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Why a Wyoming Charter Is No Hail Mary for the Anti-Fractional Banking Team

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On Oct. 28, the Wyoming Banking Division approved the application for Avanti Financial to establish a special purpose depository institution (SPDI) under Wyoming law. Avanti Financial will accept uninsured deposits, payable on demand, and use the funds received to invest in a broad set of assets including corporate debt, municipal debt, mortgage-backed securities, U.S. Treasury securities and deposits at the Federal Reserve Bank of Kansas City.[1] As we explained in "Beware the Kraken," this is an unstable arrangement because the assets will go up and down in value and thus may not be equal to or greater than the value of Avanti Financial's deposits when the deposits are withdrawn.[2] Moreover, depositors will all seek to withdraw their deposits simultaneously as soon as they learn Avanti Financial's assets have fallen in value below the amount of its deposits – akin to what we have seen with prime money funds in 2009 and 2020.

The Misnomer of "Reserves"

There appears to be a lot of confusion caused by the fact that Avanti Financial (like Kraken Financial) refers to its potential assets as "reserves" and the fact that its assets won't include loans. With that change in terminology, Avanti and Kraken's deposits can technically, albeit misleadingly, be described as backed "100 percent by reserves."[3,4] That labeling not only makes the deposits sound perfectly safe but also makes the bank sound appealing to those who oppose "fractional-reserve banking," especially those interested in alternative currencies.

All modern banks, including those in the United States, are fractional-reserve banks. That is to say, they are not required to invest 100 percent of their deposits in reserves. In the United States, and everywhere else, "reserves" are defined as cash in the bank's vault and deposits of the bank at the central bank. In fact, in the United States, deposits by banks at the Federal Reserve Banks are referred to as "reserve balances" or commonly just "reserves."

The main advantage of requiring banks to hold reserves equal to 100 percent of deposits is that they can always meet deposit withdrawals and don't need deposit insurance.[5] But to achieve this advantage, the reserves have be 100 percent safe, not fluctuate in value, and be perfectly liquid (that is, be convertible into cash instantly at no cost). Those characteristics only apply to currency and deposits at the central bank, and that is why only those two assets are called "reserves."[6]

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[1] Avanti Financial has presumably applied for, but does not currently have, a master account at the Kansas City Fed.
[2] BPI Staff, Beware the Kraken, Oct. 21, 2020. Retrieved from: https://bpi.com/beware-the-kraken/
[3] Avanti Bank & Trust, "About Us," Retrieved from: https://avantibank.com/
[4] KrakenFX, Kraken Wins Bank Charter Approval, Sept. 16, 2020. Retrieved from: https://blog.kraken.com/post/6241/kraken-wyoming-first-digital-asset-bank/
[5] We'd be happy to discuss the disadvantages, but those aren't the point of this blog.
[6] Prior to the founding of the Federal Reserve, deposits at approved commercial banks in legally designated cities ("reserve cities" and "central reserve cities") also counted as reserves, up to a certain portion of reserves. (After the founding of the Federal Reserve, various state rules for non-member banks continued to count deposits at commercial banks in central reserve cities as part of reserves.) There were also some other assorted items such as certain Treasury certificates (not all Treasury debt, just selected items associated with management of the currency) or gold certificates that could also be counted as part of the reserve.

Contrast this with the new SPDI-chartered banks in Wyoming. Most of the assets that Avanti will count as "reserves" have few or none of these qualities. Investment-grade corporate debt, meaning private debt rated no lower than BBB, can certainly default. As we all learned in 2007 and 2008, even securities labelled AAA can lose nearly all their value rapidly. Even without an actual default, corporate, muni, mortgage and longer-term Treasury debt all fluctuate in value. For instance, between March 16 and March 18 of this year, 30-year Treasury bonds fell 10 percent in value. Lastly, corporate debt and municipal debt cannot generally be sold rapidly in large amounts without losing value and so are not perfectly liquid. For all these reasons, if your deposit at one of these Wyoming SPDIs is backed 100 percent by "reserves," you have no certainty at all that it will be repayable on demand, or even repayable in full.

Fractional Reserve Banking

Some opponents of fractional reserve banking object to banks using deposit funding to make loans. As far as we can tell, these opponents consider it immoral when a bank makes a loan using a deposit as funding because the bank is "creating money" and "only the government should be allowed to create money."

But there is no economic difference between a buying a bond issued by a corporation and making a loan to a corporation. When you buy a newly issued corporate bond you provide the corporation funds with an agreement that the corporation will pay you back later plus interest. Yes, you can sell the bond or buy a bond from someone else, but you can also sell a loan, or buy a loan.[7] The same "money-multiplier" that would apply when the corporation redeposited the loan proceeds back in a bank would also apply when the corporation redeposits the bond-issuance proceeds back in a bank. So if your local bank is "creating money" when it uses deposits to fund a loan, then Avanti Financial and Kraken Financial are also "creating money" when they use deposits to fund the purchase of a corporate bond, as they plan to do.[8]

Even more directly, the agency-guaranteed mortgage-backed securities in which Avanti may invest are simply several mortgages bundled together and sold as a security.[9] Surely using deposits to buy a mortgage-backed security is morally no different than using deposits to make the underlying mortgages.

The fundamental misunderstanding seems to be that the term "reserves" is being confused with the term "assets." In the United States, as of Oct. 21, 2020, banks on average have assets that exceed their deposits by more than 25 percent.[10] Those bank assets include what the rest of the nation calls reserves (vault cash and deposits at the Fed); what Kraken and Avanti call reserves (corporate and municipal bonds, agency mortgage-backed securities and

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Earlier in U.S. history, the main bank liabilities were bank notes rather than deposits. These bank notes were often required to be secured by government debt. As a result, banks would end up holding a lot of government debt, and it was used to secure their liabilities. If the bank was in trouble, the note holders knew that they were protected by the value of the government debt as well as any equity in the bank. The securities were "reserves," but not necessarily a pool of liquidity to meet immediate withdrawals.

[7] For the same reasons, buying a municipal bond is the same as making a loan to the municipality.

[8] In other words, Kraken Financial and Avanti Financial are fractional reserve banks, just like ordinary banks. What makes them different from ordinary banks, and more susceptible to depositor runs, is that they won't have FDIC insurance or, presumably, access to the Fed's discount window. Also, as explained in our "Beware the Kraken" blog, these Wyoming SPDIs are not subject to the same rigorous bank capital requirements that insured banks are under federal law.

[9] The Wyoming statute includes among "highly liquid" securities "Debt securities issued by a business entity which are investment grade." We interpret this language to refer only to corporate bonds, but really any private security is "issued by a business entity," including securities that are asset-backed. If Avanti is, in fact, allowed to invest in investment grade asset-backed securities (ABS) such as credit card ABS, auto ABS, commercial mortgage backed securities (CMBS) and collateralized loan obligations (CLOs), then Avanti, and Kraken, are permitted to fund, if even only indirectly, credit cards, auto, commercial mortgage, and business loans. We wrote to the Wyoming Banking Division to get clarification on whether ABS securities fall within the scope of permissible investments for Wyoming SPDIs but have not received a reply.

[10] Federal Reserve Statistical Release "Assets and Liabilities of Commercial Banks in the United States - H.8." https://www.federalreserve.gov/releases/h8/current/default.htm

Treasury securities); loans to business, municipalities and households that are economically the same as corporate bonds, munis and agency MBS; and other assets. Consequently, if the word “reserves” is applied to what everyone else calls assets, then the deposits of the fractional-reserve banking system of the United States are backed 125 percent by reserves.

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