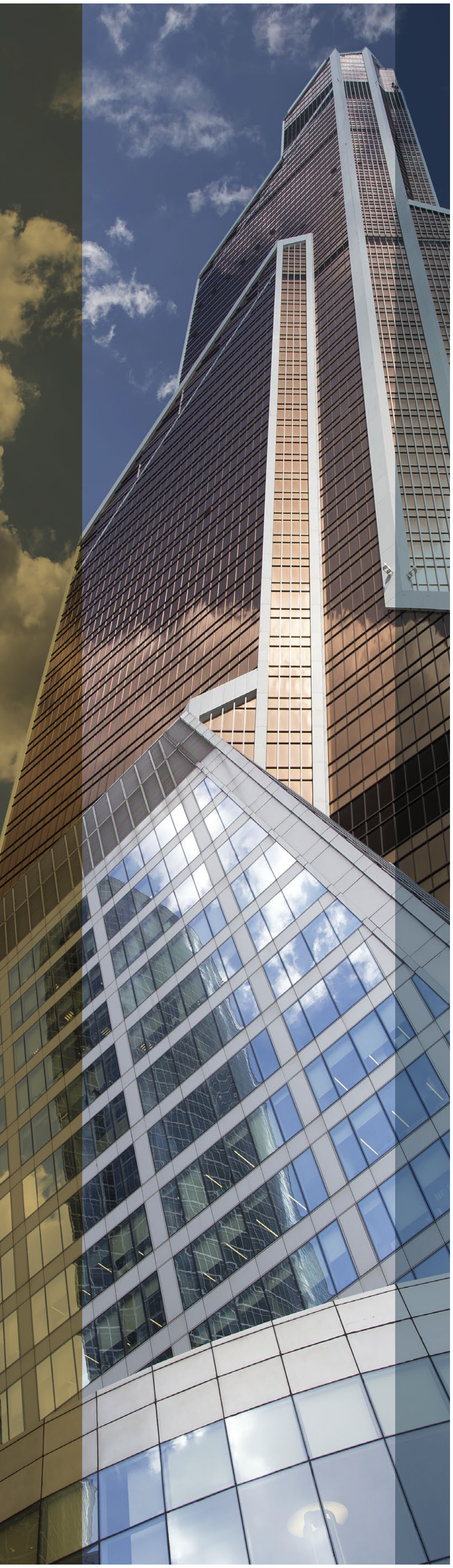

Understanding A Changing Liquidity Landscape

Sam Schwartzman
Global Head of IMG Cash Solutions
BNY Mellon Markets

The 2016 liquidity space is going through a sea change due to a myriad of market and regulatory forces, especially those surrounding short-term products. Here is what investors should know to stay a step ahead.

There is a current convergence of events occurring in the 2016 liquidity space that is resulting in hundreds of billions of dollars moving from certain short-term investment products to others. These include a number of market and regulatory changes that are having a significant impact on liquidity investing, and the relative value of certain products in 2016 and beyond, such as:

Short-term rates increasing in USD: The increase in short-term rates in late 2015 resulted in "dormant" clients re-examining their liquidity options as product yields began to differentiate more than they had in the recent years' zero rate environment. Previously, the opportunity cost of not actively managing cash had been low, resulting in many clients choosing to passively manage their cash into one sweep vehicle or not investing their liquidity balances at all. That cost is expected to increase if we continue to move into a higher rate environment, resulting in more active investment of cash, and liquidity balances moving from certain investment vehicles to others.

Money market reform in the US: As a result of the Securities and Exchange Commission's (SEC) new rules that were effective this fall, many clients have been re-examining their investments into prime and tax-exempt funds. Institutional prime and tax-exempt money market funds became floating-NAV vehicles in October 2016 and now require the ability to impose redemption fees and/or bring down gates preventing any withdrawal activity should the funds' 7-day liquidity levels fall below 30%. (Retail versions of these funds, defined as funds that exclusively consist of natural persons only, do not need to float their NAVs, though the ability to apply fees and gates, if certain conditions are met, are now required. US Treasury/Government money market funds are also not subject to the floating NAV requirement and may opt in to have the capability to apply fees and gates.) Many money market fund investors utilize the vehicles for cash that they may need immediately in an emergency situation. As a result, the possibility of a gate limiting their ability to access that cash, or a fee, causing them a loss upon redemption, may make prime and tax-exempt money market funds less attractive to these investors and cause them to reduce or eliminate their positions in these funds. In addition, the concept of a floating NAV, resulting in a potential principal loss in a money market fund, may also give some investors pause, resulting in withdrawal activity from institutional prime/tax-exempt money market funds.

Due to these changes, and their impact on the attractiveness of these funds to certain investors, a large amount of balances (hundreds of billions of dollars) has been withdrawn from these funds recently. As expected, many of these balances have been

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moved to US Treasury/Government money market funds, as floating NAVs will not be a requirement imposed on these funds, and fee/gates are optional.

Basel III-related regulations: Regulations such as the Liquidity Coverage Ratio (LCR) and the Supplementary Leverage Ratio (SLR) are forcing large banks to value short-term deposits differently than they would have historically and, in some instances, to reduce deposit levels to achieve compliance with required regulatory ratios. The LCR is a quantitative liquidity requirement that requires large banks to hold a certain amount of high quality liquid assets (HQLA) to offset outflows that could occur in a stressed environment over a 30-day period. HQLA are expected to be relatively low-yielding as they are considered to be safe and will presumably be subject to inflated demand because of the LCR and other regulations.

As a result, banks are expected to attempt to limit the amount of HQLA they hold on their balance sheets because their expected lower returns potentially limit return on capital. Overnight deposits (as well as deposits with tenors of 30 days and less) are included as outflows subject to certain factors under the LCR. Consequently, it is expected that large banks will not value certain overnight and short-term deposits as highly as they historically would have, as the need to potentially hold some HQLA against these deposits potentially limits return on capital. Given their lower value, it is expected that banks will pay lower relative rates for these deposits, creating an incentive for certain bank depositors to look at other investment vehicles with their liquidity balances.

In addition, the SLR is a new capital ratio that requires compliance in 2018, but it has already begun to be reported by the large banks since 2015. It is expected to result in large banks decreasing their asset base and consequently their offsetting deposit levels, since the minimum SLR is higher than the historical leverage ratio that large insured bank subsidiaries were subject to, and the SLR's denominator is broader and larger. As a result, in order to decrease their size to comply with the SLR, large banks may encourage certain depositors to move to alternative investment products in 2016.

With the expected impact of these events, and others, liquidity investors will want to educate themselves about the changing dynamics in this space and continue to monitor how this environment impacts the relative attractiveness of different short-term investment products. BNY Mellon is here to offer our experts' support and guidance as the new realities of the liquidity landscape come into clearer focus.

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For more information about BNY Mellon's liquidity services, visit us at www.bnymellon.com/liquidityservices or contact us.

AMERICAS
Steven Milazzo
Managing Director
+212 815 3232
steven.milazzo@bnymellon.com

EUROPE, MIDDLE EAST & AFRICA
Jason Garwood
Managing Director
+44 207 163 3290
jason.garwood@bnymellon.com

ASIA PACIFIC
Filippo Santilli
Managing Director
+852 2840 6664
filippo.santilli@bnymellon.com

JAPAN ONLY
The Bank of New York Mellon Securities Company Japan Ltd.
Hiroshi Ohno
hiroshi.ohno1@bnymellon.com
+81 3 6756 4320

@bnymellon

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