Alt-currency: What Bitcoin Means for Banking

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Highlights

- Launched on the Internet just a little more than five years ago, Bitcoin has been hailed as a complete reimagining of international finance—one that breaks down barriers between countries and frees currencies from the control of governments.
- Critics have likened the current landscape for Bitcoin and other digital currencies to the Wild West, but a more accurate comparison might be to the days of the Klondike Gold Rush.
- The narrative has moved from describing a technology platform that has earned its shady reputation to a more nuanced exploration of something that is coalescing into a legitimate and growing force in the global economy.
- An economist and vice president of one Federal Reserve Bank describes Bitcoin as a "stroke of genius," suggesting that the digital currency is likely to bring significant change to the financial industry.
- In the absence of federal regulations concerning digital currencies, some states are scrambling to craft rules of their own to attract investors, innovators and merchants to Silicon Valley and Wall Street, for example.
- Financial institutions need to start paying serious attention now and adapt quickly to the awakening "Internet of money"—or risk playing a more difficult game of catch-up later.

Introduction

Cosmologists argue that we live in a multiverse. Granted, it's only a theory, but it's a plausible one that's strengthened by new evidence[1] supporting decades-old scientific reasoning.

Even though we may never be certain if ours is just one of many or even countless parallel universes, the notion is intriguing.

Elsewhere, for example, money—which, in song at least, makes our world go around—might not exist as we know it (or think we do, if the dimension we inhabit is not all just a computer-simulated illusion).[2]

What we might imagine as the norm for currency in an alternative reality could easily draw inspiration from what's quickly emerging in our own: a decentralized, digital global payment system and technology represented by a virtual currency.

Here, science fiction has met fact in the growing phenomenon known as Bitcoin.

A New Gold Rush

Launched on the Internet just a little more than five years ago by an individual or group of individuals known by the pseudonym Satoshi Nakamoto, Bitcoin has been hailed as a complete reimagining of international finance,[3] something that breaks down barriers between countries and frees currencies from the control of governments.

How it all works is admittedly a bit complicated[4] and difficult to grasp initially. But so, too, was the Internet itself when it was first brought to the public's consciousness in the mid-1990s. There were skeptics and scaremongers then about the "information superhighway," just as there are now about Bitcoin.

Indeed, critics have likened the current landscape for digital currencies to the Wild West, based on a perception that it is generally lawless and shaped by an "anything goes" mentality. But a more accurate comparison might be to the days of the Klondike Gold Rush.

With Bitcoin, prospectors are once again rushing headlong into unfamiliar territory guided only by a fervent belief[5] that bits of a precious commodity that can be traded for tangible goods are out there, just waiting to be found.

Skepticism, Despite a Banner Year

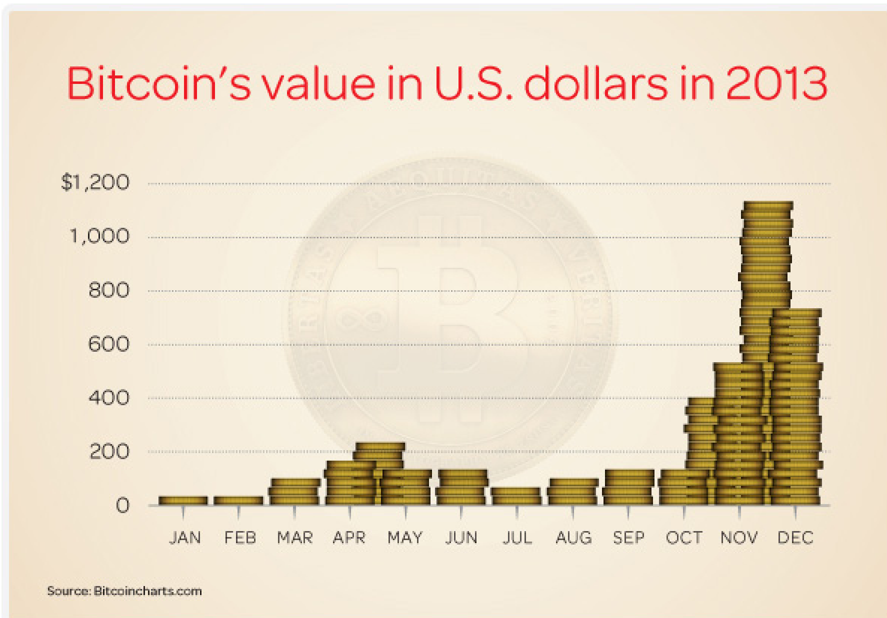
That gold rush analogy seems even more apt given how much the narrative surrounding Bitcoin shifted in 2013. It moved from tending to describe a technology platform that had earned its shady reputation to a more nuanced exploration of something that was coalescing into a legitimate and growing force in the global economy.

It helped that the price of Bitcoin skyrocketed, which drew even more media interest and coverage. The year opened with bitcoin (common practice is to use an uppercase "B" for the payment system and technology and a lowercase "b" for the currency) at $13.51 USD. It closed at a whopping $756.79—a more than 5,500 percent increase.

At one point, the price was $1,147.25, which no doubt prompted some eager selling among those who were still holding bitcoins purchased for roughly $9 USD in the currency's earliest days.

Even so, many in the financial services industry continued to dismiss Bitcoin as a fad or sideline distraction. There's still widespread skepticism, even though it's not just banks that could be affected by the virtual currency's disruptive potential.

Many other established participants, from payment processors and money transfer service providers to those associated with payment and banking hardware and software, are also at risk of seeing their entrenched business models undermined.



A Stroke of Genius?

At the very least, some effort should be put into understanding what Bitcoin represents and why it's so attractive to its many adherents.

It's not so much "money for the Internet," as some have mistakenly suggested. Rather, it's more like the Internet of money—a secure, relatively frictionless and largely anonymous way of moving funds and investing at minimal cost to most users.

"What do we have here?" David Andolfatto, economist and vice president of the Federal Reserve Bank of St. Louis, asked rhetorically about Bitcoin[6] while speaking at a gathering convened by the bank in March 2014. "A stroke of genius, I think."

He added that while the future may be unclear for digital currencies, they are likely to bring significant change to the financial industry.

"The threat of entry into the money and payments system ... forces traditional institutions to adapt or die," Andolfatto noted.

The Bottom Line

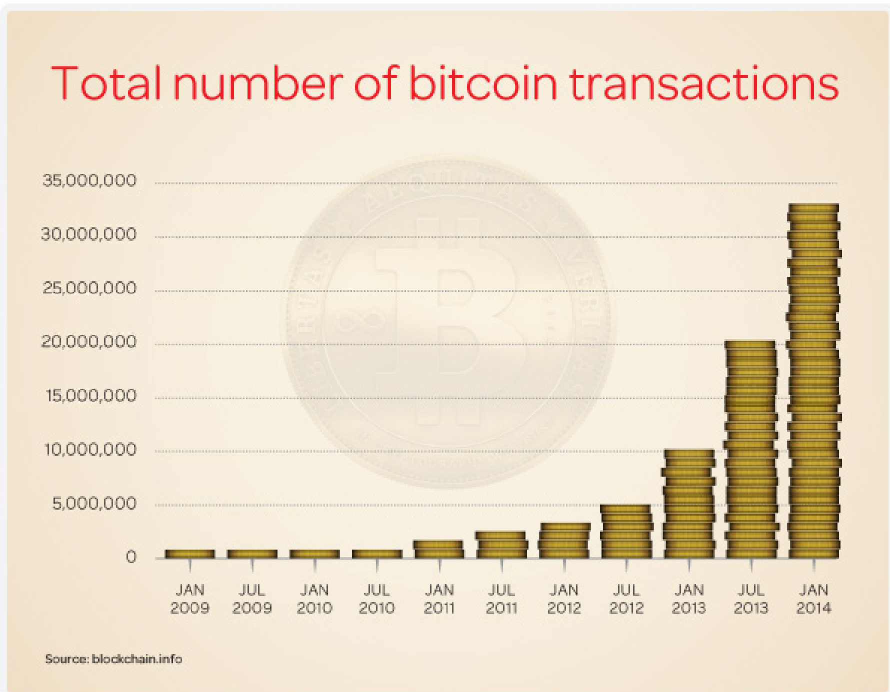
Some states have recognized the allure of digital currencies and are scrambling to craft rules of their own[7] to attract investors, innovators and merchants to Silicon Valley and Wall Street, for example. Yet for many in the financial services industry, there's still unease about getting too deeply involved—for now, anyway, when regulatory guidance is still lacking.

A problem with that position is a failure to appreciate how virtual currencies work. The global peer-to-peer networking protocol that's behind Bitcoin and others like it is intrinsically decentralized, with no central issuer or network operation. That makes it difficult—if not impossible—for an entity such as the Federal Reserve Board to intervene. "The Federal Reserve simply doesn't have the authority to supervise or regulate Bitcoin in any way," Board Chair Janet Yellen acknowledged[8] in February 2014.

The bottom line? As virtual currencies such as Bitcoin continue to mature, they will become even more of a focus for individuals who are ready, willing and able to embrace an alternative reality for financial transactions.

The question for financial institutions is how long they can really wait before recognizing that a digital economy is bound to include a digital currency like Bitcoin.

The answer: they need to start paying serious attention now and adapt quickly to the awakening "Internet of money"—or risk playing a more difficult game of catch-up later.



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