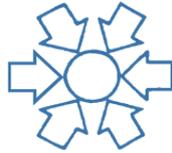


# Agility versus History: The Strategic Conflict at the Heart of Big-Tech Finance



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## Key Points

- Strategic alignment between big-tech platforms and forward-looking financial product development has tremendous promise if social-welfare, equality, and systemic-risk protections are hard-wired from the start.
- So far, little thought appears to be given to any such hard-wiring, creating immediate hazards for vulnerable households and long-term risk to financial stability.
- Although burdensome and anachronistic, most bank rules reflect a hard history of consumer abuse, operational risk, and incentive misalignment. Blowing away all these rules in a quest for rapid innovation risks all too many repeats.

It is a pleasure to appear today on a panel with some of the most expert innovators in the financial-technology (fintech) arena. As some of you know, I'm often seen as a fintech skeptic, with two recent papers by my firm, [here](#) and [here](#), along with op-eds in the [Financial Times](#) and [American Banker](#) ruffling more than a few of your feathers. I've said this privately to some of you, but I'd like publicly to make it

as clear as I can that my fintech qualms are not because I want to protect legacy banks from nimble competitors or believe that old ways are the only good ways.

All of our public work is intended to spark the debate we're having today about ensuring that disruption dislocates complacent or incompetent providers without collateral damage to innocent bystanders: consumers, vulnerable households, small businesses, and the financial system writ large. The papers we've done raise these questions and were completed without industry funding and represent solely my views and those of my FedFin colleagues.

Our goal and mine today is to temper technology innovation with the guardrails I first learned in my tech-policy studies more than a few years ago at the Massachusetts Institute of Technology – no place for Luddites, as you all know well. One of the key lessons I learned is that technological complexity often obscures technological function – or the lack thereof. Another lesson: safety rules exist for a reason and designs that ignore them sooner or later fail, sometimes badly.

As I'll show with just a few examples today, stripping fintech to its functional parts makes it clear why technological prowess does not substitute for safety-and-soundness buffers.

### ***Libra Cuts Loose***

“Move fast and break things” defines Facebook’s culture even if the company’s recent travails have forced a more cautionary note in recent public commentary. Libra epitomizes this “cut-loose” culture – it’s a stunning idea with tremendous potential only briefly sketched out in Libra’s release documentation along with great peril that goes almost completely unmentioned. Also unclear is exactly what Libra would do for whom, let alone how. As a result, one must infer what Libra wants: a new payment system and a new financial-intermediation construct.

These are of course enormous ambitions on their own and still more high-flying when one adds in the cryptocurrency and blockchain instrumentalities under-pinning the payment-system and intermediation objectives. What could go wrong? As we’ll see, cutting Libra down to its core construct is illuminating not just for this venture, but also for many other fintech offerings.

### ***Payment-System Disruption’s Hidden Debris***

At its heart, the payment system has three core elements: a payor, a payee, and agents acting on behalf of each of them able to ensure timely, complete, and final clearing and settlement. Based on this simple construct, trillions move around the globe through banks, payment processors, clearinghouses, and central banks. This is a complex system handling different types of payments in different ways at different times in different currencies, but it’s remarkably reliable and that’s no accident. Payment-system interruption has been a source of systemic risk since long before academics coined the systemic-risk moniker to describe the way the real world can be profoundly disrupted when money meant for one party goes astray.

The potential for risk is clear at each step along the payment path. First, the payor has to authorize a payment through whomever handles its means of exchange – no news here, but the day of handing over a goat for a chicken is over in almost every nation for almost every person. From Libra’s perspective, who ascertains that the payor in fact owns the means of exchange, that it is valid currency, and that payment instructions are complete? Does Libra have the resources with which to make a payor whole if any of these steps are missed? What law, if any, governs the rights of the payor to recoup its losses if the payment agent at the front end of the transaction takes the money, sends it to the wrong party, or loses it due to an operational outage or cyberattack?

Libra isn’t the only fintech payment system wannabe. Other less galactic ideas are aimed at getting banks out of the initial payor-transaction step by wiping out credit- and debit-card interchange fees. Tempting given their cost, but eliminating the bank instrumentality at the front end of the transaction raises the same authorization, validation, and remediation challenges more easily evident in the Libra construct. I don’t want to pay the merchant mark-up for these card fees anymore than anyone else, but I also don’t want to be at risk of more than \$50 if something goes wrong. Do these same protections exist in virtual payment media?

OK, let’s move on and assume that the payor’s funds and instructions are all hunky-dory and the funds now move into the payment system in hopes of reaching the intended payee. This infrastructure used to consist of trucks and aircraft moving currency from central banks and checks across the banking system. Now, it’s a lot of very, very big computers backed by resilience-and-recovery protocols that ensure that more very, very big computers – including those owned by a central bank – can step in if operational failures disrupt the clearing process. Facebook clearly has farms full of very, very big computers, but it’s exempt from contingent-risk regulation and resilience buffers and barred from the central-bank protections built into the payment system that, as in 9/11, kept the lights on at core-infrastructure providers even under ghastly circumstances.

The payment system moving money presents a very different order of operational risk than a social-media post gone astray. A four-hour downtime on Amazon or Google keeps one from getting the paper towels on time or even from sending email, but it doesn’t snarl trillions of dollars of transactions and cascading defaults when payments go missing.

Libra adds a new element of even more acute risk into the clearing process because it plans to execute payments via its own cryptocurrency. Detailing the risks here would take a lot longer than we have. Suffice it to say that one needs to know what goes into Libra’s crypto “basket,” whether hard assets are sufficient to cover payments in both baseline and stress scenarios, and if Libra might set the value of its currency basket to favor itself.

Onward to the payee. What it wants is the money promised at the start of the payment process in whole. What if a payee gets only some of the funds it expects and the fault lies not with the payor, but the paying agent or system? What if its settlement agent – Libra yet again? – takes some of the money, converts it in ways that cost the payee, or demands upfront collateral before payment execution? My guess is that any bank acting on behalf of a payee receiving cryptocurrency from Libra or fiat currency converted by Libra would want to see the full amount it owes to the payee before handing the funds down the line to their intended recipient.

Banks don't do this because banks trust banks and the rules under which they operate and the central banks that lie behind them. Would anyone trust Libra? Facebook might not think anyone has to trust it, but then it will need to construct a parallel payment-system universe and permit payors and payees to go where man hasn't gone since payments depended on bartered exchanges or the tokens (shells, bits of gold) that replaced them until something better came along in the 19<sup>th</sup> century.

### ***A Better Banking System***

Could the payment system work better and faster than it does? For sure, but innovators need to track their disrupting technologies through each step of the payment, settlement, and clearing process and be sure it works under even acute stress before they can claim victory over stodgy competitors and the regulators that govern them.

Financial intermediation – taking deposits and making loans – is also ripe for disruption but poses the same challenges at each step along the way. If I take your money as a deposit, are you sure of getting it back? If I convert deposits into loans, can I manage interest-rate, credit, operational, and liquidity risk? If I get a loan from you, have you priced it based on personal information allowing you to charge me more because you think I'm rich or – even more dangerously – desperate? Do I only get the loan if I use your social-media platform and thus give you my data? Will I get loan offers for goods or services I can't really afford because my phone has triggered an alert that I've picked up or clicked on a purse at a retailer with a profit-share agreement with Facebook or one of its many partners? Must I buy the goods or services I want on the platform to get the loan I need to finance them? Captive finance is a longstanding feature of the financial system, but one with a checkered history that warrants reconsideration.

### ***Flying the Financial-Inclusion Flag***

Facebook is not the only fintech to claim that financial-inclusion benefits supersede regulatory speed-bumps. But, urgent though financial inclusion is, it's not a banner beneath which innocent bystanders should be marched off to certain peril.

Financial inclusion can be genuinely achieved only if the financial products in which low-and-moderate households are included are financial products that provide essential services under meaningful safeguards that protect hard-earned wages, secure the loans that advance wealth accumulation, and offer objective advice to sound retirement products or emergency financial lifelines.

Regulated banks don't ignore low-and-moderate customers just because they don't much care for riff-raff in the lobby. It's also very hard to offer inclusive products with genuine equality benefits at enough of a profit to ensure a viable, sustainable offering. Traditionally, banks made affordable loans, accepted small-dollar deposits, and otherwise served unprofitable clients because cross-subsidization permitted a reasonable return across the product class.

Risk-based capital in concert with other post-crisis rules have adversely affected cross-subsidization and thus significantly under-cut the ability of regulated banks to do their bit. I've spent a lot of time [arguing](#)

[with regulators](#) about the unintended impact of [post-crisis rules on equality-essential finance](#). So far, the regulators think crisis-prevention benefits outweigh inequality costs. I disagree, but so be it.

As a result, fintech and big-tech finance could have meaningful equality impact, especially if network effects and capital exemptions substitute for cross-subsidization. However, pricing alone does not ensure increased inclusion and improved economic equality. These would be enhanced only if fintech products are on offer across the business and financial cycles, not just under benign conditions when vulnerable households need them the least. Given that virtually every new venture has not been stress-tested, this has yet to be determined. The absence of stress buffers such as ample reserves, segregated capital, and on-call liquidity are likely to be problematic under stress, but we shall see. Financial inclusion is also questionable if consumers take operational risks instead of providers, if AI underwriting is biased, if products are bundled or tied in disadvantageous ways, or if terms and conditions change at the whim of a service-agreement rewrite.

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Agility is not necessarily a vice and strict safety-and-soundness and consumer protections are no universal virtue. However, move too fast and break too much and the vital resources of vulnerable households or even financial systems are endangered. Legacy providers are often over-regulated, but most of the rules and each of the government backstops backing legacy providers is the result of hard-learned lessons in previous crises and past instances of egregious abuse.

Agility without a sense of history will lead fintech astray.