

The Hollow Bank: Regulatory Arbitrage, Competitive Displacement, and the Shrinking Insured System

Abstract

The GENIUS Act creates an asymmetric regulatory architecture in which permitted payment stablecoin issuers compete directly for consumer deposits against insured depository institutions while bearing none of the obligations that make the banking franchise a public function. Non-bank stablecoin issuers pay no FDIC insurance premiums, carry no Community Reinvestment Act obligations, and are exempt from the Basel-aligned capital requirements applied to traditional banks. The cost differential is structural and permanent: banks fund a deposit insurance safety net that their competitors benefit from without contributing to, and they finance community lending obligations that their competitors have legislated away. This paper maps the competitive displacement mechanism this asymmetry enables, the regulatory arbitrage available to sub-\$10 billion issuers through the state certification pathway created by the Stablecoin Certification Review Committee, and the trajectory by which the insured banking system shrinks as the uninsured stablecoin layer grows. The endpoint is a banking system hollowed of its community lending function, concentrated in a small number of large institutions pursuing proprietary stablecoin programs, with an FDIC insurance fund covering a diminishing fraction of the total consumer monetary layer. The paper concludes by identifying the public franchise question that GENIUS does not answer: whether the monetary function of banking carries obligations that follow the function rather than the charter type, and whether the regulatory asymmetry it has created is a

design feature of a new framework or a legislated extraction of public subsidy by private entities performing a public function.

The Asymmetry at the Core

The GENIUS Act creates two classes of dollar-denominated payment instrument issuers operating in direct competition for the same consumer deposits. The first class, traditional insured depository institutions, carries the full weight of the existing regulatory framework: FDIC insurance premiums, Community Reinvestment Act obligations, Basel-aligned capital requirements, Bank Holding Company Act provisions, and prudential oversight calibrated to systemic risk. The second class, permitted payment stablecoin issuers, including non-bank entities supervised by the OCC, carries none of these obligations in equivalent form.

The GENIUS Act explicitly exempts stablecoin issuers from the regulatory capital standards applied to traditional banks. It contains no Community Reinvestment Act requirements. It imposes no FDIC insurance premiums. It does not subject non-bank issuers to Bank Holding Company Act provisions. It creates a tailored capital, liquidity, and risk management framework designed specifically for the stablecoin business model, one that is structurally lighter than the framework governing the institutions with which stablecoin issuers compete for deposits.

This is not incidental. It is the architecture of competitive displacement built into the regulatory design. When two entities offer functionally equivalent instruments, dollar-denominated, liquid, and payment-capable, but one bears significantly higher compliance costs than the other, the lower-cost provider wins on price. The regulatory burden differential is not a feature protecting consumers. It is a subsidy to non-bank issuers paid for by the banking system's existing obligations.

The Cost Structure of the Asymmetry

FDIC Insurance Premiums

Insured depository institutions pay assessments to the FDIC based on deposit balances and risk profiles. These premiums fund the Deposit Insurance Fund, the backstop that protects depositors when banks fail. Non-bank stablecoin issuers pay no equivalent assessment. Their 1:1 reserve requirement provides holder protection in theory but no pooled insurance fund in practice. The consumer holding a stablecoin issued by a non-bank entity has no FDIC guarantee. The institution competing for that consumer's deposit paid for the guarantee the consumer can no longer access once they move to the stablecoin alternative.

The banks fund a safety net. The non-banks benefit from the credibility that safety net creates for dollar-denominated instruments generally, without contributing to its maintenance.

Community Reinvestment Act Obligations

The Community Reinvestment Act of 1977 requires insured depository institutions to meet the credit needs of the communities in which they operate, including low- and moderate-income neighborhoods. Banks are evaluated on CRA performance when applying for mergers, acquisitions, and branch changes. Non-compliance carries regulatory consequences. The obligation is structural, not discretionary.

Non-bank stablecoin issuers bear no CRA obligations under GENIUS. The act is silent on community lending requirements. A coalition of consumer and community development organizations identified this gap explicitly in opposition letters during the legislative process, noting that the bill contains only a vague, non-binding reference to "benefit to consumers" in the issuer approval criteria, insufficient to replicate CRA's mandatory community lending function.

The scale of what CRA represents makes this omission material. According to the National Community Reinvestment Coalition, CRA-qualifying mortgages and small business loans totaled nearly \$5 trillion between 2010 and 2024. In 2023 alone, CRA lending accounted for approximately \$387 billion in small business and community development loans, representing roughly 77% of outstanding small business loan dollars and 35% of outstanding farm loans. As the Progressive Policy Institute's analysis concluded,

stablecoins accumulating dollar deposits without CRA obligations do not merely create a competitive imbalance; they directly reduce the funding base for the community lending that the CRA framework depends on.

Regulatory Capital

Traditional banks operate under capital adequacy frameworks: Basel III and its domestic implementations, requiring them to hold equity capital against risk-weighted assets. These requirements constrain leverage, limit risk concentration, and provide loss-absorbing buffers. They are also expensive: capital held against risk cannot be deployed for profit.

GENIUS explicitly exempts stablecoin issuers from these capital standards, substituting a tailored framework calibrated to the stablecoin business model. A 100%-reserved instrument with no lending book presents a different risk profile than a traditional bank, and a different capital treatment is facially reasonable. The practical consequence, however, is that non-bank issuers operate without the equity buffers that constrain bank risk-taking, while competing for the deposit base that funds those buffers.

The Competitive Displacement Mechanism

The cost structure differential compounds the yield differential already embedded in the architecture. Banks must pay FDIC premiums, fund CRA obligations, and hold regulatory capital: all costs that reduce the return they can offer on deposits or require fees that stablecoin issuers do not charge. Non-bank stablecoin issuers bear none of these costs while collecting T-bill yield on 100% of their reserve base.

Even without paying yield to consumers; prohibited under GENIUS, non-bank issuers can offer superior reward structures, lower transaction costs, and more aggressive adoption incentives than regulated banks, precisely because they have shed the compliance overhead that banks carry. Their cost of acquiring and retaining a deposit equivalent is structurally lower. Their margin on each dollar held is structurally higher.

For a consumer making a rational allocation decision between a bank deposit and a stablecoin, the comparison is not between equivalent instruments with equivalent guarantees. It is between a costly, heavily regulated instrument with FDIC protection and a cheaper, lightly regulated instrument with reserve backing but no deposit insurance. In a stable environment, the stablecoin wins on cost. In a stress environment, the bank wins on guarantee. The adoption incentive architecture described in Working Paper 1, over-rewarding conversion during the land-grab phase, is designed to ensure consumers make the allocation decision during the stable period, before they have experienced the stress scenario.

State Regulatory Arbitrage

GENIUS permits stablecoin issuers with less than \$10 billion in outstanding issuance to operate under state regulatory regimes certified as "substantially similar" to the federal framework. Certification is granted by the Stablecoin Certification Review Committee, comprised of the Treasury Secretary, the Federal Reserve Chair, and the FDIC Chair, by unanimous vote within 30 days of application.

This structure introduces a multi-layered arbitrage opportunity. First, the "substantially similar" standard is subjective and contested. States competing for financial industry presence, Wyoming, Texas, and others with active digital asset legislation, have direct economic incentives to meet the minimum threshold for certification while preserving as much regulatory flexibility as possible. The result is a race to the floor on the sub-\$10 billion tier, where issuers shop for the most permissive certified state framework.

Second, the \$10 billion threshold creates a structural incentive to remain below it. An issuer approaching \$10 billion faces the choice between federal oversight and state oversight. If the state regime is materially more permissive, the issuer has an incentive to constrain growth, restructure, or fragment its issuance to remain below the threshold. Large stablecoin programs can be structured as multiple sub-threshold entities sharing infrastructure.

Third, the unanimity requirement for SCRC certification creates an inverse dynamic at the federal level: any single member can block state certification, but the practical pressure,

from Treasury, which chairs the committee and which benefits from T-bill demand that stablecoin adoption generates, runs toward approval rather than denial.

Concentration of Systemic Risk in a Shrinking Insured Base

As deposits migrate from insured depository institutions to non-bank stablecoin issuers, the FDIC-insured deposit base contracts. The institutions that remain in the insured system carry a concentrated share of systemic risk relative to a shrinking asset base. The FDIC's fund, calibrated to protect depositors across the full commercial banking system, faces increasing stress as the insured deposit base that funds its assessments shrinks while the uninsured stablecoin deposit equivalent grows outside its jurisdiction.

This dynamic has a historical precedent. The savings and loan crisis of the 1980s involved the concentration of risk in a segment of the insured system that the fund was not capitalized to handle. The resolution cost over \$130 billion. The post-2008 regulatory framework was designed explicitly to prevent equivalent risk concentration. GENIUS reverses the post-2008 lesson: it creates a pathway for the most cost-efficient, fastest-growing segment of the deposit market to move outside the insured system entirely, leaving the remaining insured institutions holding the risk the larger system generates.

Community and regional banks are again the first-order casualties. They cannot follow deposits into stablecoins without technology investment they cannot afford and partnerships with entities that have no interest in their survival. They carry CRA obligations to communities that are losing their primary credit source. They pay FDIC premiums for a fund protecting deposits that are migrating to an uninsured alternative. Their competitive position deteriorates not because they are poorly managed but because the regulatory framework has been redesigned to favor their competitors.

The largest banks occupy a different position. JPMorgan, Citi, and Bank of America are developing proprietary stablecoin and tokenized deposit products; JPM Coin, Citi Token Services, that allow them to capture the stablecoin architecture while retaining their institutional relationships. For them, the GENIUS Act is not competitive displacement. It is market expansion. They can issue stablecoins through subsidiaries, retain the T-bill float,

shed the yield obligation to consumers, and maintain their institutional fee revenue. For this tier, GENIUS is not a threat; it is a restructuring of the market in their favor, with their smaller competitors serving as the deposit base from which migration occurs.

The Hollowing Endpoint

The full trajectory of the banking system hollowing under GENIUS runs as follows.

Non-bank stablecoin issuers, operating without FDIC premiums, CRA obligations, or bank-equivalent capital requirements, compete for consumer deposits at structurally lower cost. Deposit migration from community and regional banks to stablecoin instruments accelerates, driven by the over-incentivization dynamics described in Working Paper 1. Community and regional banks lose deposit base, lose credit creation capacity, and lose the CRA funding that serves low- and moderate-income communities. The \$387 billion in annual CRA lending contracts proportionally to deposit migration.

Large banks adapt through proprietary stablecoin programs, maintaining institutional position while shedding obligations through subsidiary structures. The banking system that survives is more concentrated, a small number of large institutions operating stablecoin programs alongside traditional banking, and more exposed, because the FDIC-insured base that buffers systemic risk has shrunk while the uninsured stablecoin equivalent has grown outside its jurisdiction.

The FDIC's relevance contracts with its deposit base. Its insurance fund, built on assessments from a shrinking pool of insured institutions, covers a decreasing share of the dollar-equivalent instruments actually held by consumers. In a systemic stress event, the run dynamics described in Working Paper 1, the FDIC backstop applies to a fraction of the instruments affected. The run happens in stablecoins. The government responds to prevent system failure. The cost falls on the public. The profit from the float that financed the run accrued to the issuer.

This is the hollowing endpoint: a banking system reduced to a rump of large concentrated institutions and struggling community banks, operating inside an insured framework that covers a diminishing share of the total consumer monetary layer, while the uninsured

stablecoin system above them captures the growth, the float, and the seigniorage; without the obligations that justified the banking system's original public franchise.

The Public Franchise Argument

Banks exist as regulated entities because they exercise a public function. They create money, allocate credit, and operate the payment system. In exchange for that franchise, and for the deposit insurance guarantee that makes it viable, they accept obligations: capital requirements, CRA, prudential supervision, and systemic risk constraints. These obligations are not arbitrary impositions. They are the terms of the license.

Non-bank stablecoin issuers exercise the same function; they issue dollar-equivalent instruments, operate payment rails, and allocate reserve assets. GENIUS grants them that function without the full terms of the license. The franchise is extended; the obligations are not. The justification offered is that stablecoins are a new instrument requiring a tailored framework. The practical effect is that a new class of entities performs the monetary function of banking without the community obligations, the insurance premiums, or the capital requirements that have historically been the price of that function.

The question GENIUS does not answer, and no legislator has posed, is whether the public franchise of money creation carries obligations that follow the function, not the charter type. If it does, the regulatory asymmetry is not a design feature of a new framework. It is the extraction of a public subsidy, in the form of avoided obligations, by private entities performing a public function, facilitated by legislation that was drafted in close consultation with those same entities.

Conclusion

The banking system is not being disrupted by a superior technology. It is being displaced by a regulatory architecture that has assigned the same monetary function to two classes of entity under materially different compliance costs. The lower-cost class wins the

deposit competition. The higher-cost class retains the obligations that financed community lending, protected depositors, and constrained systemic risk. Those obligations do not migrate with the deposits. They remain with the institutions losing them.

Community and regional banks are the first-order casualties not because they are less innovative but because they cannot shed the obligations that their competitors were never assigned. The FDIC fund that protects their depositors shrinks in relevance as the uninsured stablecoin layer grows. The CRA lending that their deposits finance contracts as those deposits leave. And the largest banks, through proprietary stablecoin programs, capture the growth while the regulatory gap widens between them and the community banking sector they are designed to coexist with.

The public franchise question this architecture raises has no legislative answer. GENIUS created the asymmetry. No subsequent Act has addressed whether the obligations of the monetary franchise follow the function or the charter. Until that question is answered, the hollowing continues.

References

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