FedFin Daily Briefing

Thursday, February 3, 2022

Fed Study Presages House Two-Tier Stablecoin Standards

A new Federal Reserve staff note recommends a different approach to stablecoin innovation than that proposed by the President's Working Group on Financial Markets (see *Client Report* **CRYPTO21**). Although the PWG argued that stablecoin issuers must be housed in insured depositories, this paper suggests a two-tier system in which stablecoins and/or the reserves backing them are either directly in banks or deposited at banks to ensure both stablecoin safety and continuing financial intermediation. Indeed, the note concludes that this construct would promote more credit intermediation, while narrow IDI charters for stablecoin issuers would be akin to retail-facing CBDC, reducing intermediation even though it would also reduce run risk. The paper also details an array of positive stablecoin implications (e.g., financial inclusion, payment-system efficiency) as technology advances. The paper also contemplates next-generation stablecoins that might, for example, use Web3 to facilitate micropayments, transforming both social media and the payment system. Despite these optimistic conclusions, the paper also notes that its preferred two-tier structure does not address other concerns (e.g., AML enforcement, issuer liquidity, monetary-policy transmission).

Press reports yesterday indicate that this two-tier approach will be proposed in House legislation expected to reflect the Democrats' plan to advance stablecoin standards. We will analyze the bill upon formal introduction and, as always, provide clients with an in-depth analysis of the hearing next Tuesday.

Fed's Project Hamilton: CBDC Advances Payment Functionality, Outdoes DLT

The Boston Fed and MIT today published findings from Phase 1 of their CBDC research initiative “Project Hamilton,” which has now successfully created a core processing engine for a hypothetical CBDC. Results also demonstrate an array of other CBDC capabilities, a finding sure to factor into the Fed's thinking about the pace of CBDC implementation once it makes more progress on the basic "what-if" questions in its discussion draft (see FSM Report **CBDC10**). For example, researchers determined that CBDC can provide functionality beyond that currently possible using either cash or bank accounts such as supporting cryptographic proofs of payment, more complex transfers to or from multiple sources of funds, and flexible forms of authorization to spend (e.g., varying transaction limits). Going forward, it will investigate new functionality and alternative technical designs, with research topics potentially including cryptographic designs for privacy and auditability, programmability and smart contracts, offline payments, secure issuance and redemption, new use cases and access models, ways to maintain open access while preventing denial of service attacks, and tools for enacting policy – presumably monetary, although perhaps also supervisory and/or regulatory as the report is not specific.

Notably, the research also concludes that operating via a distributed ledger has downsides compared to platforms administered by a central actor, even in cases where the distributed leger is under the control of a single actor, with the report specifically highlighting shortcomings related to trust as well as performance bottlenecks. Project Hamilton’s code was able to handle 1.7 million transactions per second, with the vast majority of transactions securely settled with finality in under two seconds.

McWilliams Outlines How FDIC Insurance Could Cover Stablecoins

Although Jay Powell delivered his all-important annual address atop a virtual Wyoming mountain, the Federal Reserve is nonetheless mired in the Big Muddy. This mythical river was described in a high-impact Pete Seeger song mobilizing Vietnam War opposition. In it, soldiers led by politicians start out in a small, clear stream, wade on and, as the waters rise and the mud deepens, keep going because they don't and then can't turn around. All they do is march on to a surely-grim fate. So too with U.S. monetary policy: It's past time to turn around but still critical that the Fed quickly do so.

Recent Files Available for Downloading

The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics' website: www.fedfin.com or clients may obtain the reports/analyses by e-mailing info@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about *GSE Activity Reports*, click here.

- **FEDERALRESERVE69**: As this report details, all three Fed nominees before the Senate Banking Committee today emphasized the vital importance of Fed independence and their anti-inflation zeal to quell GOP opposition and cement it among moderate Democrats.
- **CONSUMER38:** Taking action to advance President Biden's competition order, the CFPB is seeking views on fees which it believes exploit consumers by virtue of unfair competition.
- **GSE-020122:** Nothing could do as much damage to a business based on fee revenue as a determined CFPB inquiry into fee revenue.
- **CBDC10:** Months after initially promising to release a discussion draft on central bank digital currency (CBDC), the Federal Reserve is now seeking comment on whether and how it might create one.
- **GSE-012422**: A new Federal Reserve Bank of Atlanta study adds another element to those prior research argues are evidence of widespread racial discrimination in U.S. mortgage finance.
- **GSE-011422**: As noted in our in-depth analysis of Acting FHFA Director Thompson's confirmation hearing, it's clear that Democrats and Republicans are thinking hard about resurrecting statutory changes to the GSEs' charters.
- **FEDERALRESERVE68**: At today's confirmation hearing, Gov. Brainard took a lot of the heat on inflation Republicans only mildly mentioned during Mr. Powell's Tuesday confirmation hearing (see Client Report **FEDERALRESERVE67**).
- **REFORM211:** As promised, FedFin begins our 2022 forecasts with this in-depth report on bank regulation.
- **FEDERALRESERVE67:** As promised yesterday (see *Client Report* **FEDERALRESERVE66**), we listened closely today to gauge the extent to which Chairman Powell faces a serious challenge to reconfirmation.
- **FEDERALRESERVE66:** Many of you have asked us to forecast key policy implications ahead of two high-powered hearings this week considering President Biden's top Fed nominees.
- **GREEN12:** Issuing the first formal U.S. climate-risk proposal, the OCC is seeking comments on high-level risk-management principles to set the context for additional, more binding action governing larger U.S. banking organizations.
- **GSE-010322**: New economic commentary from the Federal Reserve Bank of Cleveland assesses

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several recent studies on homeownership from an investment perspective.

- **MMF19:** In the wake of noncommittal statements from global regulators on ways to address money-market fund systemic risk, the Securities and Exchange Commission has proposed sweeping changes to the 2014 standards adopted after the 2008 crisis.

- **GSE-122721**: Late last week, the NCUA put a small addition into the Christmas stockings already stuffed by the regulator over the past few months with numerous regulatory liberalizations.

- **MERGER10**: Just days after the FDIC chair refused to advance a request for comment on bank-merger policy, the Department of Justice released one signaling agreement with many of the concerns Democrats aired in concert with the RFI.

- **GSE-122021**: As noted on Friday, the Biden Administration's first FSOC systemic-risk hit list reiterates Trump Administration fears about nonbank mortgage companies.

- **GSE-121721**: As noted on Thursday, FHFA continues to tread carefully through the big-bank rulebook, adopting standards said to be like-kind that aren't quite so similar when it comes to critical details.

- **MERGER9**: Released in a highly-controversial fashion (see below) by two Democrats on the FDIC's board, this RFI posits the need for a significant review of mergers involving insured depository institutions (IDIs) due to many changes in the financial industry and, so it says, the lack of substantive competitive analysis over past decades even of the largest transactions.

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