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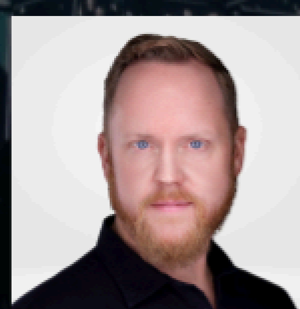
Virtual Event Series

Why Do Master Accounts Rule Banking?

Guest Speaker:

Zev Shimko
Co-Founder
Custodia Bank

Hosts:



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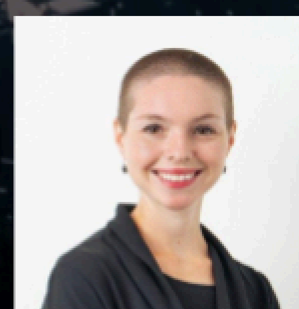

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DiffuseTap: Why Do Master Accounts Rule Banking?

Last time on DiffuseTap, Zev Shimko, Co-Founder of Custodia Bank, talked to us about the return of DeFi summer, why so much "de-banking" is happening in the space, and what happens when a bank does not have a master account with the Fed.

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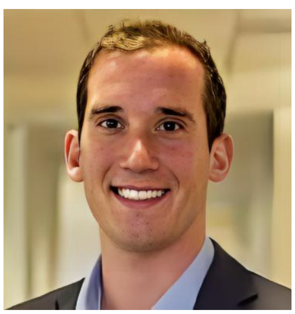
Meet the Speaker



ZEV SHIMKO is a veteran in both traditional finance and digital assets, having spent several years at multiple fintech lending platforms. He is the President, COO, and Co-Founder of Custodia Bank, an innovative, digital-native bank that specializes in digital asset payment and custody solutions for US businesses.

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KENNY ESTES: Mr. Shimko, thank you so much for joining us here today. Do you want to tell the good folks a bit about your background and what you're up to over at Custodia?

ZEV SHIMKO: Right. Good morning, everybody. My name is Zev Shimko. I am the co-founder of Custodia Bank. We are building a bank to support the digital asset industry. It is the number one problem this industry has been facing over the last few years. A bit about my background. I graduated from Northeastern University, went through the traditional investment banking route. I worked there for a few years in both debt and equity capital markets.

It's actually where I originally met my co-founder Caitlin Long, who is seen as one of the leading advocates for digital assets, especially on the institutional side. Brilliant woman, and I am very lucky to have her leading Custodia Bank. I then got curious about the startup side, so I moved out to San Francisco. One of the companies perhaps worth mentioning is Upstart.

I joined Upstart as the lead for the capital markets side of the business. They are an online marketplace lending company. This was before they really hit it out of the park and grew to 30 billion in market cap. It was a fantastic experience. I did that at a couple of other companies before going full time into crypto in 2018, for a company called SALT Lending. It was the first company in the US to lend against Bitcoin, providing dollars for Bitcoin as collateral.

I thought that was an amazing idea. For the first time, you had a perfect form of collateral where you did not need to repossess a car or a home. You had control of that Bitcoin, which you had the ability to sell instantly should there be a margin call or liquidation. Worked with Mike Cagney for a bit in Figure Technologies, which is also responsible for the provenance blockchain, before I joined Caitlin in early 2020.

We have been building Custodia Bank for four years now. We have built a bank from scratch under the Wyoming Special Purpose Depository Institution framework, and we have faced our fair share of challenges, our fair share of regulatory pressure, our fair share of uphill battles over the last couple of years. But I am excited to say that we launched the bank last year.

We have a few services across Bitcoin custody, money markets, and banking services, and are really focused on building our customer base this year. I will also note one thing, but I cannot talk too much about it today. We also sued the federal reserve for direct access to a master account. That case is still pending, but we are likely to get an answer in the next couple of weeks.

I won't give my two cents on where that is going to land. There is publicly available information there. But we are trying to be the first crypto native company with direct access to federal reserve payment systems that will solve the bank issue for this industry.

KENNY: Fascinating. And we are talking about Master accounts today, so that's timely. We will carefully navigate that minefield. But to start things off, framing. The last two years have been kind of dead. There has been a lot of upset, I guess that is a generous word for that. So, how is this played out in the crypto banking space? What does the status quo look like?

ZEV: 2022 and '23 was tough. I mean, we saw Silvergate, Signature and SVB have their issues. We saw massive layoffs from tech companies and digital asset companies. And to be quite frank, it did not feel great at times. It was not clear how this industry was going to get reliable banking. The banks that felt like "safe banks" no longer existed.

And so, there was this run to safety with some of the G-SIBs, or Global Systemically Important Banks, these large investment banks. The JP Morgans, UBS, and Citibanks of the world. The issue there is that at the end of the day, all but a handful of banks in the US, including Custodia, report to the same federal regulators.

And so, if you are having broad regulatory pressure on banking, every bank is going to feel that. Yes, if you lose one banking partner, you can find another. This is why, for example, large crypto companies have dozens of bank partners. That is not a normal thing. Normally, you have one strong bank partner, or maybe two. Crypto companies have dozens, and that includes the public crypto companies that you all know. That's because of the risk of de-banking in this space.

So, it was a tough couple years. We like to say that we survived through that bear market. We were lucky not to have to do any big reductions in force. And we really kept expenses low to ensure that we can come out of that period strong. And so, I would personally say that it's starting to feel like the beginning of '21 again, which was certainly a healthier time in the market.

We're seeing Bitcoin near all time highs again. It's feeling good. We have the halving coming up as well, and the institutional interest is pouring in. I mean, 13 ETFs were created at the beginning of the year. I think we have the fastest ETF industry that got to 10 billion in assets ever. We're seeing the interest. We're seeing the demand. But we still have not quite solved the banking issue as an industry.

That's what we're trying to do, and that is what we've been forcing with this lawsuit, if we can figure that piece out. Right now we work with bank partners. We're hoping to get our own master account, and give crypto companies reliable banking partners. Safe services. Banks that will not fall due to leverage. One factor I just mentioned about our type of Bank Charter which is new is that we are a full reserve bank. We are non-leveraged. Hypothetically, we should be able to withstand a 100% run on the bank.

If you are providing services in and around the digital asset industry, we do not believe that you can do that as a fractional lending entity. We are a full reserve bank. We don't have leverage anywhere in our model. And we want to provide safe base-layer services to digital asset companies.

KENNY: That is really interesting. I actually didn't realize that before. Full reserve. Was that a choice of the bank, or is that the Fed not getting to that level without doing that just so they can make themselves feel comfortable?

ZEV: Wyoming Charter is a full reserve charter. We are prohibited from lending dollars. Now, part of the reason for that is that we are not FDIC-insured. FDIC insurance generally protects a bank from that fractional lending program. So, I would argue that it really is irrelevant in a full reserve model.

And the FDIC has been really the most anti-crypto regulator, historically and today as well. Again, we are trying to build durable banking. We do not want to build a mortgage business. We don't want to provide warehouse lending facilities. The only way to truly provide banking in a counterparty risk-free or minimal counterparty risk is to be a full reserve institution.

KENNY: Understood. Chris preempted my question in the chat there. How do you make money if you are not lending? How does that work? Straight fees?

ZEV: Great question. I had that question from an investor this morning. It is fee-based. The revenue side of the equation is more like a tech company or a fintech. We charge fees for products and services. We are building technology. We're building things like APIs. SaaS fees will come into play.

So, we actually look more like a FinTech or tech company from the revenue side of the business. Obviously, the bank and regulatory piece is incredibly important for our own standing and the protections that we can provide customers alongside the potential direct access to our own master account.

KENNY: Okay, so it's fee-based lending. Makes sense. You mentioned that you don't have FDIC insurance, we'll call it that. What other insurance do you have in place to cover that stock gap? Or is it just purely 100%? reserve? And it's just there as full collateral?

ZEV: On the dollar side, the answer is it is 100% reserve, and there is full collateral on the Bitcoin custody side. We have a small base insurance policy that is pro rata for all of our customers. But if a customer wanted to purchase additional insurance as a dedicated limit, they would have the ability to do that. This is really industry standard.

And so, we're taking out the concept of counterparty risk. To your point there, there is still operational risk. I mean, especially on the Bitcoin custody side, our customers are doing a lot of diligence on us. We are going through a lot of internal and external audits. We are going through pen tests. I mean, we are going through regulatory exams. We are a bank at the end of the day, and that makes people comfortable. But they are still doing their diligence.

So yes, there is a concept of operational risk. You cannot really ever fully protect from that. We have your typical insurance policies, but we do not have something that is analogous to FDIC insurance on the dollar side, again, because we don't lend.

KENNY: I tell you, this is the most active I've seen the chat as far as how you actually work as a company. Question from Alec. How does the custody actually work? Is there a wallet base so you can use Custodia to move from one wallet to another wallet, and do blockchain transactional services?

ZEV: That's correct. We have an institutionally-focused offering on the Bitcoin custody side. The differentiated aspect of that is that it is a truly segregated offering down to the UTXOs. So, the unspent transaction outputs of a Bitcoin transaction, the UTXOs for Custodia are not fungible between customers. That means if you, Kenny, deposit 100 Bitcoin, and then you make a withdrawal request later on, you are getting a portion of that 100 Bitcoin that was deposited.

And that is unique for an institutionally focused platform. We have the ability to do some really cool things like UTXO management, and actually extracting individual UTXO's, which we're working on. We can get into that if there is interest, but it is wallet-based. It is segregated and on-chain. Everything is visible to the customers. And what a lot of people do not realize is that Wyoming has spent a lot of time working on the charter and related custody rules.

So, if you type in Wyoming custody rules in Google, you will actually find the multi-hundred page manual for how banks are required to operate custody as a Wyoming SPDI, or Special Purpose Depository Institution. We do not do things like proof of balance and control just because we want to, and it's good market practice. We are actually required to do that under Wyoming law.

When you think about some of the reasons why some of the custodians have blown up over the last couple of years, or maybe are rehypothecating, or maybe you can't see the assets on chain, that can't happen with Custodia. Rehypothecation of securities and Bitcoin is actually illegal in the state of Wyoming.

We are required to do proof of not only ownership, but also control for our regulators and our customers. And again, it's not just because we want to do it, but we have to do it. So, it really is a very safe, institutionally-focused Bitcoin custody platform. We built the guts of it in-house. We did not partner for the core custody infrastructure, and we were starting to onboard some very large customers on that side of the house.

It's not a hot wallet solution. It's not being used by high frequency traders. This is more akin to a cold wallet solution where it is, for example, once-a-day withdrawals. Most of our customers are long only. They want a safe place to hold Bitcoin. They're not looking for immediate withdrawals. Obviously, if you think about the relation between security and speed, that's always a trade off. We are certainly prioritizing security.

KENNY: Gotcha. There are a gazillion questions, and I'm going to ignore them for a second and talk about the topic of the day, which is master accounts. First of all, what is a master account with the Fed? Just to frame things a little bit?

ZEV: Yeah. So fundamentally, a master account is effectively a bank's bank account at the Fed. It's how money actually moves between banks. When you send a Fedwire transaction, money moves from one master account to another master account. It does not stay in the same master account unless you are moving or sending funds to another customer of the bank.

Now, only depository institutions in the US have the ability to access master accounts. In other countries, that is actually not the case. You can be a FinTech company, for example, in the UK, have an e-money license, and get access to the Bank of England payment system. The US has really locked down that process, which is why all fintechs that you're familiar with, whether they're lending companies like Lending Club or Prosper, or challenger banks like Chime have to work with other banks.

They do not have their own master account. Typically, in all cases, they have a bank partner behind them. And that bank is responsible for actually facilitating all of the payments that they are providing to their customers.

Now, you might ask, is that an issue? Does that cause concern? The short answer is yes, because the FinTech does not maintain control over the entirety of their program. What happens when your bank partner says, "we reviewed our internal policies, we're making a change. We don't want to support the sports industry anymore" and 25% of your customers in the sports industry, or the gaming industry?

That is not up to the FinTech. That is entirely up to the bank. And so, you're seeing a lot of fintechs have to pivot and change and adjust how they're offering products and services just to meet the requirements of their bank partner. Further, banks are under different regulatory environments.

I made a comment before where banks roll up to the same regulators. You can be a state bank, you can be a federal institution, you can roll up to the FDIC, the OCC, or the Fed. But they're getting similar pressures coming down. And we've seen that quite a bit in the digital asset industry.

I've never seen an industry like this where there has been so much de-banking in the space. I mean, we hear this day in and day out from prospective customers where they say, "We lost our bank accounts. My bank closed my account because I received a wire from Coinbase." Or "My bank closed the account because they realized that we're in business with a crypto miner." It's just a very sensitive topic right now.

And not necessarily because of the bank's own stance. In some cases, that's the case. But it really is the regulatory pressure coming down to them specifically. You are just seeing a lot of these crypto companies losing accounts. You're seeing a lot of crypto companies going abroad for that reason. I mean, what does that do to jobs?

Not that that's the point of this conversation, but it's very difficult if you don't control the payment side, because the bank has the oversight over your program. We are actually on that side of the business, which is a third of our business. We work with partner banks. We have good partners to settle our payments. But things can change.

And so, we want our own master account at the Fed so that we have the full oversight over that flow. We can choose what products and services to provide. We can choose which customers within the Digital Asset industry we want to support, etc.

If you don't have that control, it's just very, very difficult. Startups have failed because of it. If you do not have a bank in the US and you are a US company, you cannot really operate. You cannot pay your employees, or your vendors. You either go abroad or you fold.

KENNY: It's funny. I mentioned we have the Diffuse Digital 30, which is a publicly-listed, FINRA-approved index fund for three or four years. For about a nine-month period, we did not have a bank account. We couldn't physically.

ZEV: Okay, so it hits home.

KENNY: Yeah, absolutely horrendous. You have a master account with the Fed. Does that also open up FDIC insurance for you? Or is that a separate process entirely?

ZEV: Technically, Wyoming SPDI banks are eligible to apply for FDIC insurance. We can choose whether or not we want to, and we actually have applied in the past. But it really is a question as to whether or not it makes sense for the business. As a bank, you have to pay for FDIC insurance.

And so, would we be willing, for example, to pay 5, 10, 15, or 20 basis points for the coverage? If we are a non-lending bank, our plan with a master account is actually quite simple. Hold $1.08 For every dollar on deposit in the master account and do not touch it, so that we could literally withstand a 100% run on the bank.

I would say the average reserve that banks operate with is 8%, 9%, or 10%. We are looking at 108%. It is flipping the model on its head. And it's because we're not focused on lending. We are focused on payments. We are focused on velocity of payments.

We are focused on being a low risk counterparty. We recognize that as a new bank, it's going to be very hard if we were a fractional lending entity. How do we stand up to the counterparty risk of a GSIB? A JP Morgan, UBS, or Citi?

The only way to really stand up to that is to be a full reserve institution, and to be able to withstand a 100% run. You can't hold 10% of dollars against assets if your deposits are in the digital asset industry and can all leave the bank in a matter of 10 to 15 minutes. I mean, we're in a different paradigm when it comes to digital assets and banking, and we just want to do that in a hyper safe way.

Is it possible that you can do some lending in the future? Can you lend digital assets? Yes, but we want to get the fundamental base layer done first before we talk about some of the more complex products.

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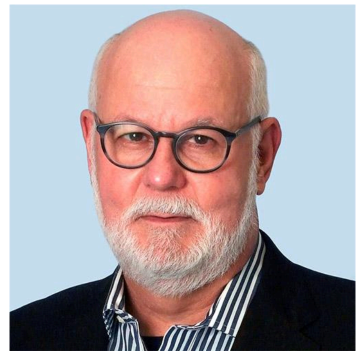

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