FINANCIAL INNOVATION

IMPLICATIONS FOR PAYMENTS AND POLICY

FEDERAL RESERVE BANK OF KANSAS CITY
JACKSON HOLE, WYOMING
AUG. 27-29, 2026

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FEDERAL RESERVE BANK OF KANSAS CITY

Stablecoin Risk

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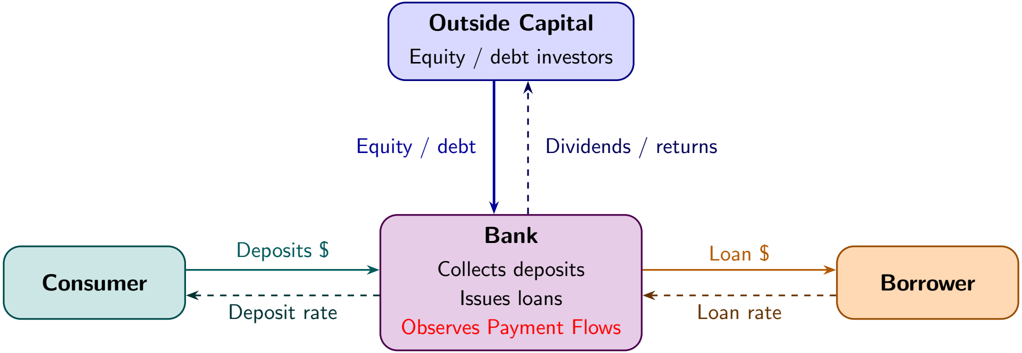
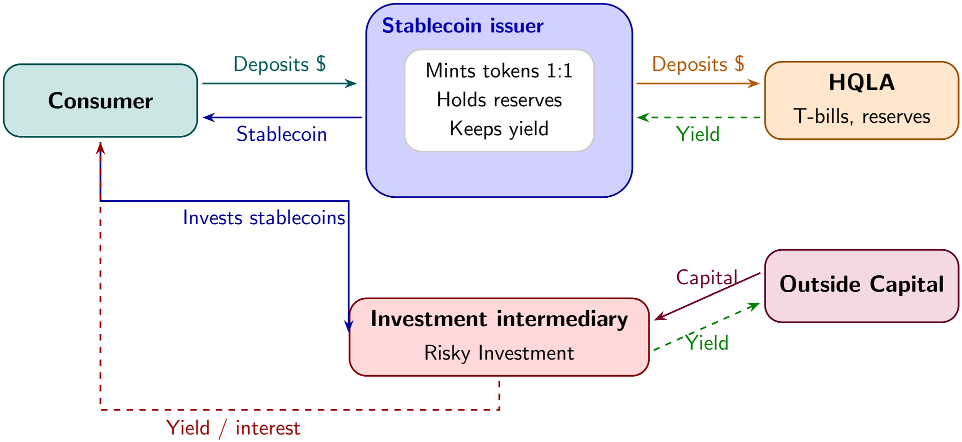
August 28, 2026

- Is there an economic difference between payments intermediated by banks and those intermediated by stablecoins?
- Besides regulatory arbitrage, Are there unique risks associated with a stablecoin payment economy?
- Economically different payment rails
  - Potential macro differences.
  - May require forward looking regulation

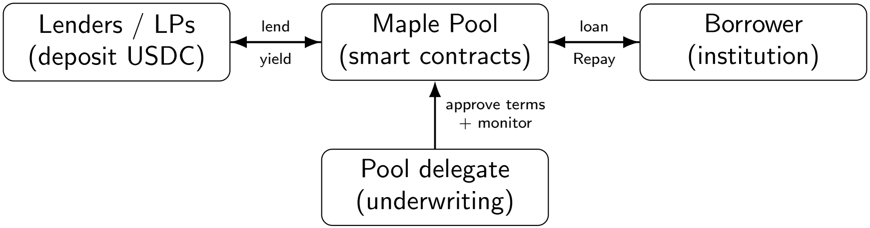
Bank Intermediated Payments



Stablecoin Intermediated Payments: No information Aggregation



Maple Finance
4.5 bn AUM



- Loans are undercollateralized
- Borrowers vetted by delegates (off Chain)
- Lenders obtain fixed yield
- Also Stakers provide insurance

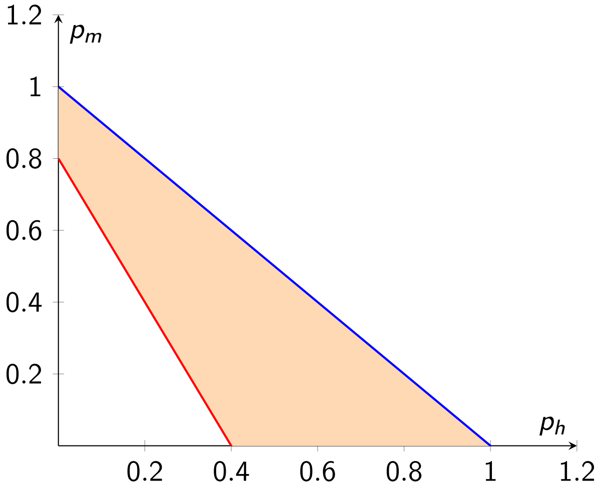
Account Based vs Token Based Payment system

- Account based payment system generates useful information about payment types
  - Maintained balances, payment prioritization, cashflow and liquidity management
- Useful to understand cashflows/repayment in bad states
- Not particularly informative about growth options or future plans
- Account based payments systems are better at evaluating default risk

Real Effects: An Example

- All projects cost $I = 0.8$.
- 3 possible cashflow states: $x_h = 2, x_m = 1, x_\ell = 0$.
- Each individual project has probabilities p_h, p_m, p_ℓ.
- Projects in the economy are uniformly distributed across these probabilities

First-best Investment

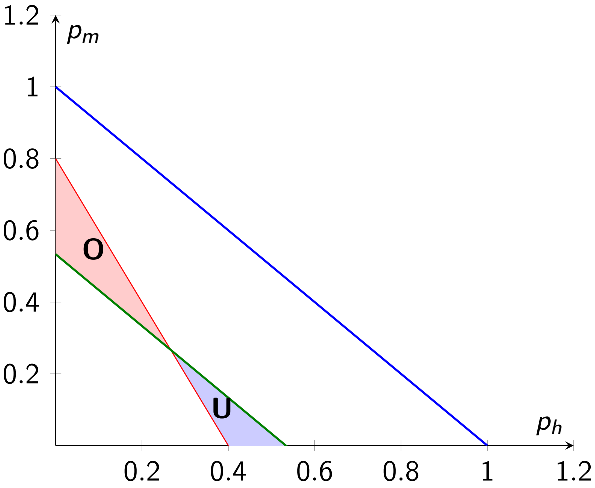


- The solid blue line represents the equation $p_m + p_h = 1$.
- The solid red line represents the equation $p_h x_h + p_m x_m = I$.
- The orange-colored area between the two lines represent combinations of (p_h, p_m) at which the investment has positive NPV.

Investment Decisions for a payment intermediary (bank)

- Based on payment flows, a bank knows p_ℓ
- Debt contract is the natural one.
- One can determine the debt repayment it requires in each state.
- Simple positive NPV rule pins down the projects that the bank wants to undertake.

Set of Projects Undertaken with Bank Lending

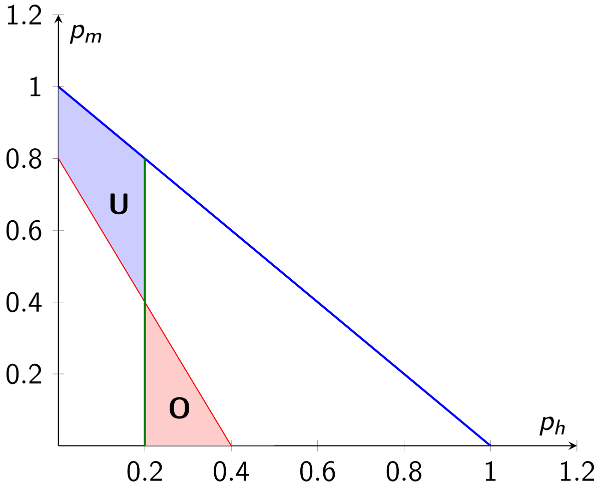


- The red-colored area (labeled "O") represents over-investment under bank lending (i.e., firms that obtain financing but have negative NPV)
- The blue-coloured "U" area is under-investment under bank lending (i.e., firms that have positive NPV but do not obtain financing).

Investment Decisions for any other intermediary

- If an investor does not know p_ℓ, can determine the state that it wants to be informed about
- Intermediary focused on the high cashflow state – equity contract.
- Simple positive NPV rule pins down the projects that this intermediary wants to undertake.

Set of Projects Undertaken with Equity/VC/PE Financing



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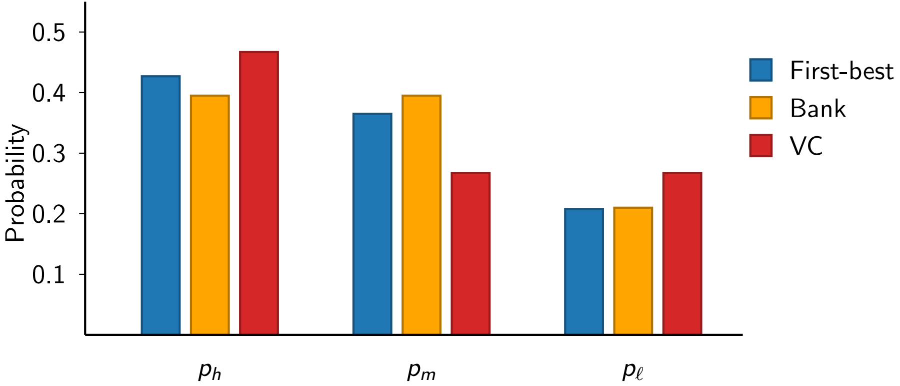
- The solid green line is the breakeven threshold when p_h is known. All projects to the right of this line obtain financing.
- The red-colored "O" area represents firms that obtain financing but have negative NPV)
- The blue-coloured "U" area is firms that have positive NPV but do not obtain financing.

Aggregate Outcomes

	Mass of Projects Invested in	Aggregate Value
First-best Investment	0.680	0.285
Bank Financing	0.716	0.276
VC Financing	0.640	0.256

Probability Distributions Across Financing Regimes



Implications #1: Relationship to Tokenized Deposits

- Fundamentally different to stablecoins because account based
- Tokenization provides extra layer of functionality.
- Similar regulatory structure

Implications #2 Value of Information

- Possible to replicate information through another mechanism?
- No: wallet to wallet transfer requires both sides to report
- Clear need for regulatory solution

Implication #3 Liquidity Transformation

- Financial Intermediaries choose illiquid investments
  - If funding comes from payments demand $\longrightarrow$ mismatch
- DeFi solution: issue tokens ("staked")
  - Claims to future returns
- Ameliorates mismatch but singleness of money problem
- Clear Regulatory concern

Final Thoughts

- Account based banking systems are economically different to token based systems
- Macro implications: Set of projects undertaken without bank-like information more extreme
- Emerging intermediation structure requires new regulatory approaches.