

Bank Deposits and Money Market Funds Compared - Considerations for Local Authorities

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?

An overnight bank deposit offers same-day access and potentially pays interest. A major international bank usually holds a good rating from an authorised credit rating agency.

An alternative liquidity management tool is the use of Money Market Funds (MMFs), which may provide enhanced features to those found within 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 banking institution 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 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 crucial in meeting 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 some MMFs

Yield

Bank deposit interest rates are linked mainly to market overnight interest rates and are historically low. MMFs can offer potentially 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.

Considerations for Local Authorities

MMFs can be an attractive solution for Local Authority Treasurers. Typically, a Local Authority Treasurer's main priority is the preservation of principal which aligns with one of the key objectives of an MMF – namely safety. The stable NAV pricing of funds such as the LVNAV and the PDCNAV (subject to the provisions of MMF regulations being met) helps in delivering the key element of preservation of principal, without the price volatility which other investment options may have.

The MMF industry has seen MMFs become a popular alternative to bank deposits for Local Authority Treasurers as an attractive and efficient tool to diversify exposure away from individual bank names. With a diversified pool of highly rated investments, the funds are able to offer attractive yields, without the need to tie up cash for longer periods of time.

Another important objective for Local Authority Treasurers is liquidity which is also a key MMF objective. MMFs are highly liquid, enabling Local Authority Treasurers to access their invested monies on a same day settlement basis and thereby allowing them maximum flexibility in their day-to-day cash management. Funds will strive to have not only diversification of investments, but diversification of investors. This helps ensure that there is always ample liquidity available to meet any given day's redemption requirements and that this ability cannot be jeopardised by any single, large underlying investors.

Whilst yield is not the main driver for most Local Authority Treasurers, it is still an element for consideration as Treasurers look to maximise yield without compromising preservation of principal or liquidity of the cash. MMFs typically offer a yield in excess of overnight deposit rates due to the laddered maturity profile of their investments which will range from overnight out to a maximum of 397 days.³

Ease of trading has become of growing importance over the years. Most MMFs will have multiple trading methods available to investors, to ensure efficient processes that cut down on the time and risks that may be associated with liquidity management. As well as having flexibility to trade via phone, fax or proprietary online systems, there is also a network of MMF platform solutions which can make the placing of transactions even more efficient.

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.

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.

³ 397-day maximum maturity limit again applies to short-term MMFs (see footnote 2). Standard MMFs have a 2-year limit.

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