CEA high-level messages on OTC derivatives

CEA reference:	ECO-10-118	Date:	26 July 2010
Contact person:	Benoit Malpas, Policy Advisor/Technical Manager Economics and Finance	E-mail:	malpas@cea.eu
Pages:	2		

The CEA believes that the central clearing of OTC derivatives is a positive move and one which we are happy to support. It will provide transparency and ways of managing risk which should ensure a safer financial system as a whole.

However, we have concerns about how the current proposals will affect insurance companies and their clients, who are ordinary savers and investors. Specifically, we are worried that long-term institutional investors such as insurance companies and pension funds may end up paying a disproportionately high price for central clearing compared to other market participants whose risk of default is arguably higher. This would have a significant impact on the underlying clients – through increased costs of services, lower investment performance, or higher risks through decreased use of hedging.

Insurers' use of derivatives is conservative as it is restricted under both current regulation and the forthcoming Solvency II regulation. They are permitted solely for purposes of efficient portfolio management and risk reduction. Because of the nature of insurers' liabilities, the derivatives most frequently used include long-dated, one-way contracts such as interest rate swaps to hedge interest rate risk or transform fixed or floating cashflow, and inflation swaps to protect against index-linked liabilities.

Although the risk of default is negligible, the high notional value of contracts on which the initial margin is calculated means the upfront costs will be significant. One firm estimates that a fund with €600m notional with a 20 year interest rate swap would have to pay an initial margin set of between 6 to 17 per cent of the notional, so between €35m to €100m – and some firms have swap portfolios in their billions. At the moment, firms post collateral bilaterally to cover mark-to-market movements and many are not required to post initial margin. The current amount of collateral required is therefore likely to be significantly lower than those needed if the proposed reforms are put in place.
There are also concerns about how variation margins will be funded. For example, for the same €600m fund, if interest rates move by one per cent, around €85m of variation margin would be needed. If collateral is limited to cash or near cash, funds will be forced either to divest some of their higher performing assets in order to have a higher allocation to lower yielding cash, or enter into financial arrangements with their clearing members. Either way, costs will go up and, if the latter option is used and lending or repo arrangements are made, the counterparty risk could be

CEA aisbl
Square de Meeûs 29, B-1000, Brussels
Tel: +32 2 547 5811 • Fax: +32 2 547 5819
www.cea.eu

© Reproduction in whole or in part of the content of this document and the communication thereof are made with the consent of the CEA, must be clearly attributed to the CEA and must include the date of the CEA document.

re-introduced into the contract. In addition, as not all products will be immediately clearing-eligible, firms will have to continue having bilateral arrangements. This will create a double layer of cost.

The combined impact of high initial margins and restricted collateral for variation margins could result in a performance drag as high as two per cent for some funds, according to some estimates. Not only does this create immediate operational concerns but there are serious implications on the insurers' ability to match their assets and their liabilities - which is the core purpose of their business.

So, by making the derivatives markets safer, the unintended consequences of central clearing may be to make insurance riskier, by creating a mismatch between assets and liabilities. Most importantly, this will affect precisely the people regulators are aiming to protect: ordinary savers and investors.
Some solutions to address these problems are relatively straightforward. For example, a wider range of collateral should be permitted for variation margins. However, the costs of initial margin are more difficult to address. It may be that any legislation has to take into account the creditworthiness of the client in some way, as is currently the case with bilateral clearing. This would mean that insurance funds do not end up paying too much for the risk they represent. As the Commission is already considering threshold exemptions for corporate clients, the notion of client differentiation has a precedent.

We hope we can discuss these issues in more detail with you, together with our members.

***

The CEA is the European insurance and reinsurance federation. Through its 33 member bodies – the national insurance associations – the CEA represents all types of insurance and reinsurance undertakings, eg pan-European companies, monoliners, mutuals and SMEs. The CEA represents undertakings that account for approximately 94% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of €1 100bn, employ one million people and invest €6 900bn in the economy.

www.cea.eu