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U.S. Insurance Industry's Exposure to Securities Lending and Repurchase Agreements Decreased in 2018

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Executive Summary

- Securities lending may represent a low-risk investment strategy for U.S. insurers, whereby they may obtain additional yield income by engaging in short-term financing.
- Repurchase agreements (repos) are economically similar to securities lending in that they represent a form of short-term secured financing.
- Historically, both securities lending and repo activity have accounted for less than 1% of U.S. insurers' total cash and invested assets.
- In 2018, U.S. insurers experienced a decline in growth in both securities lending and repo exposures.

For U.S. insurers, securities lending generally represents a potentially low-risk asset management strategy. Insurers not only earn a modest income on fees charged to counterparties (or "borrowers") on securities lent, but also they earn income on the cash or securities received in exchange for the loaned securities (the "reinvested collateral"). Historically, securities lending has not been a significant investment strategy for U.S. insurers, with reinvested collateral at less than 1% of U.S. insurers' total cash and invested assets.

U.S. insurers also engage in repurchase agreements ("repos") and reverse repos, which together are also typically less than 1% of total cash and invested assets. Repos are economically similar to securities lending in that they represent a form of short-term secured financing; reverse repos are repos from the counterparty's perspective. According to the Federal Reserve Bank of New York:

"A repurchase agreement is the sale of securities coupled with an agreement to repurchase the securities, at a specified price, at a later date ... Securities lending agreements are economically similar to repo agreements. Both agreements resemble a collateralized loan, but their treatment

*under the U.S. bankruptcy law is more beneficial to cash lenders: In the event of bankruptcy, cash lenders can typically sell their collateral, rather than be subject to an automatic stay as would be the case for a collateralized loan.*¹

Repos can be bilateral, where there is a direct agreement between two counterparties whose custodian banks settle the trade, or they can be tri-party, where there is a third-party custodian bank settling the trade between two counterparties. The Bank of New York Mellon (BNY Mellon) and JPMorgan Chase are the two primary third-party custodian bank intermediaries for tri-party repos.

U.S. Insurer Exposure – Year-End 2018

Reinvested Collateral

In exchange for securities lent, U.S. insurers receive cash and/or securities as collateral. They may, in turn, invest any cash received in securities so that collectively, all cash and securities become known as “reinvested collateral.” Insurers can earn investment income on reinvested collateral, but in doing so, they must consider not only the credit risk of the additional investments, but also the asset/liability management risk relative to the lent securities.

As of year-end 2018, reinvested collateral held by U.S. insurers totaled about \$50 billion in book/adjusted carrying value (BACV) based on data as reported in Schedule, DL Part 1 and in Schedule DL, Part 2. In comparison, reinvested collateral was about \$55.6 billion at year-end 2017 (representing a 10% year-over-year [YOY] decrease) and \$53 billion at year-end 2016. Since 2009, reinvested collateral has ranged from a low of \$47 billion to a high of \$63 billion. Table 1 shows the trend in historical U.S. insurer exposure to securities lending reinvested collateral over the past several years.

Table 1: U.S. Insurers Reinvested Collateral (\$bil BACV)

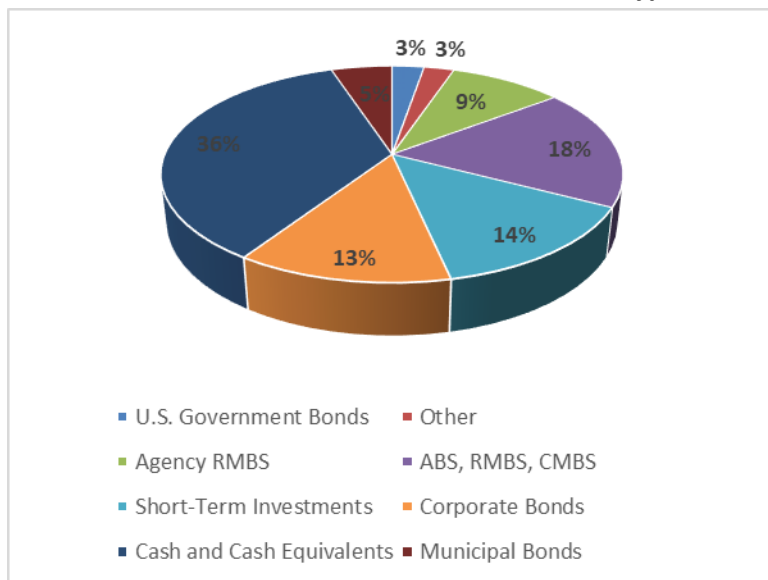
2013	2014	2015	2016	2017	2018
\$ 61.0	\$ 59.0	\$ 55.0	\$ 53.1	\$ 55.6	\$ 49.7

The composition of reinvested collateral types was relatively unchanged YOY 2017 to 2018, except for corporate bonds, which increased to 13% of total reinvested collateral at year-end 2018 from 11% at year-end 2017. As shown in Chart 1, the majority of reinvested collateral held by U.S. insurers at year-end 2018 was in cash and cash equivalents at 36% of the total, followed by about 18% in residential-mortgage backed securities (RMBS), commercial mortgage-backed securities (CMBS) and asset-backed securities (ABS) combined. Note that similar to year-end 2017, short-term, liquid investments (i.e., cash and cash equivalents plus short-term investments) totaled 50% of U.S. insurers’ total reinvested collateral at year-end 2018 (compared to about 45% at year-end 2016).

Life companies accounted for about 84% of U.S. insurers’ reinvested collateral exposure, followed by property/casualty (P/C) companies at 12%.

¹ The Federal Reserve Bank of New York Staff Reports, *Repos and Securities Lending*, December 2011, Revised February 2013.

Chart 1: U.S. Insurers' Reinvested Collateral Asset Types as of Year-End 2018



Data reported by U.S. insurers showed that the majority, or almost 70% of reinvested collateral, was scheduled to mature in 10 years or less as of year-end 2018, which was consistent with year-end 2017.

Securities Lent

U.S. insurers are not required to report the actual amount of securities lent to borrowers; rather, they report only the amount associated with the lent securities, or the amount of the whole security (i.e., the encumbered amount owned rather than the portion of it that is lent) that is reported in Schedule D, Part 1 (Bonds); Schedule DA (Short-Term Investments); and Schedule D, Part 2, Section 2 (Common Stock). As such, the total amount of securities lent by U.S. insurers as reported is more than the amount of securities actually lent. As of year-end 2018, U.S. insurers' reported data showed that exposure to securities associated with securities lent totaled approximately \$79 billion in BACV (a 10% YOY decrease), and, consistent with historical trends, the majority of securities lent activity was with life companies.

In comparison, at year-end 2017, total securities associated with securities lent by U.S. insurers totaled about \$87 billion and \$76 billion in 2016. Since 2011, securities associated with securities lent have ranged between approximately \$76 billion and \$87 billion. Table 2 shows the last six years' history of U.S. insurers' reported exposure to securities associated with securities lent.

Table 2: U.S. Insurers' Securities Associated with Securities Lent* (\$bil BACV)

2013	2014	2015	2016	2017	2018
\$ 80.0	\$ 76.0	\$ 79.6	\$ 76.3	\$ 87.4	\$ 78.9

* Coded as "LS" in Schedule D, Part 1; Schedule DA; and Schedule D, Part 2, Section 2.

A YOY analysis of securities that comprised securities lent by U.S. insurers shows that most continue to comprise corporate bonds and U.S. government bonds.

Repos

U.S. insurer exposure to repos and reverse repos has also traditionally been less than 1% of total cash and invested assets on an aggregate basis. Similar to securities lent, U.S. insurers report only the total amount of securities *associated* with repo activity; that is, the insurers did not necessarily lend out the full amount of the securities reported. They may have only lent a portion of the reported line item for which they received collateral from a counterparty (i.e., they represent securities initially sold in exchange for cash). As of year-end 2018, reported data showed that U.S. insurers had about \$19.5 billion in BACV of securities associated with repos and reverse repos (in aggregate) compared to almost \$21 billion at year-end 2017, representing a 6% YOY decrease. Table 3 shows the historical exposure going back to year-end 2013. As reverse repo activity has been relatively insignificant for U.S. insurers, it was included in repo activity totals for the purpose of this report update. For example, about \$6 billion of U.S. insurer repo activity (out of the total \$19.5 billion) was in reverse repos at year-end 2018 compared to \$3 billion and \$4 billion at year-end 2017 and year-end 2016, respectively.

Table 3: U.S. Insurers' Securities Associated with Repos (\$bil BACV)*

2013	2014	2015	2016	2017	2018
\$ 20.3	\$ 21.4	\$ 25.0	\$ 25.9	\$ 20.8	\$ 19.5

* Coded as "RA," "RR," "DR" and "DRR" in Schedule D, Part 1; Schedule D, Part 2, Section 2; and Schedule DA.

Consistent with years prior, as of year-end 2018, all securities associated with repos held by insurers were investment grade based on their NAIC designations, with 95% having NAIC 1 designations. Also consistent with years prior, the majority were in U.S. government bonds, followed by lesser amounts in corporate bonds and agency RMBS. Even though U.S. government bonds are highly liquid, the ability of the counterparty to source the same or substantially the same securities to return back to the insurer at the end of the repo agreement poses a potential risk. Life companies accounted for almost the entire U.S. insurance industry's exposure to repos and reverse repos.

Statutory Accounting Treatment

A discussion regarding current statutory accounting treatment for U.S. insurers' securities lending and repo activity can be found in the NAIC Capital Markets Bureau's previously published special report titled "U.S. Insurance Industry's Exposure to Securities Lending and Repurchase Agreements as of Year-End 2017," published in July 2018. There have been no changes to accounting treatment for securities lending or repos since the last special report.

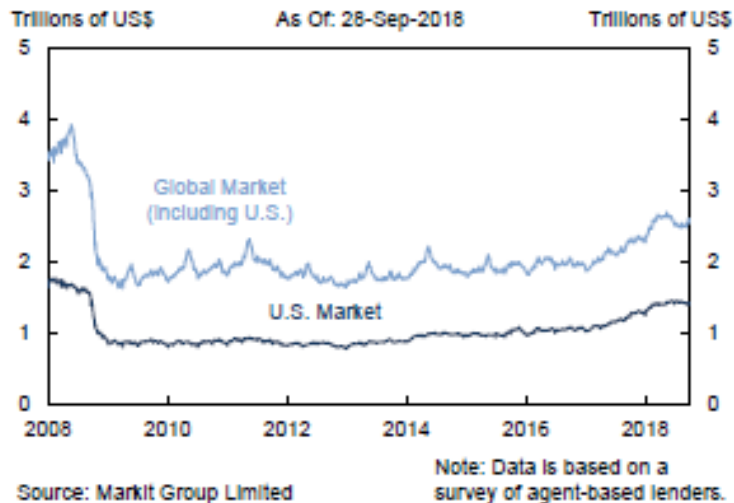
Current Market Trends

The size of the overall securities lending market was \$2.6 trillion globally as of June 2019, according to the Financial Stability Oversight Council (FSOC) 2018 annual report. (See Chart 2).² To promote transparency relative to these investments, regulatory bodies such as FSOC and the Financial Stability Board (FSB) have made initiatives for data collecting and reporting. According to the FSB, 18 policy

² 2018 FSOC Annual Report, revised June 2019.

recommendations were published in reports by the FSB dated August 2013 and updated in a November 2015 report, relative to addressing financial stability risks arising from securities lending and repos. These recommendations, however, have yet to be implemented. More discussion about these report recommendations is included in the aforementioned, previously published, (July 2018) NAIC Capital Markets special report.

Chart 2: Value of Securities on Loan



Source: FSOC 2018 Annual Report

Total bilateral U.S. repo market activity was about \$2.2 trillion as of year-end 2018 compared to a pre-crisis peak in 2007 of \$4.5 trillion, according to data from the Securities Industry and Financial Markets Association (SIFMA). The tri-party repo market was estimated to be \$2.4 trillion as of July 2019, compared to \$1.7 trillion and \$1.6 trillion in January 2017 and January 2016, respectively.

According to the 2018 FSOC annual report, visibility into the tri-party repo market has improved since the financial crisis, but more monitoring is needed. In a distressed market, not only would there be a major disruption to the financial system in general, but tri-party repo “participants may not have a ready alternative platform to clear and settle these transactions.” Currently, the Bank of New York Mellon and JPMorgan Chase are the primary asset servicers that act as intermediaries for the tri-party repo market.

Note that the data collection as recommended by the FSB and FSOC is intended to monitor financial stability and private sector risk management by regulators and market participants, whereas the aforementioned NAIC disclosures (as in the reporting requirements and Statement of Statutory Accounting Principles [SSAP]) are intended to help monitor solvency of individual insurance entities; it is important to make that distinction. U.S. insurers are required to “bucket” maturity dates of securities lending reinvested collateral in Schedule DL, Part 1 or Schedule DL, Part 2, as applicable, to address any mismatch in the maturity of the reinvested collateral and when a borrower can demand return of the cash it posted (as indicated in the applicable securities lending agreement). In addition, summary information is required on the duration of when lent securities are expected to be returned to the

insurance company and the cash is to be returned to the borrower; this helps identify potential liquidity constraints within the securities lending program.

Conclusion

Reinvested collateral from securities lending as well as repo activity has historically comprised less than 1% of total cash and invested assets. Insurers engage in securities lending as an investment strategy for short-term financing and to obtain additional yield income (on reinvested collateral held in exchange for securities lent to counterparties), and they engage in repo activity mostly to raise short-term cash and access low-risk cash flow.

While banking regulators have coordinated to establish procedures to monitor activity for the sake of financial stability, insurance regulators have made efforts to monitor this activity for solvency.

The NAIC Capital Markets Bureau will continue to monitor trends in the securities lending and repo markets and report as deemed appropriate.

Useful Links:

[NAIC Capital Markets Primer – Securities Lending, June 2018](#)

[FSOC 2018 Annual Report](#)

Questions and comments are always welcomed. Please contact the Capital Markets Bureau at CapitalMarkets@naic.org

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