GSE Activity Report

Wednesday, September 21, 2022

Can You See CBDC?

Summary

In this analysis, we drill down in Treasury's high-impact reports to the President on the future of digital assets to identify key considerations and strategic implications for housing finance. We start with an assessment of central bank digital currency (CBDC), turning in subsequent reports to other critical strategic questions surrounding the future of digital finance along with its winners and losers. When it comes to CBDC, Treasury mostly wants one and the Fed will almost surely build one, changing the course of mortgage finance in terms of who controls key liquidity and consumer-facing nodes across the financial system.

Impact

For more on the Treasury reports, go here for our in-depth analysis of Treasury's recommendations on CBDC and the payment system. These may seem remote considerations in housing finance, but that's like saying that one doesn't need to know where the river is to grow crops. How a CBDC functions will determine where funds flow in the U.S. and thus how they do or don't end up in housing.

As we have frequently noted, the Fed is ambivalent about CBDC even if many Congressional Democrats are not. This same interplay is evident in Treasury's report – it seems clear that the White House and many other top government agencies want CBDC, but Treasury is ambivalent in part due to the fact that two top officials – Yellen and Nellie Liang – hail from the Fed. We think this battle will play out in favor of a U.S. CBDC that preserves the role of banks as consumer-facing intermediaries at least to some extent and – much, much to the banks' discontent – opens the payment and thus intermediation stream also to eligible nonbanks, sure to be a subset comprised of those willing to accept a lot more bank-lead regulation.

Could Fannie and Freddie be eligible intermediaries in the context of a U.S. CBDC? They would, we think, be among the most qualified of any nonbanks given their status and regulation, at least in conservatorship. Out of conservatorship – should that ever come to pass – maybe yes, maybe no.

Would the GSEs want to be eligible intermediaries? On initial review, it seems clear that Fannie and Freddie don't need consumer deposits to ensure funding – their implicit guarantee gives them supe low-cost liabilities under the conservatorship. Outside the conservatorship is another matter, but whether core deposits are useful then would depend on what the new GSEs look like to the market.

However, CBDC gives an eligible financial institution more than money. If the Fed adopts the "two-tier" structure we anticipate, CBDC allows financial institutions to face the consumer not just as a depository, but also as an intermediary. The GSEs have long lusted after origination power, and, based on who's in charge and how all this comes together, CBDC eligibility could get it for them. It would similarly enable servicing should the GSEs decide to build out this complex infrastructure and, if they don't, at least give them a far more powerful hand in servicing "partnerships."

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What of nonbank mortgage companies? There is nothing about CBDC that prevents it from simply altering the form of money flowing through banks into nonbank mortgage companies via various liquidity facilities or the debt market. Gaining direct access to the payment system and a form of currency with FDIC-insurance or still-better resilience would, though, essentially turn nonbanks into banks with all the potential this entails unless the GSEs squeeze them out and/or the cost of CBDC eligibility is bank-like capital, liquidity, and related regulation.

Outlook

Although it's clear that the Administration wants to hurry the Fed along, it can't. As an independent agency with a particularly clear sense of its own might, the Fed will do what it wants on a CBDC when it wants. That said, the Fed is also keenly attuned to political considerations as well as to the growing number of other central banks cooking up CBDCs. The next steps for the Fed are to finalize thinking on its Board of Governors and, to a lesser extent, Reserve Banks. The Fed has so far said that, should it decide to pursue a CBDC – as we expect it will – then it will also want some form of approval from Congress and the Administration. It got this from the Administration in Treasury's report. If by "approval" from Congress the Fed means new law, that will be at the least a while and likely never if the GOP gains Congressional control. If approval means the equivalent of a no-objection letter, then the Fed can proceed when it wants and as it wants and the U.S. will have a CBDC. 2025, here's looking at you.

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