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

by: Stefan A. Jacewitz, Jonathan Pogach, Haluk Unal and Chengjun Wu

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

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. 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 regulatory changes halted the rapid growth of PI-MMFs. In the post-crisis regulatory regime, 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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Author

Stefan A. Jacewitz
Research and Policy Officer

Stefan Jacewitz is a Research and Policy Officer at the Federal Reserve Bank of Kansas City. He joined the Economic Research Department in April 2021 after serving 12 years at the Federal Deposit Insurance Corporation (FDIC), most recently as the Chief of the Quantitative Risk Analysis Section and previously as a Senior Financial Economist. Mr. Jacewitz has B.A. degrees in Mathematics and Economics from the University of Oklahoma and a Ph.D. in Economics from Texas A&M University. His main areas of research are bank regulation and financial intermediation.