

Bank Deposits and Money Market Funds Compared – Considerations for Financial Institutions

The primary role of a cash manager is to maximise the **safety**, **liquidity**, and **yield** of their cash holdings. With this objective in mind, where should the prudent cash manager place their short-term cash holdings to ensure that each of these considerations is sufficiently met?

A bank deposit and an MMF both represent potential solutions which we compare below. An overnight bank deposit offers same-day access and normally pays interest, and a major international bank will usually hold a good rating from an authorised credit rating agency. An alternative liquidity management tool is a Money Market Fund (MMF). An MMF may offer enhanced features and benefits compared to those found with a bank deposit.

	Overnight bank deposit	AAA/Aaa Money Market Fund*
Risk	Single counterparty risk	Credit diversification through broad portfolio mix
Return	Linked mainly to market overnight interest rates	Potential yield enhancement due to longer duration and diverse make-up of the portfolio
Fees	Agreed between client and bank (potential penalty to breaking term agreements)	Costs and fees embedded in product, so yields are received net
Interest	Paid daily	Accrued daily; paid monthly
Minimum Investment	None	No minimum transaction size

*Triple A refers to specific MMF ratings: AAAMmf Fitch, Aaa-mf Moody's and AAAM S&P

Safety

When an investor makes a direct deposit with a bank, they have sole concentration risk with that particular institution. Should that bank become financially distressed, there is a risk of principal loss to its depositors.

Safety or preservation of capital is the key priority for MMFs. In contrast to bank deposits, MMFs diversify their investments across a broad range of highly rated (minimum A1/P1/F1) investments, mitigating single counterparty risk.

Liquidity

The ability to transact daily, placing and receiving cash on the same day, is a key requirement of cash managers and is crucial in being able to meet obligations such as margin calls or other onward payments. Bank deposits offer this service, and so too do MMFs. The use of intraday dealing cycles¹ means that cash managers do not have to wait until fund cut-off time before they receive their cash.

¹ Not available on all MMFs

Yield

Bank deposit interest rates are linked mainly to market overnight interest rates and are historically low. MMFs can potentially offer better returns due to the longer duration of the portfolio (up to 60 day Weighted Average Maturity²) and diverse make-up of the portfolio. This will generally result in the fund outperforming short-term deposit rates.

Why should a Financial Institution use an MMF?

Changes in banking regulation over recent years have created challenges for Financial Institutions (FIs) looking to place cash on deposit with banks. Most notably, under BASEL III, short-term, non-operational cash from Financial Institutions has a negative impact on a bank's liquidity coverage ratio. This ratio is a measurement of the bank's high quality liquid assets (HQLA) which can be used to survive a stress period of up to 30 days. As such, many Financial Institutions have found that banks are either unwilling to take their cash, or offer uncompetitive rates, especially around reporting periods such as quarter-end and year-end. MMF's, on the other hand, sit "off-balance sheet" and are therefore not impacted by the same regulation, which makes them an ideal alternative for Financial Institutions to invest their cash in.

For Financial Institutions, the three key features of an MMF, namely **safety, liquidity and yield**, make their use an attractive option as a vehicle for placing short terms assets.

For institutions holding client assets, an MMF can be used in a multitude of ways. For the liability driven investment (LDI) manager, they can be used to sit at the end of the chain, as a holding area to place cash from maturing assets ahead of paying out liabilities.

The MMF core objectives of preservation of capital and provision of liquidity provide a level of assurance to such an investment manager that the assets are safe. The required liquidity levels, along with multiple-payment cycles and same day settlement, ensure that the funds are available when needed and can be left invested in the MMF up until the day of redemption. Since the potential yield enhancement in an MMF is calculated daily, the investment also maximises returns, up until the point of redemption.

The use of an automated custody-sweep, where available, is another benefit, in that it allows the manager to instruct payment from their custody account, with the required funds automatically swept out of the MMF and into the custody account.

For Insurance Companies, E-money providers and other Financial Institutions that hold client assets, the use of an MMF is well suited to holding client assets for safe-keeping purposes. An account within an MMF can be designated as a "Client Money" account and registered as such on the official books and records held by the transfer agent. These assets are then clearly separate from the Financial Institution's own assets.

Qualifying MMFs (short-term MMFs, including LVNAV, PDCNAV and Short Term VNAV funds) are also CASS compliant under the FCA eligibility criteria to hold client money. This offers Financial Institutions an alternative option for placing client cash, particularly around quarter and year-ends, when banks have typically struggled to take assets onto their balance sheets.

For Hedge Funds and more traditional "long-only" Asset Managers, MMFs can be utilized to manage

² The 60-day WAM limit applies to short-term MMFs i.e. Public Debt Constant Net Asset Value, Low Volatility Net Asset Value and Short-term Variable Net Asset Value. Standard VNAVs have a 180-day WAM limit.

unencumbered cash and as a tool to optimize collateral management. MMFs enable asset managers to invest any frictional cash held within a portfolio in order to diversify away from their custodian or prime broker whilst the liquidity profile ensures that the cash can be redeployed into risk assets on a same-day basis.

MMFs can also be utilized as part of an Asset Manager's collateral management strategy, in particular, LVNAV and PDCNAV MMFs that provide capital preservation and daily liquidity, can be used to manage the reinvestment of cash collateral. In some cases, the units held within an MMF can even be pledged as collateral.

Summary

MMFs are a useful and important tool in liquidity management. They can act as a complement to bank deposits whilst at the same time offering additional benefits.

Investors should consider a range of factors including their investment horizon and risk tolerance prior to selecting any cash management strategy.

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