

## Working Capital Finance Note Programs

### Background

Short-term interest rates remain near all-time lows requiring insurance companies to sacrifice yield for liquidity in their cash management and short-term product portfolios. An alternative is working capital finance note programs. Insurance companies have an opportunity to recognize increased yields with minimal additional risk by investing in working capital finance note programs.

The working capital finance note program structure allows for the purchase and sale of short-term obligations due from investment grade obligors. Chart 1 provides an example of a common deal structure. A working capital finance note transaction is completed by structuring a program that contractually commits the obligor to the payment of their obligation generated from the purchase of goods or services. This commitment has the effect of creating an asset not dissimilar from commercial paper (CP) in that working capital finance notes are issued at a discount, mature at par, have a short maturity in the range of 30 to 360 days (typically 60-180 days), and are pari-passu to other senior unsecured obligations of the obligor.

The benefits to participating companies are numerous. First, the obligor increases their ability to extend payment terms to their suppliers while at the same time adding liquidity to their supply chain. Second, suppliers obtain cash flow visibility, liquidity and lower cost of funds. Finally, the insurance company achieves superior returns to similar duration securities issued by the obligor, flexible capital commitments, and risk diversification.

### Portfolio Management

A primary benefit of a working capital finance note program is the pickup in yield that can be earned without significantly impacting liquidity or risk parameters. While the tenor of working capital finance notes is similar to an average money market issue, the yield is enhanced to compensate for relatively lower liquidity and operational risk. Take a recent program with a large US retailer as an example. As of October, 2010, this retailer's 180-day CP (rated A-2/P-2) was priced at L + 3bps. Similar working capital finance notes programs were priced at L + 175bps or a difference of 172 bps.

Working capital finance note programs provide flexibility for short-term product portfolios. All parties in a program participate voluntarily with minimal, if any, funding commitment. The funding party (Insurance Company) has the ability to select programs based on obligor and maturity date, allowing for customization of risk profiles and tactical investment. Additionally, many these obligors are infrequent short-term debt issuers. Investment in working capital finance note programs allows an insurance company to gain credit exposure to obligors not otherwise offered publicly. Using the same large US retailer as an example; as of October, 2010, this retailer's bond with 2 years to maturity (rated BBB/Baa2) was priced at L + 79bps. Their 180 day working capital finance note program was priced at L + 175bps for a difference of 96 bps and 18 month shorter duration.

While working capital finance note programs are new to insurance industry general accounts, the market has been in existence for over a decade. Up until recently, these programs have been the nearly exclusive domain of the banking industry. With the recent financial crisis banks have been forced to deleverage and reduce the size of their balance sheets, thereby opening an opportunity for insurance companies to gain access to this attractively priced asset.

### Risk Profile

There are several aspects to working capital finance note programs that help mitigate liquidity and operational risks. First, as discussed above, the yield incorporates a significant liquidity premium to compensate for the customized terms of the program. While the market for these assets doesn't currently approach the size and depth of the CP market, we believe the naturally short duration of these assets, combined with minimal or no commitment levels, significantly reduces the impact of any liquidity risk. While the liquidity premium is influenced by market conditions and participation levels, we believe the premium required for such durations is minimal, if any.

Due to the straight forward and simplistic model, the programs operational risks are easily addressed and remedied via program documents with obligors contractually committed to pay. The Agent/Service acts as a form of Paying Agent and typically maintains “Specified Accounts” used solely for the program. The asset purchases are classified as “True Sales/Participations”, which segregates the asset from the Agent. The Agent/Service of these programs are traditionally large financial institutions or specialized service platforms with years of operational expertise.

**Conclusion**

Working capital finance note programs are an appealing alternative for insurance general accounts from both a yield and diversification standpoint. The enhancement in yields, flexibility in participation, and potential for risk diversification compared to traditional short-term assets make them an ideal addition to cash management and short-term product portfolios.

**Chart 1 – Deal Structure**

