FOCUS ON INSURANCE COMPANIES

USING YOUR GLOBAL MARKETS COUNTERPARTIES TO HELP OPTIMISE YOUR RISK PROFILE

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Introducing BNY Mellon's Insurance Industry Roundtable Series

A panel of our insurance industry experts offer their insights on the evolving European insurance industry This newsletter provides an overview of the transcript derived from one in a series of Insurance Industry Roundtable discussions in which our executive team and industry and product experts explore key trends and issues facing our insurance industry clients.

Our Insurance Industry Roundtable series considers the challenges facing Insurers in EMEA and how by accessing BNY Mellon's comprehensive Investment Management and Investment Services solutions we can help them achieve their business objectives. Other topics include:

- Seeking alpha on Insurers' efficient investment frontier
- Cash investments in a turbulent world
- Managing your securities financing & derivatives collateral for optimum result
- Transparency: gaining an understanding of your market and counterparty risk exposures
- The hidden value of specialists - transition and beta management for Insurers

OLIVER MARTINES: How are your Insurance clients reacting to the current environment of low interest rates, the euro crisis and the general wave of proposed regulation?

MICK MURPHY: Our European Insurance clients are generally cautious investors, and have been focused on risk management and mitigation of risk over the last 3-4 years. The issues they face - low rates, the Euro crisis and regulation – are putting significant pressures on the resources of an Insurance company. That said, they have weathered the storm well. European Insurers hold European Sovereign debt, a lot of attention is being given to this asset class.

STEVE LAWLER: US Insurers are focused on the Dodd-Frank Act and it's pending rules expected to be finalized in July 2012. Insurance clients are analyzing the potential regulatory impact will have on their derivatives activity. Derivatives use by Insurance companies in the US has been somewhat stagnant as this industry looks to position themselves versus other global financial institutions as well.

OLIVER: Steve, Insurers are buying protection against equity indices and interest rates to hedge their assets and liabilities. Why is that?

STEVE: US Insurers are conscious that low rates and the euro crisis have contributed to their lack of investment returns over the past few years. Insurers typically write policies with embedded minimum returns on an equity index or interest rate, therefore it's critical for Insurance companies to hedge with derivatives these asset benchmarks.

For example, Insurers can buy equity puts on the S&P that pays a return if the index depreciates. Likewise, Insurers enter into interest rate derivative options to protect against yields rising.

MICK: Insurers have had the same issue across Europe. Some products carry a fixed rate of return, the hurdle rates are becoming harder to achieve in this investment environment. We're being approached a number of clients to see how they can overcome some of those challenges.

OLIVER: Given the size of the Insurance sector and the role it plays within the financial markets, will Solvency II impact the capital markets?

MICK: Regulation and Solvency II will have a significant impact on the capital markets over the coming years. Incompatible regulation is complicating the way firms behave, the way banks fund themselves and the way Insurers invest. But Solvehncy II transitional measures may lessen that impact over time.

OLIVER: What impact do you think Solvency II will have on asset allocation?

MICK: Insurers' asset allocation strategies will be driven by the level of capital the business holds. If they sufficient capital, they may face less pressure. Insurers with a tight capital base may well have to change the way they invest their assets.

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OLIVER: In your opinion, which asset classes look favourable under Solvency II?

IAN: In my opinion, high grade, shorter-dated bonds will be attractive under Solvency II, as will be secured transactions financing rates for high quality issuers. Issuers may be disadvantaged if they continue to issue longer-dated bonds. The changes are likely to have a large impact on the structured finance market, The uncertainty is already contributing to reduced primary issuance.

STEVE: The structured market has also been paralysed by increased regulatory requirements. We have seen a movement towards the use of listed or exchangedtraded derivatives, on occasions in an OTC format. I recently spoke with an Insurer who moved out of OTCs and into a more dynamic futures programme to improve price execution and efficiency.

MICK: Solvency II rules have yet to be finalised and the final text may not treat longer-dated corporate bonds as harshly as they are proposed in QIS5.

OLIVER: Have clients expressed any priorities or challenges to tackle this year?

STEVE: Insurance clients are placing a particular emphasis on generating appropriate risk-adjusted returns, therefore they realize their economic capital models must be refined in order to achieve these desired outcomes. Currently, they are contemplating whether to build the necessary framework internally or acquire the expertise external

MICK: A number of Insurers are also concerned about the evolving situation in Europe. Over recent years, regulation has made holding government bonds a prerequisite for large institutions. In this very challenging environment, coupled with low rates and preparation for Solvency II – there is a lot of work to be done by each Insurer.

OLIVER: Are Insurers exploring derivatives usage for duration matching in risk management?

IAN: Insurers have been using derivatives for a long time, however the types of derivative instruments they use, and their volume, may change. For example Insurers may be more interested in longer duration swaps to offset a decrease in duration from their bond portfolio.

STEVE: Insurers structure their liability policies based on the access, efficiency and pricing of a derivatives contract. However, Dodd-Frank and the European Market Infrastructure Regulation reforms are forcing the industry to take a wait and see posture until these regulations are implemented. Once the rules are made certain, we will notice an increase in off-balance sheet hedging. The securitised origination market has been paralyzed primarily by additional regulatory and accounting requirements. We have witnessed a movement towards listed or exchange-traded derivatives as an alternative to the over-the-counter format. Insurers perceive that price execution and efficiency is better served with listed futures and options in the current market environment.

OLIVER: Is counterparty risk being discussed by the Insurance community?

MICK: A number of banks have hit triggers at which Insurers no longer feel comfortable doing counterparty business, even if the volume of business is limited. We've seen increased due diligence by Insurers on their counterparties to ensure they understand their risk exposure.

IAN: Even if you have a credit support annex to reduce credit riskthere are still risks. For example replacing large volumes of trades takes time, especially if you don't have many counterparties to choose from.

OLIVER: Is the role of collateral as a risk mitigator being considered?

IAN: There is no doubt that there will be pressure on collateral. Demand for high quality collateral is increasing whist it's supply decreasesing. The pricing environment for derivatives, be it on or off exchange or OTC, is likely to vary depending upon where it is cleared.

OLIVER: Clients are reviewing currency mismatches, in a bid to reduce capital costs. As a principal FX counterparty within the wholesale market, we help clients to manage these mismatches. But can currency hedging generate alpha?

MICK: Insurers will look for diversification, uncorrelated returns and risk-adjusted return on capital. There may be a place in an asset allocation strategy for some currency exposure so they have been focused on Solvency II QIS5 rules and how they might optimise capital positions. The Solvency II QIS5 study suggests currency accounts for 10% of the market risk component.

STEVE: If hedging becomes short-term, currency will be more prevalent as an alpha-generating asset class. In my opinion, if volatility presents itself on a daily basis to the currency market, the treasurer or book manager will have to consider a disciplined hedging approach to the currency exposure.

OLIVER: Do you think Insurers will apply general hedging or short-term investment strategies to their asset and risk management strategies?

MICK: Anecdotal evidence suggests Insurers will reduce the duration of their corporate and sovereign debt bond holdings and increase hedging. When you take on a hedging strategy, you have to consider how it impacts your counterparty risk management.

IAN: We will see greater focus on risk-adjusted returns and the capital. Any asset that turns itself into a capital-efficient asset will be attractive. We've seen a lot of interest in extending loans or trading repos that hold collateral against as a capitalefficient use of the balance sheet.

OLIVER: Regulations are in transit but Insurers have to work out how they manage transactions in 6-9 months? So what can you do to help your clients?

STEVE: Insurance companies are preparing themselves for a cleared derivatives environment, and BNY Mellon is ideally positioned to offer the required infrastructure to assist clients in the future. These services range from acting as a clearing member for financial futures and interest rate derivatives to being a counterparty for derivatives that are executed on a bilateral basis, and offering post trade functionality such as collateral management to ensure compliance under margin rules.

MICK: We continually discuss with our clients their changing needs, including as the regulatory environment changes. We are highly-rated counterparty and consequently are appealing to the Insurance Industry. We are also acting as collateral manager for a number of Insurance clients.

05/2013

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