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An overhaul in collateral requirements

Regulators' response to the financial crisis is now moving into the implementation phase, with changes to collateral requirements coming in under the Dodd-Frank Act in the US and the European Market Infrastructure Regulation in Europe. Reactions held a roundtable of collateral specialists in association with BNY Mellon to ask how insurers will be affected.

Michael Loney, Reactions: What are the biggest issues facing insurers around collateral?

Bob Conron, BNY Mellon Asset Servicing: As a result of the 2008 financial crisis, the world's regulators are demanding greater support of risk assets, and, in particular, derivatives. So one of the main issues that the industry will face is finding support for the derivatives. There are questions of counterparty risk that many have already addressed. But it will remain a constant, and the implications for the derivatives space will carry through to other unrelated areas as well.

Michael Loney, Reactions: What kind of areas will they run into?

Bob Conron, BNY Mellon Asset Servicing: Here's a good example. Whether or not an insurer trades derivatives, the chief investment officer has to pay close attention to the supply of quality assets. We're about to enter a perfect storm. Not only will new margin requirements drive demand for more and higher quality assets, but so will unrelated developments, like pension de-risking and Solvency II across the EU. Any investor with fixed income securities will need to keep an eye on each of these developments, and look for opportunities as much as minimise disruption.

Michael Loney, Reactions: How big a concern is this for insurance companies?

John Norden, Deloitte: Everyone is scrambling. I think the biggest peak concern that my clients have now is how we substituted compliance in the work between EMIR [European Market Infrastructure Regulation] and Dodd-Frank. The dates for all of it have been pushed back a little bit, not yet by the CFTC [Commodity Futures Trading Commission] but EMIR has pushed back when they're going to be up and running for some of the requirements. There are a lot of questions still outstanding on non-cleared margin. Now we have a dozen or so products between interest rate swaps and credit default swaps. They have mandatory clearing. And we expect next year for FX to come up on clearing as well as have issues around non-cleared products as well.

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PANELLISTS:
- Bob Conron, BNY Mellon Asset Servicing
- Michael Loney, Reactions (moderator)
- John Norden, Deloitte

Via conference call:
- Bill Kelly, BNY Mellon collateral management team, representing the collateral management side of BNY Mellon
- Mike Kobida, CME Group
- Steve Penner, Catlin
- Les Smith, Allianz Investment Management
- Paul Traynor, BNY Mellon insurance team, responsible for the international insurance client relationships for BNY Mellon
- Vinny Tucci, ING US Investment Management

Michael Loney, Reactions: What are insurers doing here in the US as a consequence of Dodd-Frank?

Vinny Tucci, ING: ING started this process the better part of three years ago, which I believe was a bit earlier than maybe some of our counterparts. The first thing we did was put together a committee to weigh in on the changes and decide how we were going to implement and deploy resources and what was going to be needed. Once we started to understand what Dodd-Frank was going to mean, we began the interview process quickly with various DCMs. We had a very detailed RFI that we sent out for which we developed a strategy and grading system for our selection process, reviewed their capabilities, their fee structure, and potential margin calculations. So we were trying to stay ahead of all of that and foresee where it may go. We used our experience from prior milestones in the financial markets over the last 30 years when things were coming on-line

Just looking at the infrastructure and enhancements that were going to be needed affected everyone. It was very difficult with the rules changing on a weekly basis. Just trying to stay ahead of what was going to be needed, and how we were going to implement this was a huge task. We can talk forever on liquidity and how that was going to affect each one of us, and the various programmes and reviews we had to do internally, along with how and where cash was going to be allocated. Those are all the things that hit us, and it seemed to hit us quite quickly over a three year time period.

Les Smith, Allianz Investment Management: We've got the clearing done, so the next big thing that we're looking at is the swap execution facility. As the next piece of regulation that is coming in the next few months, we need to make sure we're prepared for that.

Steve Penner, Catlin: The regulatory guideposts as set out are dynamic and evolve both in terms of the scope of the regulation and the dates in which they are to go into effect. But each entity has to navigate their own way through and it depends on your counterparties, on your products, and on your geographic scope. There really is no one roadmap, so it's been a lot of work with our counterparties, with our FCMs [futures commission merchants], and with our clearing house. What's been really beneficial for us is working with those partners that do have a focus on insurance, that do have teams dedicated to understanding how the different implications these changes have on our businesses, and what we may specifically need. It's much more difficult when counterparties don't have those dedicated resources and functions to focus on the insurance industry.

Michael Loney, Reactions: Are firms gearing up for EMIR in Europe or is it too early?
Paul Traynor, BNY Mellon: Our regulations are three to six months behind where you are in the US. But we're 12 months behind you in terms of preparedness. I was at a client yesterday up in Edinburgh. They're in the final throes of appointing their clearing brokers, and they're ahead of the curve. We genuinely have clients who haven't even appointed clearing brokers. It could be that people have been focused elsewhere – we've had a sovereign debt crisis and we've had Solvency II to contend with. It could also be that we seem to use fewer derivatives, both on the life and the non-life side, than our equivalents in the US. But it hasn't gone up the agenda in the same way that it's gone up the agenda in the US.

John Norden, Deloitte: Most are way behind the curve of getting an FCM. There are a lot of issues with it as well. First is education. Companies were not really aware that they needed to do this. Companies are finding it is taking four to five months, and not because it's a difficult thing to do but just to get through all the legal documentation. So, there's a big question within the next few months of: are people going to be doing swaps, how will they be doing them if they have to go through an FCM to clear, and what is that all is going to look like? People are starting to see some of the results now.

Michael Loney, Reactions: What are the differences between what you're seeing in Europe and what's happening here in the US?
Steve Penner, Catlin: In terms of compliance with EMIR and all other regimes, our focus always is on being prudent and proactive with regard to what is required. The CFTC and the Dodd-Frank regulations were imposed upon our US trading counterparties and upon us as a category two participant. So we had to drive the process of getting all electronic trading systems, our FCM relationships and our central clearing party relationships prepared and ready to go by July 2013. Otherwise we would not be able to effectively conduct our derivative trading activity with our US counterparties. It wasn't that we were ahead of the game, or being prescient, this was a business need. These relationships took months to get into place. You wouldn't think that it would be that complicated but because of the rush, the volume, the inexperience of so many individuals involved, it was not as straightforward and as easy a process as one might imagine. We began the process in

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February of this year, getting ready for compliance, and to be fully on board with derivatives clearing for July 2013.

Les Smith, Allianz Investment Management: From a US perspective, we haven't really had a lot of involvement in the EMIR process. We are starting to get these questions from our European banks asking where we are at with following the EMIR rules. We're just really at the beginning of figuring out what we are going to need to do to comply with EMIR. Within the next one to two months we'll probably have a pretty good understanding of where the US side needs to be at to comply with the EMIR rules.

Vinny Tucci, ING: I agree a lot with what Les is saying. We just really started taking a hard look at EMIR over the last four to six weeks. We had a hard deadline in Dodd-Frank that we knew we had to meet, and we had to get to that point. EMIR kind of just crept up on us. It was probably happening across the pond, but it's not something that we completely focused on. Now that it hit the US, we see they're imposing specifics in what they call risk mitigation techniques, and it goes across reconciliation, dispute resolution, and compression. ING has implemented what is required to this point. They really don't talk about who you have to report this information to. They put these rules out, but it is not clear as to the 'who's and the 'when's and the 'where's that the information has to be reported. So it wasn't as defined, or at least we weren't as involved with the differences in EMIR versus Dodd-Frank, being a US company, it appears like there's a lot of ad hoc reporting and requests from the regulators, and they seem to be enforcing more on the buy side. EMIR is a blend of both OTC and cleared products, where Dodd-Frank was very specific about the new OTC cleared products and getting ready for the clearing of them. So we're still working to get familiar with the European regulations right now. They are having the same growing pains that the US had with continual changes to their rules, requirements and timelines.

Mike Kobida, CME Group: From a CCP's [central counterparty's] perspective, preparation for the consequences of Dodd-Frank and the gearing up have been completed many, many months ago. We are actively clearing products now, CDS and IRS. The preparation was about how to manage risk, what types of products fit the model, and then it was all about on-boarding – not just the buy side, but the sell side as well – in preparation for the mandates. That's very much behind us now, and the business is up and running. It's now about issues around connecting us to assets, and how that's going to shake out. The market's paying special attention to what the CCPs will do to change their processes to

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Bill Kelly, BNY Mellon collateral management team

be more liberal with types of collateral that's accepted. Those decisions have been made, and they're articulated already. I don't expect big material changes in the evolution of the types of collateral that are accepted.

Bill Kelly, BNY Mellon: Mike hit it on the head when he said once the rules were understood and the actions that needed to be taken were taken. Now we're just really fine-tuning and coming up with what's going to be the more strategic, durable solutions that they may need to put in place, where cash products come in as a substitute, or whatever the case might be. It's been this type of situation for a number of months now.

Vinny Tucci, ING: We conquered all the hard stuff, all the heavy lifting, to set the groundwork for phase 1. Now it's definitely a maturation that has to happen as more products come on line and everybody gets settled in. Because every day, there are still issues that come up, not major problems, but bumps in the road, i.e. somebody forgot a certain way to set something up, or we had a new DCM come on, or we had a new executing broker that wasn't mapped correctly. It's all those kinds of things now – just feeling your way through, having both the industry, and the participants, maturing with the process – that's going to take time.

Les Smith, Allianz Investment Management: We're looking now to optimise the process of how we view collateral and products, and, if we have multiple FCMs, how we optimise our whole process around collateralisation. And making sure we reduce the cost as much as we can to be able to make sure that we're doing the best thing for the insurance company.

Paul Traynor, BNY Mellon: We talked about EMIR and Dodd-Frank. But, of course, the Japanese were ahead of all of us. Have we learned anything from the Japanese experience? They were the first to move forward CCP. I look after our Japanese insurers, and it's as if this move to a CCP and this move to centrally cleared derivatives didn't happen. Our clients haven't had to change their behaviour.

Michael Loney, Reactions: Do CCPs want to have relationships with the clients? From an efficiency standpoint, does it work better to post collateral directly to the CCP than to have it pass through the FCM and then to the CCP?

Mike Kobida, CME Group: At CME we're comfortable with a direct relationship with the end client, with regards to the posting of collateral under a multi-party custody relationship. With regards to collateral, there are many ways to create greater efficiencies, by accepting collateral directly from a buy side client, and putting it into a custody account that effectively comes directly to CME. So we are absolutely open to that. We've been working towards this model from an operational and legal perspective. It's been a big lift for us. The benefits of that, for customers such as you, centre on efficiency. There are ways to optimise collateral movements that really help buy side constituents, especially an allowance of active substitution where you change the assets on deposits very regularly. A multi-party custody relationship direct with the CCP allows for that. To be clear: it doesn't change the customer protection model, at least not in the US. We don't have the individual segregation protection offered that's offered under EMIR. In the US this is all about operational efficiency and optimisation of scarce collateral.

Michael Loney, Reactions: Is there a wide range of differences between large and small firms?

John Norden, Deloitte: Yes, especially overseas. We're seeing a big difference with a lot of foreign institutions, whether they're corporates or banks, getting ready and getting FCMs together. As far as clearing, they are way behind the curve. The big issue for small companies that don't do many swaps is just the cost of carrying an FCM. One of the biggest questions we hear today from our client base is: how do I pick an FCM? Do I need multiple FCMs? What DCOs do I ultimately want to be on? And how is this all going to work with EMIR?

The answer is that you have to figure out what the cost is. The way the CFTC wrote the law was that your client – the insurance company in this case – going to a swap dealer gets to pick where it's cleared. The bank doesn't have a choice of where it's cleared. The bank has to provide that access to wherever they wanted to be clear. So the control is really in the client's hands. A lot of the banks are starting to make sure they can clear on all the DCOs. Some of that's through a self-clearing relationship and some of that is through a relationship through an FCM, or a combination of those. So the biggest question comes down to: what's the cost of carrying an FCM? What's the better deal for me, and do I need multiple FCMs?

Steve Penner, Catlin: I'd like to add that I think with any sort of wide-sweeping regulation, regardless of the intent, there are always unintended consequences. One of these with Dodd-Frank's derivative clearing obligations is that there are very significant fixed costs. There is a fixed cost to carrying each and every FCM you have. A large, a mid or a small-sized firm is going to have to weigh those costs differently, and make their elections and optimise their strategies based on these. What I'm curious about is if there's anyone out there doing any research on how is this affecting the broader macro market for interest rate derivatives, cleared derivatives etc? Is more activity moving towards the bigger players? And was that really the intent of this legislation in the first place? I don't think it's something that's been paid enough attention at the moment.

Paul Traynor, BNY Mellon: I have an observation. Our conversations with our non-life clients would lead me to believe that the smaller non-life players are looking to avoid appointing FCMs and

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staying out of the Dodd-Frank or a more cleared environment. I would pitch that at around about between $7bn and $10bn of gross written premium. Those people have done some cost benefit analysis and they have concluded they'd rather stay out of the cleared environment, and that when they need to hedge they would rather pay the wider spread than go in and take on the cost of the appointing of the clearing brokers and so on. That might change. Is that what the regulators wanted? Maybe one thing that the regulators are getting is those smaller firms doing the hedging, while it may be imperfect, at least it will be on exchange. I would imagine the regulators would say that's broadly a positive thing.

Les Smith, Allianz Investment Management: We are changing investment strategies to accommodate the large pools of collateral that are available for the insurance companies. One of the issues that lower interest rates pose to insurance companies is they move them towards more illiquid securities that are probably not going to be eligible as collateral. You have to factor in how much of those illiquid securities can the company really take on and make sure that they still can meet their collateral commitments going forward.

Michael Loney, Reactions: Are there other non-regulatory differences between Dodd-Frank and EMEA, for example, in the different assets or credit quality mixes across the two books or less use of derivatives by the European arms of the insurers?

Paul Traynor, BNY Mellon: My perception is even the North American arms of European-owned insurers are more comfortable, and have historically been more comfortable, using derivatives to hedge the various risks that they take, and are indeed more comfortable using derivatives for reasons of tactical asset overlay. We here in Europe seem to be less stressed because we're more limited users of derivatives.

Steve Penner, Catlin: When we look at the differences in the treatment of collateral between the US and the EU legal regimes it raises a different analytical problem, especially for me as a lawyer. The US requires segregation of customer margin and treats the customer as the owner of that margin and doesn't use a title transfer system.

It's still yet to be determined what the EU collateral arrangements will be and what the implications may be if they stick to the title transfer regime that we currently see for uncleared derivatives. That's the biggest difference that we are highlighting from the legal perspective.

Les Smith, Allianz Investment Management: I don't think it's that our colleagues in Europe who are less comfortable with derivatives. I would instead say that the insurance products that they sell are not necessarily as complex or require the hedging that maybe our insurance products in the US require. That's how I would see it, as opposed to the other way around, and maybe it's more about the whole risk perspective on the insurance products that we sell in the US versus in Europe.

Michael Loney, Reactions: Is a quad party solution something you are exploring?

Vinny Tucci, ING: It's very new to us. We have not explored or delved into that at great lengths at this point. We know it's an option and it makes some sense, I just don't know if it necessarily makes sense for us at this point.

Les Smith, Allianz Investment Management: We would be very interested in it, just because of the efficiencies that I think it would bring. As long as the counterpart of CCP would allow it, it would be interesting. The CCPs could have 1,000 different relationships with these clients. I don't think they necessarily want that but I think that we're a large enough group that the relationship would work for us and it would make sense.

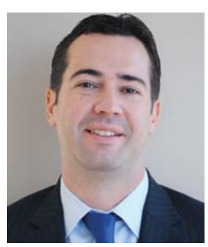
Steve Penner, Catlin: Any solution that offers operational efficiencies is something that we're very interested in. This isn't something that we've explored in detail but would be very open to learn more in working with our partners.

Mike Kobida, CME Group: There are many benefits to this. Operational efficiency by way of automation and direct interaction makes processing deposits, withdrawals and substitutions go faster – all more efficient for the buy side client. The drawbacks are simple – it is something new, a different operational build, and a multiparty legal agreement that customers would have to get comfortable with. The CCPs need certain rights and assurances and must get first priority security interest in the collateral. It's all about the comfort of the operational and legal arrangements.

Michael Loney, Reactions: Are insurers exploring outsourcing their middle and back office, either in total or just the derivative?

Bob Conron, BNY Mellon Asset Servicing: You see all colours. It's not a new phenomenon to necessarily outsource some of these functions, but insurers do appear to be a little more willing today than they have been in the past. So we've seen an uptick in outsourcing. It all depends really on the comfort level of the insurer to outsource, or whether they want to do it themselves. We've seen it all.

Vinny Tucci, ING: Outsourcing is something that every firm explores at some point. It can be cost-effective at times but it does come



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at a price. You still need to have a team that manages or oversees the relationship of your outsourcer. So it really depends on the functions. I think there's a place for it in certain functions. We've definitely explored those options and continue to explore those options. Often what it comes down to is if it makes sense and it can be implemented, it's efficient and it's going to have a cost saving across both the organisation and the client.

Paul Traynor, BNY Mellon: My sense would be, and this is European again, if you're sub about $40bn or $50bn of assets when an asset class becomes tricky to manage, you look at outsourcing more seriously than if you're north of $100bn to $150bn. We've seen people look to outsource the asset class rather than outsource the middle and back office. But it tends to be the smaller asset managers who are looking at that. If you're a large asset manager owned by a large insurer you have to be comfortable with that. You can manage it and you don't want to give up the finesse, the local touch. If you're sub $40bn to $50bn, every time there's a new asset class or every time there's a major change in how you manage an asset class, you revisit the whole outsourcing question.

Michael Loney, Reactions: Are there other demands on insurers' high credit quality portfolios?

Bill Kelly, BNY Mellon: When you look at an insurer's portfolio, the way we need to think of it is all the calls on the collateral or the assets within a portfolio to satisfy all the commitments that that enterprise would have. So that could run to repo in the US, statutory deposits and to reinsurance trusts as examples. So there's any number of calls beyond just derivatives on a portfolio that can place encumbrances on a portfolio. From an efficient collateral management perspective or portfolio management perspective we sometimes use the phrase collateral as an asset or a resource. All of that needs to be baked into the equation to arrive at that efficient horizon for the deployment and use of collateral. So the management of collateral needs to contemplate all commitments on the portfolio not just as it relates to derivatives.

Michael Loney, Reactions: Do insurers consider lending their portfolios to others as part of a transformation trade and do you have a view as to what the yield pickup on a trade like this might be?

Bill Kelly, BNY Mellon: I think we continue to see the securities financing activities as a major contributor to liquidity in the marketplace. Going back to unintended consequences, there's going to be this increased need for liquidity or access to qualifying collateral. We're seeing that demand present itself prospectively for a lot of firms – both on the insurance company side as well as with their FCMs or their dealers – to have it to be available to give to the CME, as an example. We're supporting the sell side so that liquidity in that market needs to be there.

In terms of the transformation trade that is something that both the sell side and the buy side are exploring and have put in place and we're pursuing non-traditional routes. Meaning that could, for example, qualified entities such as insurance companies be approved as a borrower in an agent lending programme not just by a sell side firm, but by a buy side firm as a counterparty in a reverse repo? So I can see the disintermediation as a diversification of sources of liquidity. It's disintermediation of maybe traditional paths but the expansion of the diversification of alternative routes to bring sources and uses from those that have collateral to those that need it.

This works with the programmes that the CME has put in place, that there's not going to be a singular solution, there's going to be multiple pathways to do this. Transformation or collateral exchange, appropriately sized, appropriately margined and risk managed, is something that the marketplace needs and I could see it adapting to different forms over time.

Steve Penner, Catlin: I don't know that we've been heavily involved in that space. Our main concern would be what funds are available to participate in such a programme given different domiciles and different regulators view of these programmes? I don't know if those are boxes that we easily tick off.

Vinny Tucci, ING: It's definitely considered. It's used today in many different forms. I know for ourselves and I'm sure the other insurers on the call, we just have to stay within the rules and the disclosure requirements. It's something that's going to be needed and we're just going to have to get creative with it when we try to fit it into the box

Les Smith, Allianz Investment Management: We're in agreement with that. From a yield perspective we think this is a great place to enhance yield. We haven't done any specifically, but I know our European counterparts have. If you can set it up right, you can probably enhance the yield on your portfolio, depending on the term structure 100 to 150 basis points.

Paul Traynor, BNY Mellon: I have one very last question: is Dodd-Frank and EMIR a good thing or bad thing? From an operational risk perspective, I think it is a good thing. From an operational efficiency perspective, it is probably a bad thing. But in the main thing I'd probably lean toward would be net positive for the insurers.

Vinny Tucci, ING: Risk mitigation is definitely a net positive. Operationally it's challenging just to get it in place. But anything new is always a challenge especially at this level.

Les Smith, Allianz Investment Management: It's probably too early to tell. We are concerned about the longer term effects of what maybe hasn't been thought through yet so that's where there could be some unintended consequences.

John Norden, Deloitte: Probably the biggest thing is that ultimately there will be unintended commercial asset classes of resolution and changes to commercial business and pricing through all this that was not anticipated. We're starting to see mandatory clearing. I think we'll continue to see it with non-cleared products marginally. ●

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