Central Bank Digital Currencies: Challenges for commercial banks

The Covid-19 pandemic is speeding up central banks' studies on creating their own digital currencies. Big questions remain, however, about how they'll evolve and how they'll work in practice but the consequences could be revolutionary

Renewed interest in digital currencies

Digital currencies are rapidly moving up the agenda for commercial banks. Although Facebook has been forced back to the drawing board with its grand Libra global currency plan, the Covid-19 pandemic is giving dramatic impetus to the central banks' studies of creating their own digital currencies. Aside from the sudden jump in cashless contactless payments, the pandemic is sparking renewed interest in the potential for central bank digital currencies (CBDCs) to expand the monetary policy toolkit to tackle a dramatic recession. CBDCs could help get cash or even loans quickly out to people and businesses or allow interest rates to be driven into sharply negative territory. But the implications for the role and profitability of the commercial banks could be profound.

Until recently the commercial banks were working on the assumption that central banks would concentrate on Wholesale CBDCs rather than Retail CBDCs. This would not be disruptive. Indeed, it would largely be welcome for the commercial banks. Wholesale CBDC would only be available to selected financial institutions and would improve cross-border settlements issues by speeding up transactions while reducing costs and scope for errors.

The consequences could be revolutionary

But now commercial banks are having to tune in to the prospect of Retail CBDCs being launched. The consequences could be revolutionary. Banks could find themselves competing with the central banks as well as the Big Tech companies. Indeed, some of their activities might even be taken over by the central banks. Universal access to the central bank balance sheet, and the creation of a new-risk free asset, would create new opportunities but also raise new challenges for central banks, commercial banks and financial markets.

What form CBDCs take will undoubtedly be complicated by the fact that different central banks will pursue different motives, strategies and experiments. Aside from improving existing payments infrastructures, some will also be looking to promote financial inclusion or curb financial crime and the black economy.

Big questions revolve around how the private and the public sector will divide up their roles and responsibilities. One key choice would be over whether the Retail CBDC would be exchanged using account-based ledgers or digital tokens. Another would be whether it is distributed directly by the central bank or via banks or other intermediaries. In its purest form, an account-based directly issued CBDC would be particularly challenging for commercial banks. They would find themselves competing for deposits with the central bank, which would be especially hard if the CBDC offered attractive interest rates or if a crisis triggered bank runs. It also begs the question of whether and how the central bank would make loans.

A token-based CBDC might be the least disruptive scenario

Given that central banks, at least for now, lack the resources for such a radical takeover of banking functions, it perhaps more likely that CBDC will be distributed through banks and other institutions. This would allow the central banks to avoid much of the cost and risk of screening and servicing customers, providing complementary services (such as cards and investment products), and building and running the technology and operations.

In principle, a token-based CBDC might be the least disruptive scenario since the tokens would effectively be digital versions of cash and avoid the burden of account management and verification. However, if this were to allow non-financial players like the Big Tech companies (such as Facebook with Libra) into digital finance this would increase competition in an already highly contested market, further reducing margins and challenging the banks' customer relationships.

The emergence of CBDCs, therefore, raises some deep strategic questions for the future of the commercial banks, at a time when their profitability is already challenged. They should welcome the timely arrival of the Digital Monetary Institute to address them.

***ING, through its New Horizons Hub, is a founder member of OMFIF's Digital Monetary Institute. An edited version of this article appears in its latest journal** here.*

Further references and links: Central bank digital currency

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