The NAIC Capital Markets Bureau monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. Previously published NAIC Capital Markets Bureau Special Reports are available via its web page and the NAIC archives (for reports published prior to 2016).

U.S. Insurance Industry's Exposure to Securities Lending and Repurchase Agreements at Year-End 2020

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Executive Summary

- Securities lending represents a low-risk investment strategy for U.S. insurers, whereby they may obtain additional yield income by engaging in short-term financing.
- Securities lending collateral held by U.S. insurers totaled about $55 billion in book/adjusted carrying value (BACV) at year-end 2020, and the majority of the collateral, or 44%, was in cash and cash equivalents.
- For exposure to 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, and it totaled approximately $42.9 billion in BACV at year-end 2020.
- Repurchase agreements (repos) are economically similar to securities lending in that they represent a form of short-term secured financing.
- Securities lending and repo activity together accounts for about 1% of U.S. insurers' total cash and invested assets.

For U.S. insurers, securities lending generally represents a potentially low-risk asset management strategy. Insurers earn a modest income on fees charged to counterparties (or "borrowers") on securities lent, as well as earn additional yield income on the cash or securities received in exchange for the loaned securities (the "collateral").

U.S. insurers also engage in repos and reverse repos, which together with securities lending collateral totaled about 1% of total cash and invested assets. Repos are similar to securities lending in that they represent a form of short-term secured financing. Insurers engage in repo activity mostly to raise short-term cash and access low-risk cash flow. Reverse repos are repos from the counterparty's perspective.

Repos can be bilateral, where there is a direct agreement between two counterparties whose custodian banks settle the trade, or they can be tri-lateral, where there is a third-party custodian bank settling the trade between two counterparties. Since 2019, the Bank of New York Mellon has been the primary third-party custodian bank intermediary for trilateral repos.

While banking regulators have coordinated to establish procedures to monitor activity to maintain financial stability, insurance regulators make efforts to monitor this activity for solvency.

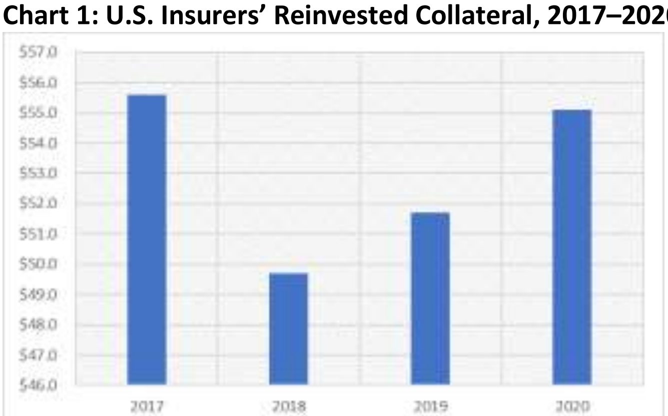
U.S. Insurer Exposure – Year-End 2020

Reinvested Collateral

In exchange for securities lent, U.S. insurers receive cash and/or securities as collateral. In security lending agreements where the insurer can sell or repledge the collateral, the cash and securities received are recognized in the financial statements and are referred to as "reinvested collateral" even though the insurer may not actually sell or repledge the 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.

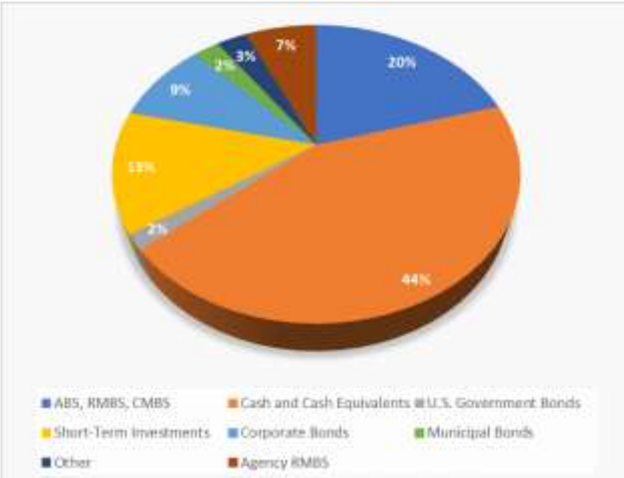
As of year-end 2020, reinvested collateral held by U.S. insurers totaled $55.1 billion in BACV based on data as reported in Schedule DL, Part 1 and in Schedule DL, Part 2. In comparison, reinvested collateral was $51.7 billion at year-end 2019, representing a 6% year-over-year (YOY) increase. Chart 1 shows U.S. insurers' historical exposure to securities lending reinvested collateral over the last four years.

Chart 1: U.S. Insurers' Reinvested Collateral, 2017–2020 ($bil BACV)



As shown in Chart 2, 44% of collateral held by U.S. insurers for securities lent at year-end 2020 was in cash and cash equivalents, followed by about 20% in residential-mortgage-backed securities (RMBS), commercial mortgage-backed securities (CMBS), and asset-backed securities (ABS) combined. Short-term investments represented 13% of total collateral, and when combined with cash and cash-equivalent collateral, almost 60% of the total was in highly liquid assets. In comparison, at year-end 2019, cash and cash equivalents were 42% of total collateral, followed by 19% in ABS, RMBS, and CMBS.

Chart 2: U.S. Insurers' Reinvested Collateral Asset Types as of Year-End 2020



Similar to year-end 2019, life companies accounted for about 86% of U.S. insurers' reinvested collateral exposure, followed by property/casualty (P/C) companies at 10% at year-end 2020. In addition, at year-end 2020, about 70% of reinvested collateral carried NAIC 1 designations, implying the highest credit quality.

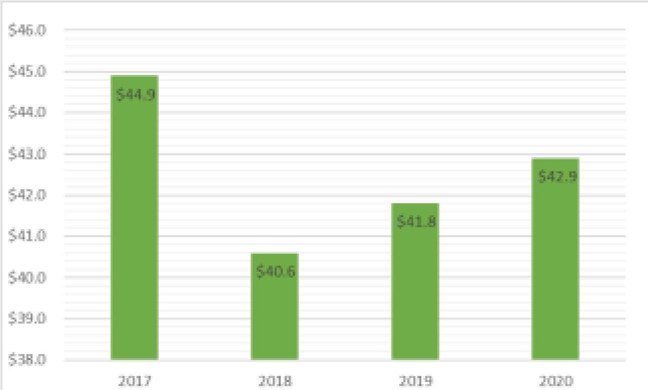
Data reported by U.S. insurers showed that the majority, or about 80% of reinvested collateral, was scheduled to mature in 10 years or less at year-end 2020. And large U.S. insurers, or those with more than $10 billion assets under management, accounted for 90% of the industry's total securities lending reinvested collateral.

Securities Lent

U.S. insurers are not required to report the specific amount of securities lent to borrowers; rather, they report 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). As such, the total amount of securities lent by U.S. insurers as reported in the investment schedules is greater than the actual amount of securities actually lent. While U.S. insurers report exposure to securities that are associated with securities lent in Schedule D, Part 1 (Bonds); Schedule D, Part 2 (Common Stock); and Schedule DA (Short-Term Investments) in the annual statement filings, the year-end exposure for securities associated with securities lent in this special report focused on the exposure as reported by insurers in *Note 5L(1)b – Restricted Assets(Including Pledged) - Collateral Held Under Security Lending Agreements (Note 5L(1)b)* – to the Financial Statements, based on accounting guidance.

As of year-end 2020, U.S. insurers' reported data showed that exposure to securities associated with securities lent totaled approximately $42.9 billion in BACV (based on Note 5L(1)b), up slightly from $41.8 billion at year-end 2019. Chart 3 shows the most recent four years' exposure to securities associated with securities lent for U.S. insurers. Consistent with historical trends, the majority of securities lent activity was with life companies at year-end 2020.

Chart 3: U.S. Insurers' Exposure to Securities Associated with Securities Lent, 2017–2020 ($bil BACV)



A YOY analysis of securities that comprised securities lent by U.S. insurers as reported in Schedules D Part 1 and Part 2 and Schedule DA showed that they mostly comprise corporate bonds and U.S. government bonds.

Repos

U.S. insurers' 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 the total amount of securities *associated* with repo activity in the investment schedules (i.e., Schedule D, Part 1; Schedule D, Part 2, Section 2; and Schedule DA). This means that insurers did not necessarily lend out the full amount of the securities reported; however, they may have only lent a portion of the reported line item for which they received collateral from a counterparty. For the purpose of this special report, and based on accounting guidance, as of year-end 2020, repo activity reported by U.S. insurers in Note 5L1C through Note 5L1F (total repo and reverse repo activity) was about $28 billion in BACV of securities associated with repos and reverse repos (in aggregate) compared to $25.9 billion at year-end 2019, representing an 8% YOY increase. Chart 4 shows the most recent four years' exposure to securities associated with repos and reverse repo activity.

Chart 4: U.S. Insurers' Securities Associated with Repos, 2017–2020 ($bil BACV)

Over at least the last few years, and as reported in Schedules D Part 1 and Part 2 and Schedule DA, all securities associated with repos held by U.S. insurers were investment grade based on their NAIC designations. At year-end 2020, all securities associated with repos carried NAIC 1 and NAIC 2 designations, implying high credit quality. The majority of lent securities were agency RMBS. Even though agency RMBS are relatively liquid given their government-sponsored entity (GSE) status, the ability of the counterparty to source the same or substantially the same securities to return to the insurer at the end of the repo agreement poses a potential risk. Life companies accounted for about 90% of the U.S. insurance industry's exposure to repos and reverse repos, with the remaining 10% at P/C companies.

Current Market Trends

The size of the overall securities lending market was $2.5 trillion globally as of September 2020, according to the Financial Stability Oversight Council (FSOC) 2020 annual report.[1] (See Chart 5.) About 57% of this total was attributed to the U.S. market.

Chart 5: Value of Securities on Loan

Source: FSOC 2020 annual report

Total repo borrowing was $4.1 trillion as of the second quarter of 2020 according to the FSOC 2020 annual report, down from $4.3 trillion a year prior. According to data from the Securities Industry and Financial Markets Association (SIFMA), total bilateral U.S. repo market activity was about $2.6 trillion as of year-end 2020 compared to a pre-crisis peak in 2007 of $4.5 trillion. Also, per SIFMA, the U.S. tri-party repo market was estimated to be $2.9 trillion as of September 2021, compared to $1.9 trillion in September 2020.

According to a report by the Federal Reserve's Open Market Committee (FOMC), to address the onset of severe market disruptions related to the COVID-19 pandemic, in March 2020 a series of adjustments to repo operations was implemented to ensure sufficient functioning of short-term dollar funding. Then, beginning in May 2020, the frequency of its repo operations was scaled back as market conditions stabilized.[2]

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[1] 2020 FSOC annual report. The 2021 FSOC annual report was not yet available at the time of this report publication.

[2] Federal Reserve Bank of New York, *Open Market Operations During 2020*, May 2021.

In 2013, the Financial Stability Board (FSB) published recommendations to address financial stability risks associated with securities lending and repos since they play a crucial role in the markets, particularly secondary market liquidity. In 2015, the FSB developed standards and process for collecting and aggregating global securities lending and repo data, in turn promoting transparency with respect to these investments. Finally, in April 2021, the FSB published a frequently asked questions (FAQ) report intended to not only promote a common approach, but also further develop national implementation of securities lending and repo data standards.

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.

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 2020 Annual Report

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