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Cash dethroned: reallocation opportunities for insurers under Solvency II

- While ‘cash is king’ remains at the forefront of many defensive allocation decisions, ultra-low and negative cash rates and bond yields are a material drag on portfolio returns.
- We believe insurers could reallocate a strategic part of their cash holdings to potentially higher-yielding, liquid, defensive assets without incurring excessive risks or capital costs.
- However, this strategic reallocation should complement, not fully replace, cash deposits or money market funds.
- By performing a detailed analysis of liquidity, safety and yield requirements, insurers can better understand their optimal allocation between cash holdings that require daily or immediate access and other liquid, defensive instruments, which may offer higher returns.
- In our view, actively managed core government bonds, short-dated credit and European AAA asset-backed securities (ABS) are among the most attractive out-of-cash options.
- Nevertheless, moving out of cash involves trade-offs, including credit risk and market volatility. Investors must assess whether the potential losses from these risks outweigh the certainty of losses from holding cash at negative rates.

The value of investments will fluctuate, which will cause prices to fall as well as rise and investors may not get back the original amount they invested. Past performance is not a guide to future performance.

Cash rates continue to punish insurers

After more than a decade of ultra-loose monetary policy from central banks and an aggressive hunt for yield by investors, prospective returns on cash and most other defensive assets have reached historic lows.

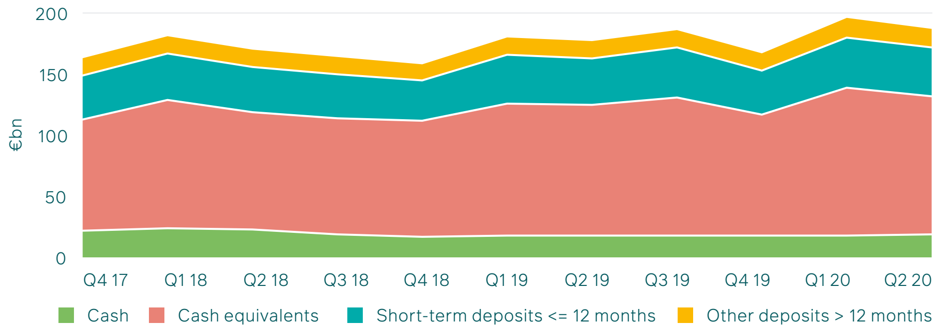
In the 12 years following the global financial crisis, cash rates have declined by around six percentage points in both Europe and the UK, with three-month EURIBOR falling to -0.6%pa and GBP LIBOR to 0.0%pa as at the end of 2020. Many other defensive assets have experienced comparable levels of yield compression, with negative yields present in both government and corporate bond markets[1].

The scale of the challenge for insurers

The European Insurance and Occupational Pensions Authority (EIOPA) estimates that around €190 billion of cash and cash equivalents currently sits on the combined balance sheets of European insurers (see Figure 1). A EURIBOR of -0.6% implies that around €1 billion of this cash will be lost through negative yields over the next 12 months.

Figure 1. European insurers currently have around €190 billion of cash on their balance sheets

Aggregated general account investments in cash and cash equivalents, European Economic Area (EEA) insurers, Q4 2017-Q2 2020



Source: EIOPA, as at 30 June 2020

European insurers also face the challenge of Solvency II regulations, which allocate high capital charges to many positive-yielding assets, including some with high credit ratings, for example senior ABS. This can make it difficult for insurers to allocate out of cash into other, liquid, defensive assets while achieving their target return on capital.

However, there are still potential opportunities for insurers to earn more attractive returns than their current cash holdings. In our view, this involves two key steps: producing a detailed liquidity analysis, and forming a fresh perspective on return on capital targets.

By undertaking a detailed liquidity analysis, insurers may determine a 'tiered' approach to holding cash is preferable – starting with immediate cash requirements and moving through different levels of contingency. This would likely require the insurer to ascribe probabilities to contingent events occurring over the following 12 months and evaluating how much time would be needed to generate cash in each case. If the insurer can identify the correlations between how liquidity needs might arise, as well as the potential risks of investment losses or recovery times, this should prove valuable to informing cash reallocation decisions.

[1]Source: ICE, LIBOR, government bond (GUKG2, GDBR2) and credit (ER01, UR01) indices, as at 31 December 2020

Evaluating the role of cash in insurance portfolios

The first step towards reallocating cash holdings to higher-yielding defensive assets is to clarify the role of cash and cash-equivalents within a portfolio.

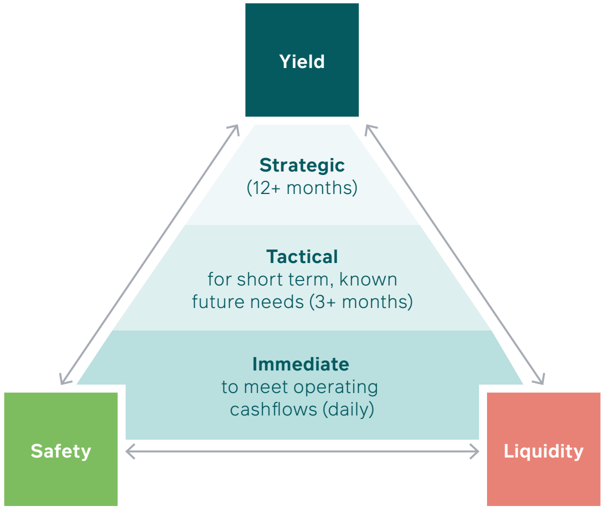
We believe insurers typically hold cash for three key reasons – usually in the following order of priority:

1. Safety
2. Liquidity
3. Return

Fundamentally, cash is not exposed to market value movements, and is completely liquid. This is why insurers deposit (sometimes vast) cash allocations into custodian accounts, despite the expense of negative real yields or, in Europe, negative nominal yields.

However, many insurers hold cash against low-probability events, such as excess claims. Depending on the likelihood of the claim, the time to make payment, and other potential sources of liquidity, there may be scope to flex either the market value risk or liquidity risk. A tiered approach could be applied, where investors holding large cash deposits refine their allocation into different buckets, each focused on meeting a specific objective across the safety-liquidity-return spectrum.

Figure 2. Adopting a tiered approach to analysing cash requirements



Source: M&G, December 2020. For illustrative purposes only.

Immediate (cash)

Expected to represent the majority of an investor's cash allocation. Cash is held in deposit accounts to fund daily operating cashflows and to provide a safety reserve, should unexpected liquidity requirements arise.

Tactical (cash)

May consist of cash or liquidity funds held to meet known requirements over a three- to 12-month horizon. It can also provide flexibility to reallocate to other asset classes, for example to exploit tactical investment opportunities.

Strategic (liquid, defensive assets)

Intended to provide a yield pick-up over cash holdings and to improve overall portfolio diversification through high-quality, liquid assets.

In our view, analysing tactical cash holdings in more detail could allow insurers to reallocate some of these positions to strategic assets, which offer greater potential for attractive investment returns.

In addition, careful analysis of the correlation between market-value risk and unexpected claims, as well as the increased return available for liquid, but non-cash holdings, may justify an insurer reducing the immediate cash bucket.

Importantly, higher-yielding, liquid, defensive assets cannot fully replace an investor's cash allocation, but rather complement it as part of a holistic approach. At the same time, the relationship between safety, liquidity and yields is not linear – we believe it is possible to materially increase portfolio returns without excessively compromising safety and liquidity.

Out-of-cash options for insurers

In our view, there are four main asset classes for European insurers to consider when revisiting their cash holdings.

Option 1

Cash and money market funds

Staying in cash should provide security and liquidity, but will continue to drag on investment returns.

Option 2

Government bonds

At current yields, a passive approach would leave the insurer with low or negative returns. However, it may be possible to generate additional returns using an actively managed approach. This will involve duration risk, however, which exposes the investor to the risk of mark-to-market losses should rates rise.

Option 3

Short-dated credit

This could be expected to provide positive yields; however, given the extent of negative rates in Europe, investors will likely be required to take a reasonable amount of credit and spread duration risk. We believe credit markets offer meaningful potential for active outperformance over passive strategies, as outlined later in this document.

Option 4

European AAA ABS

This asset class is often overlooked by European insurers due to previously steep capital charges under Solvency II. However, the EU's new Simple, Transparent and Standardised (STS) securitisation framework means that some areas of ABS can potentially offer a comparable return on capital to corporate bonds. Regarding historical credit performance, no AAA European consumer ABS or residential mortgage-backed security (RMBS) to date has defaulted or suffered an impairment.

In the following sections, we evaluate these cash alternative options in more detail.

Actively managed short-dated government bonds

Government bonds are perhaps the biggest casualties of yield compression, with approximately 25% of the global market trading at negative yields. The lack of positive-yielding debt is most prominent at the short end of the yield curve, with short-dated European government bonds and UK government bonds (1-5 years, rated AA and above) currently yielding -0.7% and 0% respectively[2]. This means shorter-dated, 'cash replacement' government bonds may not prevent cash drag, particularly in passive strategies. We believe one way that European insurers can generate additional returns is through an actively managed approach. This could potentially be achieved overweighting individual issuers that temporarily experience wider spreads over German bunds, for example. The asset class also benefits from incurring no credit spread charges under Solvency II, and interest rate risk often diversifies well against other risks under the standard formula approach.

An active strategy may look to exploit the following:

Relative value

A manager may position the portfolio to be overweight in a specific bond versus another due to mispricing or anomalies along the yield curve, while maintaining neutral portfolio duration. These opportunities can occur regularly throughout a market cycle. It may also be possible to implement relative value trades between conventional and index-linked government bonds, or to occasionally make small allocations to supranational bonds. Within European indices, it is also possible to take off-benchmark positions in euro-denominated debt from different sovereign issuers if their spreads over German bunds rise.

Yield curve slope

This involves positioning the portfolio to be over- or underweight in certain maturities, which changes the portfolio's yield curve shape relative to the index. However, we believe opportunities to add value in this way occur infrequently.

Portfolio duration

The manager may look to increase or decrease duration along the entire yield curve relative to the index based on market valuations. In our view, these directional opportunities also occur infrequently.

Due to the highly liquid nature of the European government bond universe, transactions typically incur minimal costs to mid prices.

[2]Source: ICE, as at 2 December 2020. EG5V, GVL0

Actively managed short-dated credit

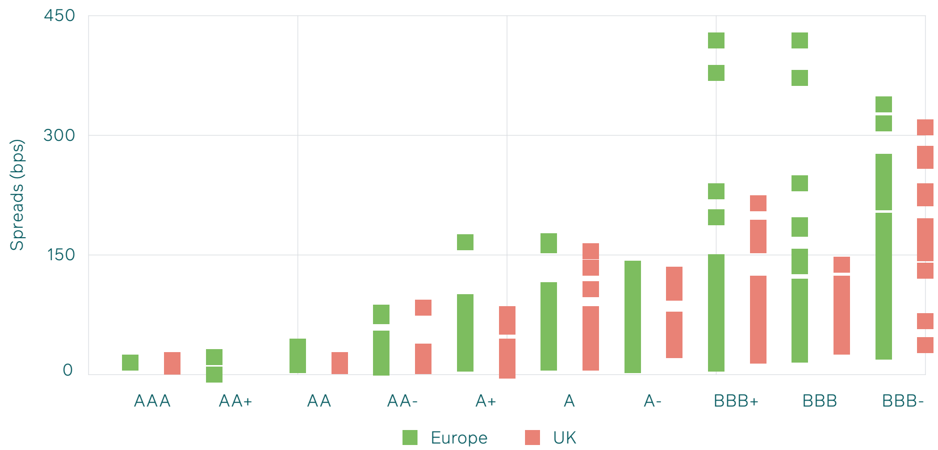
We believe short-dated (one- to three-year) credit offers the potential for consistent active outperformance without incurring significant volatility. This is primarily due to the dispersion of spreads within credit rating and currency bands (see Figure 3), which enables bottom-up managers to select bonds they believe offer the most attractive risk-adjusted returns and to avoid unattractive credit based on fundamental analysis.

Some of the potential advantages of ultra-short-dated credit as a step out of cash include:

1. Safety through diversification. The European universe contains over 3,500 bonds issued by more than 1,250 companies. We believe an actively managed European credit portfolio comprising around 400+ securities can offer diversification through a market cycle, with benchmark-aware construction providing confidence around risk and beta exposure.
2. Liquidity through market size. The universe comprises over €2 trillion of outstanding issuance.
3. Yield through a combination of spread and active management within a low volatility asset class. Hedged to euros, the global short-dated corporate universe has only delivered a negative total return once in the last 20 years – measuring -0.81% in 2018, including the effects of duration[3].

Figure 3. Spreads can differ greatly within individual credit rating bands and currencies, which can present opportunities

Euro and sterling 1-3 year investment grade index, spread dispersion



Source: M&G, ICE 1-3 Year Euro Corporate Index (Ref .ER01) and ICE BofA 1-3 Year Sterling Corporate Index (Ref UR01), composite credit rating derived from average of S&P/Moody's/Fitch as at 31 December 2020.

[3]Source: ICE BofA 1-3 Year Global Corporate Index (G1BC), total returns, euro-hedged, as at 31 December 2020

Senior European ABS

Due to Solvency II capital charges, high-quality European senior ABS may have been overlooked by insurers seeking to improve yields. However, the introduction of the EU's Simple, Transparent and Standardised (STS) securitisation framework in 2019, which significantly lowered charges for eligible securities, means that certain ABS can offer an attractive return on capital, as well as a yield pick-up. In our experience, investors are not always fully aware of the fundamental differences between European and US ABS, the latter of which is associated with the 2008 financial crisis. It is important to reiterate that no European senior AAA consumer ABS or RMBS has ever incurred a default or impairment. Meanwhile, the long-term default rate for all investment grade European ABS is 0.1%pa[4].

The asset class has several characteristics that may suit insurers looking to reallocate some of their excess cash.

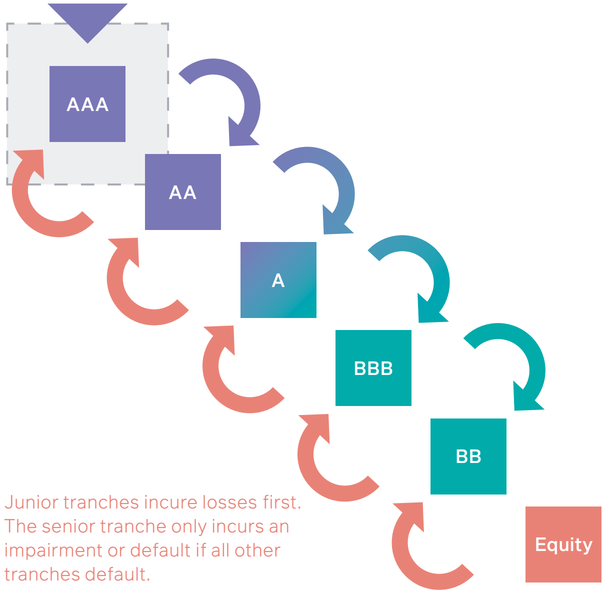
[4]Source: S&P Global Ratings, 2019 Annual Global Structured Finance Default And Rating Transition Study (p32), 9 June 2020.

Safety

Senior ABS sit at the top of the capital structure (see Figure 4), which means they benefit from robust structural protection. Their high levels of credit enhancement mean they can withstand extreme market conditions. European AAA ABS also experienced lower levels of volatility than many other asset classes in early 2020 and, as floating rate instruments, have minimal interest rate risk.

Figure 4. Structural protection in senior ABS

Income from the underlying asset pool is paid to the senior (AAA) tranche first. Once these investors have been fully paid, income flows down to junior tranches via a 'waterfall effect'.

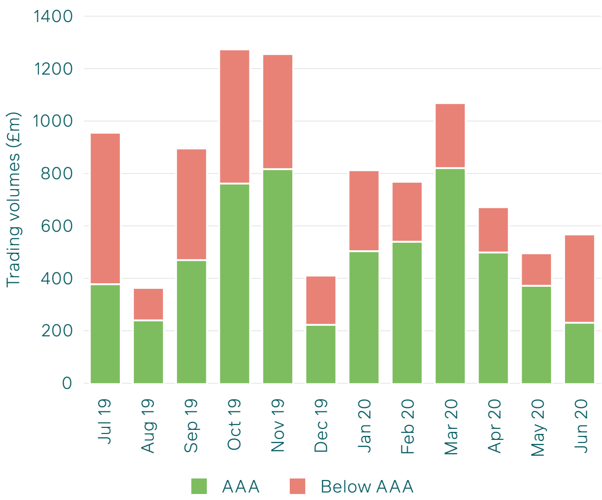


Junior tranches incure losses first. The senior tranche only incurs an impairment or default if all other tranches default.

Liquidity

AAA ABS is the largest part of the public securitisation market, with secondary market volumes offering sufficient liquidity for daily trading. These assets are listed on regulated exchanges and have a minimum of two ratings – often three. Figure 5 shows M&G's traded volumes of ABS over a 12-month period.

Figure 5. M&G traded almost £500 million AAA ABS in 12 months to June 2020



Source: M&G ABS trading desk, as at 30 June 2020. Trading Volumes include primary and secondary markets activity.

Yield

European senior AAA ABS typically offer higher all-in yields than other liquid defensive asset classes. This is a result of less central bank intervention in certain parts of the market, and ongoing misconceptions about the quality of European ABS, due to the issues US ABS faced in 2008. We explore this in greater detail in our recent paper, AAA European ABS: a defensive asset class.

Enhancing yield from a Solvency II capital perspective

As we have seen, diversifying away from cash deposits requires trade-offs. Depending on its individual situation, an insurer must assess both the advantages and disadvantages of each asset class, which may be summarised as follows:

Asset type	Potential key risks	Potential key benefits
Cash and cash equivalents	• Erosion of capital	• No capital charges • Immediate liquidity
Government bonds	• Mark-to-market risk from interest rate movements and country allocation decisions • Negative real or nominal yields	• No credit spread charges • Tactical liquidity • Potential for active outperformance
Short-dated credit	• Obtaining higher yields typically requires investors to reduce credit quality • Mark-to-market risk from credit spread and interest rate movements	• Relatively low capital charges • Large, diverse investment universe • Strategic liquidity • Potential for active outperformance
Senior ABS	• Mark-to-market risk from credit spread movements and liquidity shocks • Downgrade risk • Higher capital charges, albeit reduced for STS-eligible securities	• Historically no defaults or impairments in European AAA consumer ABS or RMBS • Higher yields than other, equivalently rated public debt • Floating rate • Historically large enough trading volumes for daily trading

Figure 6. Comparison of returns on capital (RoC) and yields on out of cash options for European insurers

Asset type	Duration (Effective duration or spread duration)	Average rating	Effective yield	Approx. spread SCR	Approx. interest SCR	Counterparty default risk	SCR (non-diversified)	SCR (diversified)	Module	RoC	Incremental RoC from € base	Incremental RoC from £ base
€ cash	–	AAA	-0.5%	–	–	1.0%	1.0%	1.0%	Counterparty risk	-48.1%	–	–
£ cash	–	AAA	0.0%	–	–	1.0%	1.0%	1.0%	Counterparty risk	0.0%	–	–
Passive short-dated € gov. bonds[1]	1.9	A+	-0.6%	–	2.0%	–	2.0%	2.0%	Interest rate risk	-30.5%	-11.5%	–
Active target short-dated € gov. bonds	1.9	A+	-0.4%	–	2.0%	–	2.0%	2.0%	Interest rate risk	-20.5%	9.4%	–
Passive short-dated £ gov. bonds[2]	1.9	AA-	-0.1%	–	2.0%	–	2.0%	2.0%	Interest rate risk	-6.5%	–	-13.5%
Active target short-dated £ gov. bonds	1.9	AA-	0.1%	–	2.0%	–	2.0%	2.0%	Interest rate risk	3.5%	–	7.3%
Passive short-dated € credit[3]	1.9	A-	-0.1%	3.6%	2.0%	–	5.6%	4.1%	Interest rate and spread risk	-1.2%	14.6%	–
Active target short-dated € credit	1.9	A-	0.2%	3.6%	2.0%	–	5.6%	4.1%	Interest rate and spread risk	3.6%	21.1%	–
Passive short-dated £ credit[4]	1.8	A-	0.7%	3.4%	2.0%	–	5.4%	3.9%	Interest rate and spread risk	16.5%	–	22.4%
Active target short-dated £ credit	1.8	A-	0.9%	3.4%	2.0%	–	5.4%	3.9%	Interest rate and spread risk	21.5%	–	29.3%
Senior ABS £	2.0	AAA	1.0%	19.9%	–	–	19.9%	19.9%	Spread risk	5.1%	–	5.4%
Senior ABS € hedged	2.0	AAA	0.4%	19.9%	–	–	19.9%	19.9%	Spread risk	2.2%	5.0%	–

For illustrative purposes only

Figure 7. Correlation matrix

	Credit risk	Rates risk	Default risk
Credit risk	100%	0%	0.25%
Rates risk	0%	100%	0.25%
Default risk	0.25%	0.25%	100%

Figure 8. Solvency II spread charge

Composite rating	Incremental % per year of effective yield up to five years
AAA	0.9%
AA	1.1%
A	1.4%
BBB	2.5%

Notes

Active data is based on a performance target of 0.20%pa in excess of the relevant passive benchmark. This is for illustrative purposes only and is not a projection or guarantee of future results. Target objectives are typically negotiated with the individual insurer.

Active data uses an identical average credit rating and SCR as the relevant passive benchmark. Actual duration and credit quality will depend on the individually negotiated mandate.

Sources: ICE BofA credit indices[1]) 1-3 Year Euro Government (EG01),[2]) 1-3 Year UK Gilt (G1L0),[3]) 1-3 Year Euro Corporate (ER01),[4]) 1-3 Year Sterling Corporate (UR01);[5]) M&G senior ABS portfolio; as at 31 December 2020.

We have used effective duration as the duration measure for the government and corporate bonds. We have referred to the spread duration for senior ABS as this is a fairer measure for securitisations.

Spread charges for ER01 and UR01 have been calculated on a broad basis, as opposed to the line-by-line approach standard formula users would use for the capital models. These charges are a point-in-time calculation and will therefore change depending on the composition of the index. These are simplified calculations for illustrative purposes only. The indices have been grouped by rating and the average DtW for that rating bracket was used to derive the spread charge. Please see the Solvency II spread charge extract in Figure 8 for further details.

Interest rate charges for credit indices EG01, GL01, ER01 and UR01 have been calculated on a broad basis, as opposed to the line-by-line approach standard formula users would use for their capital models. The calculation method is 1% multiplied by the index's average duration.

Counterparty default risk: cash holdings have been assumed to be AAA rated counterparties under Type 1 default risk.

Senior ABS: the correlation matrix in Figure 7 drives the diversified SCR. This is in accordance with the Solvency II directive for standard formula users.

As can be seen in Figure 6, reallocating cash may require insurers to recalibrate their return on capital objectives. While the return on capital estimates shown here may be below an insurer's target, they are still preferable to the certainty of zero or negative returns from cash holdings.

The optimal allocation for each insurer to different asset classes will depend largely on its individual circumstances:

1. Insurers with high coverage ratios, which can afford the additional capital requirements, may have increased scope to consider STS senior ABS or even non-STS securities. This can provide a yield pick-up combined with a higher credit rating than most European government bonds, alongside portfolio diversification.
2. Those with lower capital ratios or an underweight position in corporate bonds may consider a reallocation of excess cash to short-dated corporate bonds, due to their lower capital charges than ABS.
3. Insurers focused on maintaining low spread risk could consider actively managed government bond allocations to potentially outperform passive approaches.

In each circumstance, continuing to hold excess cash deposits will drag on returns as long as cash rates remain at or below zero. We believe a more structured approach to reallocating cash could significantly improve portfolio returns, without excessively compromising on credit quality or capital charges. At M&G, we have a long track record in managing strategies within each of the asset classes explored in this paper, and we work closely with our insurance clients to construct solutions that meet their individual requirements. We believe an optimal combination of defensive assets could help insurers to maintain the levels of liquidity required for their immediate cash needs, while improving their ability to service more strategic, medium-term goals.