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BNY MELLON
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
- The hidden value of specialists - Transition & Beta Management for Insurers
- Transparency: gaining an understanding of your market and counterparty risk exposures
- Using your Global Markets Counterparty to manage risk

TOM CASTELEYN: Mark and Ian, thank you very much for joining me today to discuss the changing collateral management and securities financing landscape and its implications for the Insurance Industry. From your recent experience and observations, what challenges do you think your insurance clients face?

MARK HIGGINS: At a macro level, Insurers are struggling with the low rate environment we are all experiencing. They are looking at new ways to increase the return from their existing portfolio of assets. Historically, only the most sophisticated Insurers have been my direct clients as only a handful were big users of derivatives.

IAN GASS: Yes, we’ve seen growth both in liquidity swap transactions and greater use of the repo trade by Insurers.

MARK: And, our colleagues are seeing a modest pick-up in stock lending. Looking to the future I suspect the Insurers will change significantly their approach to collateral management and securities financing, for two broad reasons, rather than a) the changing marketplace and opportunities that it is bringing and rather than b) regulation, both broad regulation such as the Dodd Frank Act and the European Market Infrastructure Regulation (EMIR) and industry specific regulation, particularly Solvency II here in Europe.

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MARK: This increased use of derivatives is coming at a time when the derivatives marketplace is undergoing massive change with the introduction of clearing for the more vanilla OTC trades.

IAN: Outside of the Insurance Industry there is very limited understanding of what Solvency II is. The perception is there are more important issues happening sooner. Equally, the Insurers have yet to turn their attention to EMIR.

TOM: Well, let’s start with the changing regulation.

IAN: Conventional wisdom is that Solvency II will likely drive the Industry to shorten the duration of its portfolios of physical bond holdings and to close off the resulting maturity mismatch with derivatives. That will drive up the use of derivatives by Insurers and as Mark mentioned, Insurers have historically not been big users of derivatives.

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TOM: And the Marketplace?

MARK: We’ve already touched upon it: the growth in Liquidity Swaps and the Repo Trades are symptomatic of the new marketplace. Everything is now being done against collateral.

IAN: The low rate environment is changing the economics. For example, longer-term repo trades and liquidity swaps work as the banks raise long-term funding at a reasonable cost, and the Insurer gets a pick-up on low-risk assets on their books.

MARK: We’re seeing demand for tri-party infrastructure business support as well. There is more confidence in risk and the controls around that risk. The vanilla stock lending market is back on
track and we have seen an uptake in the posting of securities as collateral. If you hold cash against your equities portfolio, you’ve got to make a return, whereas a security posted as collateral gives comfort because a custodian holds it and you don’t have to pay a return.

IAN: Yes, cash is becoming the most expensive form of collateral because it’s the purest. Banking regulation is also hitting, making cash more expensive. Your return on cash is virtually zero. So where there was previously low return for an overnight trade, now it is a virtually zero trade for a 1-mth and sometimes for a 1-yr trade. It doesn’t yield anything. That collateral is very expensive and getting the return is really hard.

MARK: Post Solvency II and EMIR there will be an even greater demand for collateral. The OTC Clearing houses will demand high quality collateral. Given the composition of the typical Insurer’s portfolio, there should be opportunities for the Insurers to further sweat their assets.

IAN: At the larger Insurers it is likely that the Securities Financing Desks will have to evolve, they will be required to evaluate returns generated against capital usage or efficiency. Examples might include whether to engage in plain vanilla stock lending or longer term liquidity swaps; or whether to clear OTC derivatives through clearing house X or Y based on the differing collateral requirements of the clearing houses and other netting opportunities.

TOM: So, what might it mean for an Insurer operationally?

IAN: Insurers will have to cope with derivatives which are exchange traded, cleared OTC, uncleared OTC and with long-dated liquidity swaps. All are likely to require collateral to be posted, sometimes 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 required mark-to-market valuations that will be required in the future.

MARK: The issue for Insurers too is that certain OTC cleared trades will be mandated to be ‘in’ and must go through central clearing, while some will be considered to be ‘out’. It’s a bit of a ‘hokey cokey’ dance to work out what’s ‘in’ or ‘out’ of OTC derivatives central clearing. If it’s an insurance-based fund, and it’s defined as ‘in’, then any derivative must be centrally cleared. Pension funds currently have a 3-yr ‘out’ under Dodd-Frank, but they may operate as ‘in’ anyway because if they stay ‘out’ they may have to pay a higher price on the trade.

Regardless of whether a derivatives trade is cleared or not, the rules will require collateral to be posted, meaning you can’t have a derivative transaction that is uncollateralised. You must mark-to-market daily, carry out independent checks and an initial margin must be priced as though the trade goes into clearing. Both parties to the trade will need to post margin to cover the variation margin and an element of initial margin.

TOM: What are the challenges in gaining the required transparency on instruments such as multi-year repo trades?

IAN: It depends on the collateral. It’s not difficult to get transparency but not all transparency is the same and some collateral is more difficult to price than others.

MARK: What drives the amount of collateral we hold is a combination of two things: 1) clients, on whose behalf we take collateral, take into account the volatility and transparency of the asset and how frequently it will be priced; and 2) they want to hold enough collateral to reduce the Solvency II capital charge on the trade, the more the trade is over-collateralised, the more likely it is the capital charge will come close to being negligible on the trade. Insurers will have to think about the operational aspects of holding collateral: how they value it, what is the right haircut, what is the initial amount, with what is the best legal structure around this, etc., all of those things have yet to be fleshed out for insurance companies.

TOM: Will Insurers be ready to meet the changing marketplace?

IAN: There’s a lot to learn. The longer they leave it, the less time they will have to go through the same learning curve as everyone else.

MARK: You’ve also got to look through to see what the underlying products are under Solvency II. The average Insurer doesn’t have a book of a thousand interest rate swaps, he has a book of structured transactions and instruments that are not suitable for clearing, but that is likely to change going forward.
TOM: What are the key issues you now face in collateral management business?

MARK: Ten deals walk through the door and not one of them is the same, whether they’ve got a split pledge, full pledge or illiquid assets.

IAN: There is jurisdictional risk to contend with too, and changes needed in operations. There are so many complications. It’s not just who the counterparties are, what the collateral is and where it is posted but there could be more than one agreement to do a specific trade under. They will also have to consider where the collateral is; can they get access to it and what are the restrictions around it? What collateral you use and where will be tougher to track as more collateral players enter the system. Over time, I would expect you would have to start pricing based on collateral filtering efficiency.

MARK: Third parties can help. If you go down the central clearing route, you’ve added another layer. You’ve got the Insurer, the asset manager, the clearing broker and the clearing house. Even if you have a trade which is suitable for clearing, perhaps just six interest rate swaps for example, there has to be economies of scale (even with the vanilla business) for those taking the trade. A third party, such as an asset manager, could use his relationship with the clearing broker to gain economies of scale as this would have a bearing on the price of the trade.

TOM: What can BNY Mellon do to support clients’ collateral management needs?

IAN: A large part of our business at BNY Mellon is securities servicing, wherever it sits within the firm. Whatever the asset class, we can service them all. If you layer on the breadth of the securities we cover and the reach of the jurisdictions we cover, we will be in a position to help. We have a trading business to deploy the capital and we have a division to trade derivatives. There are lot of components to help the client, depending on their solution needs.

MARK: We can offer support at multiple levels to an Insurer. We can keep safe, value, monitor & move collateral. We can manage an Insurer’s ISDA agreements as currently defined (typically a bilateral process) and we will support clients post EMIR and Dodd Frank in the brave new multi-party world of cleared OTC derivative trading and related collateral management. Appointing a single collateral manager who works with the Securities Financing Team across all of an Insurer’s asset managers will likely increase the efficiency of the collateral process, for example through better exploiting netting opportunities. And of course we can support an Insurer’s tri-party repo trades. We can also act as trustee or intermediary on bespoke longer dated collateralised transactions, transactions which may include esoteric assets and multiple legal jurisdictions. We have a lot of tools in our toolbox and there could be a 5 or 6 options but I’m confident that through working with our clients we’ll pick the right tools to get the job done.