Sleeping giants must stir

Insurance firms will miss an opportunity if they don't respond to financial market infrastructure reform.

We know from experience that financial market infrastructures (FMIs) are fragile. We also know that large financial institutions, even those whose products are explicitly designed to mitigate risk, are themselves seen as vulnerable to risk. If the development over time of intermediary processes in financial markets has been substantially shaped by large-institutional demand, from pension funds in particular, more recent evolution has been significantly influenced by our knowledge of the potential danger that the big players represent.

This is the background against which the current and future roles of insurance companies within their own FMIs should be assessed. What are their expectations and needs, and how are these being met? What contribution to infrastructure development do they make, and perhaps, what further contribution should they make? If the collective voice of pension funds has been louder in the past, how should insurance companies raise their own volume in future, if indeed they need to do so?

Natural synergy

Making a simple but telling observation, Olivier de Schaetzen, director, Euroclear, says: “Insurance companies are different in that they are very, very long-term investors.” We might take this as our starting point. If an FMI should properly be built for the long term, it follows that FMIs and insurance companies share an orientation towards longevity. Should we look for a natural synergy between FMIs and insurance companies in terms of future development?

It's a compelling question with some thought-provoking answers. Edouard de Lencquesaing, CEO, European Institute for Financial Regulation, says: “Looking at the new regulatory framework, with Basel III and the European market infrastructure regulation (EMIR) and other rules, it is clear that the banks' ability to finance the economy through credit will diminish. There will be more market-type instruments to finance smaller companies. That will increase the role of fund managers and insurance companies in financing companies." The specific instruments may be forms of credit portfolio constructed by agreement with the banks, but nonetheless, here is a layer of FMI-oriented services that is likely to be developed by insurance companies. De Lencquesaing mentions in particular "invest-to-lend" structures, saying: "It is clear that insurers will take a major part in this, because they are long-term investors."

The regulatory environment is thus conducive to insurance-company engagement with their FMIs; there is a synergy. There is a reason for this, and almost paradoxically, it is that insurance companies are in one

infrastructure maintenance and development. When the EU's Internal Market and Services Directorate General consulted (in Q4 2012) on a possible recovery and resolution framework for non-bank financial institutions, replies indicated "general but not unequivocal support for further studying the scope for resolution tools" in the summary of replies published in March 2013. Not quite a stirring call to action, but perhaps not surprising either.

David Strachan, co-head of the Deloitte Centre for Regulatory Strategy, says: "Insurers generate much less systemic risk than banks, and largely from their non-traditional non-insurance (NTNI) activities." These are largely the short-term activities, and indeed, replies to the EU's consultation also singled out NTNI activities, particularly by cross-border institutions, as the area

> "We as market infrastructures have to make our case to the insurance companies."
>
> ***Robert Almanas, SIX Securities Services***

key respect less important than banks. The Financial Stability Board (FSB) lists only nine global systemically important insurers (G-SIIs) on its list of such institutions (published July 2013), alongside 28 global systemically important banks. The FSB's list was published as part of the wider drive towards protecting FMIs via the development of damage-limitation tools whereby large institutions could fail without wider impact.

The possibly unintended consequence of this drive has been the revelation of the extent to which insurance companies, including G-SIIs, are regarded more positively than banks and other institutions in the context of systemic risk and by extension

most likely to give rise to concern. To extrapolate from de Schaetzen's point above about the significance of insurance companies as long-term investors, we might draw the provisional conclusion that insurance companies are at their systemically most risky when they're behaving least like insurance companies.

At arm's length

Enough of the big picture. As all of the above suggests, insurance companies do seem well placed to contribute to long-term FMI development, and their significance within their native FMIs might be expected to increase over time relative to →

David Strachan | Deloitte Centre for Regulatory Strategy

"Insurers generate much less systemic risk than banks, and largely from their non-traditional non-insurance activities."

David Strachan, Deloitte Centre for Regulatory Strategy

that of banks and other financial institutions. [In passing: the International Association of Insurance Supervisors (IAIS) has proposed that higher loss-absorption capacity requirements should apply to G-SIIs from end-2014, and replies to the EU's consultation indicated a widespread view that the forthcoming Solvency II Directive will anyway deliver the powers that the insurance supervisors need. Solvency II is not quite on schedule, and the real-world timetable for its implementation is widely debated, but it is coming.]

But what of today? Given the post-crisis, actively regulated state of FMIs today, what do insurance companies want, what do they need and what can they reasonably expect from financial-market infrastructures?

John Gubert, chairman, GSS Exco at Unicredit, says: "When I look at the insurance industry, I see really two industries. One is a savings industry which has a product packaged with life cover perhaps, but essentially it's a savings product. The other is a protection product – house insurance, fire insurance, and so on." The products of the savings side of the industry, says Gubert, are "very classic", not least in that insurance companies do run mutual funds as their core savings product. Similarly, non-life products also require a fund base.

But there is a significant difference between insurance companies and other "very classic" financial institutions. Why? First, Gubert suggests, because insurance companies have tended to approach infrastructure indirectly – exchanges through brokers, post-trade through custodians, etcetera – which is not unusual, but secondly, more importantly, because they have a distinct perspective. Gubert says: "If you talk to the insurance industry, their core needs from exchanges are liquidity and transparency; transparency because they are highly ethical and therefore want to be sure that the price discovery is open and has integrity."

Impact of OTC reforms

To be highly ethical at a time of heightened regulatory concern is positive. To have a

Edouard de Lencquesaing | European Institute for Financial Regulation

> "The major question facing us today is how to facilitate long-term investment versus short-term investment."
>
> *Edouard de Lencquesaing, European Institute for Financial Regulation*

clear footprint in corporate governance is a significant contribution. And yet – not influencing FMIs at a time of change (and in the aftermath of a time of crisis) is potentially problematic. It would be superficial to suggest that their shared concern for liquidity and transparency aligns the interests of insurers and regulators, not least because, ironically, regulatory action has impacted directly against the interests of insurers.

One key point is that regulatory intervention – Dodd-Frank as well as Basel III and EMIR – has shifted much activity away from OTC markets and onto exchanges. This poses a number of issues, not least in that insurance companies tend to be significant users of derivatives and, specifically, swap products. De Lencquesaing says: "What is new, and what is important is the impact of regulation on structured products, guaranteed products and derivatives. It's clear that in the context of derivatives, insurance companies will be impacted. The major impact will be the collateralisation of those instruments."

The "old priority" for insurance companies was to ensure that assets are both traceable and protected; the "new priority", post-EMIR, is to do the same but in the light of a somewhat more pressing need. Gubert says: "In post-trade, they are looking at the safety of assets, certainty of transactions and – although this is not just a post-trade issue – the protection of their entitlements." This last is more of an issue for cross-border institutions, and thus G-SIIs, in that there is no universally accepted definition of ownership – you don't automatically get what you think you paid for. What's changed is that these days, a key consideration for all insurers is to be able to

John Gubert | Unicredit

> "The insurance industry's core needs from exchanges are liquidity and transparency."
>
> ***John Gubert, Unicredit***

mobilise assets to cover their derivative and other activity. De Schaetzen says: "Insurance companies are expecting market infrastructures to come up with solutions to move assets efficiently from where they are to where they need to be."

In the long run

The need is for functional collateral. Insurance companies should perhaps put their other foot down; the lack of a footprint in FMI regulation/development, standing alongside that in corporate governance, begins to look like an oversight. But the challenge here is also an opportunity. De Schaetzen says: "All the regulation now is increasing the importance of collateral. There will be an increasing need to collateralise credit exposure with quality assets. What we observe is that a significant share of the quality-asset pool is in the hands of the insurance companies."

The importance of FMIs to insurance companies is not, however, simply a case of the latter waking up to the potential advantages of engagement with the former. "We as market infrastructures have to make our case to the insurance companies," says Robert Almanas, head of international services, SIX Securities Services. In this regard, he sees global collateral management as a key area where FMIs could help the insurance sector to get to grips with the growing need for co-ordination.

The strength of the insurance companies' position, in relation to FMIs, is that they hold most of the pieces (if their assets can be so described). The challenge is that regulatory intervention is changing the rules of the game. What insurance companies expect from FMIs is transparency, security and ready access to clean liquidity. What they also need, now, is access to solutions whereby they can exploit the changes that regulation has made to FMIs and their processes. Is that need being met? Perhaps the best answer would be to suggest that, in terms of the long-term stability of FMIs, insurance companies are the right institutions in the right place at the right time. De Lencquesaing says: "The major question facing us today is how to facilitate long-term investment versus short-term investment."

Ask an insurance company? •