Response to “Chartering the FinTech Future”

BPI Staff | Dec. 16, 2020

In a recently released working paper, the Chief Economist of the Office of the Comptroller of the Currency, Charles Calomiris, wrote, “The idea that today’s unbundled FinTech banks, and possibly tomorrow’s stable value coin banks, should become chartered banks is anathema to the special interests that profit from keeping progressive financial intermediaries in the shadows.” He then lists the special interests he has in mind:

1. **State authorities** because they would lose the fees they get from licensing the shadow banks as well as payday lenders.
2. **Traditional banks**,” because they see chartered FinTechs as a threat.
3. **Bundled, universal, too-big-to-fail banks** (through articles published by Bank Policy Institute economists), again because these large banks see FinTechs as a threat.[1]
4. **The Federal Reserve** because it gains political power through its “monopoly over the payment system” and so that it can issue its own cyber dollars and thereby be able to charge holders of those dollars negative interest.
5. Possibly members of the **National Community Reinvestment Coalition**[2] because the heads of these organizations “make large salaries and have gained substantial power by serving as poverty intermediaries.” Calomiris asks whether leaders of NCRC organizations will “…prioritize improving the lives of the poor” by supporting FinTech charters “even if doing so weakens their own control over resources?”

Mr. Calomiris precedes this accusation with a lengthy discussion of a hypothetical “stable value crypto coin issuing bank” that he purports to demonstrate is perfectly safe. The hypothetical bank invests exclusively in Treasury bills and has stablecoins as liabilities. Another asset of the hypothetical bank is “an intangible asset equal to the present value of fees it expects to earn from executing payments.” This intangible asset somehow has a known, specific value below which it will, with 100 percent certainty, never fall. The stablecoins issued by the bank are not allowed to exceed the value of the sum of the T-bills and the hypothesized certain minimum value for the intangible assets. If stablecoin holders demand cash, all is fine until the T-bills run out. In that case, he posits a

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[1] While the “too-big-to-fail” reference clearly is only intended as an *ad hominem* epithet and not as policy analysis, it is worth noting that it is inconsistent with post-GFC evidence, as well as the approval by the Federal Reserve and FDIC of bank living wills. *See, e.g.*, General Accountability Office, “Large Bank Holding Companies: Expectations of Government Support,” July 31, 2014; Darrell Duffie, “The Decline of Too Big To Fail,” December 1, 2019; and Francisco Covas and Gonzalo Fernandez Dios, “Putting “Too Big to Fail” to Rest: Evidence from Market Behavior in the COVID-19 Pandemic,” September 9, 2020.

[2] The NCRC consists of community reinvestment organizations; community development corporations; local and state government agencies; faith-based institutions; community organizing and civil rights groups; minority and women-owned business associations, as well as local and social service providers from across the nation.

hypothetical mechanism under which the stablecoins are progressively marked down in value 5 percent at a time as long as more stablecoin investors want cash. He asserts this hypothetical mechanism will prevent bank runs and avoid bankruptcy.

While we actually don't even think Mr. Calomiris's imaginary bank would be stable (we'd certainly want to cash in our stablecoins before the 5 percent markdowns begin), it isn't, in fact, the type of bank that BPI wrote about in our two blogs "Beware the Kraken" and "Why a Wyoming Charter Is No Hail Mary for the Anti-Fractional Banking Team." Rather, the two banks discussed in the notes—Kraken Financial and Avanti Financial—are cryptocurrency custody banks that will also take U.S. dollar deposits like any other bank and are allowed under Wyoming regulations to invest in a wide-range of risky assets: long-term Treasuries, munis, corporate bonds, even asset-backed securities. The deposits, however, aren't insured, and it is unclear how much capital the banks will be required to maintain. We expressed concern that these real-life banks could cause real-life financial instability problems because, as is widely understood, such banks are susceptible to destabilizing runs on their deposits. We suspect that the Federal Reserve and the State of New York might have similar concerns, independent of their own self-interest.

Mr. Calomiris also dismisses the possibility that a bank funded with stablecoins could face any incentive to invest in risky assets. It is worth quoting his reasoning at length:

> Could a risky version of this bank arise in equilibrium (where the stable value coin bank would convert a significant fraction of its cash assets into risky assets)? This seems unlikely. It is hard to see why that would appeal to coin holders. …Furthermore, setting up a risky stable value coin bank likely would not appeal to the bank's organizers either; note that my model assumes that if the bank is unable to meet its contractual commitment in the secondary market, the preexisting shareholders of the bank would forfeit all of their common stock.
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> Even if I am missing some reason why a risky version of a stable value coin bank might appeal to coin holders and bank organizers, such a bank would not create any new risks for the rest of the economy from losses it incurs. … Recall that the stable value coin bank modeled here operates under a coin write down protocol that automatically converts preexisting coins into new coins (of lower value) and creates new common shares to replace old ones. Thus, even if a risky stable value coin bank were created for some reason I cannot fathom, given that it does not rely on redeemable deposits, it would not contribute to systemic risk in the way that standard depository banks do.

We do not find it at all hard to imagine why the investors in a stablecoin-issuing bank would want the bank to invest in riskier assets – riskier assets earn higher yields so the owners of the stablecoins, and the owners of the crypto bank, would make more money if they increased the risk of the bank's portfolio. No doubt the decisions would always be for incremental increases in risk, but they would add up over time. While Mr. Calomiris again invokes his imaginary bank without deposits as a reason not to worry, we don't need to invoke imaginary institutions to be concerned. Shadow banks offering liquid-seeming investments while investing in risky assets were the central cause of the Great Financial Crisis (see Gorton and Metrick (2012), Gorton (2010), and Stein (2012)), and Kraken Financial and Avanti Financial will be funded with uninsured deposits and allowed to invest in asset-backed securities.

Mr. Calomiris additionally claims, citing no more than anecdotal evidence, that unbundled FinTechs are significantly improving access to financial services for unbanked and underbanked households. In particular, he credits FinTechs with developing innovative products that are attractive to these households. Promoting and expanding financial inclusion is a multifaceted problem that the financial industry, policymakers and NGOs continue to grapple with, and we cannot adequately address it in just a few paragraphs. FinTechs indeed can play a role in expanding financial inclusion through innovation, but this does not imply that FinTechs, in the long run, will provide the most efficient solutions. Many banks, thrifts and credit unions provide products and services similar to those cited by Mr. Calomiris, including financial education tools and programs and affordable checking account products. For instance, nearly 3 million households have become banked through the industry's decade-old "Bank-On" movement.

We encourage Mr. Calomiris to respond to the substance of our notes rather than accuse us (and a lot of others) of bad faith. He specifically calls out Wyoming as "…among the most progressive authorities in establishing state chartering of banks involved in producing crypto currencies." Reading of his high confidence in Wyoming's special bank charters based on musings about unrelated hypothetical imaginary crypto banks further increases our concern that the OCC has not given sufficiently serious considerations to the financial stability risks of the FinTech charter that they are promoting.

Disclaimer: The views expressed do not necessarily reflect those of the Bank Policy Institute's member banks, and are not intended to be, and should not be construed as, legal advice of any kind.

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