FOCUS ON INSURANCE COMPANIES

CASH INVESTMENTS IN A TURBULENT WORLD

BNY MELLON

MODERATOR:
Mick Murphy, Client Management, UK

CONTRIBUTORS:
Gerry Barber, Cash & Treasury Services
Laurie Carroll, Cash Investment

STRATEGIES:
Ashley Easton, Liquidity Services

MICK MURPHY
CLIENT MANAGEMENT
+44 (0)20 7163 3215
MICK.MURPHY@
BNYMELLON.COM

Introducing BNY Mellon's Insurance Industry Roundtable Series

A panel of our insurance industry experts offer their insights on the evolving European insurance industry This newsletter provides an overview of the transcript derived from one in a series of Insurance Industry Roundtable discussions in which our executive team and industry and product experts explore key trends and issues facing our insurance industry clients.

Our Insurance Industry Roundtable series considers the challenges facing Insurers in EMEA and how by accessing BNY Mellon's comprehensive Investment Management and Investment Services solutions we can help them achieve their business objectives. Other topics include:

– Seeking alpha on Insurers' efficient investment frontier
– The hidden value of specialists - Transition & Beta Management for Insurers
– Transparency: gaining an understanding of your market and counterparty risk exposures
– Managing your securities financing & derivatives collateral for optimum result
– Using your Global Markets Counterparty to manage risk

MICK MURPHY: Laurie, Gerry and Ashley, thank you for taking the time to talk about the cash investments market. So what challenges do life offices, reinsurers, general insurers and composites face at the moment?

LAURIE CARROLL: It looks like low interest rates are here to stay for some time. Insurance Companies need to work out how to place their money, how to diversify, because there is little yield to be had at the front end of the curve. Plus capital preservation is at the forefront of their minds given the situation in the Eurozone. Insurers are also preparing for Solvency II, when cash will no longer be either simple or regarded as risk free, and getting to grips with all the other regulation they are facing. The immediate challenge is market volatility along with the unknowns.

GERRY BARBER: Our clients' focus is risk. We are in a low yield environment. The risk insurers face today is not just investment name risk, it's jurisdictional risk too -where cash is sitting, where it is placed and how secure it is. When you draw in on risk, you draw in on yield too.

ASHLEY EASTON: Liquidity Services clients have been looking closely at credit ratings and are seeking greater transparency; I suspect Solvency II will only accelerate that trend. They require look through to the underlying holdings. Yes it's a challenging time regarding yield generation. However, security overrides everything at present.

MICK: How are insurers reacting to the European debt crisis?

GERRY: Insurance companies are restricting the name list they use and that has extended to jurisdictions too.

ASHLEY: More insurers are moving into sovereign debt funds, in dollars, euros and gilts to deliver security and daily access to their cash.

LAURIE: Insurers are shortening the duration of portfolios and moving out of certain countries. The sovereign debt crisis has lowered longer-term debt yields and shortterm debt is higher yielding because it might be less likely to be paid on time.

ASHLEY: We've had clients ask us about their exposure to risk and the underlying holdings in money funds. They don't want exposure to certain jurisdictions. We are providing transparency reports so they can look through and see exactly what cash funds are invested in.

MICK: Do you think there is sufficient quality corporate debt to meet demand?

LAURIE: Probably not. The fixed income market has suffered several crises in the last decade - from WorldCom to sovereigns and the eurozone. Clients have asked us to deliver an all-corporate investment grade portfolio. But that is hard to do. Most corporate debt is A3 or BBB, not the A1/P1 they seek.

GERRY: But there has been growth in the high-yield corporate debt market whereas corporates are finding is cheaper to go directly to the market with a bond than borrow from the banks who do not want to lend money.

LAURIE: That said, post Solvency II it is likely that corporations will either need to acquire a higher credit rating, and often that has a capital cost associated with it, or offer a higher yield to compensate the insurers for the capital charge of holding the corporates' paper

LAURIE CAROLL
CASH INVESTMENT STRATEGIES
+44 (0)20 7163 3834
LAURIE.CARROLL@BNYMELLON.COM

ASHLEY EASTON
LIQUIDITY SERVICES
+44 (0)20 7163 3292
ASHLEY.EASTON@BNYMELLON.COM

GERY BARBER
TREASURY SERVICES
+44 (0)20 7964 6817
GERY.BARBER@BNYMELLON.COM

MICK: Where are you seeing relative value?

ASHLEY: Euro prime funds deliver value along with sterling prime funds – there are pockets of yields.

GERRY: Yes, euros are still the highest paying currency. Sterling has remained relatively stable throughout the whole period and yields in the overnight market still average 50-55bps. Eurozone overnight market yields have been volatile. But the peaks have been fairly good. The swap environment makes AUS$ good because it is a higher interest paying currency. But most organisations have now maxed out their swap lines, so that market is dropping off again.

LAURIE: Fixed income has better value if you hold one-year duration, perhaps two or three-year duration. We're advising clients not to hold everything very short-dated. Currently you must buy 5+ year bonds to get a higher yield.

MICK: How will Solvency II have an impact on the market?

LAURIE: Solvency II may accelerate other trends. Market conditions are pushing a fundamental change in the front end of the yield curve. Putting all your money on deposit isn't necessarily the sensible route and post Solvency II diversification will be key. At a minimum Insurers will need to use a combination of time deposits with highly rated institutions and money market funds for their frictional cash.

GERRY: Regulation will further drive the collateralised environment. We are already seeing Insurers making much more use of the repo market.

LAURIE: Insurers holding short-dated paper will see anything up to 12 months treated as one-year paper under Solvency II. That may colour their investment choices.

ASHLEY: Clients will demand transparency, a "look through" into the money market fund investments.

LAURIE: There is not going to be a lot of yield in cash for the foreseeable future, given the environment. So an insurer needs to know what cash they need and how it fits into the portfolio asset liability mix. Cash has a function in a portfolio to deliver payments but is also part of the duration of the total liability asset mix. It's not a great place for yield at the moment.

MICK: So what are you doing to help the Insurers?

ASHLEY: I'd say diversification and risk mitigation. Our Liquidity DIRECT Portal has three legs: i) MoneyFunds DIRECT offers a wide range of industry-leading money market funds managed by some of the best known names in the business; ii) Securities DIRECT provides access to a wide range of individual money market securities including commercial paper, US treasuries, discount notes, and certificates of deposit all in one place; and, iii) Margin DIRECT helps insurers manage margin positions while reducing their counterparty risk as we safekeep posted margin balances in a separate account from an Insurer's counterparties. Importantly, from a Solvency II transparency perspective only a single consolidated account statement is issued, summarising all of an Insurer's holdings. Properly used, Liquidity DIRECT should help an Insurer minimise their Solvency Capital Requirement on their very short term cash and collateral balances.

With our partners we plan to deliver the necessary transparency required under Solvency II and indeed ensuring we have the right fund range to meet the Insurers needs (e.g. perhaps sovereign debt funds in multiple currencies as part of a liability matching strategy). We are keeping close to the regulations and how often we will need to produce a detailed holdings report. Solvency II is still some time away but insurers are thinking about technology and perhaps resources within their team to manage this. We can give the insurer transparency now on a one-week lag, we will be able to provide more timely disclosures on our funds ahead of the Solvency II regulation and we are working with the other money market fund funds to ensure they are aware of the need to provide the necessary "look through".

GERRY: I'd echo Ashley's diversification point. In addition to Liquidity Direct and Laurie's Separate Account Management capability I'd highlight our ability to offer i) deposit products in all major currencies; ii) access to Repo market providing access to fully collateralised short-term money market investment options with competitive rates, daily liquidity and early morning balance redemption; and iii) structured portfolio services where we can work with an Insurer to develop a laddered portfolio of fixed income investments that matches their liability profile and risk tolerance.

We have been developing a third-party deposit platform for clients to give them control of name risk exposure. They can set the names and limits on how much exposure they want, and on any amount of cash they allocate. The platform allows for the allocation of cash coming in to be positioned for those counterparties on a name by name basis.

LAURIE: Yes, diversification is key and one tool to help in achieving 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 liquidity funds over an interest-rate cycle won't provide the best outcome for a pool of cash. In a cycle of low interest rates, its beneficial to move along the interestrate 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.

The purpose of the first tier of a strategic liquidity position is to provide for day¬to¬day cash flows, 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 maturity 1 year) separately managed account with customized 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. This third tier of liquidity is 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 index 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.

MICK: Any final thoughts?

ASHLEY: Above all, market events, particularly in the last decade, demonstrate that Insurers have had to take a more active role in reviewing and structuring their cash holdings to meet their liquidity needs. Insurers 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.

GERRY: Everybody knows Solvency II is coming. I welcome it, Solvency II and the rate environment we face has driven a realisation that cash needs to be managed.

LAURIE: Yes, I think its fair to say that cash is now being recognised as an asset class in its own right.

05/2013

BNY MELLON