Collateral management survey 2013

Insurance Risk's second collateral management survey in conjunction with BNY Mellon finds more insurers are taking steps to prepare for new derivatives regulation, but concerns about collateral availability are mounting

Sponsored by BNY MELLON

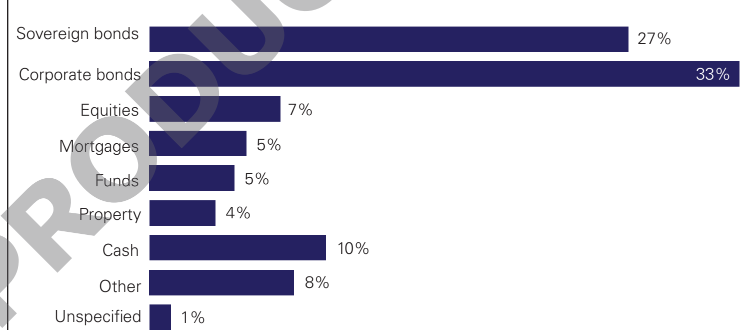
THE FINANCIAL SERVICES industry is facing a seismic shift in the use of collateral, as it moves from an off-market, over-the-counter environment into a listed, centrally-cleared one. Insurers and other buy-side firms will have a greater need to post initial and variation margin in the shape of high-quality collateral when using derivatives.

For a second year running *Insurance Risk* and BNY Mellon have conducted a survey to look at how insurance companies are preparing for the new regime and the opportunities and challenges that the changes will bring.

The survey revealed increasing concerns over the availability of eligible collateral assets to post as margin. The key findings were:

- Two-thirds of insurers surveyed expect to participate in the new cleared environment;
- Fewer respondents believe their organisation will increase its use of derivatives in the coming years compared with last year;
- The proportion of respondents that believe they will have enough assets of the required quality in their investment portfolios to meet the collateral requirements of the new environment has fallen by a third;
- The repo market is seen as the most attractive mechanism to optimise collateral and gain additional yield from investment portfolios.

What is your broad asset allocation?



Source for all charts: Insurance Risk/BNY Mellon Collateral Management Survey 2013

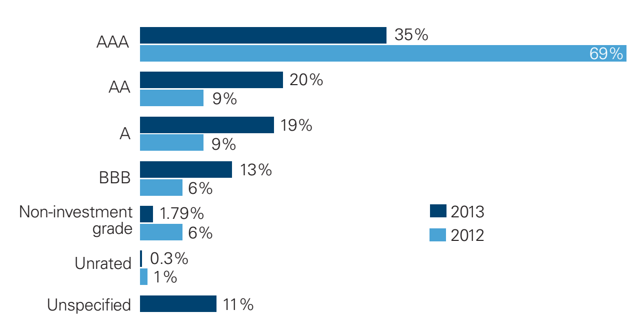
Respondents

The survey was completed by 84 respondents from insurance companies. Of the companies represented, approximately 70% had life operations, 58% had non-life operations and 24% conducted reinsurance business. Respondents held insurance assets totalling $7.45 trillion (£4.3 trillion), representing approximately 31% of the global insurance market, based on estimates of global insurance assets of $24.4 trillion at the end of 2011 (from The City UK).

Approximately one-third (34%) of respondents had gross written premiums of more than $10 billion in 2012, while one half (46%) wrote gross premiums of under $2.5 billion in that year. Similarly, more than a third (37%) had assets of more than $100 billion at the end of 2012, although nearly one-half (42%) held assets under $25 billion.

The majority of respondents (75%) wrote business in Europe, the Middle East and Africa, while 49% had operations in the Americas and 38% wrote business in Asia-Pacific.

What is your sovereign bond asset allocation by rating?

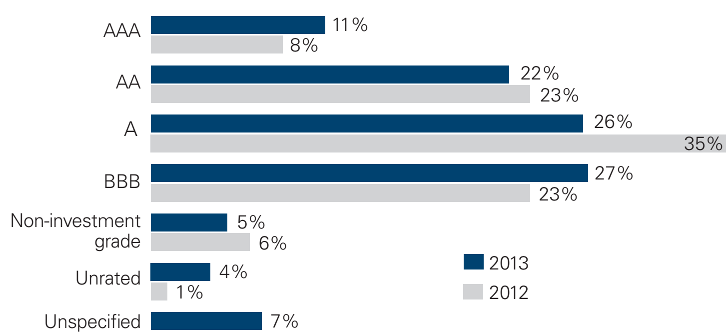


Credit quality of sovereign bond holdings reduced

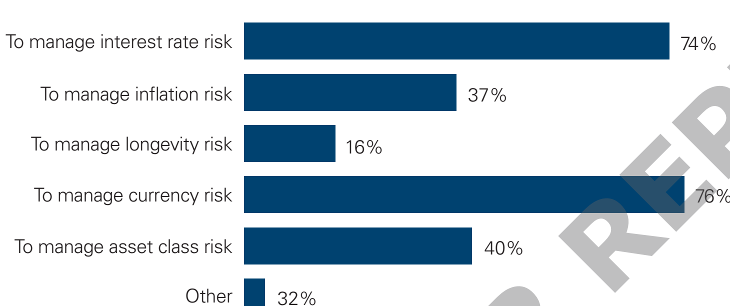
Respondents were asked to outline their company's holdings in a range of investment classes. Sovereign debt accounted for 27% of respondents' portfolios on average, while 33% of assets were corporate bonds. The results showed a slight increase in corporate bond holdings versus last year (27% in 2012's survey) and a slight decline in government debt allocations (31% in 2012).

There was a marked shift in the credit quality of respondents' government bond portfolios compared with last year. Government bond holdings were still weighted towards AAA-rated instruments (on average 35% of sovereign bond holdings); however, in last year's survey, the allocation to AAA-rated government securities was 69%. At the same time, insurers have doubled their allocations to government bonds rated AA, A and BBB.

What is your corporate bond asset allocation by rating?

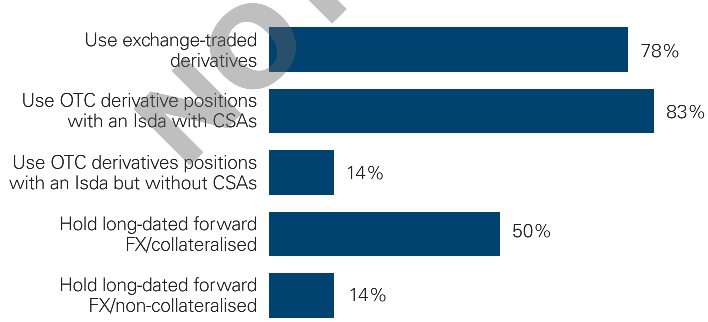


What do you use derivatives for?



As it relates to your derivatives, do you

(Please tick all that apply)



There was little change in the balance of respondents' corporate bond portfolios, with approximately 60% of the portfolio being rated A or lower. Allocations to cash doubled from 5% to 10%.

Increased use of CSAs and exchange-traded derivatives

Respondents were asked how they used derivatives. More than 70% of companies used derivatives for hedging interest rate risk and 76% hedged currency risk using such instruments. Inflation risk was hedged with derivatives by one-third of respondents.

Of those that used derivatives, the vast majority of respondents (83%) used over-the-counter markets with an Isda and a credit support annex (CSA). This proportion has increased since last year's survey, when 69% of respondents said they used these.

There was also an increase in the number of respondents using exchange-traded instruments: 78% said they did so, compared with 69% last year.

For those using the OTC market, cash was the most popular form of collateral to post as initial margin, followed by sovereign bonds. Approximately half of the respondents (48%) did not currently post initial margin, as was the case in last year's survey.

The majority of respondents currently post variation margin on their OTC positions, with nearly one-half (47%) using cash – an increase of eight percentage points on last year – and 11% posting sovereign bonds. One in 10 respondents posts a mixture of sovereign bonds and corporate bonds rated AA or higher as variation margin.

The proportion of respondents not posting variation margin has fallen from 25% in 2012's survey to 13% this year.

There has been a change in the expectations of derivatives usage since last year. Only one-third (29%) of respondents expect to increase derivatives use compared with one-half in last year's survey. Nearly one-half of respondents (46%) do not expect to increase their derivatives use in the coming years, and one quarter (24%) were undecided as to future usage.

Understanding of move to OTC cleared environment has increased

More insurers than last year expect to participate in the OTC cleared environment, with two-thirds (67%) of respondents saying they will do so compared with 53% last year.

Insurers' understanding of the impact of the move to central clearing is also increasing. More than half of the respondents (54%) claim to understand the impact and are working towards operational readiness, compared with one-third in last year's survey. One-fifth of insurers had yet to launch an impact study (a similar proportion to last year), while 10% do not believe they will be affected, compared with 22% in 2012's survey.

Those firms that had launched an impact study are focusing in particular on the trades that will have to be cleared, the selection of clearing brokers/futures commission merchants, future collateral requirements and data requirements.

Insurers look to repo market to optimise collateral

Respondents are exploring measures to optimise collateral by converting idle assets into eligible collateral. While only a small proportion of respondents currently do so, the survey shows more expect to once central clearing is in place. As was the case last year, use of the repo market is expected to be the most popular method of collateral optimisation.

A significant proportion of insurers are still not running a securities financing desk to support a range of business activities, as last year's survey also revealed.

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The majority of insurers (61%) pledge their investment portfolios as collateral, as was the case last year, although the proportion doing so has fallen from 72% in 2012. There was also a fall in the proportion of respondents pledging assets in support of secured borrowing (30% compared with 44% last year).

This year's survey did reveal that a higher proportion of insurers are pledging assets in support of standby credit facilities than last year (41% compared with 24% in 2012).

Collateral quality remains a concern

Compared with last year, fewer respondents said they currently hold sufficient ("enough" or "comfortably enough") assets of the requisite quality within their investment portfolios to meet collateral margining requirements and other pledges.

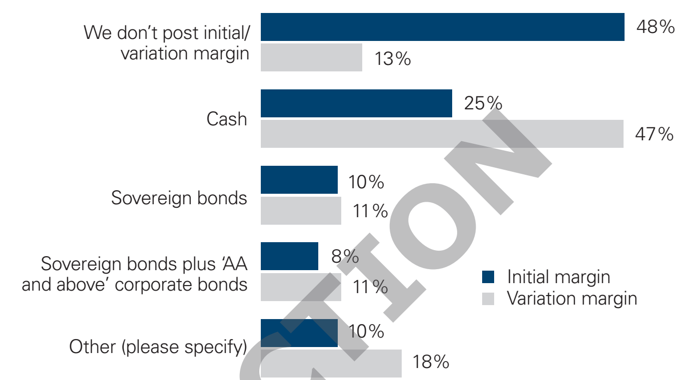
Only 25% said they "comfortably hold" enough assets (compared with 41% last year), and 19% said they hold "enough" assets (down from 24% in last year's survey). Once the central clearing reforms are implemented only 8% said they would have sufficient assets compared with 12% last year. But despite mounting concerns about the availability of collateral-quality assets in a centrally-cleared environment, fewer respondents say they may regularly or occasionally be obliged to engage in some form of collateral transformation: only 15% of respondents said this would be the case once the reforms are implemented, compared with 27% last year.

Repo markets an attractive way to boost income in the low-yield environment

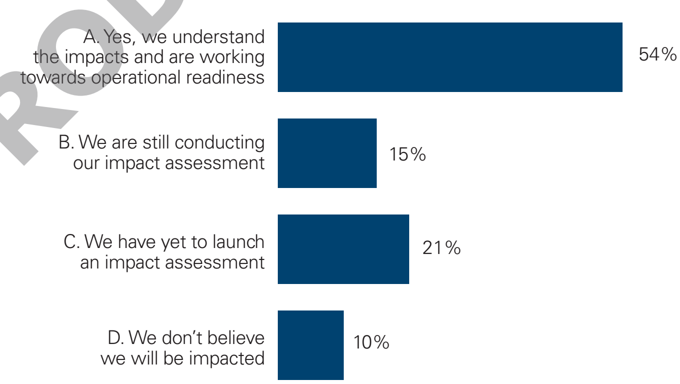
Not surprisingly, the vast majority of respondents (86%) are currently exploring opportunities to generate additional income from their existing investment portfolio.

Insurers are assessing whether the move to central clearing, and associated collateral demands, is an opportunity to generate such income.

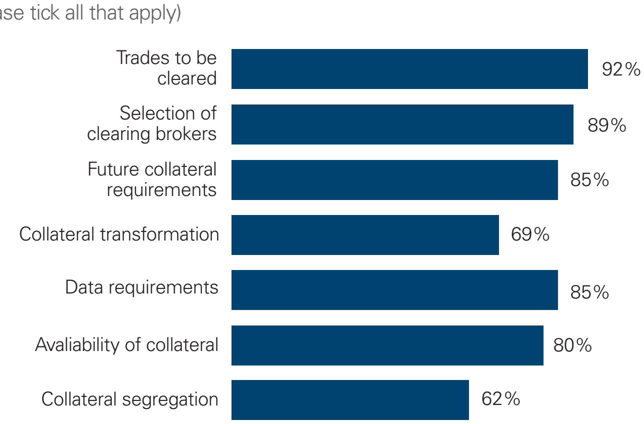
For your OTC derivative positions what do you typically post as initial and variation margin?
(Please tick the most common standard)



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)

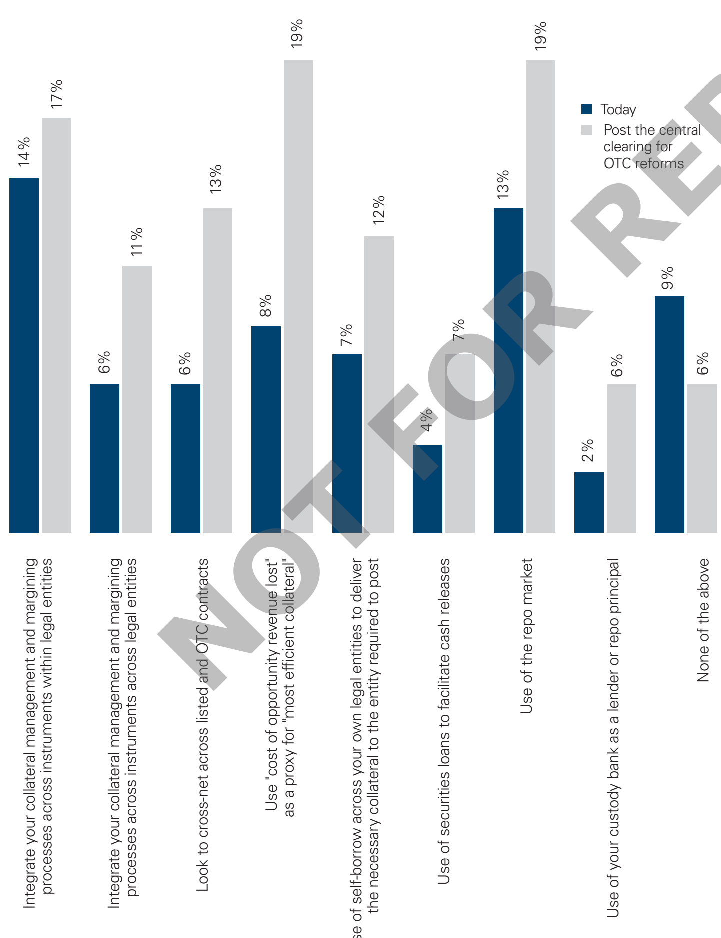


Approximately half of the survey's respondents do not think the reforms will provide revenue-enhancement opportunities – a similar proportion to last year. One quarter think central clearing is likely to present income-generating opportunities – once again, a similar proportion to last year.

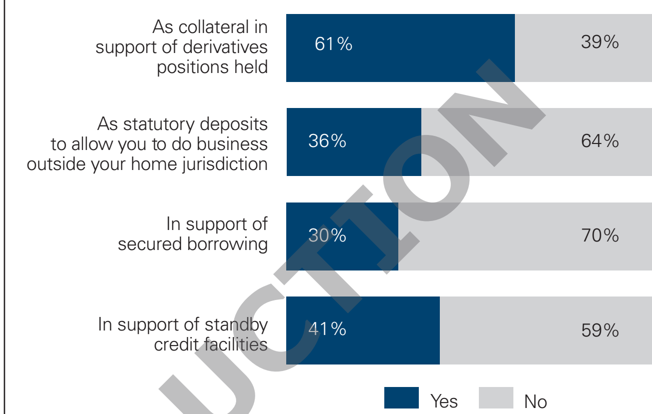
The survey shows a split right down the middle with around 50% of insurers currently generating additional revenue from their liquid assets via securities lending. A slightly smaller proportion (42%) use liquid assets for repo activity, while only one quarter do so in support of long-dated liquidity swaps – the latter being significantly less than last year when 35% engaged in this activity.

But insurers are assessing whether additional income can be generated from their liquid assets, particularly securities lending and repo activity. Of those that have undertaken an assessment, the greatest pro-

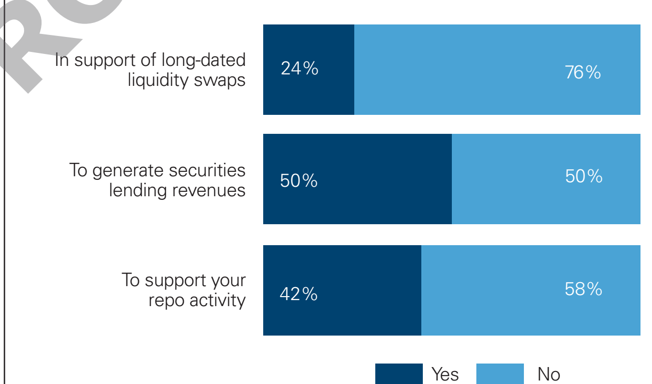
Do you, or will you, engage in any form of collateral optimisation?



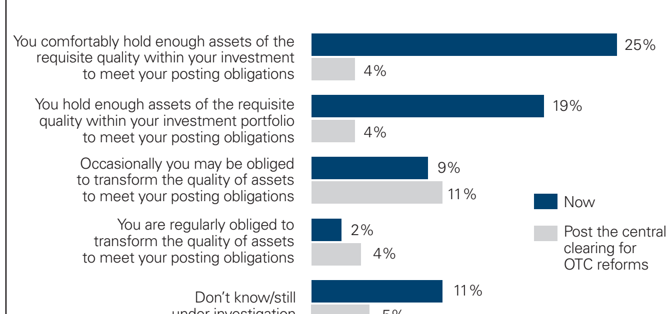
Do you pledge your investment portfolio today, for any of the following reasons?



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:



portion of respondents say repo activity is attractive, followed by using liquid assets for collateral swaps/transformation and securities lending.

Compared with last year, more respondents say these activities are attractive, with repo activity seeing the greatest growth in interest (up 24 percentage points), followed by collateral swaps/transformation (up 16 percentage points) and securities lending (up 14 points).

Engaging in long-dated liquidity swaps is seen as less attractive than last year, with only 13% of respondents viewing it as attractive compared with 36% in 2012's survey. IR

Comment: Paul Traynor, head of insurance segment, international, BNY Mellon

Through impact assessments, insurers are achieving greater clarity around whether, and how, they will be affected by the move to central clearing; with increased acknowledgement of the likelihood that they will indeed be impacted by the regulation. Accompanying this is a decline in the number of insurers, from 65% (in 2012) to 44% (in 2013), who believe they hold sufficient capital of the appropriate quality to support both centrally cleared and over-the-counter derivatives trades, suggesting awakened recognition of the implications of the regulation.

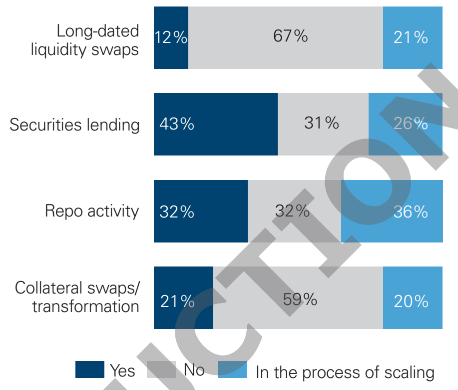
While more firms are working towards operational readiness, still a fifth of those surveyed are yet to conduct their impact assessment and may therefore not be attending to these implications. We echo last year's comments that it is critical for insurers to conduct the necessary assessment as soon as practicably possible to allow them to plan appropriately for future growth.

We are seeing a gentle upward trend towards collateralised trades. As it relates to over-the-counter derivatives trades, almost half of insurers continue not to post initial margin. This number remains high, and comparable to one year ago. Over time we expect that the number not posting initial margin will go down, as risk and cost considerations provoke a move into the cleared environment. This is supported by the spike in the number of insurers who believe they will start to use clearing for their OTC trades.

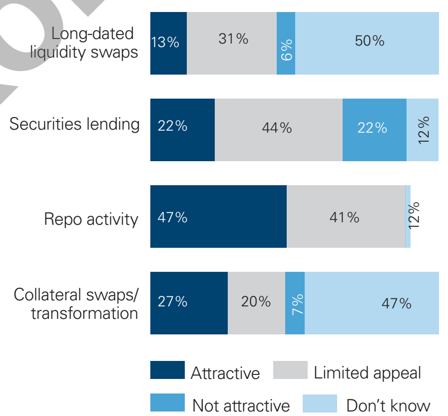
A reassessment of risk versus return relating to sovereign bonds has resulted in insurers reducing their holdings of sovereign debt, increasing corporate debt holdings and hoarding cash. Depending on the eventual standards that the central counterparties settle on for initial margin, this asset reallocation may increase the cost of using derivatives as a hedging tool within an insurer's portfolio, given the reduced holdings of sovereign bonds and the opportunity cost of posting cash for margin payments.

The search for yield is gathering momentum, with insurers exploring opportunities through the repo market and securities lending, increasing exposure to equity – particularly high dividend stocks – and trading liquidity for yield. Some insurers are considering whether yield can be found in facilitating collateral transformation.

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



If selected yes, how would you scale it?



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?