BANK DEPOSITS AND MONEY MARKET FUNDS COMPARED

The primary role of a cash manager is to maximize the **Safety**, **Liquidity**, and **Yield** of their cash holdings. With this in mind, where should the prudent cash manager place their short term cash holdings to ensure that all of these consideration are sufficiently met?

The simplest and obvious solution to holding short term cash, is with a Bank. All cash managers will have access to a deposit facility that allows for same day access, and potentially pays interest. A global bank should also hold a good rating from a major Credit Rating Agency (CRA). On the surface then, the use of a bank deposit facility looks to cover off all of the three main considerations.

However, is this accurate, and is there an alternative?

This short paper looks at the role of Money Market Funds (MMFs) in meeting the needs of cash managers as vehicles in which to place short term cash, and how the key features of MMFs (Safety, Liquidity, and Yield) compare against those of Bank deposits.

Safety

An investor who has made a direct deposit with a bank has a 100% risk concentration with that particular institution. If that banking institution were to become financially distressed, there is a material risk of principal loss for all of its creditors, including depositors.

Safety or preservation of capital is the key priority for MMFs. In contrast to bank deposits MMFs diversify the investment across a broad range of highly rated (minimum A1/P1) investments. These might include holdings in Term Deposits, Government Securities and Commercial Paper, with the amount held limited to a percentage of the total.

Consequently, MMFs are extremely well diversified, removing single counterparty risk.

In addition, Money market funds have a diverse investor base, including:

- Financial Institutions
- Pension Funds
- Corporates
- Charities
- Local Authorities

The result of this diverse investor base is that each investor type has very different cash flow requirements and where one investor may redeem from the fund the other may subscribe thus creating a netting effect. This construct, along with specific guidelines that require minimum amounts of liquidity in the fund make the investments appropriate for same day cash needs.

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.

Cash deposits offer this service, however so too do MMFs. Furthermore, the use of intraday dealing cycles[1] means that cash managers do not have to wait for fund cut-off before they receive their cash.

Yield

Bank deposits interest rates are linked mainly to market overnight interest rates and are historically low. In addition, due to the single-counterparty risk, the prudent cash manager will spread their deposit across several bank counterparts. However in doing so, the cash manager will only ever meet two of the three primary considerations; the better rated the bank, the lower rate likely to be paid and vice versa.

In contrast, MMFs can offer potentially better returns due to the longer duration of the portfolio (up to 60 day Weighted Average Maturity) and diverse make-up of the portfolio. This will generally result in the fund outperforming short-term deposit rates.

In summary

Money Market Funds are a highly useful tool in liquidity management. MMFs meet all three of the primary requirements of cash managers, and in many cases provide enhancements to the features found within a bank deposit.

- **Safety** — MMFs (typically those called Short-Term MMFs) are AAA Rated and provide investors with a diversified portfolio of highly rated counterparties.
- **Liquidity** — Same day access to cash replicates a call account structure.
- **Yield** —Although MMFs operate very like a call account, the weighted average maturity of the fund can be as long as 60 days. This enables the fund to generally outperform short-term inter-bank rates.

Fig 1: Characteristics of Money Market Funds and Overnight Bank Deposits

	Bank overnight deposit	**Aaa Money Market Fund**
Risk	Single name	Credit diversification through broad portfolio mix
Return	Related to market overnight interest rates	Potential yield enhancement as longer duration of portfolio can deliver better returns than overnight yields: return subject to portfolio
Fees	None, however bank dealer makes his margin by paying the lowest rate he can to attract the deposit	Industry average 15 basis points, however portfolio managers interest is aligned with investor. The fund is trying to give the best possible rate of return
Interest	Paid daily	Accrued daily paid monthly
Minimum Investment	None; small deposits will attract lower quotes	No minimum transaction size

[1] Not Available on some MMFs