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11/2014 GLOBAL

Collateral Management Survey 2014

The results of the third *Insurance Risk* collateral management survey in conjunction with BNY Mellon show that many insurers still have work to do as they transition to central clearing of OTC derivatives

THE THIRD ANNUAL BNY Mellon/Insurance Risk collateral management survey reveals how insurers are grappling with the challenge of central clearing for over-the-counter derivatives.

The new regime is brought into effect by parts of the Dodd-Frank legislation in the US and by the European Market Infrastructure Regulation (Emir) in Europe, and promises a fundamental readjustment of practice in the area of collateral management. The new regime means that firms will, for most trades, clear through a central counterparty and will have to post both initial and variation margin, with the former being cash or sovereign bonds and the latter cash only.

Companies in the US are already clearing OTC contracts centrally and have been doing so since mid-2013. For European firms, central clearing is expected to become effective in the summer of 2016. Until now, most insurers have been unfamiliar with posting initial margin. Nor do they often post cash-only as variation margin.

Key findings in the survey, which was carried out between July and September this year were:

- a growing number of insurers are posting initial and variation margin on OTC derivatives positions as US Dodd-Frank rules take effect and firms elsewhere follow the trend towards more frequent posting of higher quality collateral;
- the number of firms claiming to understand the implications of the move to central clearing has fallen with Europeans trailing behind their North American counterparts;
- confidence remains low among insurers that they hold enough assets of sufficient quality to meet collateral obligations; and
- more firms this year see opportunities to generate income arising from the OTC derivatives reforms, but a still larger group take the opposite view.

RESPONDENTS

One-hundred and eleven insurers participated in the survey, representing a sample with more than $9.88 trillion of assets, compared with $7.45 trillion last year. Fifty-nine percent of those taking part are active in the life sector, 64% in the non-life sector and 17% in reinsurance. Forty-four per cent of those taking part write business in the Americas and 75% do so in Europe. Forty per cent write business in Asia-Pacific. Most respondents write the majority of their business in Europe, with 14% writing most business in the Americas and 14% doing so in Asia-Pacific.

The sample represents a broad cross-section of insurers by size, with 13% holding more than $500 billion in assets, 36% holding between $25 billion and $500 billion and the remainder of the sample holding $25 billion or less.

BNY MELLON

UPGRADING BOND PORTFOLIOS

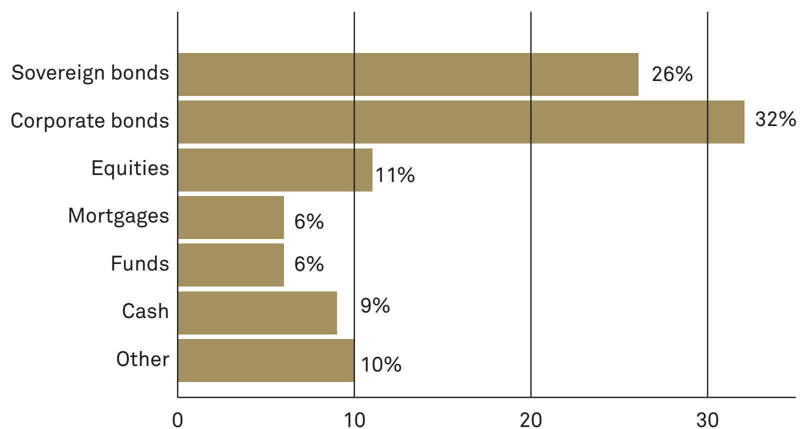
Respondents were first asked about the composition of investment portfolios. The results show little change year-on-year in the balance of portfolios between sovereign and corporate bonds other than a modest increase in the quantity of equities held. Cash holdings remain around the 10% mark, the same as last year, up from 5% in 2012.

However, there is an improvement in the credit quality of respondents' sovereign bond portfolios, with half of sovereign bond holdings at the AAA level (compared with 35% last year).

A similar tendency looks to be emerging in corporate bond portfolios where AAA holdings are up year on year but those of A and BBB bonds are down. Insurers have increased AAA holdings from 8% to 27% compared with figures from 2012, but have cut holdings of single-A corporate bonds from 35% to 23% over the same period. Holdings of unrated corporates increased over the period.

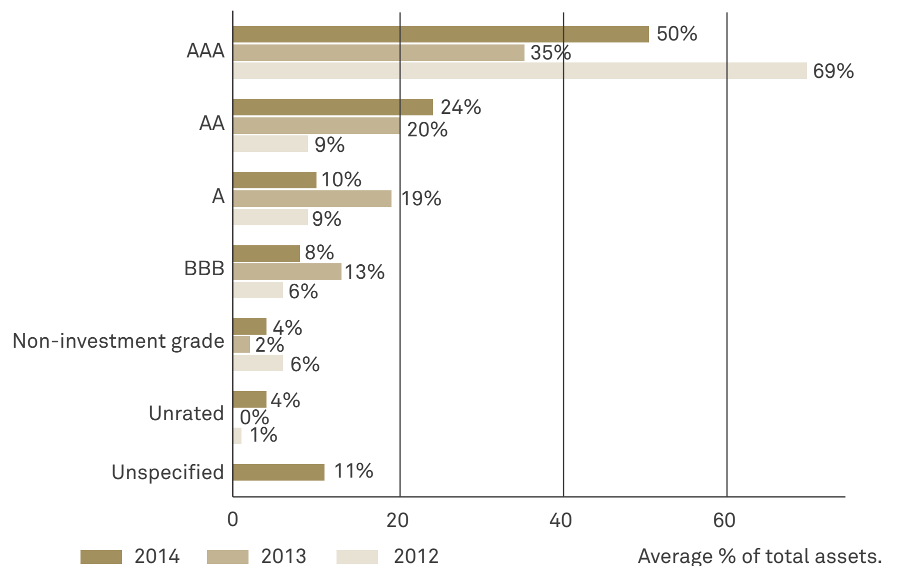
Insurers have increased AAA holdings from 8% to 27% compared with figures from 2012, but have cut holdings of single-A corporate bonds from 35% to 23% over the same period

What is your broad asset allocation?

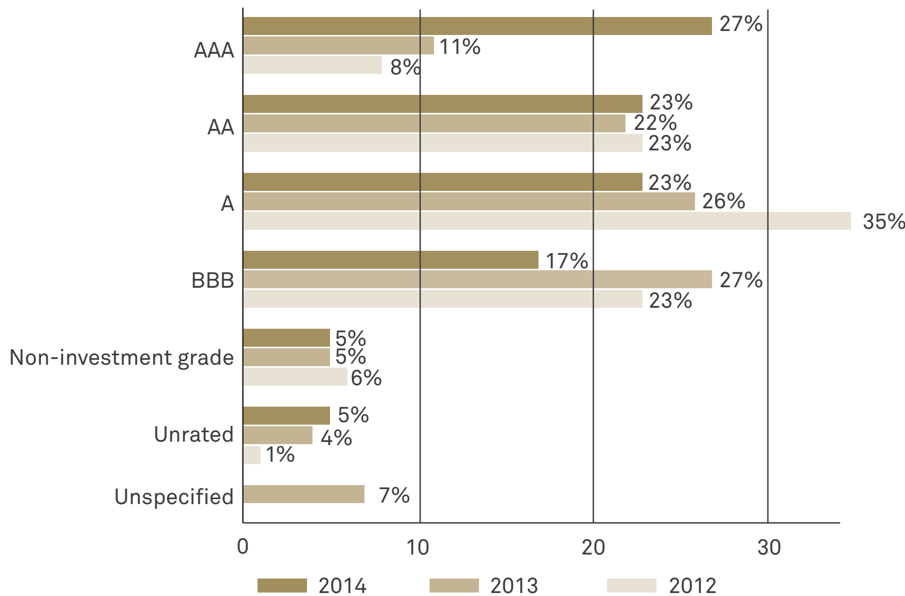


Source for all charts: Insurance Risk/BNY Mellon Collateral Management Survey 2014

What is your sovereign bond asset allocation by rating?



What is your corporate bond asset allocation by rating?



CONFIDENCE ABOUT USE OF DERIVATIVES RETURNING

Asked whether they expect to use derivatives more or less in future, 38.5% of respondents said they expect to use derivatives more. This represents a marked reversal of the trend last year, which saw just 29% taking the same view down from 50% in 2012.

One possible influence on this change might be the imminent arrival of new risk-based capital regimes. For example, at the time of the survey last year Europe's Omnibus II directive was yet to be agreed. In this survey, by contrast, several respondents cited capital treatment as a reason for greater use of derivatives in future. (The risk-free rate curve used to calculate technical provisions under Solvency II is based in part on swap rates, leading some firms to switch to using swap overlays to hedge liabilities.)

The most common use for derivatives by the sample group is to hedge interest rate risk, with 81% saying they use derivatives to do so. Second is currency risk (67%) but with a lower number of respondents using derivatives for this purpose than in past years (76% in 2013). The use of long-dated forward forex has diminished compared with previous years (from 54% in 2012, and 64% in 2013 to 34% this year).

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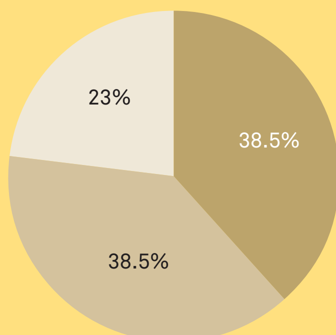
IS YOUR USE OF DERIVATIVES LIKELY TO INCREASE IN THE COMING YEARS?



Yes No Don't Know

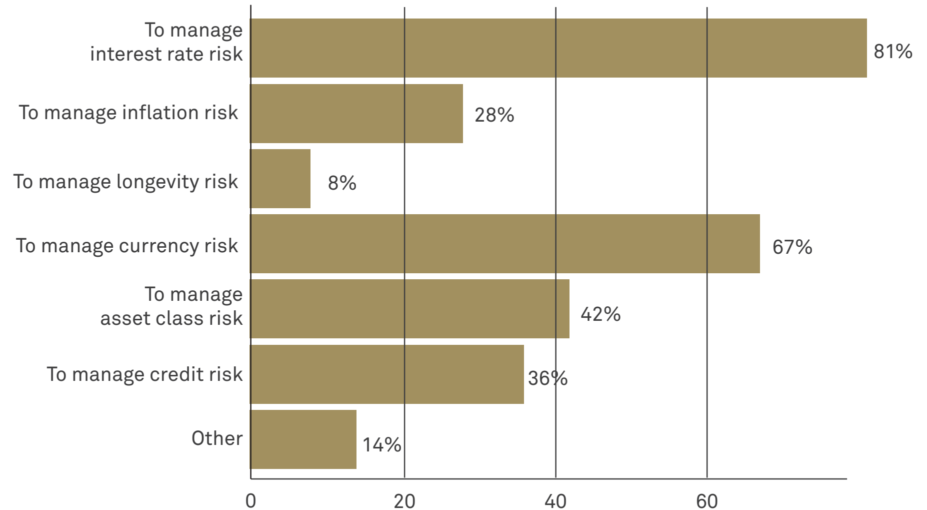
Respondents' comments

"Insurance capital regimes are starting to reward more active risk management in capital calculations."

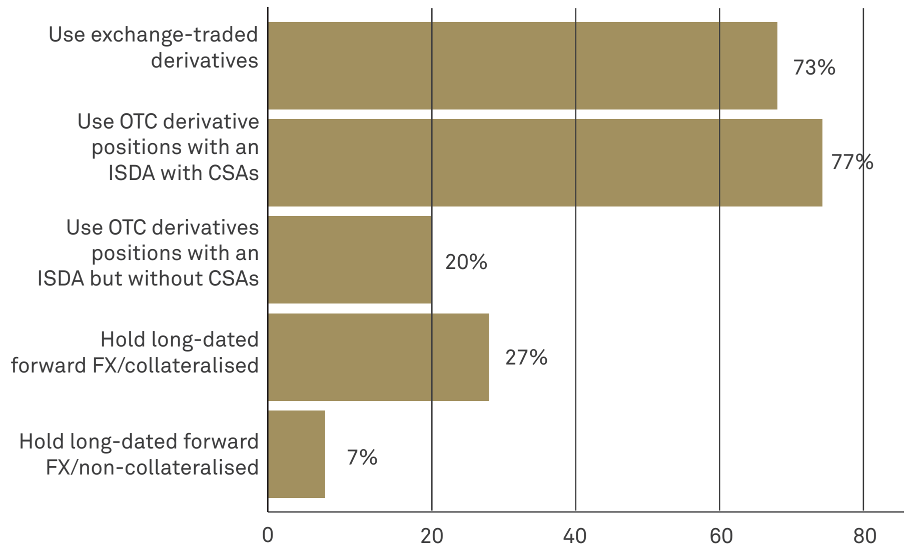
"The collateral cost is too punitive. We plan to use less liquid but better economically-aligned derivatives."

"Collateral requirements are driving asset allocation towards higher-quality, lower-yielding assets. We are looking to diversify into other asset classes and optimizing collateral to reduce income drag."

What do you use derivatives for?



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



TRANSITION TO COLLATERALISED MARKET CONTINUES

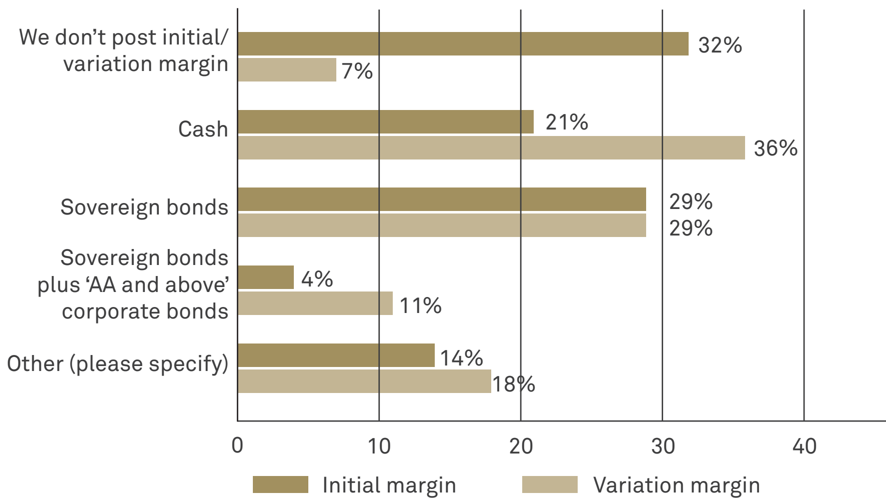
As expected, given the progression towards central clearing and the imposition of Dodd-Frank rules in the US, more respondents than in previous years said they post initial margin. Only 32% said not, compared with 47% and 54% in the previous two years.

There is also a shift in the quality of collateral posted as initial margin. Again this is expected given the requirements of central counterparties, which mostly require sovereign bonds or cash as initial margin.

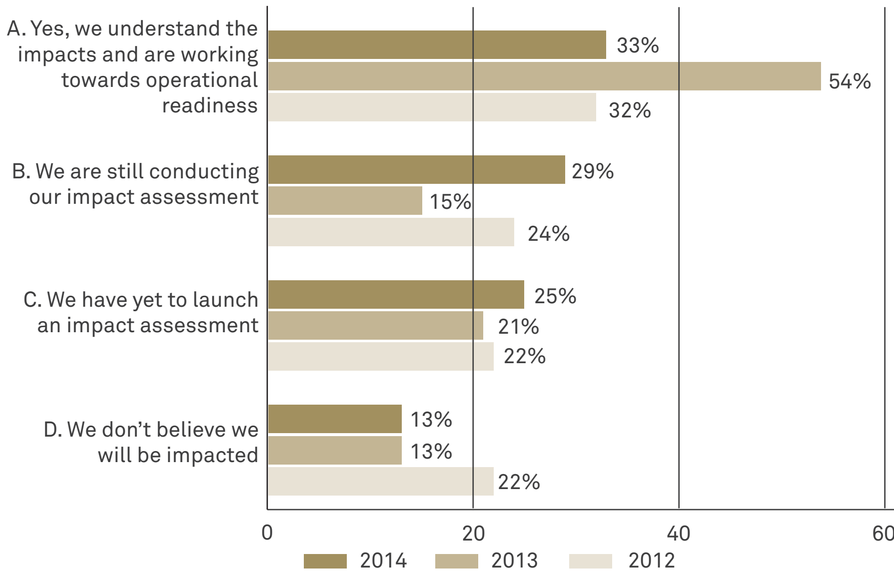
The percentage of respondents saying they typically post cash remained flat at 21%. But in this year's survey, 29% said they post sovereign bonds, compared with only 10% in 2013 and 11% in 2012. A small percentage (4%) of respondents said they continue to post a mix of sovereign and high-quality corporate bonds.

The picture for variation margin is equally clear. Only 7% of those polled said they do not post variation margin, down from 25% two years ago. The most common form of variation margin is cash, as is mainly required by central counterparties, although 40% of those surveyed continue to post sovereign or other highly rated bonds as variation margin. This largely reflects the European part of the sample, where firms are still able to post a wider variety of assets under their credit support annexes (CSAs).

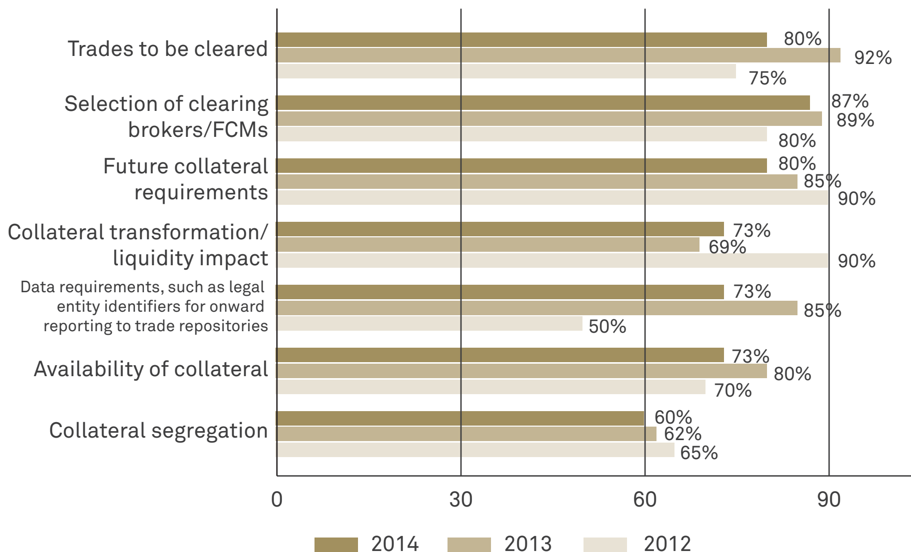
For your OTC derivative positions what do you typically post as initial and variation margin? (Please tick the most common standard)



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)



As might be expected, the implications of central clearing are less well understood in Europe than North America. Only 29% of European respondents said they understood the impact of the move to central clearing and are moving towards operational readiness

SPLIT EMERGING BETWEEN CLEARERS AND NON-CLEARERS

Twenty-five per cent of the sample is already clearing OTC derivatives centrally. Of those firms that are not, most are now decided on how they will respond to the changes taking place.

Only 16% of the 2014 respondents remained unsure whether they would move to central clearing compared with 25% in last year's survey. However, a higher percentage than last year (25% versus 13%) said they would not use central clearing. As firms have worked through the costs implicit in the transition, a meaningful number have determined that cutting their use of derivatives and trading bilaterally is a more cost-effective approach. Of North American respondents to the survey, 17% said they did not expect to use central clearing.

Several respondents to this year's survey spoke of investing in non-traditional assets as a means to earn additional yield and to liability-match without using derivatives. By doing so they are able to reduce their need to post collateral – cutting the so-called collateral drag on their investment returns that is created by holding high-quality assets that are eligible to post as collateral rather than higher yielding investments.

EUROPE BEHIND IN UNDERSTANDING OF IMPLICATIONS

As might be expected, the implications of central clearing are less well understood in Europe than North America. Breaking the overall results down by region, only 29% of European respondents said they understood the impact of the move to central clearing and are moving towards operational readiness. Close to a quarter of European respondents are yet to launch an impact assessment (23%) with a reasonable part of the European group surveyed (18%) saying they do not believe they will be affected by the changes. Results for North American respondents show that 75% of those polled consider themselves fully prepared, with the remainder saying they are still carrying out their impact assessment.

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

REPO CONCERNS GROWING

Meanwhile, confidence about the use of the repo market as a tool in collateral optimisation appears to have fallen markedly. While two years ago 45% of those surveyed said they used the repo market or intended to do so to meet collateral requirements, in the 2014 survey the same measurement has fallen to just 16.6%. Concerns about the availability of repo owing to regulatory pressures on banks to pull back from the market have been widely voiced over the past year, with banks reportedly reducing repo activity already.

COLLATERAL PRESSURES GROWING BUT SLOWLY

The survey gives some evidence of the pressure on firms' collateral to date, with 15% of the full sample saying they comfortably hold enough assets of the requisite quality to meet posting obligations, compared with 25% last year and 41% in 2012. There is a small improvement overall in the percentage saying they hold or comfortably hold enough assets to post after the OTC reforms take effect.

Looking at the results for North American firms versus those of European respondents indicates that the impact of central clearing in North America has been relatively benign thus far. Forty per cent of North American firms polled said they hold enough assets or comfortably hold enough assets to meet their posting obligations. The figure for European insurers is 25% today. Just 8% of Europeans said they expected to meet this standard once the reforms come into play.

OPINION SPLIT OVER OPPORTUNITIES TO GENERATE INCOME

Seventy-nine per cent of those surveyed said they are looking at ways to generate additional income from their investment portfolio. And a higher percentage of respondents than in previous years saw the move to a cleared environment as an opportunity to generate income.

One possibility is that insurers that are rich in cash or high-quality assets might generate income by lending those assets to counterparties who themselves are in need of assets to post as collateral. Forty-two per cent of the full sample said that in principle they see opportunity to generate income in the transition to OTC clearing. This compares with 27% in the previous year. However, 49% of those polled took the opposite view.

There is a difference here between North American and European respondents. In North America only 29% of those polled were positive about the opportunities presented, while 57% said they saw none. For Europe the optimists combined made up 39% of respondents, with the pessimists accounting for a lower figure of 50%.

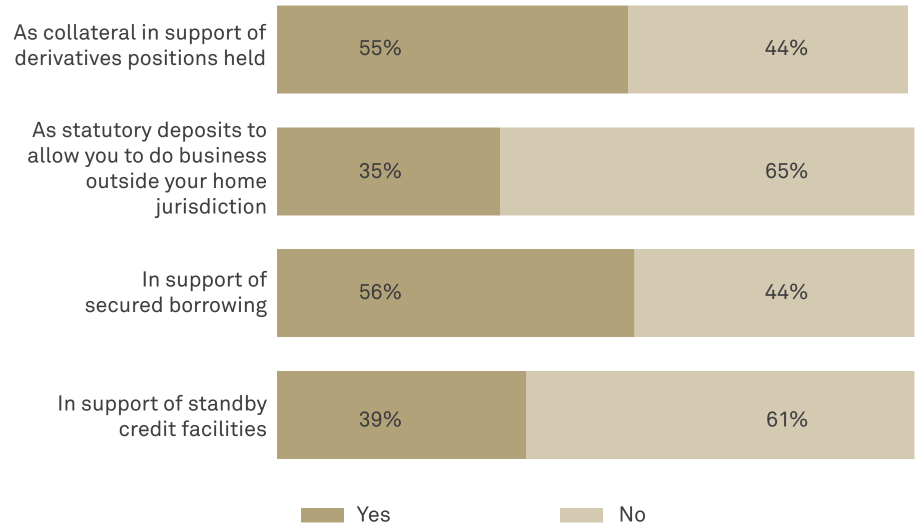
REPO THE MAIN FOCUS FOR INCOME OPPORTUNITIES

Investigation by firms of how they might generate additional return in a centrally cleared environment seems to have focused so far on the most obvious areas for potential "quick wins" – repo and securities lending – before they consider more complex options such as liquidity swaps. With regard to the relative attractiveness of the various options, again securities lending and repo seem to be key areas of focus, although a high percentage of respondents (67%) said liquidity swaps also presented an attractive opportunity.

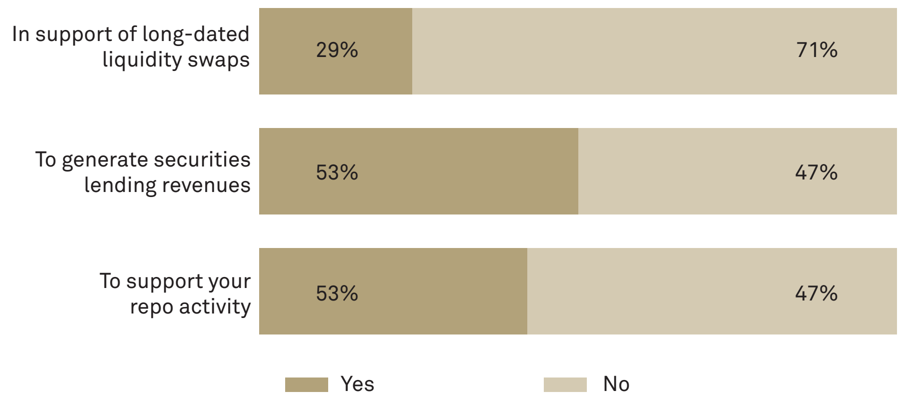
The possibility of insurers engaging with banks in two-way liquidity facilities has been the subject of discussion recently, so one possibility is that insurers see this as an exciting possibility but are less advanced in their understanding of how to approach it.

As firms have worked through the costs implicit in the transition, a meaningful number have determined that cutting their use of derivatives is a more cost-effective approach

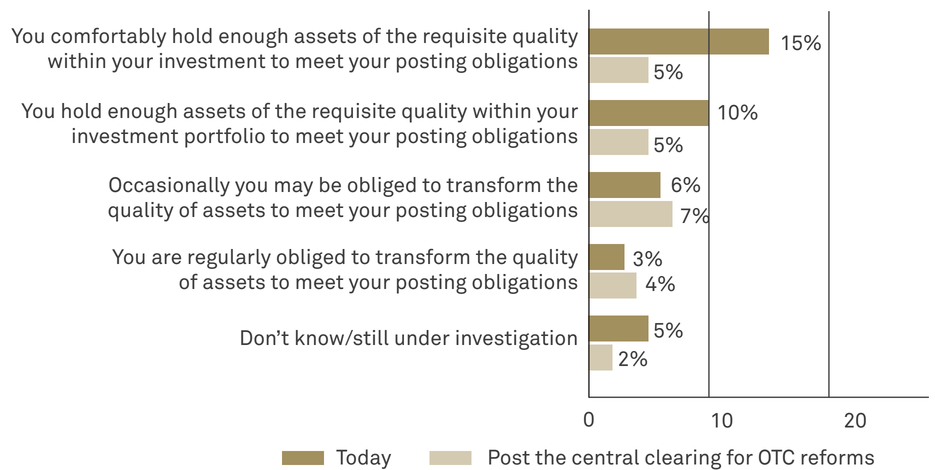
Do you pledge your investment portfolio today, for any of the following reasons?



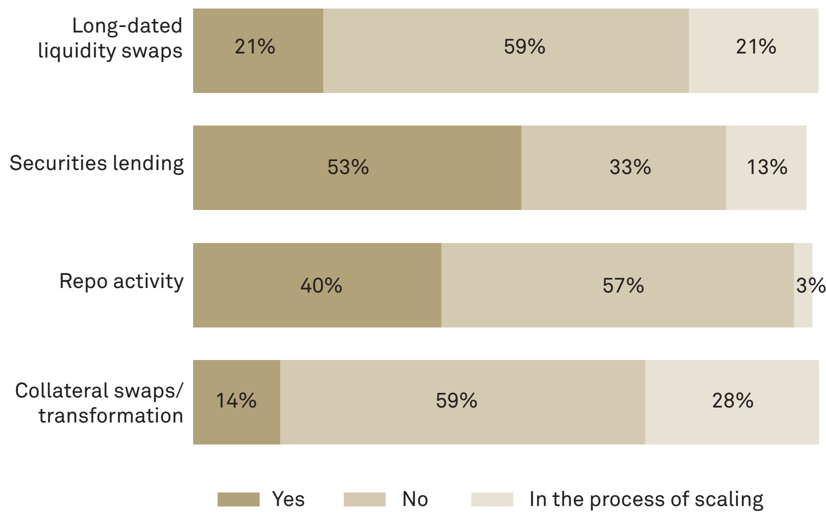
Do you use your investment portfolio today for any of the following reasons?



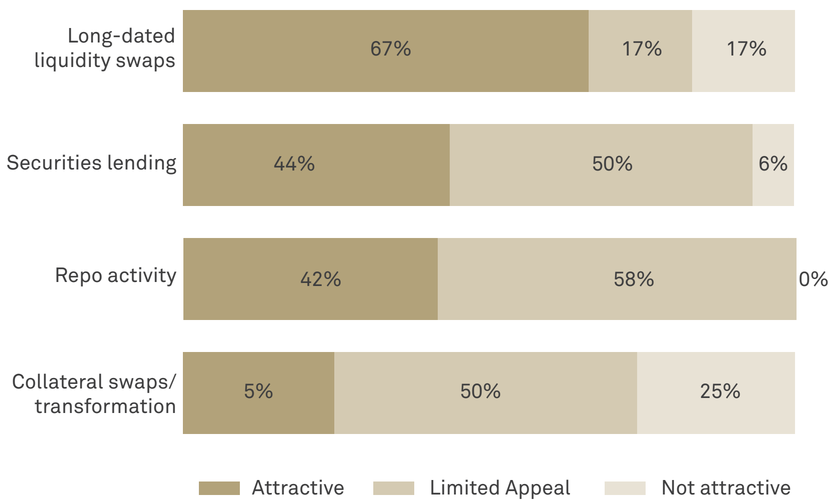
As it relates to your derivatives collateral margining requirements and other pledges would you say:



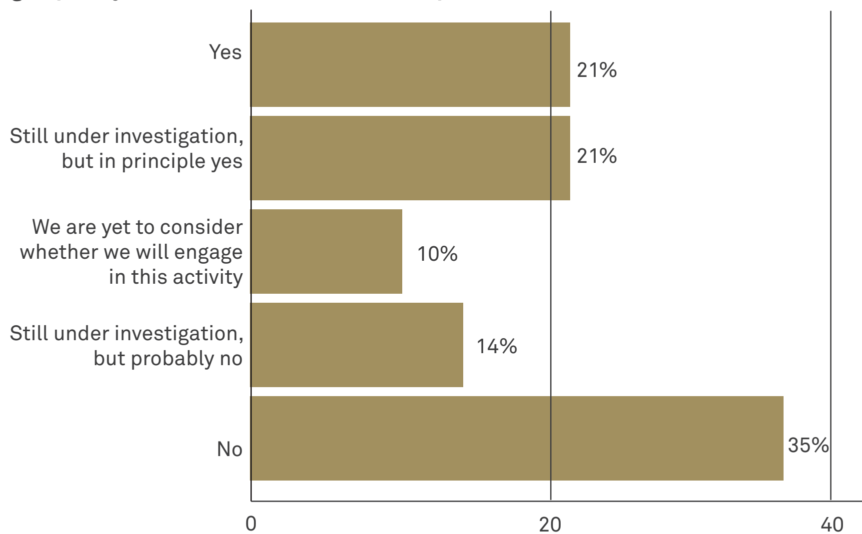
Have you assessed the potential scale of additional income you may be able to generate from any of the following?



If yes, how would you scale the opportunity?



Have you seen or 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?



COMMENT: PAUL TRAYNOR, HEAD OF INSURANCE, INTERNATIONAL SEGMENT, BNY MELLON

At the meeting of G-20 leaders in Pittsburgh during September 2009 an accord was reached. Their stated aim: "Improving over-the-counter derivatives markets: all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest. OTC derivative contracts should be reported to trade repositories. Non-centrally cleared contracts should be subject to higher capital requirements. We ask the FSB and its relevant members to assess implementation regularly and whether it is sufficient to improve transparency in the derivatives markets, mitigate systemic risk and protect against market abuse."

This is our third annual survey in partnership with Insurance Risk to survey the industry's preparedness for new derivatives regulation. Overall, and consistent with last year's results, the survey seems to be telling us that the industry is getting to grips with the impact of regulatory changes, and the threats and opportunities inherent therein. However, the more you know, the more you realise you need to learn.

To date we have seen the implementation of increased capital requirements on sell-side banks (in Europe this is covered under the Capital Requirements Directive IV). While this does not at first glance appear to impact insurance companies, they will be paying the cost of these capital requirements in the prices quoted by their counterparties – via the so-called credit valuation adjustment (CVA). This is, to some extent, negated when derivatives are centrally cleared as the capital requirement falls in this scenario. In the US, mandatory central clearing for certain products was phased in during the first nine months of 2013. However, in Europe, mandatory clearing has been postponed and the dates are still not finalised. Progress has been made: a key milestone was reached in March 2014 when the first CCP or clearing house was authorised under Emir. Further, the first set of Regulatory Technical Standards on the clearing obligation is currently awaiting endorsement by the European Commission. Once those are endorsed, Category 1 participants (comprising sell-side institutions that are clearing members active in the relevant markets) will have six months before clearing is mandated (expected to be summer 2015). Most buy-side institutions – including insurance companies – will have 18 months from the coming into force of the relevant technical standards before clearing is mandated (expected to be summer 2016).

There have been some risk mitigation measures imposed on all counterparties to OTC derivative participants by Emir. These include requirements for daily valuation of all derivative contracts, timely confirmation, portfolio reconciliation and dispute management procedures. Similarly, steps towards achieving transparency have been achieved through mandatory reporting under Emir. The first Trade Repositories were registered in November 2013. Mandatory reporting itself began in February 2014, with the reporting of valuations and collateral data beginning in August 2014.

The other key point for the future is mandatory margining of non-cleared derivatives. This begins on December 1, 2015 for counterparties with more than €3 trillion in open notional. Over time, this threshold will reduce, thus capturing an ever-increasing number of participants.

Not surprisingly then, the survey this year more starkly points to regional differences, driven by asset allocation choices, the extent of derivatives usage and the differing timelines of Emir and Dodd-Frank. The North American respondents' confidence in their ability to operate in this new environment has risen as they have conquered the detail and operationalised facilitating processes such as collateral optimisation. The Europeans, who were originally less troubled by the proposals, given their (historically) more limited use of derivatives and their large holdings of sovereign bonds, conversely have grown more nervous as they have progressed through their impact assessments.

Overall, the results point to a fall in the percentage of firms that claim to understand the impacts of central clearing, from 54% down to 33%. We believe that this is in fact pointing to an increasing awareness of the regulatory impact, which in turn is eroding confidence in companies' preparedness. It is most stark in Europe, with only 29% claiming to understand the implications versus 75% in North America.

In 2013, 47% of insurers stated that they did not post initial margin on OTC derivatives; that number has now fallen to 32%. It is even more pronounced when looking only at North American respondents, at 29%. This is clearly pointing to a growing awareness of the risk-mitigation benefits of collateral as well as the impact of Dodd-Frank in the US. Indeed, while one in five European insurers claims to use OTC derivatives with an ISDA but without CSAs, that falls to 0% in North America. Equally, the number of respondents not posting variation margin has almost halved from 13% last year to 7%, again this is most pronounced in North America where all respondents now post variation margin versus their European counterparts where just over one in 10 (11%) still does not post variation margin.

Confidence that insurers will hold enough assets of the requisite quality within investment portfolios to meet collateral posting obligations remains low albeit there has been a slight improvement over the prior year. In 2013, only 7% of insurers felt they held or comfortably held enough assets of the requisite quality to post as collateral post the OTC reforms; that has now risen slightly to 10%. We believe there are two factors at play here, impacting in opposite directions in this improvement. Firstly we believe European insurers remain cautious while they await greater clarity, this is negatively affecting confidence. And secondly, we believe North American insurers' confidence has risen as they have concluded their impact assessments, with 40%

claiming they hold enough assets of the requisite quality within their investment portfolios to meet today's collateral posting obligations.

Forty-two per cent of those surveyed believe that the move to a cleared environment might provide an opportunity to generate additional income by making their high-quality bonds available to others to post as collateral, up from 27% in the prior year. The increase year-on-year is likely driven by more thorough analysis and by insurers searching ever harder for yield in this low-return environment.

The Europeans are more optimistic at 39% versus the North Americans at 29%. This may reflect the greater proportion of sovereign debt in the European respondents' portfolios at 29% versus the North Americans' 17%.

There is a drop in the numbers that would expect to engage in collateral optimisation post-central clearing. At first glance, that seems counterintuitive; it is explained by the number of North American firms that have moved from considering various forms of collateral optimisation techniques to actually having put them into practice.

Twenty per cent have invested in technology to allow use of "cost of opportunity revenue lost" as a proxy for "most efficient collateral". One in five North American firms has integrated their collateral management and margining processes across instruments within and across legal entities. Use of securities loans to facilitate cash releases stands at 13% and a similar number are cross-netting across listed and OTC contracts. Use of the repo market has grown to 20% of all North American insurers.

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