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Collateral thinking – The impact of central clearing on insurers' assets

A panel of experts, convened by Insurance Risk *and sponsored by* **BNY Mellon***, discuss the impact of central clearing on asset allocations and opportunities to generate returns from high-quality collateral*

How does your company currently use derivatives? To what extent do you use clearing at the moment?

Frank Turley, Legal & General: We are a fairly extensive user of derivatives: both at group level, in terms of derivative overlays for risk management purposes; and within individual funds, which we've delegated to Legal & General Investment Management (LGIM), our fund manager. In terms of Legal & General (L&G) Group companies, we are not yet clearing centrally, albeit LGIM are clearing for some of their segregated clients and most of their pooled funds within liability-driven investments.

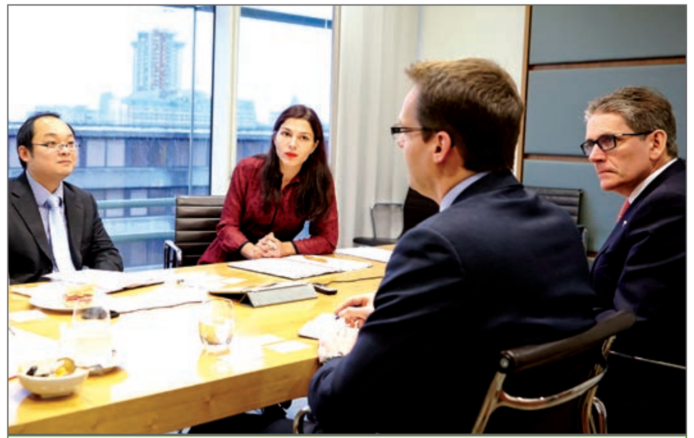
Andra Page, Swiss Re: We are a medium-to-low derivative user. We primarily use derivatives for hedging or asset and liability management and, occasionally, as overlay in cases where derivatives can provide opportunities to enhance returns. We have some insurance-related derivatives, some of which can be relatively complex because of the combination, or hybrid, between financial risk and insurance risk.

Are you clearing any of them at the moment?

Andra Page: For US entities, similar to other market participants, we are obliged to clear all interest rate swaps and credit default swap indexes traded after June 2013. For trades existing before June 2013, we have the option – but not the obligation – to clear at this stage. We have done some analysis around existing trade packages that could be cleared in a cost-efficient way.

Jin-Wee Tan, Friends Life: We use derivatives in a number of different ways but mostly for long-term hedging. Some asset managers can trade derivatives on a discretionary basis, but the bulk of our positions are originated by the life company to be executed by the asset managers of the investment portfolios. At the moment we are not clearing over-the-counter derivatives though we will. We will probably delegate that responsibility to our asset managers.

Mark Higgins, BNY Mellon: I think the question is more interesting when you ask are you ready, or have you been ready for the last two years, to go into a cleared environment? Like so many on the buy side, broadly speaking, there was a period of head-in-the-sand reluctance to prepare, which changed around 2012. It accelerated, with people getting ready for it in 2013, and then there was a delay. So people are using derivatives to varying degrees and they've accepted that they have to move into a cleared environment. Then they will look for the best opportunities when that new world comes through.



The Panel
Mark Higgins, managing director, EMEA business development, BNY Mellon Global Collateral Services
Andra Page, senior risk manager, Swiss Re
Jin-Wee Tan, head of investment projects, Friends Life
Frank Turley, group treasurer, Legal & General

Jin-Wee, how far has Friends Life progressed in analysing the impact of the central clearing regime?

Jin-Wee Tan: I tend to think in terms of the operational impacts so, for me, it's really around bringing together the various strands of our derivatives operating processes and standardising them, making sure that when we move into central clearing we only manage a limited number of central clearing processes, one or two clearing brokers, and they clear with one or two clearing counterparties.

There is a potential impact on the investment strategy because you are not generally allowed to use corporate bonds as eligible margin. You have to use high-quality government bonds and cash. That has an impact on the returns you get in the portfolios. A lot of work is being done at the moment around assessing what that potential impact may be.

Andra Page: We have chosen two financial clearing houses based on our analysis of their initial margin calculation techniques. We have carried out assessments to see which one is most beneficial from a cost and operational perspective.

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Mark Higgins, BNY Mellon

One important aspect before starting clearing was valuation – ensuring consistency between internal valuations for clearable trades and those used by clearing houses. The market standard is for the clearing house to use local currency overnight indexed swap (OIS) discounting, based on posting variation margin in the currency of the trade. Thus, we ensured bilateral trades eligible for clearing, but with non-local currency credit support annex agreements in place, can be switched to local currency OIS, if cleared.

You say you've picked two clearing houses. On what basis did you choose those?

Andra Page: On consideration of cost, transparency and operational efficiency. For instance, the degree of transparency provided with respect to the clearing house's initial margin calculation techniques and collateral accepted. Or transparency of the exchange-traded derivatives that various clearing houses allow to be cross-margined, with clearable derivatives.

Jin-Wee Tan: How much analysis have you done on the pass-through of the margin call from the clearing counterparty via clearing broker to yourself? One thing I found interesting was that, when your clearing counterparty sends a margin call to your clearing broker, your clearing broker then passes that on with a mark-up and that mark-up can be quite substantial – multiples of the actual margin call from the clearing counterparty. So one of the things I'm trying to do is optimise that as much as possible, because it's going to have far greater impact than the variation margin calls coming from the clearing counterparty. So, actually, a clearing broker is probably as important.

Mark Higgins: Are you saying that your concern is the add-on – how much you're being charged as the add-on by the clearing broker?

Jin-Wee Tan: Correct. And there must be scope to optimise that, given the level of competition.

Mark Higgins: In terms of getting it down as low as you can between the brokers?

Jin-Wee Tan: Ideally, there would be a transparent pass-through from a clearing counterparty in terms of variation margin calls. The worst I've seen is up to three times the variation margin call. So, if the variation margin call is 10 million, the clearing broker could then debit my margin account by 30 million. The day-to-day impact is clearly on variation margin because it just means that you have to sweat your repurchase agreements (repo) desk very hard to raise the requisite cash. One of the things I have to do before clearing comes into force is to ensure that I get the variation margin call as low as possible when it hits my margin account.

Mark Higgins: And in the right currency, because you're potentially going to have multiple currency calls.

Jin-Wee Tan: We don't tend to have a great deal of non-sterling derivatives, so there's less of an issue there.

Mark Higgins: You said you've got to get your repo desk working really hard, but how do you get a repo desk that works so hard that it has virtually instantaneous cash in an account? It still has to have time to strike a trade, time to book it, time to make things move around.

Jin-Wee Tan: It's a challenge. The easy solution would be to hold more cash. That has an impact on investment strategy and available liquidity.

Mark Higgins: It is really interesting what you said about getting your repo desk to work, but a lot of businesses like yours don't have a repo desk and some of the investment managers don't have a repo desk, per se.

Jin-Wee Tan: There are a number of insurance businesses that are hiring repo traders to do precisely this – meet cash requirements for central clearing.

Frank Turley: In the same way that banks over the last 10–15 years have developed very sophisticated collateral management/repo management desks, the insurance industry will be doing exactly the same thing. The whole idea 10 years ago, where you actually posted whatever was convenient collateral, has gone. So it'll be about actually making sure you understand what collateral is the cheapest to deliver based on the collateral terms, delivering that and keeping good collateral back and optimising that process.

Taking a high-level view, central clearing is reducing counterparty exposure but is resulting in an increase in liquidity risk.

In our analysis, we project forward five and 10 years to work out what we think the landscape will look like. I think this is quite important because it's very easy to focus on the new trades that will be cleared centrally, but we and other insurance companies have got quite large back books of existing derivatives.

Depending on the timing of regulation, the back book may, at some stage, be caught by central clearing. So we need to make sure, not only, that we are comfortable in terms of the new trades going forward, but also the management of the back book as well.

Mark Higgins: So would you back-load them or would you just let them mature as they are?

Frank Turley: Our view is that we will leave the back book alone. There is little advantage to us in having these trades cleared immediately; however, as and when they need to be re-couponed or if we need to do some form of trade consolidation, then these trades may need to be centrally cleared.

Central clearing is here to stay and, as we look forward five and 10 years, we believe there will be an increase in the range of trades that will be eligible for central clearing.

Mark Higgins: If it can be cleared it will be cleared. I think the stock lending world will see it, I think the repo world is heading towards it and I think, once this regulatory sea change is proven to work, then that's what has to happen. In 2015, probably halfway through, the regulators will say: 'I told you it was going to work. What's next?' I think that's where it carries on.

Frank, has L&G selected a clearing house?
Frank Turley: Yes, currently LCH, but we will be looking to add additional clearing houses later this year. We have a market-leading investment manager as part of the group and they drove the process in terms of selecting the direct clearing members and the central clearing counterparty; we reviewed and adopted LGIM's recommendation. There is a lot of analytics going on behind the scenes, but there's also an awful lot of work going on to ensure that we are compliant with trade reporting, risk mitigation obligations for uncleared trades and European Market Infrastructure Regulation (Emir) counterparty classification. We have many legal entities within the L&G Group, and some are classified under Emir as financial counterparties and others are classified as non-financial counterparties.

Have you reached the point where you have started to assess how the clearing regime is going to affect your choice of derivatives and the risk management strategies you might employ?
Frank Turley: Yes. First and foremost our focus is on the strategic asset allocation. Then, for regulatory reasons we have various constraints. Central clearing superimposes another boundary, or constraint, to our strategic asset allocation. As opposed to looking at this from a central clearing perspective, we're actually looking at it from a top-down perspective.

Will you, for instance, reduce the number of interest rate swaps you use?
Frank Turley: When we bring on new business, we're acutely aware that our asset allocation will then drive the use of derivatives, so we're making sure that the implications are priced in. This forms part of our pricing optimisation process.

Andra, to what extent have you started to analyse those consequences?
Andra Page: We do not expect central clearing to have a significant impact on our derivative use. Aside from the costs associated with initial margin, one of the problems the market is facing is that not all the products have been cleared at the same time. For instance, in the case of existing vanilla swaps hedging exposures from derivatives not yet clearable – such as cross-currency, interest rate volatility products – it is more cumbersome to manage risks, especially when the collateral agreement in relation to the bilateral non-cleared derivative is somehow different to the collateral agreement for the cleared trades. This can impact the way derivatives will be used going forward but, most likely, institutions will not stop using derivatives solely because of clearing requirements.

Jin-Wee Tan: I think, at the margins, it could change the way we use derivatives. One example I can think of is where the initial margin cost is higher for a longer-term swap, relative to shorter-term swaps. At the margin, that might change our decision to use a long-term swap and try and find a cash asset to match that particular liability exposure. We will not stop trading derivatives just because of central clearing, I don't see that happening. We may reduce our use of derivatives a little, but there are so many variables that go into that calculation that it is impossible to tell.

> *"There will certainly be an impact from regulatory clearing on securities lending due to increased demand for higher-rated securities"*
> Andra Page, Swiss Re

> *"Insurance companies need to recognise the fact they need to start playing in this space. It's not enough to just up their levels of gilts and cash if required"*
> Jin-Wee Tan, Friends Life

To what extent are you analysing how your pool of potential collateral will have to change?
Jin-Wee Tan: I think the first step is probably to analyse what Andra described, which is to look at the clearing counterparty's model of how it calculates margin requirements. That has to be a constraint on our asset allocation. The variable mentioned about the pass-through charge from a clearing broker is important as well. So, if you boil it all down, we may find that we have a large additional gilts and cash requirement, and then we need to figure out how to do that.

Do you think you will need to increase your allocation of cash and gilts?
Jin-Wee Tan: I couldn't say for certain but my planning has been on the basis that we will have to and it's, really, a worst-case scenario.

Frank, are you likely to have to increase cash and gilts?
Frank Turley: That's a very difficult question to answer as it is a multi-dimensional problem. First of all, the quantum of gilts an insurance company will hold is not only dictated by central clearing – there are other criteria as well. Solvency II will have an impact on that. L&G has committed to investing in long-dated UK infrastructure. So, naturally, as that forms more and more of our asset allocation then our derivative requirement for some of our overseas hedging reduces.

The other point is that, as an insurance company, we need to be mindful that our regulators ask us to consider the impact that various stresses may have on our business. A lot of the intellect goes into making sure that under these stressed scenarios we actually have enough collateral. I'm comfortable that we will have sufficient collateral.

Within large insurance companies there may well be many different entities. Some are financial counterparties, some are not. You have to take a step back and ask whether you have, as a group, sufficient eligible collateral. It may be the case that the eligible collateral is in one pot, but not in the other. Effective management of liquidity and collateral within insurance companies will become far more important.

Jin-Wee Tan: If you had your annuity business in a separate entity, you then have a collateral requirement related to the long-dated swaps held by that entity, which is possibly not funded by gilts. The gilts to fund your collateral may be elsewhere within the group. It's a good idea to ensure that the gilts are actually fungible between entities, and that's a major challenge.

Would you want to centralise derivatives purchasing from one central desk and manage everything through that, rather than buying derivatives through individual entities?
Jin-Wee Tan: It's hard to do that because you don't necessarily get the capital relief that you would have if you did the hedging in the funds. But I can foresee a world where collateral management is run through one entity for all the other entities within the organisation.

Frank Turley: I think it goes back to this parallel I drew earlier, in that banks have become very astute as to how they run their collateral management, repo management and funding operations. They typically have one funding desk for the whole organisation, irrespective of the different books or which country the different books are in. That's where I think other financial institutions will get to over a period of time.

Have you reached the point where you have an idea of what structure is going to be optimal?
Frank Turley: Yes, I think we have it very well thought-out at a strategic level. Derivatives have to sit within the legal entity that they are required for, however, making sure there is fungibility of liquidity and collateral at a group level becomes very important, in order that we can get the right collateral to the right place at the right time.

Andra Page: We have a central function managing collateral. It is not my responsibility in the firm, but I believe it is a challenging task due to varying regulatory requirements in different jurisdictions. Do we have a problem with the collateral? Not that I am aware of. To my knowledge, we are comfortable with our levels of high-rated securities and we are exploring opportunities to generate return from collateral management.

So having a security financing desk that is lending collateral.

Andra Page: The firm has a securities lending business that swaps different qualities of collateral for return-generation purposes, subject to risk management limits. It is not my responsibility in the firm but there are potential opportunities to do more in this space, given the regulatory clearing requirements.

Mark Higgins: It's interesting to hear you say you're doing that. I think there is going to be demand in the market, probably in about two years' time when we really see what the volumes are going to be. But it sounds like you have the risk appetite to take that and you have the correct assets that the rest of the market wants.

I am often asked if there is enough collateral in the world to meet the future needs. There is enough collateral, but it's all locked up in the grand scheme of things. So we have to try and unlock it and get it into the right hands, at the right places and at the right time, otherwise we will face problems.

Frank Turley: I think, with banks' balance sheets shrinking, the ability of banks to continue to be large players in repo markets is going to be key.

Jin-Wee Tan: It's not the end of the world if you don't have enough collateral. It's about finding smart ways to improve the quality of that collateral and to ensure that you have a strategy in place to post collateral when it is needed. It's not insurmountable. Insurance companies need to recognise the fact they need to start playing in this space. It's not enough to just up their levels of gilts and cash if required.

So, for instance, developing a repo capability.

Jin-Wee Tan: Yes, to get the repos or to do collateral transformation or liquidity management strategies – generally, to become more sophisticated.

Do you think there is going to be an opportunity for Friends Life to make money out of this?

Jin-Wee Tan: My personal view is there may be an opportunity to make money and many businesses start this way in asset management. You start with a desk that services the needs of the life company. That desk creates products that are good enough to market to clients while the whole business grows.

> *"Central clearing is going to force the insurance industry to become much more focused on the liquidity and collateral requirements of the balance sheet in the long term"*
>
> Frank Turley, Legal & General

Frank Turley: We all know why central clearing was introduced. It's going to cost money initially, but it's going to force the insurance industry to become much more focused on the liquidity and collateral requirements of the balance sheet in the long term.

Mark, do you think that is a view shared by many in the insurance industry, that there is going to be an opportunity to generate revenue? Or do you think most companies are still thinking about how they are going to get hold of collateral?

Mark Higgins: I have been touring Europe for the last three years talking about this stuff and I think this is the first time I've actually heard three people agree that there is potential opportunity. Once it starts, then you'll know whether you've got the excess and whether you can enter into the fray. I wouldn't expect anybody to go out there before the door into clearing is open, because you just don't know what you're going to get on day one and you have to look after yourself first. So I think it will be an interesting play in 2015 – maybe in the second half – once we see what the world is going to look like for insurers.

Andra Page: There is an impact from regulations, particularly when assets held to match liabilities on a statutory basis are required to be unencumbered, so cannot be posted as collateral. Regulatory clearing will certainly impact securities lending due to increased demand for higher-rated securities.

What are the key issues to focus on this year with regard to the preparations? What are the major challenges?

Frank Turley: Clarity on the regulations.

Mark Higgins: Flexibility is one of the most important things we've learnt I think, as an industry, over the last three years. The deadlines look pretty set in stone but, again, they could probably move.

Jin-Wee Tan: I think this is one of the odd instances where there is actually value in being a second mover. The first mover incurs a lot of costs and sets the path for everyone and makes the mistakes that everyone else can learn from. So one can learn a lot from sitting back in one sense.