

Special Commentary

from the Investment Advisory Group

FedNow and Central Bank Digital Currencies: Setting the Record Straight

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Jeff Terrell, CFA
Senior Analyst – Investment Strategy

- FedNow is the Federal Reserve's first new "payment rail" they have added in nearly 50 years, offering 24 X 7 X 365 instant payments for participating banks.
- FedNow is not a digital currency such as a CBDC.
- The U.S. does not have a Central Bank Digital Currency (CBDC) as the Fed continues to study its merits.
- Trends in non-cash payments since 2000 have dramatically shifted from checks to debit cards, reflecting demand for fast, efficient, and secure payment solutions.
- A U.S. CBDC can only be issued through an act of Congress and not ordered by the Fed or a Presidential executive order.
- FedNow has been in development since 2015 and its successful launch is a higher priority than a CBDC for the Fed for the foreseeable future.

Summary

News around the Federal Reserve's research project on Central Bank Digital Currency (CBDC) and the recently launched FedNow instant payments solution often collide and sometimes cause public confusion between the two. This paper aims to clarify the differences between these distinctly different payment solutions. Both focus on improving the speed and efficiency of the payments infrastructure within the U.S. banking system, but that is where the similarities end.

FedNow is the first U.S. government created real-time payments solution offering 24 X 7 X 365 instant transaction technology for bank customers, which allows for immediate end-to-end payments. The Federal Reserve launched FedNow on July 20th to a limited number of financial institutions and will expand to a wider user base with additional capabilities in 2024.

FedNow is not a digital currency or a Central Bank Digital Currency (CBDC); instead, it is a government sponsored instant payments technology solution.

In the U.S., a CBDC would represent a third form of central bank money but would be offered via a centralized blockchain network. It would supplement, but not replace, the two existing forms of Federal Reserve money: hard physical currency and digital balances held by member banks. It would be a new liability of the Federal Reserve but not its member banks. A CBDC remains in an exploratory phase, with any potential launch being years away if it occurs at all.

Background on FedNow

FedNow is the first government sponsored real-time payment solution offering participating banks and their customers the ability to instantly send or receive funds. Its development began almost ten years ago with the formation of the Faster Payments Task Force, leading to the announcement of FedNow in 2019. It is a digital payment solution for member bank participants but is not a digital currency, CBDC or private stablecoin. FedNow enables users to send/receive funds 24 hours a day, 7 days a week, 365 days a year. This is the Fed's first new payment rail since the introduction of the Automated Clearing House (ACH) in 1972. The Fed's intent is to enhance, not replace, the decades old ACH and Fedwire services.

FedNow **provides similar functionality to current private payment solutions** such as The Clearing House (TCH) Real-Time Payments (RTP) launched in 2017 and to a lesser extent

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Investment and Insurance Products:

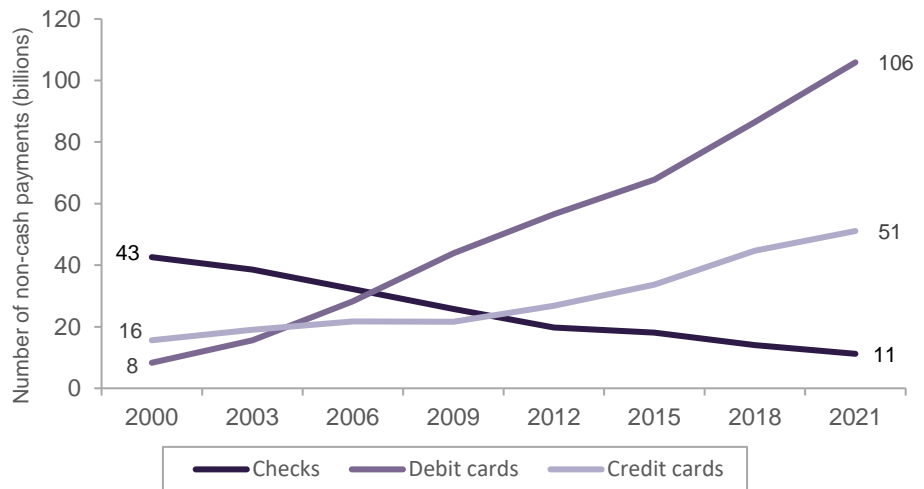
- Are not FDIC or any other Government Agency Insured
- Are not Bank Guaranteed
- May Lose Value

more retail oriented apps such as Zelle, Venmo and Cash App. FedNow will not replace existing private payment services but only time will tell if it has a disruptive impact.

Why Now?

The advent of the internet in the 1990's and the smart phone in the 2000's, has profoundly impacted customer banking preferences over the last 25 years. The digital age has slowly eroded the dominance of paper checks and ATM activity as the world has shifted away from check/cash transactions toward debit cards, credit cards and instant payment mobile apps. The chart below illustrates this trend and measures the number of transactions (in billions) rather than dollar amounts.

Trends in non-cash payments: 2000-2021



Data Source: Federal Reserve Payments Study: 2022 Triennial Initial Data Release 4-21-23

Bank customers have embraced fast, efficient, secure, and cost-effective payment solutions at an accelerated pace. Technological innovations tend not to reverse, so we anticipate these trends to accelerate as future technologies are introduced and adopted.

Commercial bank participation in FedNow is not mandatory. Banks can opt-in and choose varying levels of functionality as the network and offering expands in 2024.

Central Bank Digital Currencies (CBDC)

What is a CBDC?

The **U.S. does not yet have a CBDC** and remains in research mode. A Central Bank Digital Currency (CBDC) is a new form of digital money issued by a central bank (such as the Fed), typically denominated in the same currency of the issuing central bank and widely available for use by the public. While it may seem like we already have a digital dollar due to innovative new payment technologies we discussed above, a distinct characteristic of a CBDC is that it represents a liability of the central bank itself rather than a liability against commercial bank deposits.

A CBDC is different from a true cryptocurrency such as bitcoin for two key reasons. First, the value of a CBDC is pegged to the underlying value such as of the central bank's underlying fiat currency such as a U.S. dollar. Second, whereas bitcoin operates on a decentralized blockchain ledger, absent a middleman, a CBDC would typically operate on a centralized blockchain ledger controlled by a central bank issuing authority.

Finally, a CBDC issued by a central bank (such as the Fed) is fundamentally different from privately issued stablecoins that exist today such as Tether (USDT) and USD Coin (USDC) issued by Circle. Private stablecoins, such as these, are more native to the cryptocurrency ecosystem and remain unregulated. This limits broader commercial appeal for traditional finance use cases in their present form. The intersection of CBDC's and stablecoins is evolving and will be the subject of a future paper.

President Biden issued Executive Order 14067 titled: *Executive Order on Ensuring Responsible Development of Digital Assets* in March 2022. The order highlights seven strategic digital asset priorities. One of those priorities was to; *Explore a U.S. Central Bank Digital Currency (CBDC)*.

The White House does not have the authority to order the creation of a new currency, digital or not. In fact, the executive order was essentially a homework assignment given to relevant government agencies researching the feasibility and risks of digital assets. Primary agencies involved in the CBDC study included the Department of Treasury, the Federal Reserve, and the National Security Council, among others.

In response to the executive order, the Department of the Treasury released its recommendations in September 2022:

1. Advance work on a possible U.S. CBDC in case one is determined to be in the national interest.
2. Encourage use of instant payment systems (such as FedNow) to support a more competitive, efficient, and inclusive U.S. payment landscape.
3. Establish a federal framework for payments regulation to protect users and the financial system while supporting responsible innovations in payments.
4. Prioritize efforts to improve cross-border payments, both to enhance payment system efficiency and protect national security.

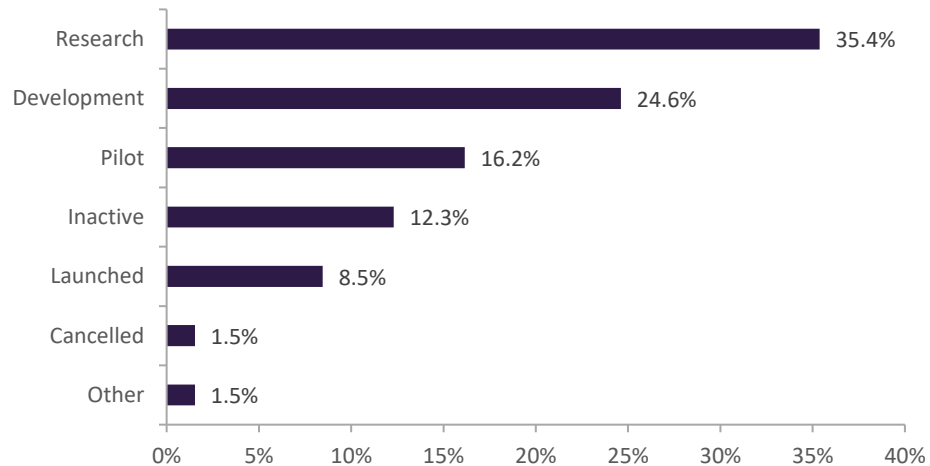
In our view, a U.S. CBDC could be years away if it occurs at all. For now, the Fed remains in research mode for several reasons:

- The successful rollout of FedNow is a core Fed priority after almost 10 years of planning and will continue to phase in over the next several years.
- The U.S. House and Senate each have introduced bills on digital assets, but nothing has been put to a vote, much less become law.
- There is a substantial bi-partisan divide with some states banning any potential CBDC, while some members of Congress have introduced bills to ban a CBDC.
- Fed Chair Powell maintains that a CBDC is not possible without new laws created by Congress and agreed on by the White House. He has testified that a CBDC would operate in concert with the existing banking system and not disintermediate or compete with it.
- The Fed's initial focus has been working with other world central banks studying the feasibility of using CBDC's to foster a more efficient cross border payments with international trading partners. This study is known as Project Cedar.
- Stablecoin legislation efforts remain inconclusive potentially including Fed supervision over both bank and non-bank stablecoin issuers.

Global development status

The world remains actively engaged in various stages of CBDC study or adoption. The variety of unique CBDC use cases and construction designs among countries makes a one-size-fits-all approach unfeasible. CBDC projects among countries differ on a case-by-case basis upon careful consideration of their respective economies and intended purpose. At present, 60% of the 130 countries contemplating a CBDC remain in the research and development phase. To date, only eleven countries have launched a CBDC.

Current CBDC Status: 130 countries surveyed



Data Source: Atlantic Council

What problems does a CBDC aim to solve?

- A faster new payment system. This potentially collides with FedNow but aligns with global trading partners that are in more advanced stages of CBDC development.
- Financial inclusion: This is more applicable to those emerging countries with large percentages (in some cases over 50%) of their population remaining unbanked. In the U.S., the Fed estimates that only about 4.5% of the population remains unbanked.
- Cross border international transactions: FedNow does not yet have this capability, though it is in the development pipeline to facilitate instant, efficient, and inexpensive transfers. Global trade is a key use case for CBDCs that may have merit.

Bottom line

The U.S. is in the early days of studying the role of a CBDC in the U.S. economy. Any issuance of a CBDC would be a collaborative effort between the Federal Reserve, the Treasury Department, Congress, the White House, bank regulators, and other government agencies. The design choices behind creating a CBDC are critically important and would potentially take years to resolve to the satisfaction of all government entities.

For now, we think the successful rollout of FedNow as an instant payment vehicle for banks and their customers is a top priority for the Fed. We suspect that as FedNow broadens its reach and features in 2024, the Fed and others will continue to research the merits of a CBDC, a process we will follow closely.

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