

Facebook's cryptocurrency Libra – questions and answers



The publication of the white paper on Libra in mid-June sparked wide-ranging discussion. The Association of German Banks has analysed the paper with its members – both banks and fintechs – and compiled a number of questions, together with some initial possible responses, based on the feedback.

This analysis is not intended to be final – we will review the questions and responses in the light of further developments. In doing so, we wish to contribute to a broad-based debate about the issue of Libra.

What is **Libra**?

- A new decentralised global structure enabling digitally integrated services.
- Possibly an approach that can really succeed in advancing digital innovation through smart contracts and cryptocurrencies.
- Libra is intended to be a global public good which will improve financial inclusion.
- The Libra Association currently has 28 founding members, mainly US companies.
- Libra offers an extensive network of merchants, tech firms, telecommunications companies, venture capitalists and not-for-profit organisations.

Analysis of Libra's **three promises**:

1. Is Libra based on secure, scalable and reliable blockchain technology?

- (+) The Libra cryptocurrency is based on Libra blockchain (open source) and uses the programming language Move, which was especially developed for this purpose.
- (+) Libra is a stable coin, backed by a basket of currencies.

(+) Initially, the Libra blockchain will enter the market in an entirely permissioned form centrally controlled by the Libra Association.

(+/-) It is a new blockchain model with a new programming language. This creates both opportunities and risks.

(-) Facebook has not explained why Libra needs blockchain. Up to now, digital payments over the internet have not used blockchain technology.

2. How stable is the Libra Reserve?

(+) All Libra deposits will flow into the Libra Reserve and will be invested in short-term government securities denominated in stable currencies and in bank deposits. Libra is thus fully backed by stable currencies. The Libra Reserve therefore resembles a currency board, like that operated in Hong Kong.

(-) The promise that Libra's value will be stable rests solely on the currency basket. This will be subject to market fluctuations, however. In addition, every user will be exposed to the exchange-rate risk arising from movements against their domestic currency. There will therefore be a constant risk of "breaking the buck", especially where emerging-market currencies are concerned. It is not clear to what extent users will accept permanent fluctuations in their means of payment.

(-) In addition to "normal" market fluctuations, the Libra Reserve will face further potential risks. These include

- the default risk of the securities or
- of the reserve's administrator.
- Negative interest rates on government securities could diminish the reserve.
- Facebook could change the composition of the currency basket, which would lead to fluctuations in value.
- Fluctuations in value could also be caused by technical problems or cyberattacks.

- And last but not least, capital controls could influence Libra's value.
- (-) Full backing by stable currencies can only be maintained if Libra is used only for the purpose of making payments. If loans were granted in the Libra universe, which is highly likely since it is supposed to be an open system, then money would be created. This newly created credit money would no longer have backing. This would make Libra, like any currency board, vulnerable to a bank run.

3. How independent is the Libra Association?

- (+) The Libra blockchain is to be overseen by the independent, not-for-profit Libra Association, which will also manage the currency basket and the Libra Reserve.
- (+) The creation of the Libra Association is an attempt to dispel the concerns of regulators, competitors and consumers that Facebook will control Libra. Facebook will not play a special role in the Libra Association. Calibra, in its capacity as a wallet provider, will be a member of the association, not the parent company Facebook. Calibra will initially be the only wallet provider, however.
- (+) Facebook will have only one vote in the Libra Association, which is to be based in Geneva. The Libra Association currently has 28 founding members comprising tech and financial firms as well as not-for-profit organisations (and in future also academic institutions). It is envisaged that this number will rise to 100 before the currency's launch.
- (-) The technological development is likely to be dominated by Facebook, however, which means it will probably be able to exert considerable influence.
- (+) Digital payment systems are becoming increasingly popular.
- (+) Digitalisation and AI offer unprecedented opportunities to meet customer needs. This includes the need for financial services.
- (+) Facebook's social networks already have a large number of users. It will be easy to convince them of Libra's benefits.
- (+) Libra raises hopes of a new generation of financial services based on blockchain technology (smart contracts, micropayments).
- (+) Libra could also be of interest to internationally active companies, as the digital currency could help them to limit their foreign currency risk. This would require Libra to be recognised as legal tender, however.
- (-) Facebook's credibility has been tarnished by the misuse of customer data, among other things.
- (-) There is no guarantee that people will accept the digital currency of a private company like Facebook.
- (-) Libra will not be free of charge. The Libra Association will keep the interest earned on the securities in the Libra Reserve.
- (+/-) There has also been no mention of how much payments using Libra will cost. It also remains to be seen whether the speed of the Libra system will be sufficient. Blockchain technology is currently quite slow.
- (-) Regulation and data security represent considerable obstacles. It is not clear at present whether it will be enough for Libra to have a licence under the EMD or whether it will need a licence for securities trading or even a banking licence. Nor is it clear to what extent existing regulation can be applied to a cryptocurrency.

Does Libra have the potential to become a **“killer application”**?

such as Libra.

- (-) Among some sections of the population, users already have more confidence (based on ignorance and information asymmetry) in big tech than they do in the existing banking and monetary system. So it is quite conceivable that Libra will be successful.
- (-) Facebook has shown that global interconnectedness is feasible. Libra could repeat this achievement. This would only be possible in the absence of an adequate international legal framework, however.
- (-) Experience from China shows that integrating payment functions into the messenger services of big techs leads to rapid and almost exclusive adoption by end customers.

Can Libra **improve financial inclusion?**

- (+) According to the white paper, 1.7 billion people (only Facebook users) have no access to financial services or have to pay high fees for payment transactions. Libra would be an easy way to open up the payments system and reduce costs.
- (+) McKinsey Global Institute concluded from a study that the provision of financial services by mobile phone could increase the GDP of emerging markets by 3.7 trillion US dollars within a decade.
- (-) Facebook and almost all the other organisations which have signed up to the Libra Association so far are for-profit entities. The project is therefore unlikely to be motivated primarily by social or socio-political concerns.
- (-) Facebook takes the view that the problem of financial exclusion can be solved simply by private investment. More complex social and economic problems are normally involved, however.
- (-) According to surveys in the US, the problem is often not a lack of access to financial services, but that people

believe they do not have enough money for a bank account. The lack of a bank account is therefore primarily a poverty issue. Changing this requires more than the availability of a digital currency.

- (-) Another reason for financial exclusion is that, from the banks' perspective, some people pose KYC/AML issues. Thanks to the data it already has available, Facebook could be in a position to become the global standard-setter for creating digital identities.
- (-) People need a smartphone and internet access to use Facebook services. In most emerging markets, this is likely to be a problem. In Africa, only 37% of citizens have internet access and only 15% have a Facebook account (M-Pesa, Vodafone's mobile payments service in Africa, operates using the mobile network).
- (-) Facebook has not yet explained how people without access to a bank can purchase Libra and has also said nothing about how much it will cost to change cash into Libra and vice versa.

What effect will Libra have on **financial stability?**

- (+/-) If Libra is reasonably successful, the Libra Reserve will quickly reach a volume of hundreds of billions. This would unquestionably have relevance for international financial stability.
- (+) Libra will make it clear to regulators worldwide that cryptocurrencies need to be regulated. This will benefit these currencies in the long term.
- (-) Libra will invest incoming funds in short-term government securities denominated in stable currencies. This class of security is also highly important for monetary policy and for banks' liquidity management. The more people use Libra, the scarcer these securities will become, which will place additional pressure on interest rates.
- (-) Libra evidently expects its use in emerging markets to

partially displace national currencies. This would result in these currencies depreciating further and becoming more volatile, however. Libra would do nothing to help improve living conditions but, on the contrary, would make them worse and could exacerbate crises.

- (+/-) The financial sector is an area of “critical infrastructure”. It is therefore important to ensure that the potential impact of major innovations on the global financial system is understood.
- (-) Libra is attempting to circumvent regulation (according to the white paper, only wallet providers and exchanges are subject to regulation). Regulators are unlikely to accept this.
- (-) It is totally unclear how national or supranational regulators will be able to enforce their rules on Libra. Providers in areas where Libra will operate are subject to various regimes (KYC, AML, CTF, data protection, PSD2, macro-prudential regulation, etc.).
- (+/-) National and international supervisors need to subject Libra to close scrutiny to ensure that it meets high international regulatory standards.
- (-) If there is a run on Libra, there will be no one to stop it. At the same time, the Libra Reserve is likely to rapidly grow to a size that will make it too big to fail. The systemic importance of the issue is obvious.

What effect will Libra have on competition?

- (+) New entrants to the market increase competition and challenge existing market participants. This leads to better and less costly financial services.
- (-) But this does not necessarily apply if the new entrant is a big tech company. There is a risk that Facebook may be able to transfer its market clout from the social network to the financial sector.

- (-) With Libra, Facebook is creating the ability to link data from social networks with payments data. This is likely to significantly increase the potential for controlling and influencing individual behaviour.

What influence will Libra have on monetary policy and capital movements?

- (-) Libra wants to create a global currency. But considering the problems that have arisen as a result of introducing a single currency in the comparatively homogeneous countries of the eurozone, this vision is likely to remain a pipe dream.
- (-) Should Libra nevertheless outperform rival currencies, a private company would control the domestic or even global money supply.
- (-) Libra is a private global currency union. It may undermine sovereignty over monetary policy in individual countries or even the eurozone. This will only be able to occur, however, if a large proportion of domestic payments and deposits migrate to Libra and if loans can also be taken out in Libra, thus creating a diversified Libra-based financial ecosystem.
- (-) In addition, central banks will lose seigniorage if the Libra partially displaces existing currencies.
- (+/-) If Libra becomes more stable than national currencies – this may be especially important for emerging countries – it will start to be used not only as a means of payment, but also as means of preserving value. Libra will thus become a vehicle for capital flight. It remains to be seen how governments that respond by introducing capital controls will be able to defend themselves against Libra. To succeed, state authorities would have to be given access to personalised user data. Sanctions could restrict the freedom of expression (Ban on Facebook, Messenger, WhatsApp, Instagram.)
- (-) Libra will only be competitive against world currencies

such as the US dollar, the euro or the yen if national jurisdictions recognise the digital currency as legal tender. Nonetheless, the possibility cannot be excluded that acceptance among users will lead to disruption of the status quo.

Can Libra ensure the **protection of private data?**

- (+) To protect users from conflicts of interest surrounding the use of data, Facebook has created a subsidiary called Calibra to provide all Libra-related financial services.
- (+) Libra undertakes to respect the privacy of customers and, unlike Facebook profiles, the number of wallet addresses that users can store will be unlimited.
- (-) At the same time, transaction chains will be based on pseudonymous, not anonymous data and will be published in full.
- (-) Past experience with Facebook's approach to data protection (Cambridge Analytics and the link-up of Facebook/WhatsApp) has not always been entirely positive.

What does Libra mean **for banks?**

- (+) Libra will invest some of the Libra Reserve in bank deposits. This will give banks an additional inflow of funds.
- (-) A further competitor will enter the payments market, increasing the pressure on banks to cooperate on the introduction of a pan-European instant payments system, including mobile and online access. Libra thus raises questions concerning the future technology of payments infrastructure.
- (-) Both customers and information about customers will be lost if they withdraw deposits from their bank and pay them into a Libra wallet instead.

- (-) Banks have expertise in designing financial services. The existence of a new type of asset does not mean that banks will lose their importance. Nevertheless, any use of Libra by banks will strengthen Libra's position.
- (-) Should the use of Libra be extended to purposes beyond pure payment transactions, e.g. if loans are granted through smart contracts, this could have a seriously detrimental effect on the banking industry in its present form in the medium term.
- (-) If Libra were given access to the central bank in the form of an overnight deposit account, it could completely bypass the banking sector. The comparative advantage of banks would disappear.
- (-) Successful implementation of Libra would significantly increase and accelerate the pressure on banks to consolidate.
- (-) In the absence of an alternative digital currency supported by banks and governments, Libra's prospects of success are high.

The above questions and answers are based on our present knowledge and may change as the Libra project progresses.

**You can contact the Association
of German Banks at**

Bundesverband deutscher Banken
Postfach 040307
10062 Berlin
Germany
+49 30 1663-0

bankenverband@bdb.de
en.bankenverband.de

Dr. Siegfried Utzig
Wirtschaft
Tel: +49 30 1663-1140
siegfried.utzig@bdb.de

Tobias Tenner
Digital Banking
Tel: +49 30 1663-2323
tobias.tenner@bdb.de