Focus on Insurance Companies

CASH INVESTMENTS IN A TURBULENT WORLD

BNY MELLON

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 document 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:

- Investing in Illiquids: Challenges for Insurance Firms
- Managing Your Securities Financing & Derivatives Collateral for Optimum Results
- Seeking Alpha on Insurers' Efficient Investment Frontier
- T2S: Opportunities for Insurers arising from Europe's New Post-Trade Landscape
- Transparency: the Data Management Challenge Facing Insurers
- Using Your Global Markets Counterparties to Help Optimise Your Risk Profile

KATE ANDERSON: Thank you for joining me for this discussion about the cash investment options available to insurance firms. What impact is this prolonged period of low interest rates having on cash investment strategies?

GERRY BARBER: On the one hand, it has taken some firms a while to accept and adjust to this extended low-interest-rate environment. On the other, many insurers are increasing their sophistication in terms of how they manage their cash investments, partly in response to Solvency II, but partly also as a reaction to the charges incurred for leaving money at bank overnight in the prevailing low-rate environment.

By going through the process of dividing their cash into three time-defined 'buckets', insurers are better able to weigh up their investment options effectively. In particular, they are being more proactive, particularly with buckets two and three, appreciating that having all their cash and cash-like investments in deposits or even liquidity funds won't provide the best outcome over an interest-rate cycle.

In our experience, splitting one's cash investment strategy into three buckets provides a level of diversification that can help deal with a low-interest-rate environment. For the first tier, which provides for day-to-day cash flows, annuity payments, or frictional trading balances, a money market fund or a short-term separately managed account with customised guidelines may suit. The second tier – which provides for claims, debt servicing, dividends and other longer-horizon cash needs – is best constructed with maturities averaging between six months and one year. As such, an enhanced cash or an ultra-short (one-year average maturity) separately managed account could meet this need. The rationale of the third tier is for longer-term investments against matched liabilities and/or required holdings of regulatory near-cash investments. This tier of liquidity might best be provided by a portfolio of maturities a one-to-three/ one-to-five-year range or a matched funding separately managed account with customised guidelines.

Once one accepts that sitting on your hands and waiting for rates to normalise is not a viable long-term strategy, there is an obvious long-term danger of positioning for a rate rise prematurely. As firms try to avoid this pitfall, we've seen an increased interest in floating rate notes, both outright but also as a component of money market funds.

KATE: How else can insurance firms secure yield in the current environment?

GERRY: BNY Mellon is helping clients find homes for cash from overnight to much further out. A custodian may be willing to hold client cash on its balance sheet, but will also work with clients to find other options, perhaps time deposits or certificates of deposit if cash is available for 90 days or more. If the cash is available for longer periods, the priority must be to get cash off balance sheets, out of money market funds and into longer-dated vehicles.

KATE: To what extent are money market funds a part of the answer to the problem of low-to-negative rates?

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MARCUS LITTLER: All providers of money market funds are squeezing their fees in order to offer-low to-zero yields, rather than the negative ones they are encountering at banks for keeping cash on balance sheet. But it's true that they're not offering the returns they have in previous years and as such insurers should combine them with other solutions. With bespoke solutions such as separate managed accounts, you have the benefit of being the sole investor and the strategy is tailored specifically to your needs, while pooled products offer the advantage of sharing liquidity across a range of investors.

KATE: Across the different cash investment 'buckets', what developments are changing insurers' behaviours and preferences?

ASHLEY EASTON: Through our Liquidity DIRECT Portal, we're still seeing a lot of money market fund activity, but there is probably more interest than previously in the fact that we also offer longer-dated instruments, such as gilts, US Treasury bills and commercial paper. We're not seeing a great deal of demand for time deposits.

GERRY: Another response to the Solvency II / low-interest-rate environment by larger insurers in search of cash investment alternatives is an increased interest in supplying cash to the repo markets. It remains to be seen how opportunities for insurers in the repo markets evolve, not least because Basel III is focusing banks' funding strategies on long-term rather than short-term money, and it's at this latter end that insurers are looking for new options. Less frequently, because it's not possible in all jurisdictions, some insurers are making cash available for term against securities.

MARCUS: At the very near-term end of the spectrum, we've seen a number of insurance firms explore currency plays. It's more painful to be long in cash in certain currencies. Firms that are long in euros but need ready access to their cash, for example, might invest in sterling-denominated Libor-plus funds, then undertake a euro hedge. Even when these carry costs are considered, the outcome is better than the negative return they might otherwise have to endure. Insight Investment has recently launched a euro hedge share class that helps clients achieve this outcome. One caveat is that the value of such funds is not as stable as a cash instrument and as such they need to be marked to market daily to take account of fluctuations in net asset value.

GERRY: BNY Mellon can offer help to facilitate insurance firms' needs across all these options. In the repo market, they can use our tri-party repo platform, where we help them to interact with broker-dealers on an agency basis. If they're buying funds, clients may wish to do that via one of the group's asset management firms. As in the case mentioned by Marcus, we'd also be able to put on a hedge via BNY Mellon Global Markets.

KATE: How else has Solvency II impacted cash investment decisions?

GERRY: It's difficult to isolate influences on cash investment decisions. Where one might have expected Solvency II capital charges to have encouraged insurance firms to move from holding cash at bank to investing in money market funds, especially those investing in gilts and US Treasuries, the bigger drivers of this move have probably been low interest rates and increased geo-political uncertainty.

KATE: How are other regulatory developments changing the cash investment options for insurance firms?

MARCUS: Both in the US and Europe, the new shadow banking rules are making fundamental changes to how the value of a money market fund is calculated. Essentially, these mean that the vast majority of funds will need to be calculated on a variable net asset value (VNAV) basis rather than constant (CNAV). Once the new regulations have come into place, the only CNAV funds available to wholesale clients will be those that invest in the safest possible instruments, such as US Treasuries, or ultra-low volatility funds.

Under VNAV, to maintain same-day pricing, providers would have to cut the fund and price it, imposing early morning cut-off times for cash investments. This means it would be very difficult to continue to permit intra-day sweeps. In the US, the law is already in place, but there is every expectation that very similar legislation will be pushed through in Europe. The new regulatory framework is really a response to the huge and rapid shift from 'normal' money market funds to the very safest in response to the early events of the global financial crisis, such as the collapse of Lehman Brothers in September 2008. Although there was no risk to the underlying instruments, the subsequent substantial flow of redemptions experienced by many

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money market funds was perceived by regulators as posing a systemic risk. They have since taken the view that the VNAV approach guarantees the ability of clients to redeem immediately. From a product structure or revenue perspective, there is no difference between offering a CNAV or a VNAV fund, but it can pose a number of difficulties for clients, such as corporate treasurers, as noted above. There is an argument that traditional CNAV product 'gate and fee' approach to redemptions would only result in a day or two's delay in redemption in extreme circumstances, while avoiding the risk – which exists with a VNAV fund – of a self-fulfilling downward spiral to further redemptions as the VNAV level ticks down. But this argument looks to have been lost.

KATE: How has the US market responded to the new regulatory framework for money market funds?

MARCUS: We conducted a survey into our US clients' responses and found that almost 40% intended to stay put with the existing funds as these made the move from CNAV to VNAV. About 30% said they would move their cash out of those existing funds, and a further 20% said they would switch to money market funds that invested only in US Treasury bills. Some others said they would alter their policies to accommodate the various options as they became clearer.

KATE: What more can insurance firms do in order to improve diversification and risk mitigation within their cash investment strategies?

ASHLEY: BNY Mellon can support diversification and risk mitigation in a number of ways. Our Liquidity DIRECT Portal has three legs: i) MoneyFunds DIRECToffers 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 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. In addition, we are working with the other money market fund funds to ensure they are aware of the need to provide the necessary 'look through'.

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