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Fiat-Backed Stablecoins and Narrow Banking

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Summary:

Devastated by the misery of millions of people during the Great Depression caused by the collapse of the entire US financial system, a group of economists at the University of Chicago sought to reform the banking sector. The "Chicago plan" suggested a replacement of "fractional-reserve banks" with "full-reserve banks" (also called "narrow banks" and "limited-purpose banks"). Most economists dismiss this idea. However, the rising popularity of stablecoins and the 2025 GENIUS Act in the US introduce this form of banking to the general public. The goal of this note is to analyze the similarities and differences between the narrow banking proposal and the fast-growing fiat-backed stablecoins.

Key Findings:

1. Fiat-backed stablecoins and narrow banks share very similar characteristics with respect to: (i) their reserve requirements and (ii) the services that they provide and do not provide.

2. However, stablecoins rely on additional "moving parts" that narrow banks do not have, which make them more risky.

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Keywords: Fiat-backed stablecoins, narrow banking, full-reserve banks, limited-purpose banks, GENIUS Act

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Comments to the author are welcome at Oz.Shy@atl.frb.org.

1 Introduction

Devastated by the misery of millions of people during the Great Depression caused by the collapse of the entire US financial system in general, and of the banking sector in particular, in 1933 a group of economists at the University of Chicago sought to reform the banking sector in order to avoid future failures. The "Chicago plan" advocated for the separation of lending activities from deposit taking and payment services. In other words, the proposal called for 100 percent reserves on bank deposit accounts. Today, most economists refer to this proposal as "Narrow Banking," a term that was coined in Litan (1987). Some economists call it "full-reserve banking" or "Limited Purpose Banking" as described in Kotlikoff (2010) and Chamley, Kotlikoff, and Polemarchakis (2012). I will elaborate on the meaning of "full-reserves" in section 3 because it is often interpreted in ways that go beyond just storage of cash. But the general idea is to reduce or eliminate the possibility of bank failures, bank runs, and the resulting government bailouts by securing depositors' money even during a run on the bank.[1]

Why would anyone want to write an essay in 2026 on a 1933 proposal for a banking reform? The answer is that the new form of banking called "fiat-backed stablecoins" resembles the idea of narrow banking that originated more than 80 years ago.[2] This short essay does not attempt to provide a comprehensive survey of the literature on the wide variety of stablecoins. My only intention is to draw attention to some similarities between fiat-backed stablecoins and narrow banking.

This paper is organized as follows: Section 2 analyzes fiat-backed stablecoins and reviews some of the literature. Section 3 describes the narrow banking proposal. Section 4 and table 1 provide the main analysis that compares the two forms of banking. Section 5 concludes.

2 Fiat-backed stablecoins

Stablecoins are cryptocurrencies that peg their value to a financial asset such as a national currency or a mixture of cryptocurrencies. There are several types of stablecoins. The three most common types are: fiat-backed, crypto-backed, and algorithmic (uncollateralized). Fiat-backed stablecoins are also referred to as "off-chain collateralized" stablecoins. *This essay focuses only on fiat-backed USD stablecoins*. There are two reasons for this focus: First, they are backed by cash and T-bills and therefore resemble very much the narrow banking proposal. The other types of stablecoins are either backed by cryptocurrencies or are just contracts that are denominated in stablecoins and therefore bear no resemblance to narrow banking. Second, most stablecoins are fiat-backed. For example, focusing only on stablecoins that are pegged to

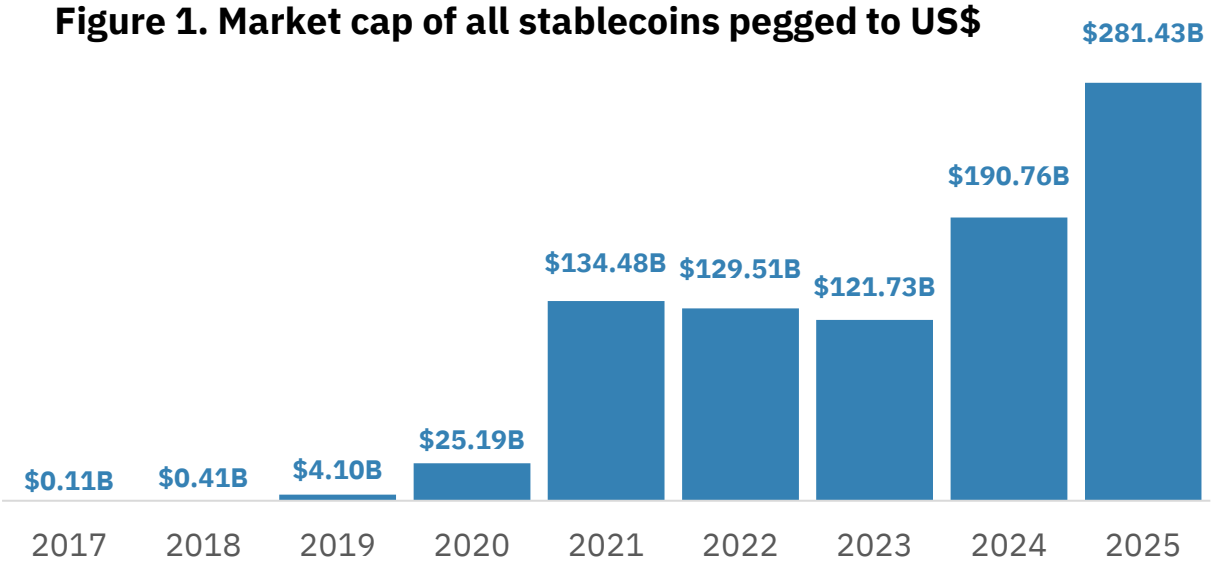
[1] The FDIC maintains a list of failed banks; see fdic.gov/bank-failures/failed-bank-list.

[2] Pennacchi (2012) points out that prior to the early-twentieth century, US banks tended to be much narrower than they are today. Common modern banking practices, such as maturity transformation and explicit loan commitments, arose only after the creation of the Federal Reserve and the FDIC. In fact, the US Postal Savings System operated as a type of narrow bank from 1911 to 1967.

the USD, at the end of January 2026, the total dollar value of fiat-backed stablecoins was $278.87 billion, which is ten times higher than the $27.71 billion value of all non-fiat-backed stablecoins.[3]

Figure 1 displays the market cap of all fiat-backed stablecoins that are pegged to the USD.

Figure 1. Market cap of all stablecoins pegged to US$



Souce: https://defillama.com

Note that the total values displayed in figure 1 are still negligible compared to the more than $18 trillion worth of deposits held in US banks.[4]

It is too early to predict whether stablecoins will eventually grow to the level of trillions of dollars—closer to the levels that are held in traditional bank deposits. So far, the major use of stablecoins involves buying and selling other crypto assets rather than making daily payments. There is some potential for stablecoins to reduce the high costs of cross-border payments by bypassing the legacy high-cost cross-border payment rails that currently use traditional banks. See Shin (2025) for discussions and evaluations also in the context of tokenized deposits.

Arner, Auer, and Frost (2020) provide an early study of regulatory and supervisory issues related to stablecoins. Baughman, Carapella, Gerszten, and Mills (2022) explain how stablecoins serve as both a means of payment and store of value for a range of decentralized finance (DeFi) transactions. The authors emphasize that a stablecoin's stabilization mechanism—the process by which a stablecoin maintains its peg against the real-world asset—

[3] See defillama.com/stablecoins.

[4] See fred.stlouisfed.org/series/DPSACBW027SBOG.

is a key factor in determining the risk to the users. Liao and Caramichael (2022) provide additional discussions.

3 Narrow banks

Phillips (1992, 1994), Phillips and Roselli (2009), Pennacchi (2012), and Benes and Kumhof (2012) provide comprehensive historical overviews of how the idea of narrow banking was formed and how it has evolved over time. Whereas the intention of the original proposal was to require banks to maintain 100 percent cash reserves, narrow banking reserves are now interpreted as a mixture of cash and government securities (T-bills).[5]

There are two related ways to think about narrow banking: The first is to let mutual funds manage loans where the risk could be mitigated by selling mutual funds consisting of some cash, bonds, stocks, mortgages, business loans, and personal loans while banks will be prohibited from making loans.[6] Second, banks could have two floors: The narrow bank on the bottom floor will accept deposits and provide payment services but not loans. These deposits could be insured. The second floor (perhaps in the same bank) could engage in investment banking and provide loans, but, unlike the first floor, these investment activities will not benefit from government insurance and bailouts. The advantage of removing loans from banks is that banks will no longer bundle risk with depositors' money; see Shy and Stenbacka (2000, 2007, 2008).

Although the idea of narrow banking was endorsed by top economists, such as Irving Fisher and Nobel Prize laureates Milton Friedman, James Tobin, and Robert Merton[7], most economists dismiss this idea in favor of the fractional-reserve banking system for two reasons. First, banks engage in "maturity transformation," where depositors use banks for short-term safekeeping and payment activities while the banks turn deposits into long-term loans such as mortgages; see the seminal papers by Diamond and Dybvig (1983) and Diamond (2007). Second, some economists argue that fractional-reserve banks are the right institutions to engage in both deposit taking and lending because of the synergies between these two activities; see Kashyap, Rajan, and Stein (2002).[8]

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[5] Demeulemeester (2018) distinguishes between two divergent approaches that prevailed in the 1930s: the "Chicago Plan" and the "Currie-Fisher" approach which supported a 100 percent money proposal that would leave the proper banking sphere largely untouched.

[6] In addition to mutual funds, other structures that are not short-term liabilities could be funding the loans. These include open-end mutual funds or business development companies as described in Beltratti and Bock (2018).

[7] See Fisher (1936), Friedman (1960), Tobin (1987), and Merton and Bodie (1993).

[8] Pennacchi (2006) shows that these synergies may not exist in the absence of government insurance programs such as the FDIC, and that there may be financial institutions other than banks that can serve as conduits of liquidity to borrowers.

4 Fiat-backed stablecoins and narrow banks: Shared characteristics

The table compares some key features of fiat-backed stablecoins and narrow banks. For the sake of completeness, the table also attempts to compare these features with those of central bank digital currency (CBDC) and the traditional fractional-reserve banks.[9]

A rough comparison of four forms of banking

	Stablecoins	Narrow	CBDC	FR Bank
	Service provided			
Payments	Yes	Yes	Yes	Yes
Safekeeping	Yes	Yes	Yes	Yes
Pay interest	Possible, lower than T-bills			Yes
Make loans	No	No	No	Yes
Payment rails	Blockchain	ACH, wire, FedNow, RTP, mobile apps		
Currency	Private	National	National	National
	Reserves			
Cash holdings	High	High	100%	Lowest
Cash stored at the CB	Pending	High	100%	Low
Cash stored at other FR banks	High	None	None	Some
T-bills holding	High	High	None	Low
Other assets	None	None	None	High
	Liability and government assistance			
Prime liability rests on	Issuer	Bank	Central Bank	Bank
Government insurance/bailout	No	Possible	No	Yes
	Risks to users			
Runs (with bailout of FR banks)	Unknown	Low	Unlikely	Low
Runs (without bailout/insurance)	Unknown	Low	Unlikely	Highest
Deviation from 1:1 to US$	Observed	None	None	None
Crypto wallet settlement failures	Unknown	None	None	None

Notes on the table: "Stablecoins" refers to an issuer of fiat-backed stablecoins pegged to the USD only. "Narrow" refers to a narrow bank. "CBDC" refers to central bank digital currency. "FR bank" refers to a traditional fractional-reserve bank. Bailouts apply to FR banks only. "CB" refers to central bank. "Unknown" risk means it definitely exists, but it is too early to estimate its level.

Some words of caution about the table. The features attributed to stablecoins reflect what is known at the time of writing this paper. Lobbying by stakeholders may eventually lead to a different regulatory system in which issuers of stablecoins, digital wallets, and exchanges

[9] For CBDC and FR-banks, see federalreserve.gov/central-bank-digital-currency.htm and investopedia.com/terms/f/fractionalreservebanking.asp.

would be allowed to pay interest and hold cash at the central bank.[10] The same applies to the risk assessments listed in the table, which some readers may disagree with and which might all change over time. In addition, the features listed under narrow bank are based on proposals that were made over the years and less on observed features.

Subsections 4.1, 4.2, 4.3, and 4.4 elaborate on the table according to the same order depicted in it.

4.1 Comparing services

All the four types of banking are designed to provide payment services. But not all payments are the same. More precisely, a payment is a transfer of purchasing power from a payer to a payee. The origins and destinations vary significantly. For example, a payment could start with physical cash (dollar bills) and end up as cash deposited at someone's traditional bank account. Or the payment could start or end at a mobile wallet denominated in USD, stablecoins, or other cryptocurrencies. In other words, to be able to compare payment services, payments must be classified according to their *last miles* taken by the payer and the payee; see discussions in Shy (2021, 2023).

Keeping in mind the last-mile restrictions that characterize each individual payment, Baughman, Carapella, Gerszten, and Mills (2022) explain the process of making a payment with stablecoins. In short, the payer starts the transfer process by purchasing stablecoins with USD (say, via a bank transfer). The issuer then "mints" one stablecoin for each dollar it receives. Then, the payer uses a wallet (or the same issuer if wallet services are provided) to transfer stablecoins to the payee via another issuer (or the same issuer, depending on where the payee would like to be paid). Finally, the last mile is for the payee to either keep the stablecoins or cash them out and transfer the cashed USD to a bank account or another destination.

Issuers of stablecoins and narrow banks are not supposed to extend loans. As the table shows, only traditional fractional-reserve banks make loans. The same holds for paying interest, although stakeholders now lobby to allow stablecoin holders to receive interest either directly from the issuer or indirectly through exchanges or other affiliates.

4.2 Comparing reserves

The structure of reserves is where fiat-backed stablecoins very closely resemble narrow banking and makes them fundamentally different from traditional fractional-reserve banks. Issuers of fiat-backed stablecoins and narrow banks must maintain full reserves that are kept as cash and T-bills. The original proposal for narrow banking called for 100 percent cash reserves. However, over time the proposal has evolved to a mixture of cash and government securities, which—depending on the type of security—might add some risk from sharp fluctuations in interest rates.

[10] See americanbanker.com/opinion/stablecoin-interest-is-not-the-biggest-threat-facing-bank-deposits.

Finally, the table shows that issuers of fiat-backed stablecoins store their cash reserves in traditional fractional-reserve banks. Subsection 4.4 shows how this might affect their stability by causing the price of stablecoins to deviate from their pegged USD in the event of the failure of these fractional-reserve banks.

4.3 Comparing liability and government assistance

The narrow banking proposal does not rule out government insurance programs such as the FDIC. Given that narrow banks are significantly less likely to fail, insurance premiums are likely to be negligible compared to the premia paid by the traditional fractional-reserve banks. As for stablecoins, the GENIUS Act does not consider any government assistance.

4.4 Comparing risk to the users

Catalini, Gortari, and Shah (2022) note that the disintermediation of stablecoin transactions (as opposed to centralized payment systems) makes it difficult to enforce compliance standards, ensure the stability of the financial system, and protect consumers from fraud and financial risk. Such disintermediation might make narrow banks safer than stablecoins as narrow banks are much easier to supervise.

Risk of runs: Runs on narrow banks and stablecoins might occur because they do not keep 100 percent cash reserves. Although government securities are considered very safe assets, their value might fall when interest rates rise. However, unlike narrow banks, runs on stablecoins may also be triggered by (i) rumors of failures of intermediaries such as digital wallets and exchanges that are connected to the original issuers of stablecoins; and (ii) failure of fractional-reserve banks where the stablecoin issuers store their cash reserves.

Risk from deviations from the USD: Stability of fiat-backed USD stablecoins could be measured by deviations, both in magnitude and frequency, of the stablecoin price relative to the pegged currency (USD). Lyons and Viswanath-Natraj (2023) investigate which arbitrage design and other design elements contribute to the stability of USD-pegged stablecoins. Duan and Urquhart (2023) find strong evidence of instability of stablecoins and that the deviations from the $1 mark are gradually corrected at different speeds for most stablecoins. Other papers that investigate the (in)stability of stablecoins include Grobys, Junttila, Kolari, and Sapkota (2021); Kristoufek (2021); d'Avernas, Maurin, and Vandeweyer (2022); and Hoang and Baur (2024).

The table indicates that issuers of stablecoins store their cash reserves in traditional fractional-reserve banks, making their cash reserves risky as fractional-reserve banks are vulnerable to runs. Du, Sonawane, and Watsky (2025) provide a case study showing how the 2023 failure of the Silicon Valley Bank affected the price of a variety of stablecoins.

Risk of wallet and settlement failures: Payments involving stablecoins are accomplished via intermediaries (wallets and exchanges) that connect issuers of stablecoins. In particular, these wallets facilitate transactions among issuers of different stablecoins and other cryptocurrencies. The enlarged network of intermediaries might increase the risk of failure.

5 Concluding remarks

The 2025 Guiding and Establishing National Innovation for US Stablecoins (GENIUS) Act is the first federal regulatory framework governing stablecoins.[11] It imposes restrictions on stablecoin issuers that resemble some forms of narrow banking proposals made several times since the Great Depression. The Act requires issuers to maintain high-quality liquid asset reserves to honor "enforceable redemption rights," which means that holders of fiat-backed stablecoins can demand $1 for each dollar-denominated stablecoin and redeem their stablecoins in a timely manner. The Act also prohibits issuers from paying interest on stablecoins and excludes stablecoins from FDIC deposit insurance.

Fiat-backed stablecoins and narrow banks share very similar characteristics with respect to their reserve requirements and the services that they provide (and do not provide). In that sense, they bear similar risks. However, stablecoins rely on additional "moving parts" that narrow banks do not have, which make them riskier.

The additional "moving parts" involved in each payment made with stablecoins include: (i) the conversion of national currencies, such as the USD, to newly minted issuer-specific stablecoins; (ii) the reverse process of converting stablecoins back to a national currency; (iii) the use of one or multiple digital wallets and exchanges to store and transact with other parties via a blockchain (distributed ledger); and (iv) observed price deviations from the 1:1 pegged currency. In addition to these four risks, because issuers of stablecoins store their cash reserves in traditional fractional-reserve banks, they also face exposure to runs on these banks.

[11] See congress.gov/bill/119th-congress/senate-bill/1582/text.

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