For global professional / qualified / institutional clients and investors and US retail clients and investors

Liquidity Perspectives—3Q18

Investment policy guidelines: Taking another look

Overview

- Regulatory changes within the money market industry and the current environment are forcing many treasurers to rethink their cash management strategies and adjust their investment policy guidelines.
- Developing methods and guidelines for segmenting cash into operating, reserve and strategic cash categories may help in developing a sound investment policy. Doing so may help to mitigate many of the most pressing challenges facing treasurers today, allowing them to:
  - Maximize operating cash value
  - Broaden the investable universe
  - Reduce the potential impact of negative rates and provide flexibility in dealing with regulatory changes, especially those impacting money market funds

New environment may require a re-examination

It has been a challenging decade for cash management. As we have already seen in the US, regulatory changes to the money market fund (MMF) industry have driven changes in the short term investment world.

Upcoming regulatory changes in Europe and China, together with current interest rate levels, have created a demanding environment for treasurers in managing liquidity. The combination of market and regulatory factors is forcing many treasurers to look at their investment policy guidelines in ways they haven't in years.

Not only do investors have to adapt to the way banks are valuing deposits and address new considerations around money market funds, they may also need to re-evaluate their investment policies and how they can be adjusted when traditional methods of capital preservation may not be effective. For example, negative-yielding overnight deposits and money market instruments denominated in certain currencies (e.g., EUR and CHF) can effectively erode the value of the very capital they are supposed to preserve.

The importance of cash segmentation

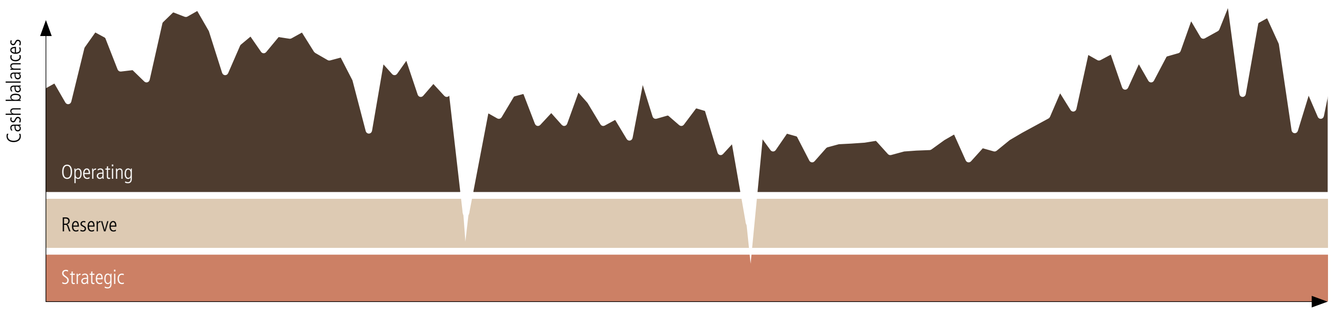
Many investment policy statements provide detailed guidelines on how to invest cash, but they rarely address specific cash buckets. The one-size-fits-all approach may have worked in a world when interest rates were at historically higher levels, the line between operating and non-operating deposits was blurred, and there was limited distinction between stable and variable net asset value (NAV) short-duration products within the respective investment guidelines. However, today's challenges may call for a more customized approach. A clear delineation of cash may be critically important to achieving desired outcomes while also adapting investment policies to the new world.

- **Maximizing returns on operating cash**

  Large corporations and financial institutions now face bank-mandated limits on what is considered an operating or non-operating deposit, in the wake of Basel III. Determining these limits, or "headroom," is often made by looking at the average daily debit activity registered through a demand deposit account over a six-month period (updated quarterly). The fact that companies may have to cap their banking balances to a daily average (not a monthly average) makes it extremely challenging for treasurers to manage intra-month spikes. Failure to comply or exceeding the headroom can disrupt a firm's operations and negatively impact overall returns. Thus treasurers are considering incorporating methods of measuring "headroom" into their investment guidelines to differentiate between operating cash (which is linked to transactional activity) and excess operating cash. This excess operating cash may best be deployed in money market-type instruments that can provide daily liquidity and act as a complement to their bank accounts.

  Money market funds have the ability to absorb spikes and enhance returns on overall operating cash balances. Introducing parameters and policies for investing non-operating cash in investment guidelines, such as reserve cash and longer-term strategic cash allocations, can create more flexibility for deploying it in higher yielding funds or other investment options.

Figure 1. The liquidity spectrum: segmenting cash



Operating Cash: 0 – 3 months	Reserve Cash: 3 months – 1 year	Strategic Cash: 1 – 5 years
– Transaction and Operating Cash – Deployment through money market funds – Investment horizon is overnight	– Balances set aside for possible acquisitions, stock repurchase, research and development, etc. – Deployment in commercial paper and ultra-short duration strategies – Investment horizon is three to nine months	– Longer-term balances that companies keep on the balance sheet as buffer – Deployment in short duration strategies that tap into securities such as corporate bonds, agencies, asset-backed securities, etc. – Investment horizon is one year or longer

Source: UBS Asset Management. For illustrative purposes only.

– **Broadening the universe of investable securities**
Having a single set of guidelines for all types of cash may limit treasurers' ability to tap into the broader set of investment vehicles that have become more diverse in response to the new environment. A one-size-fits-all approach can be limiting because the universe of allowable investments is capped to one option. This creates an opportunity cost, because all cash is subject to guidelines applicable to working capital. However, banking and money market fund reforms are ushering in alternative solutions, such as the combined use of short-term money market funds, longer-term variable net asset value (NAV) money market funds and short-dated bond funds for different pockets of cash with different liquidity requirements.

Despite the diversification benefits and potential yield enhancements these solutions could offer, most policies have not traditionally accounted for them. One way treasurers can have access to additional cash management tools is by segmenting cash and assigning distinct guidelines for each "bucket." For example, a portion of cash balances that is considered "reserve" could be invested further out the yield curve to temper the effect of negative rates, for instance, in the eurozone. A broader set of investable options could be considered for "strategic" cash, including longer dated investment solutions, and could also mitigate the effects of regulatory changes affecting money funds.

Adjusting investment policy to accommodate changes
Using the upcoming European money fund reform as an example of the impact of new regulation, the changes are focused on three main areas:

– The creation of new MMF categories: Public Debt Constant NAV (CNAV) and Low Volatility NAV (LVNAV)
– Increased liquidity and diversification requirements across all types of MMFs
– Defines levels at which a fund's board of directors can impose fees and gates to Public Debt CNAV and LVNAV funds

Some treasurer's investment policies may be restrictive, only allowing for certain types of funds for their cash management. Investment guidelines should be reviewed in advance of any MMF reform implementation to ensure that investments are not out of compliance with the new guidelines.

As a result of the regulatory changes and the process involved in getting policy changes approved within investment guidelines, there will be two key variables:

– Capital preservation: Is it strictly or loosely defined? Strictly means zero tolerance for gains and losses.
– Cash segmentation: Is the policy cash-bucket specific or not?

Investment policies with separate guidelines for each cash bucket can provide more flexibility in dealing with gates and fees. For example, liquidity requirements on reserve cash are not as stringent as they are on operating cash, so with minimal changes to a policy, short-term money market fund investments could simply be shifted from the operating cash bucket to the reserve cash bucket and still stay compliant with treasury investment guidelines. Establishing flexibility within one's investment policy guidelines can help to address the challenges ahead.

The only thing that is constant is change
Money market regulation continues to expand throughout the world with the markets and investors taking note. Revised guidelines for treasurers, new definitions for investment strategies and policies, and cash segmentation are all tools that can make investors more flexible and help to tackle the headwinds of global interest rates.

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