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 document 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:

- Cash Investments in a Turbulent World
- Investing in Illiquids: Challenges for Insurance Firms
- Managing Your Securities Financing & Derivatives Collateral for Optimum Results
- Seeking Alpha on Insurers' Efficient Investment Frontier
- T2S: Opportunities for Insurers arising from Europe's New Post-Trade Landscape
- Transparency: the Data Management Challenge Facing Insurers

KATE ANDERSON: We're in a fast-changing and challenging environment, where regulatory reform and macro-economic fundamentals are resulting in liquidity concerns, capital constraints and many adjustments to existing process and documentation. Bearing in mind this context, what are the major drivers of insurers' risk management and mitigation priorities?

RICHARD GILL: In the first instance, I think we need to understand the changes to the market in general, before focusing on the impact on insurers in isolation. The rapidly changing regulatory landscape has been the catalyst for a lot of liquidity issues across multiple markets over the past 12-18 months. In addition, increased volatility and electronification have caused liquidity fragmentation. As a result, markets don't have as much depth as previously. We see this in the FX markets and beyond.

OLIVER MARTINES: In European fixed income markets, we've certainly seen the impact of quantitative easing on liquidity. And as Richard points out, the regulatory environment has caused pockets of illiquidity in certain currencies.

RICHARD: It's not just in certain currencies, but in certain regions. One of the bi-products of Dodd-Frank Act's Volcker Rule, which came into force in July this year, is that many international institutions were very wary of dealing with branches of US legal entities, due to concerns that they might unwittingly 'touch' mainland US. That caused a number of liquidity problems of its own, but solutions were found and overall that problem has been worked through.

OLIVER: The larger institutions had invested the necessary resources and were well prepared, but the mid- to small-tier firms weren't. Similarly, as the deadline approached for delegated reporting of derivatives transactions under the European Market Infrastructure Regulation (EMIR), there was a rush to service providers to finalise the necessary paperwork. One lesson from that experience is to prepare well ahead of any regulatory reporting deadline, because the sheer workload can cause capacity issues, even at large institutions.

KATE: What further reporting and documentation issues are on the horizon?

ROSS WHITEHILL: As well as EMIR and tax reporting changes due early 2016, the best execution requirements under the revised Markets in Financial Instruments Directive (MiFID II / MiFIR) could be a major burden for insurers. Firms will need to provide evidence on why a particular trade was executed on a particular trading venue, for example. At this stage, the details of the reporting requirements are unclear, but even the larger groups are struggling with it.

OLIVER: One complicating factor is that jurisdictions are introducing new regulatory requirements at different times. As well as Europe and the US bringing in new rules at different speeds, Asia-Pacific jurisdictions such as Japan, Australia and Hong Kong also have their own timetables. This means global groups have to fragment their compliance efforts, supporting different regulatory requirements in different markets.

ROSS: In terms of MiFID II / MiFIR reporting, clients are beginning to seek help with their upcoming requirements. But they are not presenting detailed needs yet, largely because the European

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Securities and Markets Authority only released regulatory technical standards in September 2015, and there are still further clarifications to come. Similarly, clients are beginning to look to sell-side counterparts to offer solutions to requirements under the Securities Financing Transaction Regulation.

RICHARD: For the moment, delegated reporting services are being provided to buy-side clients without charge, but there may come a time when that service attracts a fee, as the number of different reporting requirements increases across multiple jurisdictions. The increased regulatory focus on transparency of service provision may also drive change.

KATE: From an FX perspective, what changes are we seeing in terms of client demand?

OLIVER: We're seeing a continuing desire from insurers to hedge out unrewarded currency risk. In terms of passive hedging, we absolutely see our insurance clients engaging in passive FX strategies for their retail funds. Some of them are also talking to us about also doing that on their own portfolios, but many are already benefitting from our passive currency hedging services for the institutional share classes of their retail funds.

Hedging periods have remained relatively consistent, typically quarterly, sometimes six months, with perhaps less demand around the one-year mark. Due to the uncertain interest-rate environment, many clients don't want to lock themselves in for too long. Changes in the credit appetite of providers are tending to push average tenors down, but perhaps more importantly are increasing the requirement for use of credit support annexes (CSAs) and ISDA master agreements, for FX swaps and forwards. At present, many clients are still negotiating without having an ISDA master agreement, but we are currently working to put these in place ahead of regulatory requirements.

RICHARD: Since the Dodd-Frank Act, US clients can only engage in swap trading activity with a CSA, an ISDA master agreement or specific swap trading relationship documentation (STRD), which was introduced for swap market participants that did not have an ISDA or CSA in place.

OLIVER: Regardless of whether they have already signed a STRD, clients that do not have a CSA or ISDA in place will need to sign up to these or a 'CSA-lite' document. To avoid the kind of rush we saw prior to the EMIR reporting deadline, clients should look to get these in place sooner rather than later.

KATE: How are regulatory changes affecting how clients manage risk, in terms of the formulation and implementation of their investment strategies?

OLIVER: Across the client base, we've seen a reduction in use of FX options, in favour of cash-based transactions. We had expected demand for non-deliverable forwards (NDFs) to take off, but overall there has been a strong preference for cash instruments over more synthetic alternatives. The move from NDFs to cash instruments reflects a desire for simplicity, driven by regulatory requirements. There is of course also a cost to using exchange-traded instruments such as NDFs.

RICHARD: Over the past 12-18 months, we've seen a notable increase in demand for 'negotiating the un-negotiables', by which I mean regulated currency markets that were hitherto largely available via sub-custodians. These are now coming rapidly into the mainstream, mainly because investors are looking to invest beyond established markets, for example certain African and Asian countries where access to FX is restricted. To help clients execute investments and currency transactions in those markets, we bring to the table our settlement expertise, our extensive sub-custodian network and our market experience.

OLIVER: Another factor affecting client behaviour is the growing electronification of the FX market. This brings margin compression, transparency in price discovery and more of an auction-type approach.

KATE: Are clients looking to hedge investments or are they also seeking alpha generation?

OLIVER: There is an element of the latter, but it's still mainly the former. In most cases, clients have entered into an equity or fixed income transaction and are looking to minimise the time delay between the initial execution and putting on the appropriate currency hedge. Overall, the increased client interest in these emerging and developing markets is a response to the low interest rates and returns in more established markets. In this environment, every basis point matters, so clients are keen to reduce any drag on their investments.

KATE: How are regulatory developments impacting insurance firms' relationships with their global markets counterparts, for example in terms of counterparty appetites and limits?

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ROSS: Changes in regulation have created opportunities for returns for insurers and other long-term investors. The 'collateral downgrade trade' offers a revenue / yield opportunity for insurers, as banks continue their search for high-quality liquid assets (HQLAs) in response to Basel III. The central clearing mandate for OTC (over-the-counter) derivatives under EMIR also represents an opportunity in terms of the increased level of collateral that will be required by certain market participants, but it is also a challenge for insurers that need to collateralise their obligations for exchange-traded and OTC derivatives trades. The quid pro quo is that all insurers sit on pretty attractive portfolios that can be put up for securities financing, which can meet the increased demand among banks for HQLAs.

OLIVER: Solvency II, as well as certain other regulatory changes, does mean that insurance firms are scrutinising the financial health of their counterparties with increasing levels of detail. Insurers certainly want to deal with counterparties that are rated at least as single A credits or ideally above, because they have to set aside less capital against the counterpart risk of dealing with such firms.

Solvency II also introduced the consideration of concentration risk to insurers' assessments of their global markets counterparties. We're definitely seeing a push toward insurers diversifying their counterparties, while also being mindful of implications of dealing with counterparts that have lower credit ratings. We're definitely seeing these kinds of counterparty limits influencing client behaviour.

ROSS: It is interesting that collateral considerations have not yet had an impact on that particular dynamic. One might expect the weight of collateral availability by a counterparty to have an offsetting effect on a lower credit rating.

OLIVER: In the current environment, in which there are so many more calls on collateral assets, there is a need for global markets counterparts to ensure that they can accept and handle effectively a wider range of assets and instruments put up by clients and counterparts as collateral.

KATE: Has Solvency II led to a change of investment strategies among insurers toward shorter dated instruments, and what have been the risk management implications?

OLIVER: The regulatory landscape has changed so much over the past two years that it's difficult to isolate Solvency II's impact on clients' hedging strategies from other factors, including macro-economic developments. There is, however, no doubt that portfolio managers and treasurers alike are having to reconsider their investment decisions based not only on their evolving market viewpoints but also regulatory implications, such as the cost to the underlying fund of accessing liquidity.

RICHARD: The tendency to wait and see, due to macro-economic uncertainties, has been reinforced by certain regulatory developments. Changes in the UK regulatory framework for the provision of research and execution services, for example, has already dramatically stemmed the flow to investment managers and other buy-side clients of the kind of market colour and intelligence historically provided by the sell-side that can help to drive investment decisions, especially from a short-term perspective. There is a move toward the production of more generic research, which is fuelling increased demand for flow data among portfolio managers.

OLIVER: We have a wide client base of insurers, stock picking houses, fixed income specialists, and private equity firms. As such they are looking for FX expertise and guidance, in terms of liquidity and access. As MiFID II approaches, with further changes to rules on research provision, a lot of firms are looking at how to position their future research services, both in terms of content and cost.