

FSR OUTLOOK 2022: FUTURE OF PAYMENTS - WILL CENTRAL BANK DIGITAL CURRENCIES REVOLUTIONISE THE PAYMENTS LANDSCAPE?

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Legal Briefings

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As wholesale CBDCs enhance cross-jurisdictional payments, are retail counterparts still a solution looking for a problem?

In a nutshell:

- **2021 saw an increased focus on CBDC by central banks and market participants.**
- **Wholesale CBDC have the potential to revolutionise cross-border payments. However, the case for retail CBDC is less urgent in many jurisdictions and needs to be weighed against the potential risks.**
- **2022 will see continued co-operation and collaboration by central banks on wholesale CBDC initiatives, and further policy and technical reviews by many jurisdictions of the viability of retail CBDC. China will continue to vigorously promote its e-CNY.**

The use cases and support in various jurisdictions for CBDC (ie a direct liability of and payment instrument issued by a central bank) varies, particularly when looking at retail CBDC (effectively a digital form of cash) vs wholesale CBDC (similar to reserves commercial banks place with central banks and restricted to use within the banking system).

While most central banks taking an interest in CBDC continue to weigh up the benefits of retail CBDC vs the risks (which include the disintermediation of banks) and whether there is a strong case for them (it has been asked whether retail CBDC are really a solution looking for a problem?), it is becoming evident that wholesale CBDC have the potential to revolutionise cross-border payments, making cut-off times obsolete, saving time and cost and allowing for settlement finality, among other potential advantages.

CHINA

While all virtual currency-related business activities have recently been declared illegal in China, by contrast, users of the People's Bank of China (**PBOC**) approved CBDC (the e-CNY) surged to 140 million in November 2021. PBOC's efforts to pilot and vigorously promote the e-CNY continue, with the next key target being the Beijing Winter Olympics.

China's domestic payments landscape has previously been dominated by two mobile payment service platforms. However, these platforms have notably been shut out of the e-CNY's. Instead, PBOC is acting as the central manager of the digital currency ecosystem and designated commercial banks are acting as the lower-tier institutions that can open digital wallets and convert cash to and from e-CNY for users.

Internationally, PBOC has partnered with other central banks on various projects, including the "Multiple CBDC Bridge" project (MCB Project), to make real-time cross-border CBDC transactions a commercial reality, although its whitepaper on the e-CNY states that it is "mainly" designed for domestic use.

HONG KONG

As part of its "Fintech 2025" strategy announced in June 2021, the Hong Kong Monetary Authority (HKMA) intends to strengthen the research work on CBDC with a view to future-proofing Hong Kong in terms of CBDC readiness.

The HKMA issued a technical whitepaper on 4 October 2021 on retail CBDC, titled "e-HKD: A technical perspective" (**Whitepaper**). The Whitepaper identifies various issues for further exploration (summarised as "problem statements"), including in relation to:

- privacy;
- interoperability;

- performance and scalability;
- cybersecurity;
- compliance;
- operational robustness and resilience; and
- technology-enabled functional capabilities.

On 3 November 2021, the HKMA, together with other participating authorities and the Hong Kong Centre of the Bank of International Settlements Innovation Hub (**BISIH**), published 15 potential business use cases under the MCB Project. In one of the use cases, testing of sample trade settlement transactions across 11 industries and four jurisdictions has commenced and is expected to enter pilot stage from 2022 onwards, with an aim to achieve a system that could support the full process of international trade settlement.

SINGAPORE

The Monetary Authority of Singapore (MAS) first experimented with tokenising the Singapore dollar in 2016 as part of Project Ubin, the success of which inspired Partior, a blockchain-based interbank clearing and settlement network established by DBS, J.P. Morgan and Temasek. Partior enables banks to settle cross-border payments in different currencies in real time, using either commercial bank digital money or wholesale CBDCs. Partior is progressing to increase its currency coverage and onboard more banks.

MAS is currently partnering with the Reserve Bank of Australia (RBA), Central Bank of Malaysia, South African Reserve Bank and the BISIH on "Project Dunbar", a blueprint for a multi-currency cross-border settlement platform that uses wholesale CBDCs. If successful, Project Dunbar would enable instantaneous, real-time settlement of cross-border payments and eliminate the current reliance on the complex network of correspondent banks coordinating across multiple time zones to enable cross-border settlement. A project report will be published in March 2022.

MAS has determined that retail CBDCs can potentially pose significant risks to monetary and financial stability, and on balance, the case for a retail CBDC in Singapore is not urgent. Nonetheless, MAS has said it recognises that there could be benefits offered by innovative retail CBDC in the future and is therefore embarking on "Project Orchid" to build the technology infrastructure and technical competencies necessary to issue a digital Singapore dollar should Singapore decide to do so.

UNITED KINGDOM

The UK is still at an early stage and no decision has yet been made to develop a UK CBDC, although HM Treasury (HMT) and the Bank of England (**BoE**) are actively exploring the concept.

On 9 November 2021, HMT and the BoE announced a potential timeline for UK CBDC development. In 2022, HMT and the BoE will publish a consultation on the merits of a UK CBDC. Depending on the response, this may lead to a "development" phase taking several years. The earliest date for launch of a UK CBDC is likely to be the second half of the decade. This follows the BoE's discussion paper on UK CBDC published in March 2020 and launch of the UK CBDC Taskforce in April 2020.

The March 2020 discussion paper included an illustrative example of a mixed public/private 'platform' model: the central bank would build a technology platform with the minimum necessary functionality for CBDC payments; and private sector 'Payment Interface Providers' would use that to provide customer-facing CBDC payment services.

EUROPE

Similar to the UK, the EU is at early stages in relation to "digital euro". In July 2021, the European Central Bank (**ECB**) launched the investigation phase of the "digital euro" project, lasting 24 months to consider functional design, legislative and privacy issues. This follows the ECB's initial report on the merits of a digital euro published in October 2020.

Throughout 2021, experimentation work has also been carried out by central bank, academic and private sector participants. The experimentation work did not find any "major technical obstacles" to a digital euro and considered the following topics: the digital euro ledger; privacy and anti-money laundering; limits on digital euro in circulation; off-line user access and facilitating inclusiveness.

It will be interesting to see how digital euro developments interact with broader regulation of crypto-business, eg the proposed EU Markets in Crypto-Assets Regulation.

AUSTRALIA

The RBA has been considering the public policy case for issuing a general purpose or retail CBDC in Australia for some time. However, the case is still yet to be made. The RBA has commented that while the use of cash in transactions is declining in Australia, cash remains a widely accepted and available means of payment.

More recently, the Senate Select Committee on Australia as a Technology and Financial Centre (**Committee**) released its Final Report on 20 October 2021 addressing a number of Australian FinTech and regulatory issues, particularly with respect to CBDC. The RBA submitted to the Committee that it was particularly interested in the use of CBDC for cross-border payments (the RBA is involved in Project Dunbar with MAS as referred to above). The Committee has recommended that Treasury lead a policy review of the viability of a retail CBDC in Australia.

UNITED STATES

A discussion paper is expected to be issued by the Federal Reserve Board (**Board**) before the end of 2021 outlining the Federal Reserve's current thinking on digital payments, with a particular focus on the benefits and risks associated with CBDC in the US context.

Federal Reserve Chair, Jerome Powell, has said the Federal Reserve is committed to hearing a wide range of voices before any decision on whether to move forward with a US CBDC is made. Official views are mixed.

In the meantime, CBDC-related projects are underway at the Board and the Federal Reserve Bank of Boston. The Federal Reserve is also collaborating internationally in groups such as the BISIH's CBDC coalition.

CONCLUSION

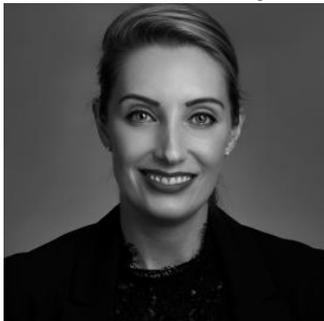
There are various motivations for pursuing CBDC, including increasing financial inclusion, facilitating faster and cheaper payment options, countering privately managed virtual assets, facilitating surveillance of financial activities and participants, and building newer, more direct levers to implement monetary policy. However, such motivations don't apply in all cases and they need to be weighed against the potential risks. These include loss of privacy, vulnerability to cyber-attack, and systemic risk arising from payment failures. Retail depositors may embrace retail CBDC and shift their deposits out of the commercial banking system – this could result in an increase in the cost of wholesale funding for banks, and a corresponding increase in borrowing costs for the economy, or possibly a shift to non-bank financial credit. Potential volatility in lending rates, and disruption to the money markets, would need to be carefully managed during any period of transition, and commercial banks would need to adapt their balance sheets to reflect the migration of retail deposits to CBDC.

Banks and payment providers will therefore be closely monitoring policy and regulatory developments in the coming year, especially since it seems likely that there may eventually be a divergence in approach to CBDC in different jurisdictions, at least in the case of retail CBDC.

In the meantime, we expect to see in 2022 continued co-operation and collaboration by central banks on wholesale CBDC initiatives and further policy and technical reviews by many jurisdictions of the viability of retail CBDC. China will also continue to pilot and vigorously promote its e-CNY.

KEY CONTACTS

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