BankThink: Bankers need to engage on CBDCs before it’s too late

By [Rob Blackwell] **January 12, 2022, 10:31 a.m. EST** **5 Min Read**

While the debate over whether the U.S. should create its own central bank digital currency continues, the ultimate conclusion is already clear — like it or not, a U.S. digital dollar is coming.

If you’re a banker, particularly a community banker, this should scare the hell out of you. Because depending on how the digital dollar is created, it could create serious competition for federally insured deposits, drying up the primary source of funding for banks.

So far, bankers have been largely absent from this debate, understandably distracted by the economic turmoil caused by the pandemic and other policy fights. There is also a sense that while the issue is important, there is plenty of time to worry about it later.

But there is growing pressure for regulators and Congress to respond quickly because the U.S. is already behind internationally in the discussion over CBDCs. That’s in part due to China, which has rolled out a digital version of the yuan in several provinces. European countries are also experimenting with CBDCs. This dynamic will likely force policymakers to act sooner than most bankers expect.

“I do think as commerce happens internationally, it’d be hard to think the U.S. could get away without having a digital dollar when China will have one and the EU is talking about it,” Jim Reuter, the CEO of $26.7 billion-asset Firstbank in Lakewood, Colorado, told me on IntraFi Network’s Banking with Interest podcast. “That issue is what makes some members of Congress sit up and pay attention to this because the thought of falling behind any other country is pretty motivating for them.”

So far, Reuter is one of the few bankers fully engaged in the issue — and he’s warning other bankers to get involved. That’s because depending on how policymakers structure it, a U.S. CBDC could potentially replace bank deposits. While there are many iterations of CBDC proposals, there are three basic models, each with potentially big implications for banks.

Direct Fed Accounts: In this model, the Federal Reserve itself would offer digital dollars directly to consumers, in what experts refer to as a “retail model” for a CBDC.

“Just literally think about everybody having the opportunity to open a bank account with a fancy kind of old-style postal savings system,” David Andolfatto, a senior researcher at the Federal Reserve Bank of St. Louis, said on the podcast.

This model is likely to be attractive to some Democrats, many of whom have long favored postal banking and may see this as the 21st-century equivalent. Many believe it will address financial inclusion, giving easier access to unbanked and underbanked consumers.

But this obviously would come at a cost to banks, as a retail account at the Fed means fewer deposits at banks. To address this concern, some have called for limits on the amount of digital dollars a consumer could hold. For example, one suggestion for a [“minimally invasive”] model is $2,500 per person. But even that amount of funding going to the Fed instead of a community bank could have an outsized impact.

“I had our IT team run a query and 70% of our consumer accounts, during a one-year period, went below $2,500 in terms of the balance in the account,” said Reuter. “The average account at our bank, a consumer has about $1,700 in there. So ‘minimally invasive,’ it’s all in the eyes of the beholder. I think it would have an impact on funding for us.”

Of course, the loss of those funds on banks’ books doesn’t just impact the institutions themselves. Without those deposits, there’s less funding available for lending. That could have a potentially dire impact on small businesses, which receive the majority of their credit from community banks, and others in places that depend on community banks.

Wholesale model: Under this setup, bankers and other companies serve as intermediaries for a U.S. digital dollar. Broadly speaking, this is similar to the system we have now, except in digital form (Cash is both a U.S. note and something held on consumers’ behalf at a bank). The advantage for banks in this approach is that they would continue to have access to consumer deposits.

But there are big questions about how exactly this model would be built, and the devil is in the details. For example, policymakers have to decide which firms may act as distributors. Is it just banks and credit unions, or does it include payment companies like PayPal? What about fintechs? Or Big Tech firms like Facebook, Google and Amazon? Depending on the answer, it could result in fintechs or Big Tech gaining an even bigger foothold in banking.

Hybrid model: There is also a third option, which is a combination of the above. In that scenario, a CBDC would be distributed by banks and payment companies, but would be a liability of the Fed, not the institution holding it. This model may be a worst-of-all-worlds option for bankers, as the possible drawbacks of both the retail and wholesale models would be in play — banks could lose funding and face enhanced competition from other players in the market.

I’m just broadly scratching the surface here as to how a CBDC may be created. There are multiple approaches, some of which disintermediate banks and some of which don’t. But that’s precisely the point. It’s not clear what policymakers are going to decide, but the details here will have far-reaching consequences. The only thing apparent is that it’s almost certain to happen one way or the other.

“Bottom line, yeah, I think it’s inevitable,” Tim Massad, former chairman of the Commodity Futures Trading Commission, [told me on the podcast]. “But the key thing to remember here is a CBDC can mean a lot of different things. There is not one design.”

The only good news for banks is there’s still time to shape the outcome. But the only way for that to occur is to get involved now. This issue has to move up the industry’s priority list.

The Fed is slated to release a paper soon examining whether to create a CBDC. Both Massad and Reuter expect it to be the equivalent of a toe in the water where the central bank outlines the pros and cons of a CBDC and puts some details on the options above. The Fed is unlikely to make a recommendation as to which approach is best, but the paper will function as an early call for comments on how to proceed.

This is a critical opportunity for banks to begin a dialogue with the Fed and other policymakers. When the paper is released, bankers would do well to read it and work with their trade groups to develop a coherent policy position. If they don't, they could soon face a world where policymakers create a CBDC without them — and run the risk of being left behind.