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Putting cash to work
Now and post Solvency II

It looks like low interest rates are here to stay for some time. Insurance companies need to work out how to place their money and how to diversify, because there is little yield to be had at the front end of the curve. Laurie Carroll, director, cash investment strategies at BNY Mellon Asset Management, explains how investors can play a more active role in reviewing and structuring their cash holdings to work harder while still meeting their liquidity needs

Low interest rates are here to stay for some time, and capital preservation is front of mind. There is little yield to be had at the front end of the curve. Post-Solvency II cash will no longer be either simple or regarded as risk-free. In the view of BNY Mellon, the legislation will likely:

- fundamentally change the way insurers structure their investment portfolios to match liabilities in a capital-efficient manner;
- increase the proportion of cash investments held, whether in the form of deposits or money market fund investments; and
- require insurance companies to develop a capital assessment of cash as an asset class.

Essentially, there are three main facilities for managing the inventory of cash. These are: bank deposits; triple A rated money market funds; and separate accounts.

Insurers are increasingly looking at separate accounts as they have the potential to earn a higher return while still catering to the individual insurer's liquidity needs. When examining the short- and long-term plans for the pool of cash, Solvency II subjects assets to the relevant sub-module stresses, and capital charges are calculated accordingly:

- Fixed-income investments are sensitive to interest rate movements, therefore, risk is measured by applying a charge (+ or -) for various interest rate scenarios and determining the delta between stressed and current valuations.
- Currency risk arises due to changes in – or volatility of – currency exchange rates. Risk, in this regard, comes into play whenever a money market fund's currency differs from that of the insurer.
- Spread risk reflects the change in the value of net assets due to a move in yield caused by credit quality and duration. This sub-module should address changes in the level and volatility of spreads. For all bonds (including sovereigns), the spread risk module is designed to deal with the widening and narrowing of credit spreads. For corporate bonds, it focuses on the external rating and duration of the credit risk.
- The market-risk concentration sub-module includes assets in the equity, interest rate, spread risk and property risk sub-modules. It excludes assets covered by the counterparty default risk module in order to avoid any overlap between both elements of the standard calculation of the Solvency Capital Requirement (SCR).
- The SCR counterparty risk module intends to account for possible losses due to an unexpected default or deterioration in the credit standing of counterparties and debtors of insurance and reinsurance companies.

In weighing up the alternatives of bank deposits, triple A rated money market funds and separate account management, there is merit in examining the differences between the various offerings. There can be variance in credit ratings, maturities, fees and redemption costs, as well as in the legal structure and the level of transparency offered.

In seeking to mitigate risk, diversification is one of the most important considerations. Compared to a bank deposit, a potential key benefit of a money market fund and a separate account is diversification with respect to credit exposure and the type of instrument within the portfolio as well as counterparties.

With money market funds, insurers generally seek three main objectives: capital preservation (achievable through diversification), followed by liquidity and, lastly, yield. An advantage is that they are separate legal entities, ring-fenced from exposure to the sponsoring bank's balance sheet and subject to rigorous investment guidelines and reviews by the rating agencies. Assuming that the provider of the money market fund will provide a full look-through to the underlying holdings, then these funds can be very capital-efficient for the insurer.

Spread risk and concentration risk make the largest contribution overall to the SCR. As illustrated in table A, a well-diversified money market fund provides a low capital charge. Understanding the risk profile that the look-through provisions create facilitates compatibility with an insurer's strategic data solutions and timelines.

A. Hypothetical example of the methodology an insurance company might use to analyse its money market fund holdings

Portfolio allocation (%)	100%	34.5%	9.3%	3.6%	30.4%	16.3%	1.5%	4.4%
Attribution	Portfolio	TD	GOV	REPO	CP	CD	CSH	CORP
Concentration	**0.753%**	0.000%	0.000%	0.000%	0.672%	0.336%	0.000%	0.050%
Spread risk	**0.716%**	0.000%	0.000%	0.000%	0.425%	0.229%	0.000%	0.062%
Counterparty risk	**0.027%**	0.027%	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%
Interest risk	**0.048%**	0.000%	0.007%	0.000%	0.021%	0.016%	0.000%	0.003%
Benefits of diversification	**0.500%**	0.000%	0.000%	0.000%	0.323%	0.173%	0.000%	0.035%
Total BSCR	**1.044%**	**0.027%**	**0.007%**	**0.000%**	**0.796%**	**0.406%**	**0.000%**	**0.080%**

The BNY Mellon Euro Liquidity Fund is used for the purposes of this illustration. Data as at December 31, 2011. Based on Standard Formula – QIS5 Technical Specifications. *Source: BNY Mellon Cash Investment Strategies*

1. Short-duration solutions

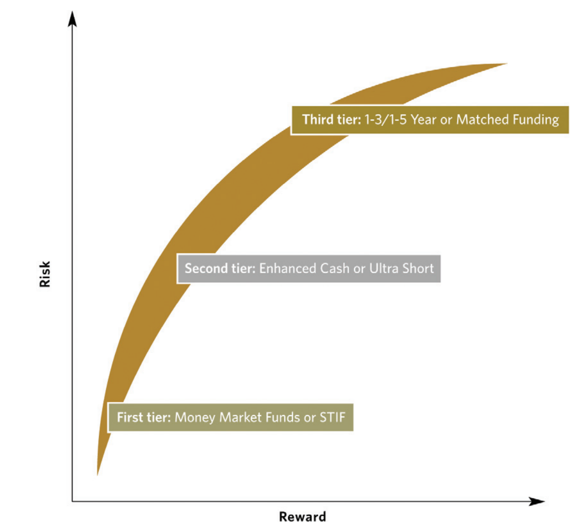

Figure 1 reflects portfolio management's view that inefficient markets may provide greater opportunity for total return. Not reflective of any actual investments or historical activity

One method of helping achieve that diversification is to look at an insurer's cash investment strategy as being in three buckets. For an insurer, having all their cash and cash-like investments in deposits or even money market funds over an interest rate cycle won't provide the best outcome for a pool of cash. In a cycle of low interest rates, it is beneficial to move along the interest rate curve. In our view, having a portion of money in a liquidity fund or bank deposit, and also a portion in a separate managed account, will prove beneficial. The 'tiering' of cash within a separate account (essentially dividing up the pool of cash into three tiers) can provide a flexible solution, segmenting the cash for additional yield or returns (see figure 1).

The purpose of the first tier of a strategic liquidity position is to provide for day-to-day cashflows, annuity payments, or frictional trading balances for instance. A money market fund or a short-term separately managed account with customised guidelines can provide this first tier of liquidity.

The aim of the second tier is to provide for claims, debt servicing, dividends, etc., basically longer horizon cash needs. In our view, this second tier is best constructed with maturities averaging between six months and one year; enhanced cash or an ultra-short (with an average one-year maturity) separately managed account with customised guidelines would provide a solution for this need. Tier-two objectives include moderate maturity extension and focused credit guidelines against known liquidity requirements. Higher yields (reflecting the higher risk) than the first tier are to be expected.

The rationale of the third tier is for longer-term investments against matched liabilities and/or required holdings of regulatory near-cash investments. We consider this third tier of liquidity to be best provided by a portfolio of maturities in the range one to three/one to five years or a matched-funding separately managed account with customised guidelines. Tier-three objectives entail tailored liquidity to match liabilities or one- to three-year and one- to five-year indexes and, assuming the insurer's capital can sustain it, investment-grade credit quality. Matched funding is tailored to an insurer's specific risk tolerance and/or cashflows, and allows flexibility for yield curve positioning.

Above all, market events, particularly in the last decade, demonstrate that investors need to take a more active role in reviewing and structuring their cash holdings to meet their liquidity needs. However, we believe investors should draw comfort from the fact that there are many more instruments and possibilities available than they may have considered to ensure their pool of cash works hard for them.

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