Financial Services Management

Federal Reserve Digital-Dollar Accounts

Cite
S. 3571, Banking for All Act

Recommended Distribution:
Policy, Legal, Government Relations

Websites:
https://www.congress.gov/116/bills/s3571/BILLS-116s3571is.pdf

Impact Assessment

- This legislation would not only mandate a new national digital account, but also redesign the full scope of U.S. deposit-taking activities and the role of the Federal Reserve and that of the Postal Service without accounting for new costs, the future of financial intermediation, the structural change in the role of the Fed and its Reserve Banks, or the ability of banks to absorb significant new costs without consequences severe enough to threaten their viability.
- All transaction and most savings account customers now receiving small rates of interest and charging fees under current market conditions would almost surely migrate to these pass-through Fed accounts. Changes to other accounts to preserve financial-intermediation capacity would prove costly. Banks would likely shift to short-term wholesale funding, but this is problematic under current rules and potentially costly and/or risky.
- All State nonmember banks and credit unions could apparently elect to accept these deposits, which are mandatory for member banks. These entities would also be reimbursed for cost regardless of size. Member banks might thus shift charters to state nonmembers to avoid this mandate or, if markets compel participation, obtain reimbursement for it. Charter arbitrage could redesign the construct of U.S. regulation and supervision, putting a considerable burden on states and the FDIC, creating regulatory-arbitrage risks, and undermining the ubiquity of these Fed accounts.
- USPS facilities would become new retail centers, with costs also reimbursed by the FRB. Given the USPS's unfamiliarity with finance and acute financial and operational challenges, Fed reimbursements would likely need to be very substantial to prevent further USPS strain.
- All U.S. households and businesses could have ready access to no-cost deposit accounts that enhance federal benefit delivery and transaction-deposit access. Financial inclusion, fund protection, and a more rapid transition to online banking might thus occur. This would likely be offset by a decline in bank lending, including that for community development. Fintechs might provide

lending to replace banks, but their post-crisis capacity is likely to be insufficient to support macroeconomic growth and ensure inclusion. The Fed might thus step in, engaging in retail lending along with the broader investments it would almost surely undertake to deploy digital-account funding.

- This bill does not waive Fed reserve requirements for digital accounts, but since these would be transferred to the Fed, bank required-reserve balances could dramatically shrink. How the payment system would operate in the absence of interbank reserves comparable in volume to deposit accounts is at best uncertain unless the Fed operationalized a payment system covering all digital-account holders. Monetary policy in the absence of bank reserves would become still more interest-rate based. Because the Fed would hold these accounts and sets reserve rates, policy could be more efficiently transmitted. However, the impact of these deposit rates on lending is uncertain since national credit formation would rely largely on other funding sources unless the Fed also began to make loans.

Overview

In the course of crafting the CARES Act,[1] Democrats in the House and Senate sought so far unsuccessfully to launch the U.S. quickly into providing a U.S. central-bank digital currency (CBDC) in which banks act as agents for the Fed, gathering deposits and then passing them on to the central bank. Although the initial impetus for including this in the COVID packages was as a way to speed federal payments to households and small businesses, the Senate version in fact brings the Federal Reserve System fully into the deposit-taking fabric of U.S. financial intermediation, with legislators planning to pursue the measure both in connection with the U.S. COVID response and on its own. The bill does not address whether the Fed would also make loans, how banks would do so without these deposits, the future of U.S. finance without bank financial intermediation, or implications for monetary policy and macroeconomic growth. It does, however, detail how these new "digital wallets" would need to be designed, essentially barring all fees and mandating full transaction-account functionality in return for a low interest rate that, under current market conditions, may well be more than many U.S. retail and business-account holders now receive on existing transaction balances after taking fees into account. Significant funding shifts are likely and, because funds are transferred to the Fed, trillions could quickly move out of the private financial-intermediation system into the U.S. central bank. The Fed would also take on an array of new compliance duties comparable to those mandated for private financial institutions, although the bill does not make clear who would supervise it, how violations would be punished, and how to address the privacy implications of a government agency conducting know-your-customer investigations.

Advancing longstanding proposals to use the U.S. Postal Service (USPS) as a retail-banking venue,[2] the measure also requires the USPS to gather and at least to some extent also to service these digital accounts. This creates an alternative, low-cost retail-delivery system but also does not address how financial intermediation for lower-income households and small businesses would continue in the absence

1 See **RESCUE72**, *Financial Services Management,* March 3, 2020.

2 See **POSTAL9**, *Financial Services Management*, May 9, 2018.

of bank lending and investment aimed at these communities. The USPS could also experience heightened financial and operational strain.

Impact

Although proposals for what some call "Fed accounts" circulated for years in Europe and, more recently, in the U.S.,[3] Facebook's proposed Libra digital-currency made the question real not just for retail finance, but also global central banking.[4] Many global banks are actively pursuing CBDC to enhance monetary-policy transmission and better control increasingly-digital financial systems, although some – e.g., China – are doing so as much to enhance government control as to increase payment-system and monetary-policy efficiency. The Federal Reserve is exploring CBDC and has even launched small-scale operational experiments prior to the COVID crisis. While still ambivalent about the need for CBDC, some within the Federal Reserve System believe it will be inevitable once the FedNow faster payment system is implemented.[5] Interestingly, some states are also experimenting with controlled payment systems, with New York legislators for example discussing a "public Venmo" system. None of these is likely to advance in the near-term due in part to the COVID crisis, but the crisis on its own could accelerate developments, especially at the federal level.

The bill's sponsors and others advocating variations on CBDC or even state-level digital currency believe that an immediate CBDC speeds federal assistance to households and small businesses more efficiently and without the conflicts and risks they believe result when banks act as financial intermediaries. However, the scope of many proposals and of S. 3571 in particular suggests that advocates also envision a large-scale redesign of the U.S. financial system. In it, regulated banks would be entry points for accounts held by the Fed that are presumably then circulated back into the economy in ways that support financial inclusion and community development not possible, advocates assert, in a private financial-intermediation construct. In this model, banks become deposit utilities and the Fed would determine U.S. credit allocation either directly or by recirculating funds back into the private financial system in some way left unspecified in S. 3571.

Other CBDC models have central banks directly interacting with the public in often unspecified ways and then expressly making loans in ways that support monetary and fiscal priorities. Banks would presumably compete with this CBDC model but for how long and in what way is often not made clear. Central-bank credit allocation also raises numerous questions about future free-market functioning and resulting productivity and innovation, although recent

---

3 *EconomicEquality* Blog Post: https://economicequality.blog/2018/06/12/vollgeld-as-voldemort-is-the-swiss-villain-coming-for-american-banking/.

4 See *Client Report* **CRYPTO12**, October 23, 2019.

5 See **PAYMENT17**, Financi*al Services Management,* August 19, 2019.

developments will surely raise similar questions about the pre-COVID financial markets.

However, apart from these policy challenges, S. 3571 raises an array of near-term questions. For example, these new “digital-wallet” accounts would be mandatory at all banks that are members of the Federal Reserve System and available to all citizens and U.S-domiciled businesses, not just under-served consumers or small companies. As discussed below, accounts would be interest-bearing (albeit at very low rates), presumably carry FDIC-insurance and thus be subject to DIF premiums, have no fees or related charges, and provide the full functionality – including no-cost ATM withdrawals – available on other transaction accounts. As discussed below, the legislation does not discuss how comparability is to be determined, leaving this to FRB regulation. How these rules proceed might reduce some of the cost and competitive challenges of these accounts, but the statutory drafting gives the Fed only limited discretion to do so.

Regardless of how the Fed defines comparability, these digital pass-through accounts will be very costly to member banks. The bill provides for reimbursement to banks with assets below $10 billion, but leaves larger ones to fend for themselves. Like all member banks, large ones could not refuse to accept digital deposits no matter the cost, leading to significant strategic changes due not only to these costs, but also to the need to find alternative funding sources if lending and other activities now based on retail deposits are to continue.

As noted, these digital accounts so upend traditional assumptions about the payment-system construct and monetary-policy transmission that each would require large-scale reconstruction. The role of the Fed would almost surely get even larger because all of its deposits and, perhaps, resulting loans would make it not only a central bank but also the nation’s most important financial intermediator. The payment system could be safer and more efficient and monetary-policy transmission more effective, but questions about government control, innovation, productivity, and economic equality would also need to be addressed.

What’s Next

S. 3571 was introduced on March 23 by Senate Banking Ranking Member Brown (D-OH). Federal Reserve Banks would have to establish a system in which digital accounts are available to all U.S. citizens and U.S.-domiciled businesses no later than January 1, 2021.

As noted, initiatives along these lines were included in the House and Senate debate ahead of final action on the CARES Act. These efforts are likely to continue, but efforts at mandating Fed accounts will also continue to face objections based on substance, process, and press of other business. Nonetheless, this bill and others like it mark the parameters of progressive thinking on a U.S. CBDC that, even if the FRB does not voluntarily advance one, could be imposed on the financial system as events transpire and the political line-up shifts after the 2020 election.

Analysis

A. General Provisions

In addition to the rules expressly discussed below, the Fed would have the authority to set other standards for these digital-dollar wallets. Although these provisions cover only member banks and, in some cases, the Post Office, the Board could expand access to state nonmember banks and credit unions through new master accounts. The bill does not make clear if, were it to do so, all state nonmember banks and/or credit unions would need to offer these accounts as required of member banks. However, drafting suggests that the Fed must permit state nonmember banks and credit union to offer these accounts if desired. Fintechs and other nonbanks would be ineligible.

Post Office facilities would gather these deposits with access to the Fed in areas with limited bank branches such as disaster areas and under-served communities as defined in the bill. How Post Offices would ramp up to do so, especially in disasters, or absorb the costs of doing so, is not specified.

B. Definitions

These include:

- digital dollars, defined as digital ledger entries recorded as liabilities in Federal Reserve Bank accounts;
- digital dollar wallets, which are a "digital wallet" or account maintained by a Federal Reserve Bank on behalf of any person eligible to hold digital-dollar balances;
- pass-through digital dollar wallets. These are digital wallets or accounts maintained by member banks for any person entitling the customer to a *pro rata* share of pooled reserve balances maintained by the member bank at a Federal Reserve Bank; and
- postal retail facilities mean facilities operated directly by the U.S. Postal Service serving the public.

C. Digital Wallets

Member banks would need to open these pass-through retail accounts for all persons, including those eligible to receive federal payments, including COVID-related ones. Banks would need to establish separate legal entities for this purpose making it unclear if these entities would carry FDIC insurance or operate as subsidiaries or affiliates without FDIC coverage and resulting cost. Digital-account assets would be solely the pass-through account housed in the Fed and the liabilities of which are only digital-dollar accounts, with banks larger than $10 billion required to offer these accounts through online or telephone channels. The Fed-account asset is exempt from capital and liquidity regulation. Coverage by reserve requirements is unclear.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone: (202) 589-0880
E-mail: info@fedfin.com Website: www.fedfin.com

Additional requirements include:

- no account fees or balance requirements;
- interest paid at the greater of required or excess reserves;
- functionality no less than that provided by the bank on existing transaction accounts with respect to debit cards, ATM access, online-account access, bill payment, mobile banking, customer service, and other features mandated by the FRB in the public interest. The bill contains no guidance as to which transaction accounts these digital accounts must be compared, thus making it possible that these accounts would have features comparable to accounts with considerably larger balances, numerous fees, or other features that offset bank cost;
- no overdraft fees;
- disclosures "branding" the accounts as pass-through digital dollar accounts maintained by the bank with the Fed;
- no account closings or restrictions on the basis of profitability considerations; and
- "reasonable" protection against fraud or cyber-security breaches. It is unclear if these protections must be above those otherwise available to transaction-account customers.

Post Offices would offer accounts under terms generally tracking those applicable to banks and would provide access to the accounts via ATMs maintained on behalf of the Federal Reserve Board. The bill does not say, but appears to intend, that the Board pays for these ATMs. Post Office digital accounts would say that they are established at Federal Reserve Banks on behalf of the U.S. Government.

D. Anti-Money Laundering

Federal Reserve Banks would be required to comply with various AML laws. This appears to require the Federal Reserve to engage in know-your-customer (KYC) and beneficial-owner investigations even though account information is maintained by banks. The liability associated with AML violations would at the least be complex to administer for federal agencies, although the Reserve Banks are in fact also private corporations under certain sections of U.S. law and thus could be held accountable in some way.

E. Privacy

The Federal Reserve Banks and their employees would also be subject to federal financial-privacy law and criminal liability.

F. Reimbursement

Post offices handling these accounts and banks with assets below $10 billion would be reimbursed by the Fed for actual and "reasonable" costs. If the Fed expands access to state nonmember banks and credit unions, then they would be reimbursed regardless of size. The Fed would set out regulations governing this.