Time to come clean on CSAs

Insurers are lagging other financial institutions in preparing for the central clearing of derivatives and the knock-on impacts for investment strategy and risk management. By Emily Penn and Ross Evans, Insurance ALM Advisory, RBS

ALTHOUGH THE liability-driven investment population has been very proactive in making changes, the issues around central clearing have slipped under insurers' radars due to the industry focus on Solvency II.

Under European Market Infrastructure Regulation (EMIR), more and more derivatives are now, or will be, centrally cleared. The move will mean a host of unintended consequences, impacting the assets held to match long-term liabilities.

Mandatory clearing of derivatives is expected in summer 2014, although there is scope for a temporary exemption for certain pensions businesses of insurers.

The main driver of change and root cause of the issues lie in clearing house demands for highly liquid collateral. Currently, under traditional 'dirty' credit support annexes (CSAs), insurers can post a wide range of collateral including EUR, USD and GBP cash, government and corporate bonds.

In contrast, centrally cleared derivatives will be executed under 'clean' CSAs, where only cash and sovereign bonds in the currency of the underlying derivative will be permitted by the clearing house. Competitive and market pressures will mean, in the future, that clearing houses will look at expanding the range of collateral to include high-quality corporate debt and leading-index equities.

There is a strong rationale for clean CSAs because the way derivatives are valued has undergone fundamental change over the past five years.

Pre-crisis, Libor was used to project both the future cash flows of derivatives and to discount those cash flows to price them. However, this was no longer tenable after the financial crisis when Libor's status as a 'risk-free' rate was questioned. Libor is still used to project future cash flows, but now a rate based on the rate of return on the underlying collateral posted is used for discounting. This is to better reflect the cost of funding the derivative.

As a result, the value of a derivative now depends on the CSA or, more precisely, the cost of funding the collateral posted. Where gilts and cash are posted, typically the overnight swap curve (Sonia) is used to discount the cash flows. However, for a dirty CSA there is no standard methodology to build the discount curve. This means different CSAs lead to different valuations and, further, different banks will assign different prices even under the same dirty CSA.

A further consideration for insurers is the difference between the curve used to value derivatives and the curve used to value the liabilities being hedged. Since the latter is typically a Libor swap curve, it introduces an exposure to the basis between the Libor curve and the CSA discount curve. The result is a market that is inefficient, opaque and brings volatility to insurance company balance sheets.

Clean CSAs are much simpler because they are standardised. Libor is still used to project future cash flows but an overnight curve is used to discount them. There is more transparency, more consistent pricing and greater competition for pricing. Standardisation and clean CSAs also mean insurers' balance-sheet volatility is easier to manage.

Changing CSA terms usually involves a fee to reflect the change in value of the portfolio under the different discount curves. The insurer may receive or pay this fee depending on the size and nature of the underlying portfolio. As such, CSA changes were often just seen as a profit and loss opportunity for banks. However, changing regulation means insurers need to act now to prepare for the upcoming changes.

A move from a dirty to a clean CSA can be done in conjunction with a re-coupon of those derivatives with high mark-to-market valuations. The exercise reduces risk and frees up cash that can then be used either directly as collateral in a clean CSA or to invest in higher-yielding assets. For example, insurers with large annuity portfolios hold long-dated assets to match their liabilities. These funds tend not to hold large quantities of cash and gilts at the moment, but they will be forced to do so if they have to trade derivatives centrally. This is despite the fact that many of their investments are in high-quality, investment-grade assets, and policy-makers want insurers to become more involved in funding vital infrastructure projects.

Insurers may view the requirement to hold large quantities of cash and gilts as collateral as a barrier to the use of derivatives. Derivatives are an important risk management tool for insurers and a reduction in use will jeopardise strong risk management practices.

The changes also mean insurers, who are typically very safe counterparties, may need more cash to post as initial margin than riskier counterparties, such as hedge funds. This is because insurers have long-term directional contracts to hedge their liabilities, whereas hedge funds use a variety of instruments to express market views and these may have offsetting collateral requirements. In essence, insurers will be subsidising margin requirements for more risky counterparties.

In summary, insurers need to think actively about the impacts of central clearing and the need to move to clean CSAs. They will have to make the switch at some point anyway because of the forthcoming over-the-counter bilateral (uncleared) margining rules under EMIR. These will eliminate the scope for dirty CSAs, so it is important to be well prepared so the changes can be made in a non-pressurised situation.

While the regulation changes will impact asset allocation, they also bring about greater transferability and pricing transparency of derivatives.

Contact
Emily Penn
Director, Insurance ALM Advisory
T: +44 (0)20 7085 3319
E: emily penn@rbs.com
ww.rbs.com/mib