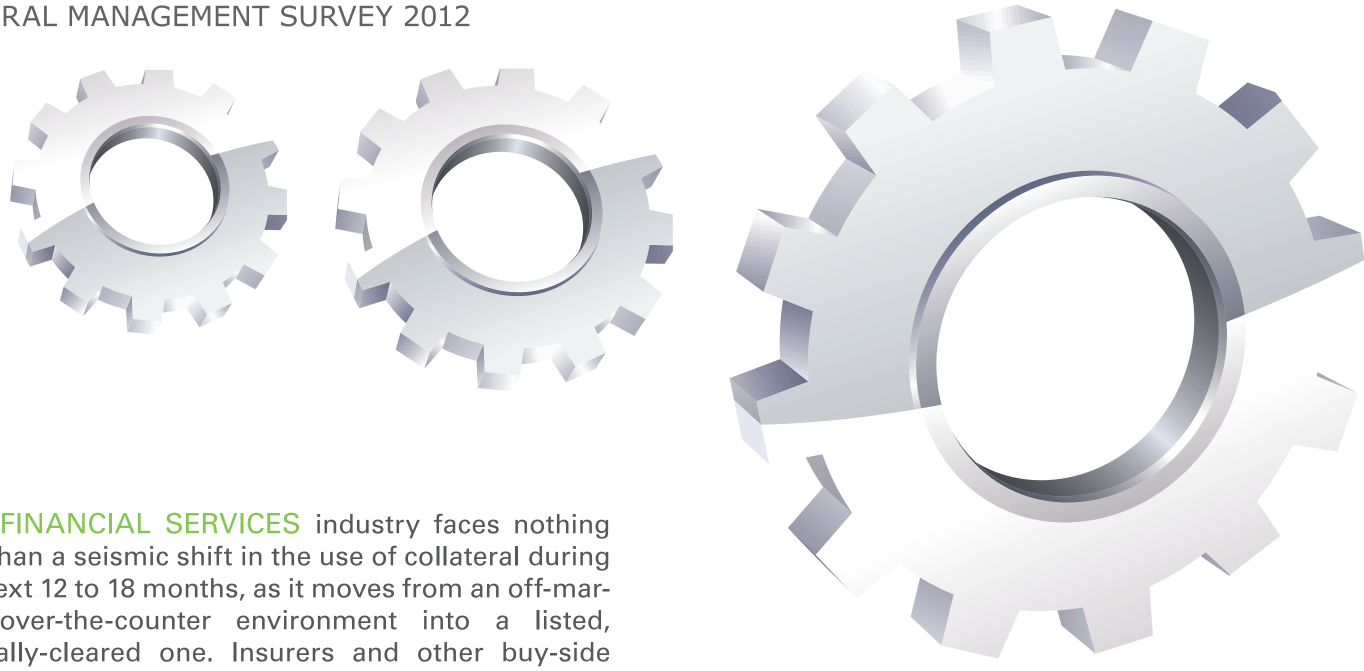
Collateral management survey 2012

The move to central clearing of OTC derivatives trades will have a dramatic impact on the insurance industry's use of collateral. A survey, conducted by Insurance Risk in conjunction with BNY Mellon, finds many insurers have yet to assess fully the implications of the new regime for their business and most are largely unprepared for the new collateral requirements

Sponsored by BNY MELLON



THE FINANCIAL SERVICES industry faces nothing less than a seismic shift in the use of collateral during the next 12 to 18 months, as it moves from an off-market, over-the-counter environment into a listed, centrally-cleared one. Insurers and other buy-side firms in particular will have a greater need to post initial and variation margin in the shape of high-quality collateral when using derivatives.

Insurance Risk and BNY Mellon, with assistance from Ernst & Young, conducted a survey to find out how insurance companies are preparing for the new clearing regime and the opportunities and challenges that the changes will bring.

The survey illuminates that seismic shift:

- more than half of insurers (53%) surveyed expected to participate in the new cleared environment;
- half of the respondents (50%) believed their organisation will increase its use of derivatives in the coming years;
- yet only a small minority (13%) believed they will have enough assets of the required quality in their investment portfolios to meet the collateral requirements of the new environment.

The survey polled 59 insurers, of which 47 were primary insurers and 12 were reinsurers. Almost half of the respondents (46%) were pure-play life re/insurers, while 19% were non-life companies and 32% conducted both lines of business.

One-third (33%) had gross written premiums of more than $10 billion (£6.2 billion) in 2011, while a quarter (23%) held assets of more than $100 billion at the end of 2011.

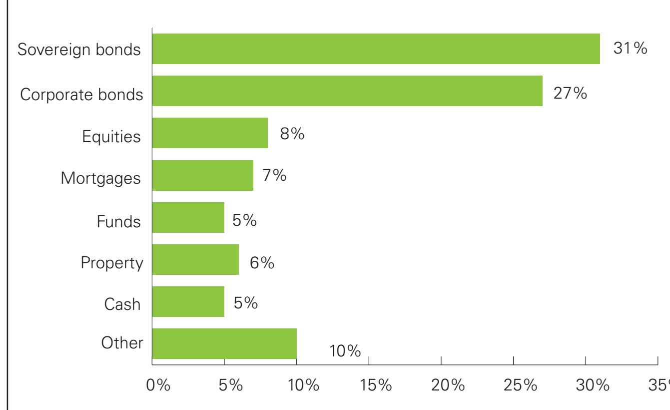
The majority of respondents (69%) wrote business in Europe, the Middle East and Africa, while 39% had operations in the Americas.

Respondents were asked to outline their company's holdings in a range of investment classes. Sovereign debt accounted for 31% of respondents' portfolios on average, while 27% of assets were corporate bonds.

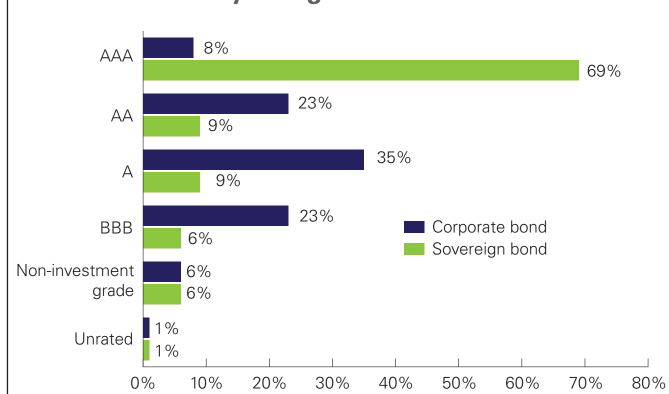
Government bond-holdings were heavily weighted towards AAA-rated instruments (on average 69% of sovereign bond-holdings), whereas corporate bonds were predominantly lower rated, with approximately 30% being BBB-rated or below.

Equities amounted to 8% of respondents' holdings on average, while cash was 5%.

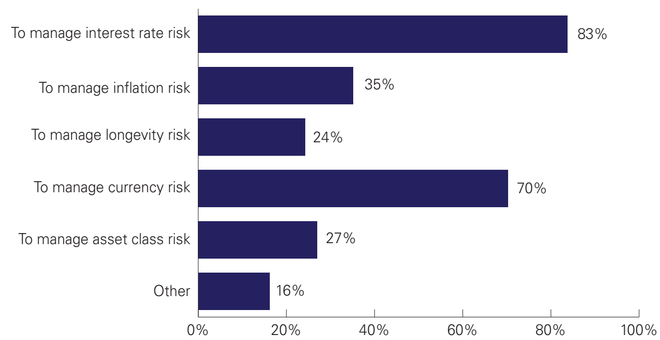
What is your broad asset allocation?



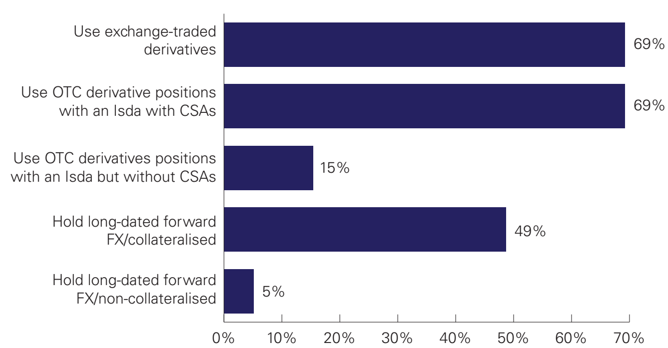
What is your sovereign bond and corporate bond asset allocation by rating?



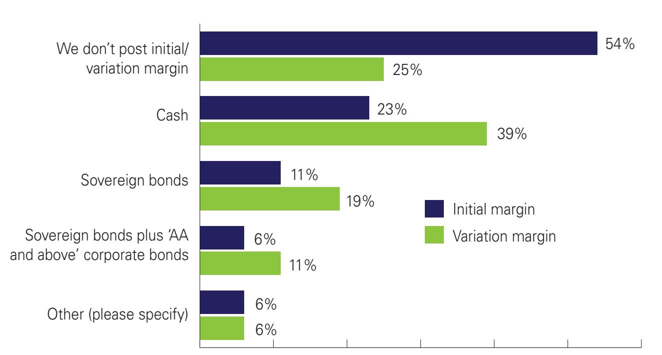
What do you use derivatives for?



As it relates to your derivatives, do you
(Please tick all that apply)



For your OTC derivative positions what do you typically post as initial and variation margin?
(Please tick the most common standard)



Derivatives use to increase

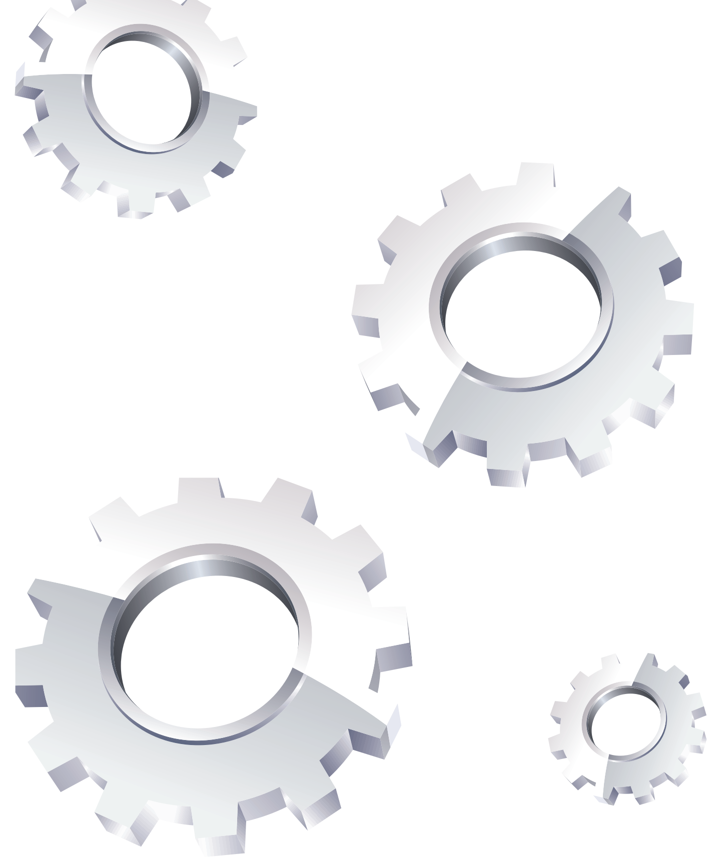
Respondents were asked how they used derivatives. More than 80% of companies used derivatives for hedging interest rate risk and 70% hedged currency risk using such instruments. Inflation risk was hedged with derivatives by one-third of respondents.

Of those that used derivatives, exchange-traded instruments were used by more than two-thirds of respondents (69%), with the same proportion using OTC markets with an Isda and a credit support annex (CSA).

For those using the OTC market, just under half of the respondents (46%) currently post initial margin. Cash was the most popular collateral to post as initial margin, followed by sovereign bonds.

A higher proportion (75%) of respondents currently post variation margin on their OTC positions, with nearly 40% of respondents using cash and one-fifth posting sovereign bonds. One in 10 respondents posts a mixture of sovereign bonds and AA or higher-rated corporate bonds as variation margin.

Approximately half of the respondents expect to increase their derivatives use in the coming years, although just under a third (29%) are undecided as to their future usage.



Impact of clearing yet to be fully assessed

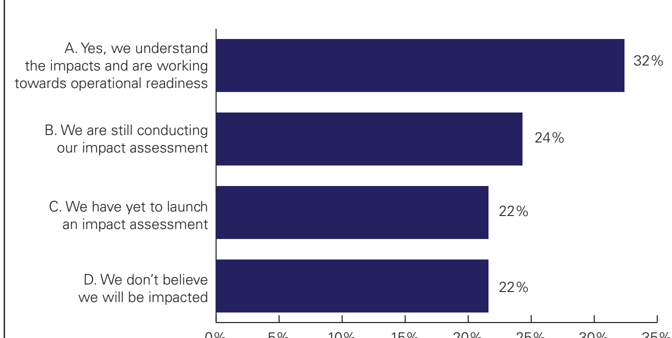
Over half (53%) of the respondents expect to participate in the new OTC cleared environment, while one-third (36%) do not yet know. One-third (32%) of insurers have concluded an impact study on the changes that a move to a centrally cleared environment will bring and are now on the journey to operational preparedness.

This leaves just over two-thirds (68%) of insurers that have yet to assess the potential impact, or believe they will not be affected.

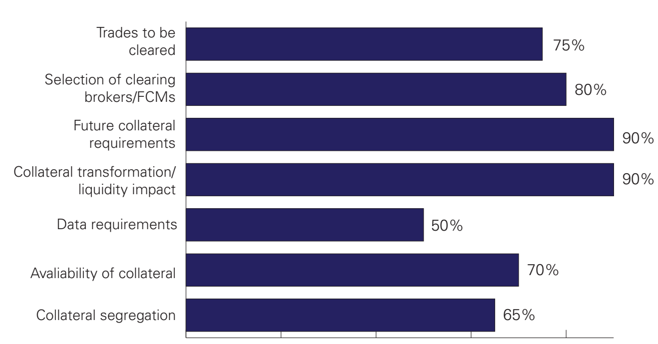
Whether this reflects the significant burden imposed by the new regulation, or a lack of understanding regarding the true impact of this change on their businesses is open to question.

Most of those firms that have launched an impact study are focusing on those tasks that help estimate the potential scale of any challenge, namely which trades will need to be cleared; the amount of collateral required, its availability and its impact on liquidity; and the availability of suitable counterparties.

Has your firm investigated the impact of the move to central clearing for OTC derivatives?



If you answered A or B to the question above, which of the following factors were taken into account? (Please tick all that apply)



Comment: Paul Traynor, head of insurance, Europe, Middle East and Africa, at BNY Mellon

The majority of the larger insurers are giving the move to a centrally cleared environment the attention it is due, typically using the existing expertise within their securities financing desks to support this process.

Those firms that have yet to conclude their analysis would be well-advised to do so as soon as is practical. It is vital that firms fully appreciate the ramifications of the new regulations if they are to plan adequately for future growth.

Attention must now turn to addressing the operational challenge and ensuring plans are in place to guarantee the availability of adequate collateral to meet insurers' posting needs.

Insurers will have to cope simultaneously with derivatives transactions which are on both an exchange traded, cleared OTC base and an uncleared OTC base, all of which are likely to require that collateral be posted, probably both initial and variation margin.

Insurers will need to amend and update their derivatives documentation, as well as appoint multiple clearing service partners and enhance their systems to cope with the mark-to-market valuations that will be required in the future. Daily mark-to-market will be required, as will independent checks. There may be additional challenges around ensuring the required transparency for certain multi-year instruments, and some types of collateral is more difficult to price than others.

Insurers will have to consider the operational aspects of holding collateral. There are many potential complications, however, given this is dependent not just on who the counterparties are, what the collateral is and where it is posted.

What collateral to use, and where, will be harder to keep track of as more collateral players enter the system. Over time, we expect to see the introduction of pricing based on collateral filtering efficiency. Many of those processes have yet to be fully fleshed out for insurance companies.

Collateral optimisation

Insurers are looking at a number of measures to optimise collateral, (converting idle assets into eligible collateral), the most popular being the use of the repo market (25%), followed by the integration of collateral management and margining processes across instruments both within and across legal entities.

A growing number were looking at the possibility of securities loans to facilitate cash releases, using their custody bank as a lender or repo principal; 7% of respondents currently do this, but 14% expected to do so following the cleared OTC reforms.

A significant proportion of insurers are not running a securities financing desk. This is despite the fact that insurers can pledge their securities to support a range of business activities, not just as collateral in support of derivatives positions held.

The survey found that while the majority of insurers (72%) pledged their investment portfolios as collateral, a smaller proportion do so in support of other activities. Only one-quarter (24%) pledged their securities in support of standby credit facilities.

The survey shows that the insurers have relatively low cash pools; however, they have substantial holdings of AAA- and AA-rated bonds.

Hence, it is not surprising they are looking at entering the repo market both to enhance yield and transform collateral into cash; that cash will be posted against variation margin calls on their derivatives positions, most likely interest rate swaps.

The survey suggests that the industry does not yet seem to be open to swapping more to the market than is needed to cover their own obligations.

Firms will need to optimise collateral. They will also need to enhance their operations and manage risk – be it credit, liquidity or operational risk – across a broad spectrum of markets and products.

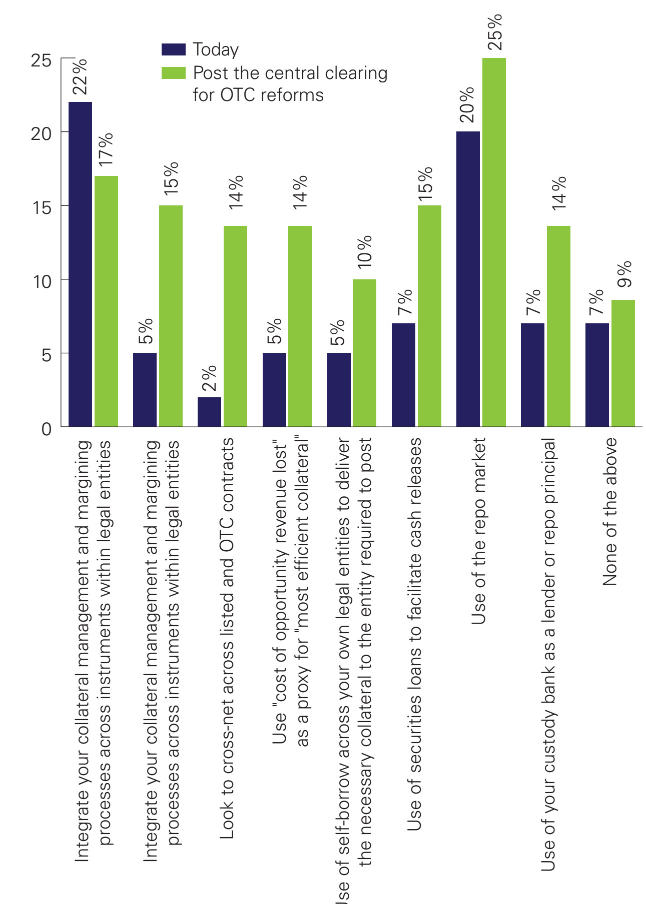
We believe that insurers are not yet fully aligned internally as to what to do next, but are in a good position to cover their own needs – when they know what they are.

Insurers are potentially ignoring a source of yield pick-up by not posting the most efficient collateral and instead keeping back those securities that could earn revenues elsewhere, for example through a securities lending programme.

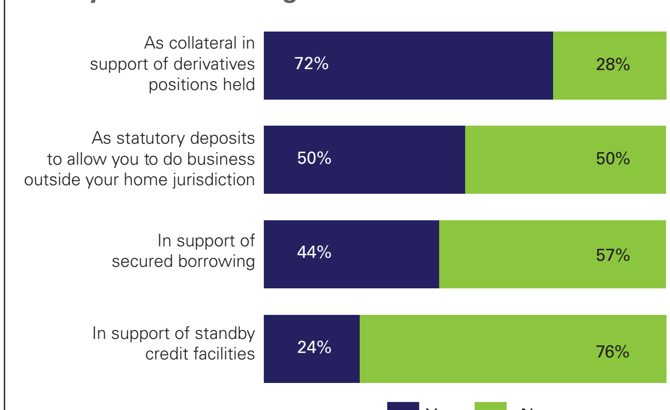
Additionally, we believe insurers should explore the revenue opportunity presented when they provide their own high-quality assets to third parties in exchange for lesser-quality collateral as part of an asset transformation. Among those that have looked at this revenue opportunity, only 22% have discounted this option as being unattractive.

Paul Traynor

Do you, or will you, engage in any form of collateral optimisation?



Do you pledge your investment portfolio today, for any of the following reasons?

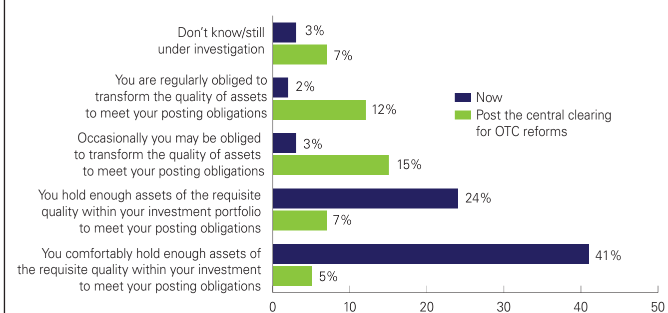


Collateral quality a concern

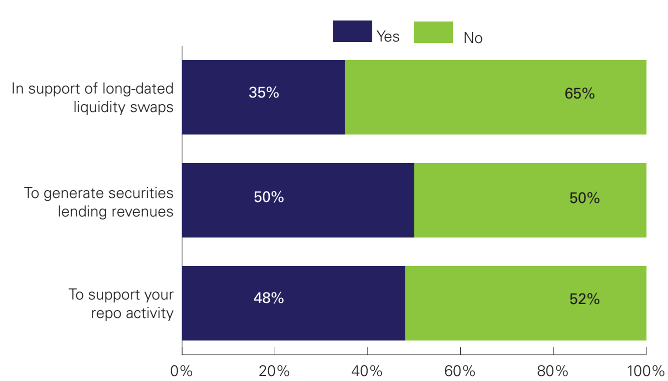
The majority (64%) of respondents noted that, under the current regime, they hold sufficient (enough or comfortably enough) assets of the requisite quality within their investment portfolios to meet their collateral margining requirements and other pledges. That is not surprising when you take into account that 54% do not post initial margin and 25% do not post variation margin.

However, insurers do worry about the changing environment. Only 13% believed they held enough assets of the requisite quality within their investment portfolios to meet their future collateral margining requirements and other pledges. Indeed, 27% believed they may be obliged to engage in some sort of asset transformation before being able to post the appropriate collateral, despite a third of their corporate bond portfolio investments being rated AA or above.

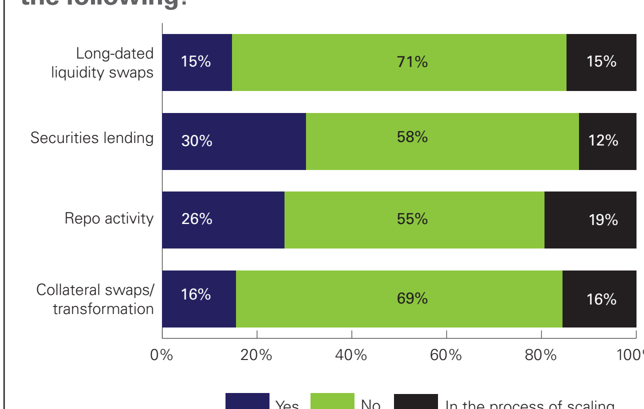
As it relates to your derivatives collateral margining requirements and other pledges would you say:



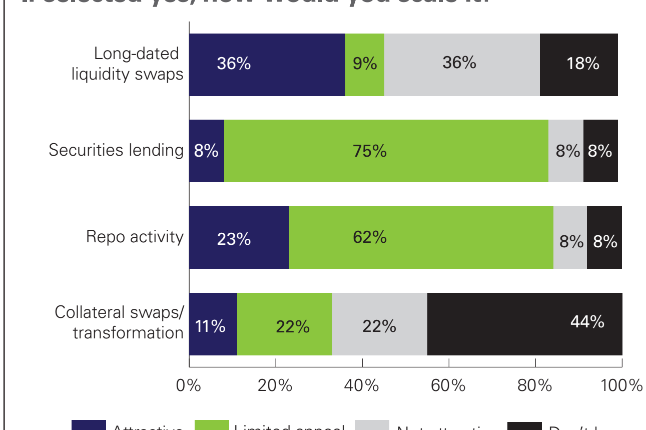
Do you use your investment portfolio today for any of the following reasons?



Have you assessed the potential scale of additional income you may be able to generate from any of the following?



If selected yes, how would you scale it?



Comment: Derek Pennor, director, financial services, Ernst & Young

One can postulate a number of reasons why more insurers are not developing opportunities to use their liquid assets:

Insurers themselves are heavy users of over-the-counter interest rate and inflation swaps – 50% expected this use to increase, hence requiring further collateral. Many were increasingly looking into collateral optimisation techniques to support this.

European regulators are placing a higher degree of scrutiny on insurers' liquidity processes and plans, potentially also increasing internal demand for liquid assets.

Insurers currently have a wave of regulation to address and central clearing may not be front of mind for all CFOs and CEOs.

Many insurers are defining their optimal balance sheet in a market-consistent world. For some insurers, this means redeploying liquid assets in search of longer term, more illiquid assets. Market trends in Europe have seen the development of bespoke 'liquidity trades', investment in infrastructure and lending to the property market via secured loans or mortgages. So rather than the 'obvious' conclusion that insurers are behind the curve in sitting on their liquid assets, perhaps insurers are leading the charge into some more interesting and socially beneficial areas.

Another consideration is whether insurers have the infrastructure to lend their liquid assets in the way that many other market participants do. Some insurers have natural advantages here with integrated banking/treasury functions or asset managers, but some insurers would be reliant on third parties to help with the infrastructure and processes needed to lend their liquid assets.

There are challenges to be overcome. We believe that insurance business operating models have to change to support the opportunity in areas such as the repo market to match the margining requirements of potential clients.

In addition, a tripartite partnership approach between the insurer, the prime brokers and the custodians should be adopted to minimise operational risks.

While the implementation of central clearing through Dodd Frank, Emir and AsiaPac OTC reform could lead to an enhancement of revenues for insurers by leveraging their pool of high quality assets as collateral, we believe there are several challenges to overcome. Robust planning and design of the operating model across the insurance, banking and asset management industries will be required to prepare for the new collateralised world.

Opportunities for income generation

The vast majority of respondents (81%) are exploring opportunities to generate additional income from their existing investment portfolio. Only 26% of survey respondents identified the move to a cleared environment as an opportunity to make more use of their liquid assets. The survey shows a split down the middle with around 50% of insurers currently generating additional revenue from their liquid assets via securities lending and repo activity, and 35% of insurers also supporting long-dated liquidity. The remainder do not engage in any such activity.

An even smaller proportion (15–30%) of insurers had considered the potential revenue to be generated from their liquid assets, with liquidity swaps and repo activity seen as the most attractive additional sources of revenue.

Less than one-fifth (12–19%) of insurers are currently assessing the potential revenue sources. It would not be a surprise to see those insurers revisit their securities-lending activities if yield improvements do manifest within stock-lending and collateral markets.

Eighty-five per cent of respondents found repos attractive or with limited appeal to generate income, however, slightly less than 50% actively use repos on their portfolio. Therefore, it is logical to infer that around a third of respondents would need to acquire the capability to apply repos to their portfolios in some way. This could either be through partnership with an independent broker, with the treasury function of their own institution or building the capability from first principles.

Whichever way is chosen, it is a fundamental decision to enter a new business and not to be taken lightly as infrastructure, expertise and cost may all contribute to margin erosion. IR

Do you see the move to a cleared environment as an opportunity to generate additional income on your investment portfolio by making your high-quality bonds available to others to post as collateral?