FedFin Client Report

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BIS Prefers Two-Tier CBDC, But Major Questions Remain

Client Report: CBDC6

Executive Summary

As previously noted, the BIS has released its most full-throated endorsement yet for CBDC. This not only puts further pressure on central banks – the Fed very much included – to accelerate work, but also on the shape of emerging CBDCs. Earlier this week, FRB Chairman Powell said that digital IDs may prove essential to CBDC and the BIS paper confirms this without answering many of the most thorny questions about personal privacy such an ID surely poses. Although Mr. Powell so far prefers a wholesale CBDC that fully preserves the role of banks as the customer-facing payment intermediary, the BIS paper posits two-tier retail systems akin in many ways to FedAccounts (see FSM Report **CBDC**). These are found to have considerable benefits if designed with open infrastructure that provides equal access to personal data and enhances inter-operability. Were the Fed to open payment-system access to nonbanks (see FSM Report **PAYMENT22**), U.S. CBDC would take on more of the BIS's preferred construct, although the extent to which the Fed could ensure open access and fair competition would also require the new law the Fed believes necessary also for any form of CBDC. A national digital ID would be particularly controversial in the U.S.

Impact

1. Framework

BIS calls CBDC an "advanced representation of money for the digital economy" with the potential to create a "virtuous circle of greater access, lower cost, and better service" if properly designed. However, since it concludes that a “vicious circle of data silos, market power, and anti-competitive effects" could also ensue, the paper devotes considerable attention to how CBDC might best protect public welfare based on the premise that stablecoins are risky and private crypto-currencies are speculative assets that often have "few redeeming public-interest attributes" in sharp contrast to central-bank money.

Much in the paper also addresses bigtech risks in the money and payment system. The BIS paper judges public welfare not only in terms of payment efficiency and monetary-policy transmission, but also by competition and data privacy. Absent effective governance, bigtech payment and currency activities are at best a "mixed blessing." As

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before, the BIS emphasizes the need for entity-based regulation governing bigtech payment activities, not just like-kind activity standards.

2. Two-Tier CBDC (Hybrid) Option

As noted, much in the paper posits and favors retail CBDC in which the central bank plays few consumer-facing roles but still relies on private-sector payment-service providers. The interplay of the two sectors is discussed in detail due to the wide variance in advanced and emerging nations and within each group of nations, with the BIS generally concluding that certain tasks (e.g., account opening and maintenance, AML compliance, financial intermediation) would undermine the ability of central banks to be the "lean and focused public institution" the BIS prefers. However, in this model, central banks would still record all payments and serve as a source of support directly for the payment system and thus indirectly for all payment-system participants (i.e., bank and nonbank). The paper also discusses the intermediated approach favored in a recent BIS paper, but notes that many additional safeguards are necessary to ensure finality since data are housed outside the reach of the central bank.

Key design features of the two-tier CBDC construct include:

- digital-ledger reporting of payment transactions, likely maintained by the central bank (this remains an issue under study);
- central-bank access to all records to ensure an open system;
- varying degrees of anonymity;
- lower rates on CBDC deposits than on those at banks or caps on deposit amounts to preserve the role of banks as intermediaries and prevent runs;
- digital IDs accompanied by robust privacy and cyber-security protections. The paper includes details on how digital IDs would be opened, maintained, and verified to support open architecture and thus market competition; and
- an array of design features likely to prove essential if this CBDC model is to play its desired role in cross-border payments. Key considerations are to prevent currency substitution, tax evasion, and illicit commerce. Key here will be action on the FSB's work to advance cross-border payments (see FSM Report **PAYMENT23**), with the BIS dubious that any supranational digital ID that would empower cross-border digital payments will otherwise succeed. However, a significant amount of cross-border cooperation will still be necessary to empower multi-currency CBDC payments.

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