Research Working Papers

Explaining the Life Cycle of Bank-Sponsored Money Market Funds: An Application of the Regulatory Dialectic

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How banks and regulators react to each other helps explain how the money market fund industry has evolved.

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In this paper, we present empirical evidence of the regulatory dialectic in the prime institutional money market fund (PI-MMF) industry. The "regulatory dialectic," developed by Kane (1977, 1981), describes how banks and regulators react to each other. For decades, a cap on commercial deposit interest rates fueled dramatic growth in bank-sponsored PI-MMFs as a form of shadow banking. We show that during the growth period, banks with more commercial deposits were more likely to enter the PI-MMF industry in an effort to keep their commercial customers in affiliated subsidiaries. However, the 2008 crisis and subsequent re-regulation of the industry halted the rapid growth of PI-MMFs. In the post-crisis regulatory regime, we find that bank-sponsored funds were more likely to exit the industry than nonbank-sponsored funds. Simultaneously, the industry shifted from PI-MMFs to government institutional MMFs as substitute products. We conjecture that the collapse of the PI-MMF can lead further to the emergence of substitute products, such as stablecoins as part of the continuing dialectical process.

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Related Research

- Jacewitz, Stefan, Haluk Unal, and Chengjun Wu. 2022. "Shadow Insurance? Money Market Fund Investors and Bank Sponsorship." *Review of Corporate Finance Studies*, vol. 11, no. 2, May 2022, pp. 414–456. Available at https://doi.org/10.1093/rcfs/cfab027

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