The HOT SPOT

Liquidity Swaps: Potentially Increasing Interconnectedness between Insurance and Banking (2/24/2012)

Given the current environment in Europe, and as a means to ensure access to funding, some European banks have entered into "liquidity swaps." These liquidity swaps involve European banks selling (the illiquid) securities to counterparties (i.e., investment banks or insurance companies) in exchange for a discounted value of government bonds or other liquid assets. In turn, the European banks utilize these swapped liquid assets as collateral to secure loans from the European Central Bank (ECB).

Demand for liquidity swaps has increased in Europe in recent months, particularly between European banks and insurers. According to a guidance consultation paper written by the United Kingdom's Financial Services Authority (FSA) in July 2011, liquidity swaps between European banks and insurers are an increasing trend, causing the FSA to become concerned about the spread of systemic risk (that is, resulting in continued collapse of the financial system) in Europe. The suggested rationale is that liquidity swaps offer a solution to insurers' search for yield, and they also fulfill the banks' need for liquidity. For a fee, the banks can pledge illiquid structured assets (at a discount) in return for liquid collateral.

The FSA also is concerned about the interconnectedness between the insurance and banking sectors, meaning that a bank failure could also cause distress or failure among connected insurance companies. Thus far, we have not seen any evidence that insurers in the United States have engaged in this activity. However, the Capital Markets Bureau believes that liquidity swaps could present issues to be concerned about if U.S. insurers become active in this market. If U.S. insurers did become involved in this market, then they might be reported as either a repurchase agreement, which we do not view as appropriate, or as a sale and long-term purchase commitment.

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