# Combating the collateral crunch

**Dominick Falco, Asia-Pacific Head of Global Collateral Services at BNY Mellon, explains why he believes insurers in particular have a lot to gain from a more holistic approach to collateral**

Collateral could be described as the oil that keeps financial markets running smoothly. Thanks to the 2008 financial crisis, new global regulation and a heightened awareness of counterparty risk, oil has never been in greater demand. Indeed, according to Bank for International Settlements data, the global collateral shortfall is estimated to be between US$3 trillion and $5 trillion[1].

Insurance market participants are feeling the crunch. According to a recent *Insurance Risk* study conducted by BNY Mellon, more than half of survey respondents believe they will be impacted by the implications of the Dodd-Frank legislation's requirements for central clearing of some over-the-counter (OTC) derivatives. The survey also revealed that 54% of insurers do not currently post initial margin. Consequently, a number of insurers are now preparing themselves operationally for this new environment. Indeed, insurers that often buy foreign-denominated bonds and engage in derivatives trades to hedge their currency risk will have an increasing need to mobilise collateral to cover exposures they have with counterparties.

BNY Mellon's Dominick Falco highlights that, in the ASEAN region, there is a particular demand and need for collateral services. "In southeast Asia, insurers deal with a smaller domestic market but have more of an international investment portfolio and so they are often dealing with multi-currency assets that require sophisticated currency hedging. That hedging activity must now be collateralised.

"They will need to enhance their operations and manage risk – be it credit, liquidity or operational risk – more effectively across a spectrum of markets and products. We are already seeing demand for solutions around the segregation, optimisation and financing of collateral, as institutions look for answers to a range of questions that span not only collateral management and derivatives servicing, but also activities such as securities financing in response to changing demands."

Traditional banking participants in the repo market are now upgrading their term funding books to deal with Basel III and specifically the net stable funding ratio. "There is significant interest in longer-term funding. We are seeing clients demanding not just one-year evergreen trades, but also looking to enter into the longer-term borrowing market," says Falco.

BNY Mellon's *Insurance Risk* survey confirmed that, while they have relatively low levels of cash available, insurers are substantial holders of AAA rated and AA rated bonds – making them natural counterparties to their banking peers.

Falco believes the recent expansion in the range of assets comprising the Liquidity Coverage Ratio has changed the mix of collateral required, but firms using BNY Mellon's service have enjoyed a seamless transition.

"Our products tend to be collateral-agnostic, especially when we talk about processes that manage securities. So, if corporate bonds are acceptable versus G-7 government debt, or if equities are acceptable, the processes are not that different," he says.

"For clients using BNY Mellon as a collateral manager, we mobilise assets and enable switching between collateral types. So, if one asset runs out versus another, that is acceptable. Or if an asset is sold, there is a level of operational efficiency."

The move towards risk-based capital regimes across Asia is also providing firms with an impetus to manage their collateral more effectively. "Insurers find that higher capital charges apply to them for unsecured exposures, so there's a greater need to collateralise their positions," says Falco.

## Step change

While cash is still the primary collateral type pledged, there is a gradual but significant step change towards diversification of securities. Falco sees cash and non-cash platforms coming together as mandated by the market. "Clients recognise the efficiencies of using securities as collateral, which is where we can help to deal with the complexity of settlement, pricing and suitability of collateral. Having the tools to optimise collateral usage for a given exposure gives firms an advantage in the market place."

"The complexity of moving collateral and checking that it meets a counterparty's requirements becomes difficult to handle when the collateral book grows. As a result, we are seeing increased interest from clients that want to outsource the management of this process. Although cash is fully fungible and easy to settle, the ability to accept and post non-cash collateral brings significant efficiencies – as long as the operational burden is removed."

"Like the rest of the financial services industry, insurers face a seismic shift around collateral over the next 12–18 months, as we move from an off-market, OTC environment into a listed, centrally cleared setting. Insurers and other buy-side firms will have a greater need to post margin in the form of high-quality collateral. Accordingly, firms will need to optimise the use of their collateral, converting idle assets into eligible collateral. For some, establishing a securities financing desk may also be a source of yield pick-up."



[1] BIS Quarterly Review, *June 2012*