



AFR Education Fund Submission to House Financial Services Committee - July 17, 2019

“Examining Facebook’s Proposed Cryptocurrency”

Americans for Financial Reform Education Fund (“AFR Ed Fund”) appreciates the opportunity to comment on today’s hearing. AFR Ed Fund is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry.¹

This hearing is on Facebook’s proposed Libra digital currency. Due to both the grandiose nature of the claims in Libra White Paper and the widespread distrust of Facebook as an unaccountable tech and media giant with a record of user privacy violations, this proposal has received a great deal of publicity and criticism. When an internet giant with a worldwide network of billions of users states that it intends to take the lead in creating a “global currency and financial infrastructure that empowers billions of people” this rightly draws a great deal of concern about its effects on the financial system. Our comment focuses mainly on the financial regulatory status of key elements of the Libra system, which are not the only issues raised by Libra.

As we discuss below, the heart of the proposed Libra system is the way in which the Libra tokens are designed as liabilities backed by the hard currency assets in the Libra Reserve. These kind of financial arrangements have a long history and are regulated under our U.S. system as banks or investment companies. It is crucial that these core elements of the Libra system be properly regulated as what they are. Establishing Libra governance through a kind of trans-national governmental body located in Switzerland must not exempt it from full U.S. regulation if it operates in the U.S., any more than the U.S. operations of Credit Suisse are exempted from such regulation.

Under the rubric of “fintech” numerous actors are introducing financial products that sit outside the core framework of financial regulation. Facebook’s Libra is the most extensive effort so far to do this, and also the clearest demonstration that this pattern cannot be allowed to continue. Like so many other “fintech” products, key elements are in fact quite similar to many existing financial products that are tightly regulated. These existing products are regulated for good reason. If Libra is not subject to similar regulation the consequences will range from harm to users of the product, to competitive imbalances, to risks to the entire global financial system if Facebook is permitted to expand the Libra network to the extent envisioned in its White Paper.

¹ Members of AFR Ed Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. A list of coalition members is available at <http://realbankreform.org/about/our-coalition/>

The usual justification for permitting fintech products to exist in a regulatory netherworld is that such permissiveness is necessary to encourage innovation and competition that bring extraordinary public benefits. These claims are wrong. Innovation – sometimes even to an excessive or irresponsible degree – already occurs regularly within the existing regulated financial system. Permitting the growth of a parallel unregulated system will only encourage false “innovations” that imitate existing products but lack key systemic and customer protections. As for competition, it is best served by a clear regulatory framework applied to everyone, and by a financial payments infrastructure accessible to all on an equal basis. It would certainly not be served by allowing a tech giant with enormous market power to launch a major new financial product without having to follow the same rules as its competitors.

Finally, there is all too often a confusion between benefits to the public and benefits to insiders who control key elements of financial technology. This confusion can be clearly seen in the Libra white paper, which claims to create “an inclusive financial network for the world”, when it proposes to build a network that will be governed by tech and finance insiders. True inclusivity will require that we create genuinely public systems.

Facebook may not succeed in its ambition of creating a new global currency. Its previous attempt at a digital currency, Facebook Credits, failed and is already little remembered today. That payment system featured exorbitant fees and was eventually replaced by local currencies. Libra is a much more ambitious effort. However, if regulators and government permit it to expand to the size described in the White Paper, which calls for a system scalable to “billions of accounts”, it would become the largest financial entity in the world, “too big to fail” on a global scale. The consequences of this could be dire. A combined currency system and global payments infrastructure of this scale would present a significant issue for national sovereignty and public control of the monetary system. A Libra system of this size would also place significant pressure on the liquidity and stability of the entire system of global currency markets, since, as discussed below, Libra is parasitic on national fiat currencies to deliver on its stable value promise.

A large Libra system would also offer numerous opportunities for insiders to the system to exploit users in various ways, both financially and through access to user data. While the White Paper promises that Libra “eventually transition to a fully open system”, it is clear that at least in its initial phases it will be dominated and controlled by entities that are already major players in tech and payments, ranging from Facebook itself to Visa and Mastercard. The promised transition to an “open system” is vague and provides little reassurance concerning the long run control of the system, especially given the first mover advantages of Facebook and its pre-existing network.

The White Paper claims that there will be significant benefits to efficiency and financial inclusion through the creation of a much faster, lower cost system of global currency transactions. However, the White Paper offers no detail or commitments whatsoever on how the Libra system would actually lower the costs for the unbanked to participate in the financial

system, either through operational efficiencies or redistribution from financial insiders to the unbanked. In theory, the cross-border nature of a large Libra system could lower the cost of international remittances, particularly for citizens of non-U.S. countries with underdeveloped banking systems. But within the U.S. and other countries with more developed financial systems Libra would simply introduce an additional layer of costs into financial transactions by requiring conversion from the local fiat currency to the Libra.

There is a better way to access the same kinds of efficiencies claimed for Libra. That path is through improving the efficiency and competitiveness of payment systems that are genuinely publically controlled. The Payments Systems Directives in the European Union and the Open Banking Initiative by the Bank of England envision opening up the current public payments infrastructure to use by regulated third party providers of financial services. Such providers would compete on an equal basis, would be tightly regulated for data security and consumer protection, and compete using common protocols for access to a public system.

There are of course many questions around the details of how to implement such access to the public payments infrastructure. In the U.S. context, there are important policy questions about how to accelerate the needed modernization of our current payments system and the degree of public vs private control of our payments system. The Federal Reserve has both the capacity and the responsibility to build a faster, more efficient, and more broadly accessible real time payments infrastructure, and should act more forcefully in this space. But approaching these issues from the standpoint of modernizing and improving access to a genuinely public payments system for existing currencies is a far better approach than facilitating the efforts of tech giants to create new currencies and payment systems.

To that end, legislators and regulators should not permit the establishment and growth of a Libra-type system, especially one that is unmoored from full and appropriate regulation of each of its elements. As discussed below, the Libra Reserve and token are quite similar to traditional, and regulated forms of finance, which makes any innovation benefits questionable and any exemption from regulation totally unjustified. Connecting these elements to a distributed ledger represents a newer approach but one that carries no clear benefits and many dangers when compared to simply improving our public payments system in a manner that provides accountability in governance and true competitive openness. Below, we expand briefly on these points, examining elements of the Libra product and their connection to financial regulation. This analysis is quite preliminary as many questions remain about the Libra product.

What Is Libra?

Based on the White Paper, Libra combines a fiat currency asset pool called the Libra Reserve with an arrangement by which tokens representing rights to this pool are held in a Facebook-controlled digital wallet and can be exchanged as payment through an internet-based distributed

ledger. Decisions regarding management of the fund and associated payment network are to be made by a private governing association that is at least initially dominated by tech insiders.

The fact that the Libra arrangement is backed by fiat currency assets is central to its appeal and marketability. Unlike commodity-type cryptocurrencies like Bitcoin that fluctuate wildly in value, Libra promises a stable value. It can only do this because each unit of Libra represents ownership of fiat currency assets in the underlying Libra Reserve. So even though Libra presents itself as an alternative to sovereign currencies, it is dependent on the system of government fiat currencies in order to achieve a level of stability and value that will make it attractive to users.

The idea of issuing certificates from a private actor that are backed by a pool of trusted financial assets is of course an ancient one. Centuries ago these assets might have been gold; today they are fiat currency assets that are considered stable. In the case of banks the deposit accounts at a bank are backed by asset pools that are regulated for prudential safety and soundness, in supplemented by central bank liquidity support. In the case of investment companies, shares in registered funds are backed by pools of securities and cash. Investment companies face disclosure requirements and regulation of the nature quality of their assets. Such regulation is strongest for fund structures that promise liquidity and stable value such as money market funds.

We consider it critical that the core financial element of the Libra arrangement – the asset composition of the Libra Reserve fund and the process by which it is connected to redeemable Libra tokens – receive full and proper regulatory oversight within our existing regulatory system. The asset pool in the Libra Reserve and the Libra tokens they back must not be exempted from regulation simply because they are connected to a distributed ledger payment mechanism. There is nothing novel about issuing certificates that are backed by an underlying pool of assets. Such arrangements are routinely regulated as investment companies or as banking entities. Exempting Libra from such oversight would create serious risks to users of the arrangement and possibly to the global financial system if the Libra system becomes large enough. It would also create a competitive imbalance with other regulated entities.

In many ways, Libra resembles an investment company. There are many kinds of funds that promise stable value, most notably money market funds (MMFs) and fixed income Exchange Traded Funds (ETFs). Based on the current version of the White Paper, the Libra Reserve appears to function in a similar manner to a fixed income ETF. Like an ETF, its value is maintained by a select group of authorized participants (called “Authorized Resellers” in the White Paper) who are permitted to directly buy and sell units of the fund on regulated exchanges. Market arbitrage by authorized participants maintains the fund’s value relative to the index or securities basket it tracks, as participants buy shares when units of the fund are undervalued and sell when units of the fund are overvalued. Users of the Libra monetary token will effectively be shareholders in a kind of Libra Reserve ETF, but unlike most ETF shareholders will not receive

a return from the assets of the fund. Instead, they are simply promised the principal value of their share. Investment returns will accrue to large-scale insider investors in the overall Libra enterprise, who will hold “Libra Investment Tokens”.

The White Paper specifies that the Libra Reserve will be invested in a liquid and stable basket of international currency assets, including both bank deposits and short term government securities. This implies a value linked to some weighted average of the world’s currencies, as well as interest payments and risks associated with government securities. Holders of Libra tokens will therefore be exposed to fluctuations in relative currency valuations and to various types of political and interest rate risks as well.

In the absence of regulation and disclosure of Libra Reserve’s asset holdings, the risks to ordinary Libra users due to the composition of underlying Libra Reserve assets could be considerable. This is especially so since the large scale investors holding Libra Investment Tokens, who receive all investment returns, may have an incentive to incur excessive risks in Libra Reserve holdings in order to maximize their investment returns. The complex Libra governance structure, which will initially be dominated by holders of Libra Investment Tokens and other insiders (but apparently transition to a more open but unspecified structure in the future) does not protect against this. Furthermore, if Libra attains the “billions of accounts” scale envisioned in the White Paper, its own growth will create enormous strain on the supply of foreign exchange assets that are genuinely liquid and low-risk, increasing pressure for the Libra Fund to move into higher-risk or illiquid assets. If the Libra Association which governs the fund is not regulated as an asset manager under U.S. securities laws that risk would be heightened.

The Libra arrangement could also be viewed as a banking arrangement, with holders of Libra Tokens as depositors in the bank, the Libra Reserve being the asset side of the bank’s balance sheet, the Libra Association being the bank’s board of directors, and the Libra Investment Token holders being somewhat akin to equity investors. The similarity to a bank would be heightened if the Libra arrangement operates on a fractional reserve basis, and issues tokens in excess of the redeemable value of the Libra Reserve. Fractional reserve issuance would allow Libra to expand much more quickly, but also heighten the risks to depositors and the financial system. The current version of the White Paper states that Libra intends to operate on a one to one reserving basis, but this policy could be changed in the future. If Libra did choose to operate on a fractional reserve basis it would be even more critical that it be regulated as a bank, with full prudential oversight and subject to the size and growth limitations in U.S. banking law.

Ordinary users of Libra will initially hold their shares in the Libra Reserve fund as payment tokens (“Libra”) in a digital wallet established by the Facebook subsidiary Calibra. Both funds and banks offer users access to such on-line accounts already. Obviously on-line banking is offered by most major banks today, and online brokerage accounts today include numerous

options for using money market fund shares as a payment mechanism through checks or bank wires, or for quickly and conveniently converting shares in funds into liquid cash.

The Calibra subsidiary has already registered with the Treasury as a money services business. But money services businesses do not hold securities and money services regulation is not designed to regulate securities investment or banking. Further, money services regulation is fragmented and mostly takes place at the state level. There is no mention in the White Paper of regulating Calibra at the Federal level as either a banking arrangement or a securities broker. In the absence of such regulation, users of the service will lack the customer protections provided to bank depositors and the protections afforded to brokerage clients under the SEC's Customer Protection Rule. Staff of the SEC and FINRA have recently issued a statement on custody of digital asset securities, which provides a thoughtful discussion of the issues around brokerage designation for holders of digital assets, including the significance of the Customer Protection Rule.² Many other crypto-currency firms have applied for brokerage licenses.

The final, most novel, and most technically complex element of the Libra arrangement is the distributed ledger system which will permit Libra tokens to be used as a payment mechanism with other participants in the network. It is at this point that Libra departs most clearly from long-established financial models. Like other stablecoin arrangements currently being created, it permits tokens backed by the Libra Reserve to be used as a form of currency on a private transnational network. There are further indicators in the White Paper that the distributed ledger will eventually be used for a greater range of transactions than simply payments.

The White Paper claims that the distributed ledger system will make possible instantaneous global value transfer through anonymous or pseudonymous accounts. Such a system clearly raises numerous issues concerning tax evasion and money laundering. Facebook has claimed that these issues can be addressed through national regulation of the digital wallet on-ramps to the system. But this would be enormously challenging if not impossible to implement on a global scale. A greatly increased risk of tax avoidance and criminal use of the banking system is inherent to a system of privatized trans-national currency. As discussed above, improving the efficiency and openness of sovereign national payment systems is a far superior alternative.

² *Joint Statement on Broker-Dealer Custody of Crypto Currency Assets*, Financial Industry Regulatory Authority and Securities and Exchange Commission, July 8, 2019. <https://bit.ly/32yOiBR>