

Facebook's Libra

28 June 2019 | Marcel von Pfyffer, Arminius Capital

- Libra is planned to be a global cryptocurrency suitable for international transfers. Its value will be stable because it is based on a Reserve of high quality assets.
- There are many unanswered questions about Libra's regulatory status, particularly about its compliance with anti money laundering rules. It will not be accepted in developed countries until it satisfies each country's regulator.
- Libra can productively target remittances, which are an important segment of the global money transfer market. Remittances from rich countries to middle income and poor countries totalled USD \$529 billion in 2018.
- The impact on Western banks will be modest until Libra changes its business model.

WE'RE FROM FACEBOOK AND WE'RE HERE TO HELP YOU

Facebook ('FB') has announced the 2020 launch of Libra, a global cryptocurrency. According to FB, "Libra's mission is to enable a simple global currency and financial infrastructure that empowers billions of people." FB also announced various beliefs, e.g. "we all have a responsibility to help advance financial inclusion, support ethical actors, and continuously uphold the integrity of the ecosystem."

Libra will be a blockchain currency which will be based on a Reserve composed of stable assets such as bank deposits and short-dated government bonds in various national currencies. Resellers around the world will sell Libra coins to the public and buy them back at narrow margins, i.e. the Reserve does not deal directly with the public. Libra will be listed on multiple electronic exchanges, which will offer transactions in Libra by means of web portals and phone apps.

The Libra system will be managed by the Libra Association (currently 28 companies, but expected to reach 100), each of whose Members has invested USD \$10 million. FB will participate in the Association via its subsidiary Calibra, which will be regulated to ensure that FB does not have access to data from Libra.

MORE QUESTIONS THAN ANSWERS?

Like all of Facebook's product releases, the Libra announcement was designed to make a big splash, and it has succeeded. But most commentators have noticed that FB's documentation was fully loaded with pious platitudes and technical explanations, but very light on details relating to regulation, fees, costs, and legal structures. Not surprisingly, the technology nerds have welcomed Libra with enthusiasm, while the finance nerds have regarded it much more warily.

Perhaps this is because of the lack of details. Perhaps it is because Mark Zuckerberg once claimed that FB's motto was "Move fast and break things". (He subsequently amended it to "Move fast with stable infrastructure".) The banking and finance sectors have always been over-supplied with people who "move fast and break things", and not enough of them end up in jail.

The financial regulators reacted politely, promising to give Libra and any similar digital currencies their full consideration. For example, Bank of England governor Mark Carney said that, if Libra achieved widespread acceptance, it would have to be "subject to the highest standards of regulation". For readers who haven't met many regulators, this means "You will be comprehensively examined by staff wearing latex gloves."

THE REGULATORY MAZE

The first obstacle for Libra is the global, US-enforced rules about anti money laundering (AML) and "know your client" (KYC), which are intended to prevent transfers to and from criminals, terrorists, and tax evaders. Investors in our Arminius Capital funds know about AML, KYC & FATCA all too well – having had to deal with our very zealous fund administration and unit registry services department. Forgive them, they are just doing their job in this brave new compliance world. Banks around the world have been fined billions of dollars for not being fully compliant with these rules. In Australia, for example, a passport and driver's licence are required ID, and individuals have to be checked against a list of known criminals, terrorists, and other baddies. Facebook, however, states that the "Libra blockchain is **pseudonymous** and **allows users to hold one or more addresses that are not linked to their real-world identity.**" Go figure.

Secondly, every jurisdiction has its own rules about banks and payment systems and similar entities. PayPal, for example, originated in the US as a "licenced money transmitter", i.e. a company which operates under a separate licence in each State, requires users to provide their real-world identities, and reports all transactions to the US Treasury. In most other jurisdictions, PayPal has to hold a banking licence of some kind. For example, in Australia PayPal has to be an Authorised Deposit Taking Institution, whereas a Luxembourg banking licence allows PayPal to operate throughout the EU. In China, PayPal operates in joint venture with the local tech giant Baidu, which holds the appropriate banking licences. In countries such as India and Japan it has had to curtail its services in order to comply with local banking regulations. In some countries it has ceased operating altogether. (PayPal is a founding Member of the Libra Association.)

Thirdly, the Libra Reserve adds an extra level of complexity to the question of regulation. FB has not explained the legal structure of the Reserve, but it does say that new digital coins will be minted automatically when demand increases and destroyed automatically when demand contracts (One of the very few advantages of Bitcoin from the perspective of a Bitcoin user is the physical limit of the number of Satoshi's mintable). This sounds very similar to the mechanism of "creation and redemption of units" which is a characteristic of exchange traded funds (ETFs). If the Libra Reserve does turn out to be an ETF, it would be regulated by the SEC under the Investment Company Act of 1940. If it is listed on electronic exchanges in other jurisdictions, it would be covered by local securities regulations. For example, in Australia it would be listed on the ASX and subject to ASIC regulatory oversight.

Then there are a host of questions which depend on the answers to the previous questions. How will Libra comply with local consumer protection rules? Will Libra be able to use the systems which Visa and Mastercard have developed to detect and prevent fraud and identity theft? How will Libra ensure data privacy for international transfers in both the origin jurisdiction and the destination jurisdiction? Does Facebook know how to spell "data privacy"?

WHAT IS LIBRA'S TARGET MARKET?

The Libra system is more complex than the tech-based payments systems currently in operation. It has been likened to M-Pesa, the Vodafone-backed system which operates in Kenya, Tanzania, and a few other jurisdictions. A user of M-Pesa can, by means of her feature phone, deposit and withdraw cash, pay bills, and make transfers to other users. In most jurisdictions, M-Pesa is not linked to the local banking system and cannot carry out international transfers.

Libra, by contrast, is specifically designed for international transfers. The Libra Reserve is composed of securities in multiple currencies, with the intention that its value will be roughly the same regardless of the country you are in. The network of Libra resellers is intended to be global, i.e. Libra will need resellers in the origin jurisdiction and the destination jurisdiction.

These design features of Libra mean that it may not be much use for money transfers within a country. Why would you use Libra instead of an existing domestic payment system where you can pay anyone the exact amount you want to, at no cost to yourself? The domestic payments market is already crowded: 96% of developed countries have real-time payments systems already, as do 63% of developing countries. PayPal has carved out a small market share since its 2002 IPO, but the industry is littered with failures such as Google Pay, Samsung Pay, and Venmo.

The "roughly stable" feature of Libra is also a disincentive for many types of international payment. If you have to pay a supplier in another country, you usually want to pay the **exact figure** on their invoice, not a figure which fluctuates depending on currency movements in the Libra Reserve.

These factors explain why Libra's target market is the 1.7 billion people in the world who do not have access to banking services. In 2018 these "unbanked" people sent USD \$529 billion in remittances, mostly from the country where they are working back to their families in their home country, e.g. Filipino maids in Hong Kong, Chinese traders in Africa, or Pakistani labourers in Saudi Arabia. (The figures are from the World Bank: its [Global Findex Database 2017](#) and its [Migration and Development Brief #31](#), April 2019.)

If Libra's charges are low enough and its value is stable enough, it may be able to win market share in international transfers in developed markets. International bank-to-bank transfers are cheap if you are dealing in size (over \$50,000 at a time), but smaller amounts not only attract fees of \$10 to \$20 at each end, they are also done at exchange rates which favour the banks. If the Libra coin fluctuated by less than 0.5% per day and the Libra reseller were to charge a fee of 0.5%, I for one would give Libra a try!

HOW WILL LIBRA AFFECT AUSTRALIAN BANKS?

It is unlikely that Libra will have a material effect on Australian banks in the next five years, **even if it were permitted to operate here**. In some jurisdictions, foreign exchange dealing and international payments are important profit centres for banks. But in Australia these activities are well below the 5% materiality level which would require them to be broken out for segment reporting.

More than three-quarters of bank profits come from the core business of lending, as represented by the Net Interest Margin. Wealth management used to be a major contributor to the remaining profit, until the Hayne Royal Commission. From now on, non-interest income will be mostly derived from loan-related fees, funds management, credit cards, and domestic payments.

In short, Libra's structural capabilities and holistic promises of bringing its new lily-white pure virtues to the establishment's banking industry are as confused as its branding. The Libra name itself has its own various connotations, and even the Calibra brand is remembered as a 6-of-1, half-a-dozen of another, car from the 1990s that was shared across so many platforms it didn't know whether it was an Opel, a Holden, a Vauxhall or a Chevrolet. It nearly even became a Saab. What we have seen in the initial global response is that there is one body who is not as confused as Libra, and they are the global regulators, who have steadfastly verbalised how underwhelmed they are by Facebook's latest effort to "help people connect". We wish Facebook well with its faceless currency and for their "pious" assault on the global banking industry – and of course the banking industry lobby groups.

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