, economic, and social effects of a U.S. CBDC, we believe the paper's emphasis on public outreach reflects the importance the Federal Reserve places on broad stakeholder input, despite the resulting slow process to design and potentially launch a U.S. CBDC. The paper is written in clear, accessible prose, with little technical jargon, which seems designed to begin the public debate on inclusive terms.

2. The Federal Reserve is unlikely to launch a U.S. CBDC without legislation.

The Federal Reserve's authority to issue a CBDC is unclear under existing law. In testimony to the Senate Banking Committee in July 2021, Federal Reserve Chair Powell stated that “we would want very broad support in society and in Congress. And ideally, that would take the form of authorizing legislation as opposed to a very careful reading of ambiguous law to support this.”⁴

The paper reflects this position, stating that the Federal Reserve will not proceed with the issuance of a CBDC without support from the executive branch and Congress, “ideally in the form of a specific authorizing law.” Taken together with the paper's statements about the need for stakeholder and government-wide support and the need for research supporting CBDC as a better approach than the alternatives, it is unlikely that the Federal Reserve would proceed to develop or launch a U.S. CBDC without some form of authorization from Congress.

3. The Federal Reserve is open to both banks and nonbanks to provide access to the U.S. CBDC.

The paper recognizes that a direct retail CBDC— where individuals and businesses would directly hold CBDC accounts at Federal Reserve Banks—would represent a significant expansion of the role of federal government, in this case, the Federal Reserve, in the U.S. economy. The paper also points out that the Federal Reserve is not currently authorized to offer such accounts.

By contrast, the Federal Reserve's suggestion that a U.S. CBDC would “best serve the needs of the United States” by being “intermediated” strongly implies that it prefers an intermediated system, in which private sector intermediaries would offer accounts (digital wallets) through which users would hold, transfer, and use CBDC. Instead of limiting these intermediaries to insured banks, which currently have access to digital central bank money in the form of Federal Reserve master accounts, the paper leaves open the possibility of non-banks serving as CBDC intermediaries and, interestingly, contemplates an “open market for CBDC services.”

The paper does not contain additional details about which types of nonbanks would be eligible to provide CBDC account services, though it poses questions for public comment, asking “What types of firms should serve as intermediaries for CBDC? What should be the role and regulatory structure for these intermediaries?”

We expect public comments to grapple with the extent to which intermediaries should include firms outside the bank regulatory perimeter, and to what extent the Federal Reserve may consider a federal supervisory or regulatory overlay as a condition to permitting such firms to serve as CBDC intermediaries.

4. Further steps will depend on whether a U.S. CBDC's potential risks to the financial system can be sufficiently mitigated through design choices.

A “widely available CBDC would serve as a close—or, in the case of an interest-bearing CBDC, near-perfect—substitute for commercial bank money.” The Federal Reserve expresses concerns about the risks that widespread substitution of

CBDC for commercial bank money could pose in three areas: the structure of the financial system, financial stability and monetary policy.

The first category of risk arises from banks' reliance on deposits as a source of funding. If savers were to choose a CBDC over bank deposits, the reduction in deposits in the banking system could increase the cost of funding for banks and thus reduce the supply or increase the cost of credit to households and businesses. As described in the Federal Reserve staff's [CBDC literature review](#),⁵ a reduction in bank deposits would increase banks' cost of funding unless deposits can be replaced with another source of funding, such as discount window borrowing from the Federal Reserve. The Federal Reserve is rightly concerned about the risk of being forced to assume the role of allocating credit across the economy, if its [discount window collateral eligibility criteria](#) were to replace the role played by banks' credit underwriting processes.

The second category of risk, financial stability, arises for similar reasons. In a crisis, the existence of CBDC as a risk-free alternative to bank deposits could exacerbate a flight to safety,⁶ making runs on financial firms more likely or more severe.

The third category of risk, monetary policy, raises more subtle concerns, but of a similar nature. In the current "ample reserves" regime, the Federal Reserve primarily relies on setting interest rates on excess reserves and overnight reverse repos to control the demand for cash. Among the concerns cited in the paper, a shift away from bank deposits into CBDC, would reduce the aggregate amount of reserves in the banking system, potentially rendering the ample reserves regime less effective in maintaining monetary policy.

The paper focuses on two CBDC design choices that could mitigate these concerns. First, a CBDC could be non-interest bearing, which would make it less attractive as a substitute for commercial bank deposits or other forms of private money. Second, CBDC account balance limits could cap the amount that any user is permitted to hold at one time. These design choices, however, may also limit the utility of a CBDC.

In our view, any further steps on a U.S. CBDC will depend on whether empirical research can establish that the CBDC design choices available to the Federal Reserve sufficiently mitigate the risks posed by the potential for widespread substitution of commercial bank deposits and, if so, whether those design choices result in a U.S. CBDC that is better than the alternatives.

5. Big policy and design questions are left wide open.

The paper does not address in any detail several key policy and design choices, though it does acknowledge these choices. The paper states the importance of balancing between the competing interests of consumer data privacy and the prevention of financial crimes, but it does little to frame discussion beyond stating that "[a]ny CBDC would need to strike an appropriate balance between safeguarding consumer privacy rights and affording the transparency necessary to deter criminal activity." Overall, the purposefully limited nature of the paper has provided little detail on how the Federal Reserve might approach these important considerations.

The paper also does not discuss technological or operational aspects of how a CBDC system may be built—for example, the paper does not discuss blockchain technology in the context of a CBDC until its Appendices. We expect a forthcoming paper from the Federal Reserve Bank of Boston to shed some light on these topics.

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- ¹ See, e.g., Federal Reserve Governor Lael Brainard, Speech at the Consensus by CoinDesk 2021 Conference, Private Money and Central Bank Money as Payments Go Digital: An Update on CBDCs (May 24, 2021), <https://www.federalreserve.gov/newsevents/speech/brainard20210524a.htm> (noting that “the design of any CBDC would need to include safeguards to protect against disintermediation of banks and to preserve monetary policy transmission more broadly,” and “would need to both safeguard the privacy of households’ payments transactions and prevent and trace illicit activity to maintain the integrity of the financial system, which will require the digital verification of identities”).
- ² Issac Boltansky, *Fed’s CBDC Report Underscores Long Road Ahead for Effort*, BTIG Washington Industry Report (Jan. 20, 2022).
- ³ Sir Jon Cunliffe, Deputy Governor, Financial Stability, Bank of England, Do we need ‘public money’?, Speech at Official Monetary and Financial Institutions Forum, Digital Money Institute (May 13, 2020), <https://www.bankofengland.co.uk/speech/2021/may/jon-cunliffe-omfif-digital-monetary-institute-meeting>.
- ⁴ *The Semiannual Monetary Policy Report to the Congress: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs*, 117th Cong. (July 15, 2021) (testimony of Jerome H. Powell, Chair, Federal Reserve).
- ⁵ Francesca Carapella & Jean Flemming, *Central Bank Digital Currency: A Literature Review*, FEDS Notes (Nov. 9, 2020), <https://www.federalreserve.gov/econres/notes/feds-notes/central-bank-digital-currency-a-literature-review-20201109.html>.
- ⁶ See Cunliffe, *supra* note 3.