IS CASH KING?
A CASE STUDY FOR EUROPEAN INSURERS LOOKING TO REDUCE REGULATORY CAPITAL

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Since the COVID-19 crisis escalated in early 2020, we have spoken with a number of insurers looking to reduce their regulatory capital requirement as a way to navigate a possible economic recession. For many of these insurers, common sense leads them to considering larger allocations to cash in their portfolios as an obvious way to reduce investment risk and minimise the use of regulatory capital.

However, despite the obvious logic, increasing your allocation to cash does not always deliver the expected outcome. Although cash is a “safe” asset from an investment perspective, it comes with counter-party risk from a regulatory perspective (i.e. risk that the institution holding the cash goes bust). As such, the regulatory capital charges associated with holding cash completely depends on how you are holding that cash and the counterparty risk of the institution where the cash is held.

For institutions with credit ratings of A and below, the regulatory capital charge may actually be more punitive than parking cash in fixed income securities such as government bonds.

The notion that cash is king for those seeking to reduce regulatory capital is certainly not universal, particularly in the current environment where financial institutions are potentially on the receiving end of credit downgrades. What’s more, the yields on offer from holding cash in the UK and Europe are far from attractive and will be deep into negative territory once adjusted for punitive capital charges.

So, for insurers who find their cash-related regulatory capital requirements increasing whilst their cash yield is falling, what can be done? The case study below details a project we have worked on with a UK insurer underwriting risk in the UK and across the globe:

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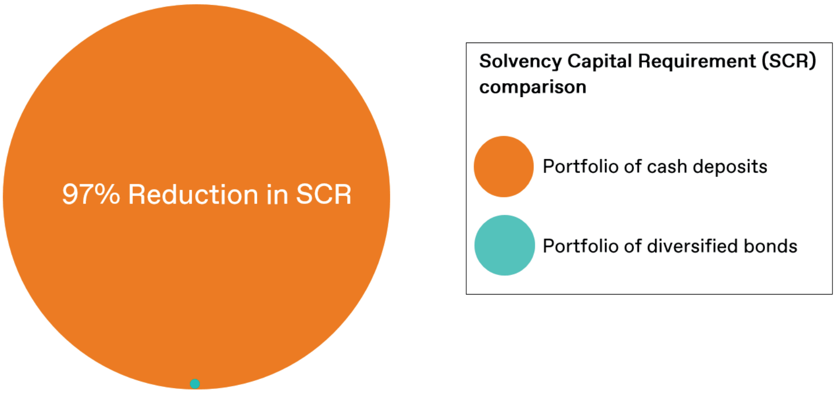
CASE STUDY: REDUCING REGULATORY CAPITAL BY REDUCING CASH

We have worked closely with a Property & Casualty insurer to help them reduce the regulatory capital requirement from their investment portfolio. The insurer holds the bulk of their assets in short-term deposits and had two main issues; a large counterparty capital requirement as a result of their holdings in short-term deposits and a currency mismatch between their assets and liabilities.



Initially, our focus was on analysing the current short-term deposits.

- Where were they held?
- What return were they generating?
- What was the rating of the counterparty involved?
- What was the maturity and cash flow profile of the current deposits?

Reviewing these factors opened up a conversation about the positive impact of switching the assets from exposure to counterparty risk from the deposit holders to credit risk related to the investment grade bond issuers.

We carefully managed the credit risk element to ensure that the portfolio risk profile remained within the Insurers' tolerance. This resulted in a significant reduction in the regulatory capital requirement since the bonds held are highly rated and short-dated.

During the transition from short-term deposits to a portfolio of highly rated bonds, we worked with the Insurer to review the liability profile and, specifically, its currency allocation. For insurers operating across a large geographic area, currency mismatches are not uncommon but often represent an 'easy win' to minimise regulatory capital requirements. Taking this liability profile information, we incorporated the currency requirements into our investment planning leaving the Insurer with a portfolio diversified across currencies, sectors, rating and duration. Transitioning a proportion of their total assets into currency matched, investment grade bonds reduced a significant proportion of their regulatory capital requirement as well as provided them with higher yielding assets relative to cash.

	Spread risk SCR				
Bond duration	1	3	5	10	15
AAA	0.0%	0.0%	0.0%	0.0%	0.0%
AA	0.0%	0.0%	0.0%	0.0%	0.0%
A	1.1%	3.3%	5.5%	8.5%	10.9%
BBB	1.4%	4.2%	7.0%	10.5%	13.0%
BB	2.5%	7.5%	12.5%	20.0%	25.0%
B or lower	4.5%	13.5%	22.5%	35.0%	44.0%
unrated	3.0%	9.0%	15.0%	23.5%	29.5%

Movement in SCR from counterparty into spread risk

Counterparty risk SCR	
AAA	1.3%
AA	3.0%
A	6.7%
BBB	14.7%
BB	54.4%
B	100.0%
Unrated	100.0%

If the portfolio is analysed purely from a regulatory capital perspective, the insurer saw a:

- Reduction in the interest rate risk regulatory capital requirement (and a better matched portfolio from an asset-liability matching perspective).
- Reduction in currency risk
- A reduction in the total market risk capital requirement as a result of a larger diversification benefit from holding different asset classes (as well as an investment risk benefit from holding a more diversified portfolio)
- A reduction in the concentration risk of the portfolio as a result of having exposure to a more diverse base of issuers rather than a handful of banks.

All other things being equal, the transition reduced the regulatory capital requirement for the portfolio by 97% and increased the likely return profile.

It is important to note that moving assets out of cash into bonds does come with additional portfolio volatility. However, this is managed through deliberate targeting of bond duration and interest rate risk management, especially in light of the macroeconomic environment.

It is also worth noting that, depending on the accounting regime in which an insurer operates, there may be P&L volatility linked to holding bonds instead of cash. Exploring these implications and discussing their impact are obviously a crucially important part of the process and essential before making any investment decisions.

In the current environment it is important to get every bit of value from an insurance investment portfolio. Carefully managing the portfolio's capital requirement is an obvious way of doing this. Obvious solutions to reducing portfolio risk may not necessarily be optimal and so insurers should be working with an asset manager willing and capable of engaging with the wider implications of holding cash.

Cash is not always king.