Disintermediation, Disintegration, and Innovation:
The Future of Finance Controlled by Big Tech and Giant Central Banks

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Prepared for the Conference of Counsel
Washington, D.C.

October 3, 2019

Key Points

- Libra's wake-up call is leading central bankers as soon as this month to create central-bank digital currencies. CBDC redefines not only the role of central banks, but also the ability of Big Tech to harness data for payment-system power.
- The combination of CBDC and Big Tech payment power could quickly destroy the link between deposit-taking, lending, and capital-markets activity, transferring pieces of the financial market to central banks or Big Tech and abandoning others with resulting risk to growth, equality, and systemic resilience.
- Little thought has yet been given to consumer, equality, stability, and macroeconomic risks resulting from restructuring finance without regulated intermediation. It's already almost past time to do so.

It is a real pleasure again to open this annual conference of the most senior lawyers from the nation's largest banks. We have exchanged views over the years not only on the risks leading up to the great financial crisis, but also ever since about heightened regulatory burden and resulting franchise-value challenges. I've also very much appreciated your interest in my efforts to develop a new financial instrument speeding biomedical cures[1] and developing new ways for banks to enhance U.S. economic equality.[2] Today, I'll focus on a series of decisions your CEO will confront in two weeks at the IMF and

World Bank annual meetings. A change in how finance flows through private banking organizations has been under way since 2008 – ask your mortgage bankers if you've any doubt. Now, though, the gradual flow of finance beyond regulated banks could turn into a cascade powered by the formidable and combined forces of Big Tech companies and central banks. This is a far-reaching challenge to your bank's role as both a financial intermediator and payment-service provider. However, it's also a big risk to the basic construct of financial intermediation. Before we demolish banking as it has been known for decades, it's worth being sure we will like what comes next.

To the extent a fintech or Big Tech company runs rings around your bank because it's better at serving customers than your bank, so be it. The systemic challenge comes when the fintech or Big Tech company runs rings around a bank due to the fintech's prowess at running rings also around bank regulation. The *Financial Times* has concluded that, "…regulatory arbitrage is actually at the heart of most fintech models,"[3] because many companies depend not on the genius of their offerings for whatever profit they accrue, but instead on controlling a lot of customer data that then turns into money that then turns into cross-selling all without the costly rules that curtail like-kind bank offerings. This may generate enormous profits, but is it equitable? Indeed, is it even safe? What happens when fintech and Big Tech are tested in a downturn or under financial-market stress?

And, what if Big Tech companies team up with central banks through new central-bank digital currencies? In mid-October, global policy-makers will advance exactly this framework. It poses significant strategic challenges for regulated banking organizations. Beyond that, do we really want central banks so directly engaged in finance that we end up with a centrally-planned, government-run system?

Libra's Wake-Up Call

Libra's product launch may well be the worst-ever, New Coke included. Policy-makers ranging from President Trump[4] to his usual enemy, House Financial Services Chairwoman Waters[5] and on to FRB Chairman Powell,[6] Treasury Secretary Mnuchin,[7] and even the amassed financial authorities of the world's largest countries[8] are demanding a Libra redo, if not retraction.

This might seem to be the salvation for traditional retail-payment services and financial intermediation, but it isn't. Indeed, Libra shows the anarchic power Big Tech platform companies have to redefine finance in their own image. As a result, financial policy-makers are not counting on rhetoric or even new rules. Over the next few weeks, they may move from seeking to prevent Libra and like-kind Big Tech ventures also to actively preempting them with central-bank digital currencies and intermediation activities. Many of your banks may think they're increasingly run by regulators; soon, though, regulators may also run banking.

The Central-Bank Construct

Let me spend just a few minutes sketching out the central-bank construct as it will be discussed at the Bank and Fund meetings and as it is simultaneously advancing in countries ranging from those in the EU to China. Although the Federal Reserve has so far eschewed any such ambitions, it may well succumb due to the combination of monetary-policy frustrations and the political challenges it now confronts. Indeed, just yesterday, the head of the Federal Reserve Bank of Philadelphia said that central-bank digital currencies are "inevitable" and, while the FRB should not lead this transformation, it will surely need to join it.[9]

First to central-bank digital currency or CBDC for short. The idea here seems simple and not even all that different from central-bank fiat currency, but it has far-reaching structural impact. Some nations are loving CBDC as a way to preempt Libra and promote financial innovation. Others such as the Bank of England like that fine, but think CBDC has even greater potential as a way to end the dollar's status as the global reserve currency.[10]

Any way you look at it, CBDC's basic component is a digital currency that would be backed by fiat currency and thus move seamlessly through a national payment system and broader macroeconomy without the need for actual currency. In some countries where cash is essentially obliterated in day-to-day transactions, all national financial activity would be conducted in CBDC that avoids the speculative and operational risks of private digital currency as well as the muss and fuss of moving currency through the intermediating hands of private banks. In countries such as China where citizens like to hold on to their funds, CBDC could take the form of "tokens" – i.e., electronic equivalents of cash that then move in and out of the central bank's portals without the need for physical fiat currency.

What happens to bank reserves at the central bank? The IMF's research on CBDC has the answer.[11] CBDC would be "e-money" that is a variation on Libra's "stablecoin" in that it would be really stable because it would be powered by central banks. This new CBDC could then move in and out of the financial system through any e-money provider, whether it be a bank or nonbank as long as the provider holds reserves at the central bank in assets that are both safe and liquid – i.e., sovereign obligations – in amounts large enough to ensure that all e-money transactions are liquid under any market eventuality.

This essentially substitutes narrow banking conducted by anyone with enough assets in place of regulated banks. Regulated banking also enjoys other privileges, most notably FDIC insurance and central-bank liquidity access. However, in this narrow, e-money model, there is no reward for regulation since all risk is at least hypothetically evaporated by virtue of 100% reserves.

Farewell to Fractional Banking

As you know, the Fed is already wrestling with the end of fractional banking due to a proposed narrow bank charter arbitraging interest on excess reserves to bypass big-bank wholesale intermediation.[12] The IMF construct would have e-money providers not only post reserves at central banks, but also enjoy IOER in order to ensure ample return for the cost of 100% reserves. No mention is made in the Fund model nor in central-bank CBDC proposals of what might happen if the e-money provider was part of a larger company with diverse financial, social-media, commercial, or retailing activities. The assumption appears to be that 100% reserving suffices; if so, then the entire construct of consolidated bank regulation, inter-affiliate transaction restrictions, and barriers between banking and commerce would crumble. Perhaps for good reason, but still worth a thought.

But, let's let them go for the moment. CBDC advocates do recognize one problem with their new-age construct: the end of financial intermediation as it has been known since the birth of banking. The reason for this is straightforward: CBDC in is CBDC out across the payment system with no leverage allowed for leveraged lending. This is a lot safer, but also a lot less generous when it comes to ensuring credit availability for economic growth.

The Really Central Central Bank

Fear not, though. CBDC advocates also have a solution and it's interestingly one also shared by advocates of fintech finance as an antidote to the risks of traditional finance. As a new paper from the United Nations lays out,[13] key policy-makers now believe that traditional intermediation often does not benefit consumers, reducing sustainable financing in favor of profit-hungry speculation through financialized assets that exacerbate inequality. Better, it is thought, for fintech somehow to help consumers to channel funds through their phones so that consumers on other phones can readily get loans for productive purposes. Who makes all these decisions along the way, secures one consumer's funds, or guarantees that another consumer can repay his or her loan is not made clear no matter the general conclusion that fintech finance is better than financialized big banking.

The central bank of central banks, the Bank for International Settlements, has a variation of this theme. Last week, it announced a new BIS green fund that would facilitate central-bank green investments not only in portfolios ballooned by quantitative easing, but also in the reserves held for foreign-exchange or other operational purposes. [14] The U.S. "Green New Deal" initially had a similar proposal – i.e., the Fed would take its assets and loan them out for renewable energy and the like.[15] Other proposals would have the Fed do the same for infrastructure, affordable housing, or other objectives.[16]

In this "people's QE," trillions of fiat money or in a new-age central bank, CBDC would go into good causes, not bad old loans for the projects a banker might prefer. Bankers of course could still make loans, but with what deposits and at how much adverse selection has yet to be thought through.

Central Banking as Central Planning

I have not laid out several other proposals that make central banks even more central at cost to traditional financial intermediation. Among these are ideas proposed by a think tank affiliated with Sen. Warren to allow the U.S. Federal Reserve to take direct retail deposits and then lend them to small businesses and other deserving borrowers.[17] Put this in CBDC and it's not only all the easier, but also all the more appealing to fintech and Big Tech companies.

Couple this with the FedNow faster-payment system and, to make the central bank still more central, open it to nonbanks, and the central bank becomes even more the mother-lode of all power and profit. Layer on a standing repo facility to the Fed's reverse-repo facility for monetary-policy purposes and the redesign is complete, with private-sector banks disintermediated not only from consumer finance, but also from their core function as capital-market infrastructure.

I have only sketched out some of the risks attendant to the transformation of finance into a concentrated business dominated by Big Tech companies backed by a central bank with its arms in every financial function from gathering deposits to making payments to offering loans and backstopping investments to supporting a capital market function. I suspect these risks will be more immediately apparent to each of you than they are to the Big Tech companies and central bankers that would gain immeasurably from this new system, at least until something goes wrong.

Much of what I've said may seem far off, but then who would have seen Libra coming until it burst on the scene? Frightened by it, central bankers want to tame that beast by putting it under their direct control. They know that this might end banking as they used to know it, but few mourn its passing – after all, traditional banking is far from risk free and its approach to credit allocation can be intensely unequal. However, are central bankers really ready to become omnipresent bankers? If they do, can fintech and Big Tech be counted on to be better than banks by virtue only of 100% reserves? Will innovation really be enhanced by so much concentrated power at central banks and so much uninhibited rent-seeking at unregulated financial institutions?

Conclusion

I suggest you ask these questions now and develop compelling answers to them if you think private banking serves a social and macroeconomic purpose. Big Tech companies and central bankers are pursuing their own interests dealing with Libra, ensuring effective monetary-policy transmission, and promoting sustainable finance. These are all indisputable, worthy ends, but they may be achieved only at the cost of very destructive means.

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