

Facebook's Libra

A game changing innovation or aspirational experiment?

Facebook recently announced a “blockchain powered currency” called Libra which appears to be a potentially game changing development in payments. There is little detail as the project is in a consultation and discovery phase. This will probably be followed by a development ‘sprint’ and soft launch in 2020 if FB receives feedback that it will not be resisted by users and regulators. Stripped down, here's what FB said in its press release:

- A new subsidiary called Calibra will provide financial services.
- The first Calibra product will be a digital wallet for the currency Libra.
- Libra will be powered by blockchain technology and available globally.
- Calibra will operate the Libra network.
- The Libra wallet will be available in Messenger, WhatsApp and standalone.

FB has thus legally distanced Libra from its current portfolio of businesses but has made it clear its users will be able to deal in Libra from within their family of apps. FB also said that Libra would not share account information or financial data with FB or any third party without customer consent but did not specify whether that is to be achieved through opt-in or opt-out. FB also promised it would not use a customer's Libra data for improved ad targeting which is its only source of revenue.

As background, it is interesting to note that FB has been on a charm offensive since the Cambridge Analytica scandal and now says it wants deeper engagement from regulators so that it knows the standard to which it will be held accountable. The Libra initiative and consultation phase is consistent with this. It has also made aspirational comments on security and privacy for Libra which replicate what banks and card issuers already offer consumers, including refunds if there is fraud.

At first glance, it appears that (Ca)Libra has been designed by a committee comprising strategic technologists and new-age bankers to be a safe haven, quasi-fiat currency. Users will first have to buy Libra using fiat currency which will be held as a positive balance in a Libra wallet the contents of which will be transferred as debits and credits between holders of individual and merchant Libra accounts. The fiat money received from Libra purchases will be invested in high grade, low volatility financial instruments to be held in a reserve.

Libra is, prima facie, a digital wallet but with a crucial difference. FB hopes that Libra will be accepted as a medium of exchange in its own right because it is held in a secure repository and backed with hard, low volatility assets. If an asset, such as a digital currency, is trusted to retain its value, it can be held as a store of value and used as a payment method for goods and services without constant reference to the underlying reserve investments which support it. This is the case with major fiat currencies which are no longer backed by gold or indeed anything except the ability to demand taxes from citizens. And this is why FB is calling Libra a new type of global currency.

Although Libra uses some features of Distributed Ledger Technology like Bitcoin, it is not a fully-fledged Cryptocurrency. FB clearly recognises the risk of users labelling it a high volatility, risky product. The Libra initiative is also not really an innovation - the spirit of rebellious entrepreneurialism seems absent. This is borne out by the traditional and clichéd connection with Geneva, Switzerland as the place where the Libra Foundation will be

domiciled and from where the supply of Libra will be created and managed. On the other hand, history confirms that the real money is made from the second wave of deployment of innovative technologies and not by pioneers who too often run out of money and customers. Neither of which are problems for FB. And if nothing else, FB knows how to scale an idea or offering.

Reaction to Libra

The reaction to the Libra announcement from the media, opinion formers and influencers has focused on the problems and risks with little said about the potential for benefits for consumers and business. Most commentators seem to be Libra sceptics, and few acknowledge that it is a sensible and business-like evolution for FB. One with the potential to generate enormous benefits to society from lowering costs in payments and FX and offering convenience and choice to ordinary people and small business. There is almost total silence from banks and credit card issuers and even the eclectic list of high-profile tech members of the Libra Association seem to be eerily quiet. This is probably because there is recognition in the FB camp that there is so much uncertainty as to how Libra will turn out that having multiple voices speaking from within the Libra initiative will only create confusion and problems. The negatives typically refer to FB's potential for failing users in terms of data privacy, regulatory compliance, barriers to adoption by users and profiteering. The most significant uncertainties at the core of the proposition are:

- a) Data Security and Privacy: FB has not taken sufficient care in the past and so the risk of this happening from data held by Calibra is surely high.
- b) Antitrust: FB's dominance in social media and digital advertising must increase the risk of an abuse of its dominant position in both its current markets and now financial services.
- c) Central Banking: Libra will make it difficult for central banks, particularly in the developing world, to exercise monetary control and monitor drains on their reserves.
- d) Technology: Calibra uses Blockchain technology in a watered-down way and is untested.

Data security and privacy concerns have affected many firms and not just FB. The Cambridge Analytica scandal at FB was very high profile because of the political dimension even though the sale of results from data harvesting from its platform was not directly attributable to FB and more a case of unintended consequences. Nonetheless, FB accepted responsibility for not alerting users to the consent and privacy default settings whereby a third party was able to acquire behavioural data on tens of millions of users. FB seems to want to avoid this ever happening again and hopes that its new approach to data security and privacy and the use of Blockchain technology behind which Libra usage data will sit will be the answer.

The issue of anti-competitive behaviour is always going to be present where a firm like FB with a large market share enters an adjacent market. However, international competition authorities are alert to this and regularly investigate and prosecute the tech giants for misdemeanours. Also, the banking system, although showing oligopolistic tendencies from time to time in certain markets, is quite competitive, particularly in payments and FX, which would normally make it hard, if not impossible, for any single firm to be dominant. Moreover, the emergence of a vibrant Fintech sector in payments and transfers is challenging incumbents

and bringing more competition. With so many competitors and rapidly evolving products, antitrust risk from Libra seems to be low and should remain so for many years to come even though FB could easily have a market share from the sheer number of users to give it a position of dominance.

Similarly, for there to be a meaningful impact on central banks, Libra would first have to become dominant in payment or FX markets. If that did happen, central banks and regulators could quite easily combat this by regulating Libra as a bank or payments firm and even going as far as requiring disclosure and applying controls over its activity in fiat currency transfers.

Finally, it matters little what technology purists say if a product or service is fit for purpose. FB doesn't seem interested in creating a decentralised and anonymised currency per se because it wants to know who controls the nodes where data is held but without allowing any one node to be able to tamper with records. Blockchain and other Cryptocurrencies have been shown to be lacking in many ways when compared to traditional tech solutions in currency and asset management and Libra appears to want to use DLT to improve security and to appear to be technologically savvy as a marketing tactic.

In summary, it seems that the risk of bad outcomes in these areas is remote, at least for now, and FB's motives seem to be those of a commercial enterprise run for profit for the benefit of its shareholders.

Benefits for Users

The main benefits for users of Libra seem to be that it will:

1. Be a safe store of value.
2. Have lower price volatility than Cryptocurrencies and most fiat currencies.
3. Lower the costs of making local and cross border payments.
4. Be easy and convenient to use.

Economic benefits can arise from FB either: a) disintermediating banks and payment services providers to lower costs, or b) subsidising consumers' transactions costs in return for other benefits for itself. They are particularly important for users who live in countries where local fiat currency value is volatile when compared to fiat currencies of major economies like the USA, UK, the Eurozone and Japan. This suits FB well as it has both more users and a bigger market share in countries with high volatility currencies such as India, Brazil Turkey and most of Asia (excluding Japan and China) which are also countries where consumers face very high banking fees and payments and FX charges. These markets alone represent a problem worth solving and so a fantastic opportunity both for FB and its user base. As for ease of use, there are now many web based payment and FX platforms which allow users to reduce transactions costs and which are simple and quick. Whereas FB has 100 times the number of potential customers of these firms combined, they have quite a head start over Libra. It is therefore strange that FB has not made meaningful acquisitions in the space to learn from their acquired experience before launching Libra and has instead decided to build from the ground up.

Benefits for Facebook

FB brings to any new initiative immediate access to nearly 2 billion consumers and a large number of businesses who use it as a media platform and messaging tool. No bank, payment firm, commercial firm or even sovereign country has such a broad reach to an international community of connected users. In addition, FB has deep knowledge of how each user interacts with their family, friends and associates to be able to decide whether Libra would appeal to them. This depth of customer knowledge will enable FB to achieve rapid take up of Libra.

So, what are the benefits for FB of the Libra initiative? At first blush, it seems to be a classic business school case study: FB is profitable and still has plenty of opportunity for growth from capturing more users for its social media and messaging platforms even though digital advertising revenues may be softer in the coming years. It also appears that FB sees very few opportunities to diversify or invest in meaningful acquisitions within its current sphere of activity. Therefore, entering a new market like financial services by launching Libra, gives it a way to keep its current user base engaged, its offering refreshed, and to be seen as a (Fintech) champion for the little guy against universally disliked banks, remittance and credit card companies. On which subject it's worth noting that FB keeps emphasising the extra value Libra will bring to transactions in less developed countries because that is where it sees take up and because spreads and margins in financial transactions there are significantly higher than in more developed countries. Then there is the defensive element; despite FB being confident about maintaining and growing its quasi monopoly on social media as the remaining 50% of the world gets internet access over the coming decades, through Libra it may have found a way of tying in its existing and future customers for social media and messaging with the promise of cheaper and easier payments based banking of a sort.

Implementation Issues

Launching Libra should not be too difficult from a data architecture perspective as FB accounts domiciled in any of the scores of countries where FB is present are identical in almost every respect. This means it is fairly trivial once a user creates a Libra balance to make a transfer to another Libra user anywhere in the world by debiting one holding and simultaneously crediting another. In this regard, FB has a game-changing advantage over any competitor and even most global banks in that it can very quickly enable hundreds of millions of payors and payees from its existing social media and messaging platforms. The hard part will be onboarding users on to the Libra platform in terms of compliance and KYC checks.

Payment activity using Libra will both drive, and be driven by, network effects as we have seen in so many Fintech platforms. For example, in the case of PayPal it was the breakthrough of reaching critical mass of payors and payees who wanted to deal with each other which transformed it from a software solution which sat on top of the banking and payments systems into a global payments business. TransferWise, on the other hand, is a money transfer service which relies on reducing frictional costs by either matching payors and payees where there is two-way flow or cutting margins where interchange dealers are used. Both benefit from network effects whereby the more users they have the more payor-payee relationships and activity can be carried out on their platforms. Libra will be able to compete with both through its pre-existing user base of 2 billion potential users giving it an extraordinary

advantage of avoiding the need for a ramp up phase to reach critical mass driven by network effects.

The Libra strategy ultimately relies on removing frictions and intermediation fees at the interchanges which apply to fiat currency exchanges and transfers. The problem FB has to overcome once the technology is in place is to either avoid being treated as a dealer or to get a license in important countries with foreign exchange controls like India and Brazil. This could take years to achieve as FB will need to deal with red tape and lack of understanding by regulators and governments. Moreover, incumbents will undoubtedly apply enormous pressure to block or at least slow down any decision to allow Libra to compete with them.

As FB is not pursuing a decentralised Crypto model, it will also face heavy scrutiny from a compliance and regulation perspective in most countries. Each Libra account holder will need to be checked for KYC when Libra is exchanged for currency or vice versa and not just on the first occasion. As a positive, FB already does identity verification reasonably well in that many third party sites use the FB login as a proxy for login on their own websites. This will probably not be enough to meet financial services standards. For Libra, FB will need to set far stricter standards as regards checking for fake identity, anti-money laundering, sanctions and PEP. As a start, it will need to implement more robust ID verification than just a two-factor verified email address which is pretty much all that is needed for a FB account. It could do this by proposing that existing FB users do a Libra ‘upgrade’ from a standard FB account which would fit in very well with a strategy to improve ID verification and compliance for its social media business and also any future e-commerce style business it has up its sleeve.

Conclusion

If and when Libra is launched, FB will be able to use it in many different ways: to diversify from social media and messaging; customer retention; to enhance usage of its current offerings; as a major pivot to transform the company and its culture towards a financial services and e-commerce business and no doubt others we don’t yet know. All of these strategies are rational, to be expected and likely to be a good thing for FB and its current and future users. The critical issue, and one which is underestimated, is what regulators, banks and other financial intermediaries will do in response. And if regulators will be pressured by them to stop the onward march of one of the most successful media businesses of all time into the most profitable and protected industry of them all, financial services.

Although there is scepticism and uncertainty, Facebook’s Libra initiative is something to be encouraged and applauded. With the caveat that FB needs to be watched very carefully as it has over the years proclaimed in its various mission statements that it wants to “move fast, break things, build things and add stable infrastructure”. Then first two will lead to a quick death for Libra and harm FB and so it is the last two that FB needs to focus on. And not just when it is forced to and has no choice.

Manu Duggal

About the Author: Manu had a 15-year career in investment banking after which he became a consultant and investor. He went on to study law and eventually founded a Fintech platform. He acts as a consultant, Non-executive Director and advises on disputes in the functional areas of technology, finance and insurance. He holds an LLM, an MBA and undergraduate degrees in Physics and Law. More about him and his other articles can be found at www.manuduggal.com.