Articles + Publications | February 2, 2022

Government Efforts to Address Cryptocurrencies Ramp Up as Federal Reserve Releases Report on Digital Currency

WRITTEN BY

Carter Nichols | Ethan G. Ostroff | James W. Stevens | Tom Tilton | Kalama M. Lui-Kwan | Alexandra Hazday

Several recent events highlight the expanding effort by the federal government to address the growing digital currency marketplace and the government's role in it.

According to recent reporting, the Biden administration is preparing an executive order that will outline a comprehensive strategy for cryptocurrencies and ask federal agencies to assess the potential risks and opportunities. The executive order, expected as soon as next month, is slated to put the White House in a central position to oversee policy and regulatory efforts regarding digital assets. The order is expected to take a "whole-of-government" approach that will reach beyond the nature of transactions, touching issues like energy consumption related to cryptocurrency mining.

The administration's move comes on the heels of recent guidance, statements, and rule-making efforts by the Office of the Comptroller of Currency, Securities and Exchange Commission, and Commodity Futures Trading Commission. These efforts also coincide with other federal regulators opening the door to the expanding consumer marketplace for digital assets, such as the National Credit Union Administration's announcement that credit unions may partner with third parties to allow members to buy, sell, and hold digital assets.

The news of the forthcoming executive order also follows the release of the Federal Reserve's report titled, "Money and Payments: The U.S. Dollar in the Age of Digital Transformation."

The Fed's report is "the first step in a public discussion" regarding the creation of a central bank digital currency (CBDC) — legal tender just like a paper bill, but in digital format, which would be "a digital liability of a central bank that is widely available to the general public."

The Fed's report focuses on a retail CBDC to be used by the general public, as opposed to a wholesale CBDC that would be used by financial institutions for back-end settlement. The CBDC would be issued to the public by third parties, and not directly from the Fed. This runs contrary to a wholesale CBDC that many other countries are considering, including Canada and the European Union.

The Fed has identified several characteristics of a potential CBDC:

- ***Privacy-protected*:** Consumer privacy in the digital marketplace is a primary concern, particularly given the global reach of digital assets.

- ***Intermediated*:** The Fed suggests that a CBDC would be best implemented through the private sector, which could offer digital wallets for transfers, payments, receipt, and holding of CBDCs. This structure is viewed as the most optimal because it would not change the current framework of the Fed, which does not open private accounts, while simultaneously relying on the expertise of the private sector for security and innovation.

- ***Widely transferable*:** To be effective, the Fed emphasizes that any CBDC must be easily transferrable to maintain the free flow of currency within the market.

- ***Identity-verified*:** Although consumer privacy is a paramount concern, the Fed notes that a balance must be struck between privacy and "the transparency necessary to deter criminal activity," including anti-money laundering and countering the financing of terrorism.

The Fed's report identifies numerous potential benefits that a CBDC presents, which largely mirror the benefits that digital assets have brought to the marketplace already. For example, the Fed recognizes the growing demand for digital currency, and it opines that a CBDC would be a safe and reliable way to meet that demand. To that end, CBDCs offer a lower bar to entry for businesses and consumers in the online marketplace or for payment processing where existing payment systems may be too cost prohibitive. CBDCs also create easier avenues into the global marketplace, eliminating the higher costs and inefficiencies of traditional international payment systems.

CBDCs are not without potential risks, however. The introduction of cryptocurrencies and other digital assets has had enormous effects on consumers, businesses, and governments alike. The Fed's report recognizes that the introduction of a CBDC could lead to foundational changes in the structure of the financial market. For example, a CBDC — particularly one that bore interest — could lead to significant changes in the commercial banking market and put strains on banks' lending capabilities if enough consumers transitioned from deposits in banks to digital assets. There also are more direct risks, such as those to consumer privacy and the resiliency of digital payment systems.

The Fed's paper and insight into its thinking on the creation of a Fed-backed digital currency dovetail with policy guidance being prepared by the Federal Deposit Insurance Corp. (FDIC) and recent comments by FDIC Chairman Jelena McWilliams on the need for stability and security in the crypto marketplace when it comes to stablecoins (*i.e.,* cryptocurrencies that are backed 1:1 by some other asset-like fiat currency). The Fed's report does seem to leave room for private stablecoins to continue to coexist, reflective of Fed Chair Powell's view that a "well-regulated, privately issued stablecoins could coexist with a CBDC."

The timetable for a Fed-backed CBDC is still uncertain, and the report does not commit the Fed to any particular action. The Fed is now soliciting input on the benefits, risks, policy considerations, and design for a CBDC through May 20, 2022. The report also emphasizes that the Fed will not act alone, making clear that it will look for guidance from the president and Congress before moving forward. The administration has yet to comment on the possibility of a CBDC, but this may come as early as next month with the release of the executive order. Congress first will have to agree on a framework for authorizing the new CBDC.

RELATED INDUSTRIES + PRACTICES

- Digital Assets + Blockchain
- Payments + Financial Technology
- Financial Services