BALANCING LIABILITY DRIVEN INVESTMENT WITH CRISIS LIQUIDITY

BACKGROUND

Liquidity assumptions are being tested

It used to be the case that markets were deemed either liquid or illiquid, however the flash crash in US Treasuries on October 15, 2014 raised some questions about even the world's 'most liquid market'. Indeed, with eight intraday moves exceeding five standard deviations since 2012 – and none in the ten preceding years – many financial institutions would agree that occasional bouts of enormous illiquidity are more commonplace.[1] These changes in market dynamics are driven in part by the regulatory changes on banks and broker dealers' ability or willingness to make markets and warehouse risk in times of stress.[2]

Liability driven investment and solvency considerations may conflict

Long term investment is an intuitive approach for insurers with long term liabilities, such as life insurers. However, these long-term assets often require restructuring or hedging via derivatives to better match policyholder liabilities and reduce risk capital. For example, an insurer participating in a floating rate loan syndication will typically need a matching interest rate swap **(IRS)** to manage the risk back to fixed rate and lock in the spread.

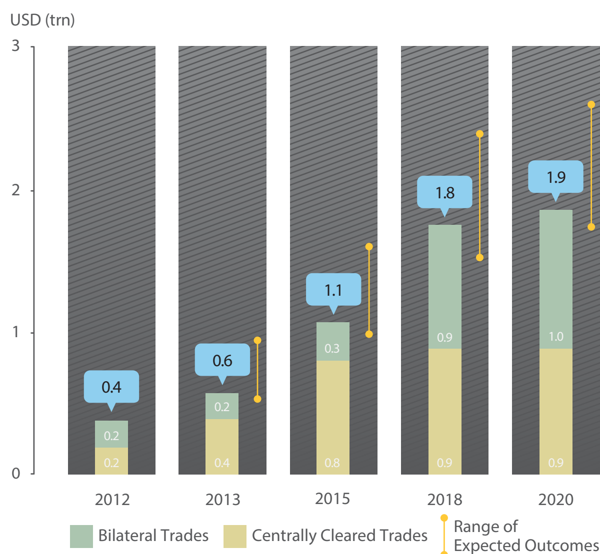
Long-term derivatives, such as IRS come with substantial counterparty credit risk which is mitigated via collateralisation. An over the counter **(OTC)** IRS will be subject to the specific terms of the collateral swap annex **(CSA)** with the counterparty bank, which may allow for a broad range of collateral.

1 Risk.net "Liquidity events becoming more common, buy-siders claim" (08 Sep 2015)

2 Treasury Market Practices Group's Minutes (26 Feb 2015)

However, increasingly regulators are implementing mandatory clearing of OTC derivatives, with Central Counterparties **(CCPs)** requiring some variation margin in cash. That means insurers with their liquid assets in term tradeable securities will need access to the repo market.

Figure 1 – Estimated future cost of collateral



	2012	2013	2015	2018	2020
Incremental collateral need versus 2012 USD (trn)	-	+0.25	+0.75	+1.4	+1.5
Collateral as percentage of unencumbered assets (dealers only)	4	5	8	11	12

*Excludes potential collateral and netting across asset classes. Sources: Oliver Wyman Analysis, BCBS, IOSC

Rising interest rates will intensify collateral needs – Is the repo market always accessible?

The long-dated, fixed-rate receiver positions of insurance companies will change out-of-the-money in a rising interest rate environment, requiring billions in cash variation margin to CCPs. A key risk is that **pre-emptive collateral / cash hoarding may turn previously liquid securities into illiquid assets.**

When quantitatively modelling liquidity risks, it's this pre-emptive hoarding and intensification of collateral needs that has many insurers reconsidering the adequacy of Global Master Repurchase Agreements **(GMRAs)** with their usual broker dealers. Regulators as well as advanced insurers are increasingly asking what would happen under adverse scenarios if the repo access became more limited, with concerns manifested in the 2014 Insurance Risk collateral management survey (Figures 2 and 3).

Figure 2 – Use of the repo market as a tool in collateral optimisation

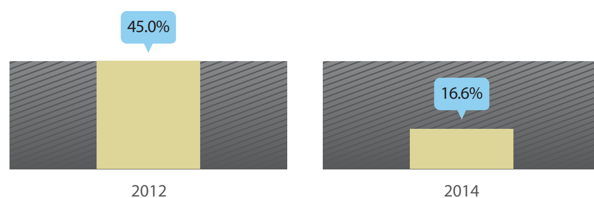
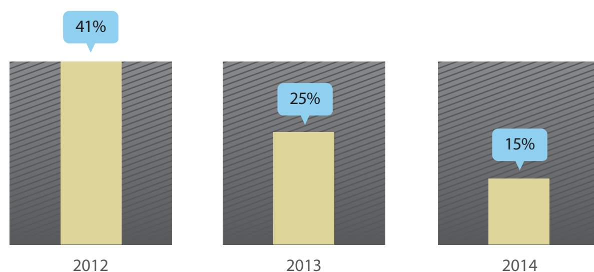


Figure 3 – Comfortably hold enough assets of the requisite quality to meet posting obligations



Pricing of repo markets is another concern as Basel III's leverage ratio requirement on banks kicks in from 2018. For many Asia Pacific banks, the leverage ratio at 3% is unlikely to be a binding constraint in the near term. However, for many of the US and European based broker dealers that are deemed 'global systemically important banks', the leverage ratio could be 6-8% forcing a repricing for repos of 50–100bps.[3]

Term repo with the right bank counterparty can provide both liquidity and long-end exposure

Buying longer-dated assets and repo'ing them out gives insurers the best of both liquidity and exposure to the long-end. However, consideration must be made to how liquidity may be rationed by banks if there is a wide-scale liquidity problem and increasingly, insurers are evaluating which banks can support their liquidity needs in times of crises.

"During a crisis, cash tends to accumulate in the accounts of the highest rated banks as investors seek safety. Lower rated banks may be more selective providing cash or seek larger haircuts on illiquid assets." — Noel Carlin, ANZ Head of Collateralisation and Repo Trading.

Most insurance companies have GMRAs with their usual brokers, but in the event of financial turmoil, it may not be these banks that will have the cash.

SHARING OUR INDUSTRY INSIGHTS WITH CLIENTS

While insurers within the Asia Pacific region are generally considered flush with liquidity, there is growing pressure to optimise collateral management. Recent signs of deterioration in market depth and resiliency across sovereign markets in Asia Pacific has also driven a growing number of regulators to enforce or encourage insurers to quantitatively model liquidity risk, and consider the collateral requirements they would face in a variety of market shocks.

Whether insurers run models on market shocks or incorporate liquidity risks into their general risk management framework, the availability and cost of repo market access in crises are key considerations. Key bank beneficiaries of a flight to quality will have the greatest propensity to make cash available to relationship clients in times of stress.

ANZ Financial Institutions Group and Global Markets have been fielding questions from a number of insurers about global bank regulation and the implications of a shift to central clearing. Term repo forms one part of ANZ Global Markets' suite of solutions for funds and insurers covering liquidity, capital and risk management as well as yield enhancement investment options.

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3 Risk.net "Tighter spreads prompt insurers to rethink liquidity premium" (14-Sep-15)