Carl B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation
(202) 624-2118 t (866) 953-4096 f
carlwilkerson@acli.com

Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
RIN 1557-AD43
Docket ID OCC–2011–0008

Mr. Robert deV. Frierson, Secretary
Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
RIN 7100 AD74
Docket No. R–1415

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064–AD79

Mr. Gary K. Van Meter, Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090
RIN 3052–AC69

Mr. Alfred M. Pollard, General Counsel
Federal Housing Finance Agency
Eighth Floor
400 Seventh Street, SW
Washington, DC 20024
RIN 2590-AA45

November 26, 2012

Re: Supplemental Request for Comments on Proposed Margin and Capital Requirements for Covered Swap Entities

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. Life insurers actively participated in the legislative dialogue on derivative market reform and provided constructive input on proposed rulemaking implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). The ACLI respectfully submits the following response to the Prudential Regulatory Agencies' request for supplemental comments on Proposed Margin and Capital Requirements for Covered Swap Entities.

I. Background to Supplemental Request for Comments

On May 11, 2011, the Prudential Regulatory Agencies[1] published a notice of proposed rulemaking in the Federal Register that would establish margin and capital requirements for Swap Dealers and Major Swap Participants.[2] Among other things, the proposal addressed initial and variation margin

[1] The "Prudential Regulatory Agencies" include the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Farm Credit Administration and the Federal Home Loan Bank Board.
[2] *See* 76 Fed. Reg. 27546 (May 11, 2011) at 60057; http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf .

requirements for uncleared swaps. In a parallel regulatory initiative, the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) established a Working Group on Margin Requirements (WGMR) in October 2011 to develop harmonized international standards for uncleared swaps. Later, BCBS and IOSCO published a July 2012 Consultative Paper ("Consultative Paper") that outlined proposed margin requirements for non-centrally cleared derivatives. The consultative paper addressed: (i) the instruments that would be subject to margin requirements; (ii) the market participants to be subject to margin requirements; (iii) initial margin and variation margin methodology; (iv) eligible collateral; (v) treatment of provided margin; (vi) treatment of inter-affiliate transactions; and, vii) treatment of cross-border transactions.[3]

In response to these international efforts to implement consistent global standards for margin requirements for non-centrally cleared derivatives, the Prudential Regulatory Agencies indicated that they will consider the final WGMR policy recommendations when adopting final rules for margin on uncleared swaps, and may adapt final rules that conform to the final policy recommendations of BCBS and IOSCO. The Prudential Regulatory Agencies, therefore, determined it was appropriate to extend the comment period on the proposed margin requirements to give interested parties an opportunity to submit supplemental input on the Consultative Paper concurrently with the Prudential Regulatory Agencies' proposed rules.[4]

ACLI submitted comments on the Prudential Regulatory Agencies' rule proposal on initial and variation margin requirements governing uncleared swaps for Swap Dealers and Major Swap Participants, which appear in Appendix 1.[5] We reaffirm and incorporate these comments on the Prudential Regulatory Agencies' 2011 proposal in this letter. ACLI greatly appreciates the opportunity to submit supplemental comments on these matters in light of the BCBS-IOSCO proposal for international harmonization of margin requirements. In the discussion below, we highlight a series of topics in the Consultative Paper together with ACLI's position on these matters. As further background, a copy of ACLI's submission in response to the BCBS-IOSCO Consultative Paper appears in Appendix 2.

II. Summary and Analysis of Selected Topics in the Consultative Paper

A. Impact of Margin Requirements on Liquidity

The BCBS-IOSCO Consultative Paper states that the potential benefits of margin requirements must be weighed against the liquidity impact that would result from derivative counterparties' need to provide liquid, high-quality collateral to meet those requirements, including potential changes to market functioning as result of an increasing demand for such collateral in the aggregate. The paper notes that financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. Moreover, the paper observes that liquidity impact of margin requirements cannot be considered in isolation.

[3] According to the Consultative Paper, "[t]he economic and financial crisis that began in 2007 demonstrated significant weaknesses in the resiliency of banks and other market participants to financial and economic shocks." In the context of over-the-counter (OTC) derivatives in particular, the Consultative Paper observed that "the recent financial crisis demonstrated that further transparency and regulation of OTC derivatives and participants in the OTC derivatives markets was necessary to limit excessive and opaque risk-taking through OTC derivatives and to reduce the systemic risk posed by OTC derivatives transactions, markets, and practices."

[4] *See* 77 Fed. Reg. 191 (Oct. 2, 2012) at 41109; http://www.gpo.gov/fdsys/pkg/FR-2012-10-02/pdf/2012-24276.pdf .

[5] *See* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=47742&SearchText=american%20council . Referred to hereafter as "ACLI Comment Letter."

As a general matter, the Consultative Paper emphasizes that all derivatives not centrally-cleared by a central clearing party (CCP) should be subject to margining requirements. In principle, the paper indicates this includes all five major asset classes of derivatives (interest rate, credit, equity, foreign exchange and commodity) and all derivative products (both standardized and bespoke) that are not centrally cleared by a central counterparty for any reason.[6]

We fully agree with the Consultative Paper's position that the potential benefits of margin requirements must be weighed against the liquidity impact that would result from derivative counterparties' need to provide liquid, high-quality collateral to meet those requirements, including potential changes to market functioning as result of an increasing demand for such collateral in the aggregate. ACLI's July 11, 2011 submission to the Prudential Regulatory Agencies noted that limiting eligible collateral to cash and government securities could impose unintended negative consequences on the market for these securities, and could create liquidity log jams.[7]

We emphasized that limiting non-cash eligible collateral to U.S. Treasuries and guaranteed agency securities may also alter the markets for these securities -- artificially increasing prices due to rising demand and suppressing yields for investors in these securities. There could be new sensitivity in the markets for these securities which could lead, in times of market stress, to increased volatility which could ripple across the financial markets. Increased demand for U.S. Treasuries as eligible collateral would be exacerbated by the "flight to quality" in times of market turmoil or distress. Otherwise sound firms could potentially be placed into a scenario where they are forced to liquidate other high quality asset types to fulfill increasing margin requirements with a narrowly defined collateral universe. Being able to avoid this type of scenario is arguably a primary reason behind the wide range of eligible collateral types available at the Federal Reserve Discount Window.

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[6] The Consultative Paper establishes initial policy proposals for margin requirements for non-centrally-cleared derivatives through key principles addressing seven main elements:

1. Appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.
2. All financial firms and systemically-important non-financial entities ("covered entities") that engage in non-centrally-cleared derivatives must exchange initial and variation margin as appropriate to the risks posed by such transactions.
3. The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the proposed requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally-cleared derivatives at issue and (ii) ensure that all exposures are covered fully with a high degree of confidence.
4. To ensure that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.
5. Initial margin should be exchanged by both parties, without netting of amounts collected by each party (i.e. on a gross basis), and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.
6. Transactions between a firm and its affiliates should be subject to appropriate variation margin arrangements to prevent the accumulation of significant current exposure to any affiliated entity arising out of non-centrally-cleared derivatives.
7. Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions.

[7] *See* ACLI Comment Letter at 6.

The Consultative Paper's focus on the impact of margin requirements on liquidity reflects a prudent approach to designing margin requirements for uncleared swaps. We encourage the Prudential Regulatory Agencies to implement this conceptual framework into its proposed rule.

B. Eligible Collateral for Margin

The Consultative Paper discusses two means to define eligible collateral. One approach would limit eligible collateral to only the most liquid, highest-quality assets, such as cash and high-quality sovereign debt, on the grounds that doing so would best ensure the value of collateral held as margin could be fully realized in a period of financial stress.

A second approach would permit a broader set of eligible collateral, including assets like liquid corporate bonds and equity securities, and address the potential volatility of such assets through application of appropriate haircuts to their valuation for margin purposes. The Consultative Paper observes that potential advantages of the second approach would include (i) a reduction of the potential liquidity impact of the margin requirements by permitting firms to use a broader array of assets to meet margin requirements and (ii) better alignment with central clearing practices, in which CCPs frequently accept a broader array of collateral, subject to collateral haircuts. After evaluating each of these alternatives, the BCBS and IOSCO have proposed the second approach allowing broader eligible collateral.

ACLI fully supports the second approach in the Consultative Paper to broadly define collateral eligible for margin. In our July 11, 2011 comment letter[8], we explained that ACLI developed a proposal based on an analytic framework that utilizes basic portfolio diversification techniques on corporate bonds to demonstrate, almost to the level of statistical certainty, that high quality corporate collateral would provide enough cushion even against some of the most severe economic downturns.[9] Our proposal

[8] *See* ACLI Comment Letter at 7.

[9] A brief summary of ACLI's approach in our July 11, 2011 comment letter may provide helpful context. In light of the Dodd-Frank Act's prohibition on relying on credit ratings provided by nationally recognized statistical rating organizations (NRSROs), ACLI's proposal uses the Barclays U.S. Credit Index, a broad-based index containing 4,430 issues/CUSIPs representing an outstanding amount of $3.4 trillion. The Barclays U.S. Credit Index (together with its predecessor, the "Barclays Index") has many advantages, including clearly defined eligibility rules, a defined list of eligible CUSIPs limited to large liquid issues and a ready source of daily pricing and historical data. The Barclays Index is also widely benchmarked by money managers evidencing wide acceptability by other financial end users. In addition, the Barclays Index is one of many indices that are available to reference high-quality, U.S. corporate bonds and our analysis could be applied to other indices as well.

Following the Prudential Regulators' position that termination (close out) of uncleared derivatives and liquidation of collateral could take ten days in a stress scenario, we analyzed individual CUSIPs from the Barclays Index during 2008 and found that nearly 20% of CUSIPs experienced a ten-day price decline in excess of 20% with a maximum decline in excess of 90% in 0.2% of the CUSIPs, leading to the conclusion that tail events, though rare, do occur. Thus, a collateral pool consisting of one CUSIP is not advisable.

In expanding the analysis to look at the impact of adding additional CUSIPs to the collateral pool, ACLI chose a single month (September 2008) to ensure a continuous set of CUSIPs and selected a random portfolio as of September 1, 2008, subject to diversification rules limiting each issuer to a specified percentage and each broad sector (Financial Institutions, Industrials, Utilities, Transportation, Agencies, Local Authorities, Sovereign and Supranational) to no more than 45% of the portfolio. The market value of the equally weighted portfolio was calculated as it evolved through the month, including the largest 10-day (rolling) price drop that occurred during the month.

The analysis shows that corporate bond tail risk can be controlled with basic diversification rules (e.g., minimum of 20 CUSIPs and 45% concentration limit per High Level Sector) and that collateral haircuts of 15-20% provide a high degree of protection upon the occurrence of a CSE default. The maximum decline at the 99th percentile was 10.25% in our portfolio simulation. We also learned that further diversification beyond these rules provided little incremental benefit while substantially increasing recommended prudent haircuts, portfolio diversification and concentration limits to further support an expanded list of eligible collateral. Permitting a broader list of eligible collateral for both initial and variation margin would achieve the intent of securing derivatives positions and minimize the liquidity stress in the marketplace while avoiding other unintended consequences described above. In sum, therefore, we strongly recommend the incorporation of the Consultative Paper's approach allowing broader categories of eligible collateral into the Prudential Regulatory Agencies' Final Rule.

C. Proposed Examples of Eligible Collateral

As a guide, the Consultative Paper provides examples of the types of eligible collateral that satisfy the key principle would generally include:

- Cash;
- High quality government and central bank securities;
- High quality corporate bonds;
- High quality covered bonds;
- Equities included in major stock indices; and
- Gold.

The Consultative Paper notes that

> The illustrative list above should not be viewed as being exhaustive. Additional assets and instruments that satisfy the key principle may also serve as eligible collateral. Also, in different jurisdictions, some particular forms of collateral may be more abundant or generally available due to institutional market practices or norms. Eligible collateral can be denominated in any currency in which payment obligations under the non-centrally-cleared derivative may be made, or in highly-liquid foreign currencies subject to appropriate haircuts to reflect the inherent FX risk involved.

ACLI strongly supports the examples of eligible collateral listed in the Consultative Paper in fulfillment of the paper's key principle, and endorses the statement that the illustrative list is not exhaustive. We agree that additional assets and instruments, such as Residential Mortgage-backed Securities and Commercial Mortgage-Backed Securities may also satisfy the Paper's key principle, and should be evaluated by regulators as eligible collateral. A broad range of eligible high-quality collateral, with appropriate concentration limits, diversification constraints and haircuts, will prudently assure satisfaction of counterparty obligations while also enhancing liquidity in the market.

D. Key Principle on Margin in Consultative Paper

To ensure assets pledged as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect secured parties covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default, the Consultative Paper explains that these assets should be highly liquid and should, after accounting for an appropriate haircut, maintain their value in a time of financial stress.[10]

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operational burdens. Our analysis shows that high quality corporate bonds, appropriately haircut and diversified, can be prudently included as eligible collateral for cleared and uncleared derivative exposure. We also suggest that other high-quality collateral types such as Agency Debentures and Agency RMBS should also be included as eligible collateral.

[10] The Consultative Paper recommends the set of eligible collateral should recognize that assets that are liquid in normal market conditions may rapidly become illiquid in times of financial stress. In addition to having good liquidity, eligible collateral

The Consultative Paper recommends that securities issued by the counterparty or its related entities should not be accepted as collateral. The paper further notes that accepted collateral should also be reasonably diversified.

We support the concepts in the Consultative Paper that assets pledged as collateral for initial and variation margin should be capable of being liquidated in a reasonable amount of time, even under adverse market conditions to protect collecting entities against a counterparty's default. As noted above, we support reasonable diversification in accepted collateral.

E. Consultative Paper Commentary on Margin Standards Across Jurisdictions

The Consultative Paper states that:

> Market conditions and asset availability differ across jurisdictions. National supervisors should develop their own list of eligible collateral assets based on the key principle, taking into account the conditions of their own markets and making reference to the list of examples of eligible collateral under the proposed requirement section. Allowing jurisdictions to develop their own list of eligible collateral assets is expected to reduce margining requirements' impact on the liquidity and prices of eligible assets, reduce concentration risk, and provide sufficient flexibility to permit new assets to serve as collateral in the future as markets evolve.
>
> Subject to meeting the key principle, the scope of eligible collateral assets should be kept broad, with appropriate haircuts. It is expected that demand for high quality liquid assets may increase with the implementation of various regulatory reforms, including central-clearing, margin requirements for non-centrally-cleared derivatives and Basel liquidity requirements. Keeping the scope of eligible assets broad may help relieve pressure on the supply of eligible collateral assets. It may also help avoid concentration risks.
>
> Haircut requirements should be transparent and easy to calculate, so as to facilitate payments between counterparties, avoid disputes and reduce overall operational risk. Haircut levels should be risk-based and should be calibrated appropriately to reflect the underlying risks that affect the value of eligible collateral, such as market price volatility, liquidity, credit risk and FX volatility, during both normal and stressed market conditions.
>
> Given the diversity of eligible collateral assets, there may be practical difficulties for supervisors to stipulate in advance the haircut level for each type of collateral. The pre-determined haircut levels may also become outdated as market conditions change. Adopting internal or third party models that have been approved by supervisors to calculate haircut level may therefore be desirable. However, some firms may be unable or unwilling to develop internal haircut calculation models that meet regulators' requirements. To provide a conservative alternative in those cases, the Consultative Paper proposes a set of standardized haircuts that can be used in lieu of model-based haircuts.

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should not be exposed to excessive credit, market and FX risk. To the extent that the value of the collateral is exposed to credit, market, liquidity and FX risks (including through differences between the currency of the collateral asset and the currency of settlement), appropriately risk-sensitive haircuts should be applied. More importantly, the value of the collateral should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally-cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected (i.e. the so-called "wrong way risk").

ACLI strongly supports the recommendations in the Consultative Paper that the scope of eligible collateral should be kept broad, with appropriate haircuts. Alternatives reflecting internal or third party haircut models coextensively with a set of standardized haircuts that can be used in lieu of model-based haircuts provide a sound and responsible flexibility.

F. Inter-Affiliate Swap Transactions

The Consultative Paper suggests that transactions between a firm and its affiliates should be subject to appropriate variation margin arrangements to prevent the accumulation of significant current exposure to any affiliated entity arising out of non-centrally-cleared derivatives. The paper expresses the view that requiring variation margin on inter-affiliate transactions is advisable as it presents no net cost to a corporate group but does protect against the possibility that one affiliate builds up a large and uncollateralized exposure to another affiliate or parent that could jeopardize the entire corporate group.

The Consultative Paper notes, however, that despite the BCBS and IOSCO consensus view and proposal that variation margin be required on transactions between affiliates, some members believe that an exchange of variation margin is not necessary between affiliates, subject to compliance with specific criteria specified by the appropriate supervisory authority (e.g., requirements that the affiliates share the same appropriate centralized risk evaluation, measurement and control procedures, the affiliates are included in the same financial statements on a fully consolidated basis, and there is no current or foreseen material practical or legal impediment to the prompt transfer of funds or repayment of liabilities between the affiliates). In view of this equivocal reaction from its members, BCBS and IOSCO have requested input on the appropriate treatment of inter-affiliate trades.

We believe, as a general matter, that requiring variation margin between affiliates within a corporate group does not reduce systemic risk and does not increase safety and soundness of the financial system, provided of course, that the outward facing, net exposure of the corporate group is fully margined with initial margin and variation margin. Inter-affiliated entities that are by definition part of a corporate group should be responsible for management of their affiliate-facing credit risks without additional oversight from regulators. Transfer of variation margin between affiliates does not effect a substantive reduction of credit risk because there is no impact on outward facing credit risk. Rather, within a corporate group, liquidity should not be constrained and funds should be allowed to flow among the affiliates, subject to prudent risk management policies and procedures and in the case of regulated entities such as insurers, existing regulatory obligations. Requiring variation margin between affiliates would increase costs to the corporate group and be an exercise in form without substantive risk reduction.

Also, we note that a Federal Regulator (the CFTC) has specifically addressed this matter in the context of potentially clearable swaps among affiliated entities.[11] In its rule proposal, the CFTC distinguished between corporate groups that are 100% wholly-owned and commonly guaranteed and those that are not. According to the rule proposal, the former corporate group would be exempted from having to exchange variation margin and the latter type of group would not be. While we respectfully disagree with any variation margin requirement within a majority owned corporate group and also believe that the commonly guaranteed language is unnecessary, we suggest that the proposed 100% wholly-owned exception be extended to both clearable and non-clearable swaps with the corresponding deletion of

[11] *See*, 77 Fed. Reg. 50425 (Aug. 21, 2012) Clearing Exemption for Swaps Between Certain Affiliated Entities].

the commonly guaranteed language that could restrict flexibility in how centralized derivatives entities are organized within the structure of a corporate group.

G. Universal Two-way Margin Requirements

The Consultative Paper indicates that a majority of the BCBS and IOSCO members supported margin requirements that, in principle, would involve the mandatory exchange of both initial and variation margins among parties to non-centrally cleared derivatives, which was labeled as "Universal Two-way Margin." BCBS and IOSCO recognized that two-way margining would impose substantial liquidity costs, and that the use of thresholds could potentially balance the policy goals of reducing systemic risk and promoting central clearing with mitigating the costs of bilateral margin exchange. BCBS and IOSCO considered a variety of options for implementing universal two-way margin. The Consultative Paper, however, revealed that no unanimous view developed on the design and calibration of thresholds to achieve an optimal compromise between liquidity burdens and reduced systemic risk.

In our July 11, 2011 comment letter to the CFTC and the Prudential Regulatory Agencies, ACLI emphasized that two-way posting between CSEs and financial end users is of particular significance to the life insurance industry. It is customary practice for life insurers to require two-way posting of variation margin in the OTC market, which enhances the safety and soundness of life insurance companies in a manner consistent with the regulatory scheme to which they are subject, thereby enhancing the stability of the financial system as a whole.

ACLI emphasized the CFTC's observation that the imposition of a two-way margin requirement will *enhance* the stability of CSEs and the financial system for a number of reasons, including:

- Two-way margin removes each day's exposure from the marketplace for all products and all participants and prevents CSEs from accumulating obligations they cannot fulfill; and,
- Unchecked accumulation of exposures was a contributing factor to the financial crisis that led to the enactment of the Dodd-Frank Act.

As a result of further discussions with market participants, ACLI believes that swap dealers and financial firms should have the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impact of initial margin requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include tri-party or custodial arrangements as well as granting re-hypothecation rights over initial or variation margin

In sum, therefore, ACLI broadly supports two-way margin requirements between swap dealers and financial firms in variation margin, while providing flexibility for the parties to determine whether and to what extent Swap Dealers and Major Swap Participants should be required to pledge Initial margin to financial firms. We also recommend that the parties have the right to determine the protections afforded to initial margin pledged by financial firms to Swap Dealers and Major Swap Participants, which could include placement in third-party custodial or Tri-party Accounts, and note that liquidity concerns can be addressed in part by establishing appropriate initial margin requirements and broadening eligible collateral types.

III. Conclusion

ACLI supports harmonized international standards for initial and variation margin in uncleared swaps transactions. The BCBS-IOSCO Consultative Paper contains several important elements very relevant to the Prudential Regulatory Agencies' proposed rule that would establish initial and variation margin requirements on uncleared swaps for Swap Dealers and Major Swap Participants.[12] The Prudential Regulatory Agencies' solicitation of supplemental comment and the extended comment period in light of the BCBS-IOSCO Consultative Paper reflects sound judgment. Most of the concepts in the Consultative Paper comport with the Prudential Regulatory Agencies' 2011 rule proposal on margin requirements for uncleared swaps.

We strongly support the incorporation of concepts from the Consultative Paper into the Prudential Regulatory Agencies' proposed rule, including enlarging the scope of eligible collateral and focusing on the impact of margin requirements on liquidity. ACLI concurs with the Consultative Paper's strong support for universal two-way variation margining and urges the Prudential Regulatory Agencies to adopt a flexible approach with respect to initial margin requirements for Swap Dealers and Major Swap Participants to mitigate the impact on liquidity. We support alignment of margin requirements for uncleared swaps globally, especially between major market jurisdictions. All of these matters will lower the risk of financial entities, and prevent regulatory arbitrage.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson

CC: Mr. David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Kurt Wilhelm, Director-Financial Markets Group
Jamey Basham, Assistant Director-Legislative and Regulatory Activities Division
Ron Shimabukuro, Senior Counsel-Legislative and Regulatory Activities Division
Marvin Shaw, Counsel-Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Sean D. Campbell, Deputy Associate Director-Division of Research and Statistics
Jordan Bleicher-Division of Banking Supervision and Regulation
Christopher M. Paridon, Counsel-Legal Division
Anna M. Harrington, Attorney-Legal Division

[12] *See* 76 Fed. Reg. 27546 (May 11, 2011) at 60057; http://www.gpo.gov/fdsys/pkg/FR-2011-05-11/pdf/2011-10432.pdf .

Board of Governors of the Federal Reserve System
20th and C Streets, NW
Washington, DC 20551

Bobby R Bean, Associate Director-Capital Markets Branch
John Feid, Senior Policy Analyst-Division of Risk Management Supervision
Thomas F. Hearn, Counsel-Legal Division
Ryan K. Clougherty, Senior Attorney-Legal Division
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

William G. Dunn, Acting Associate Director-Financial and Capital Markets Team,
Office of Regulatory Policy
Joseph T. Connor, Associate Director for Policy and Analysis,
Office of Secondary Market Oversight
Rebecca S. Orlich, Senior Counsel-Office of General Counsel
Farm Credit Administration
McLean, VA 22102-5090

Robert Collender, Principal Policy Analyst-Office of Policy Analysis and Research
Peggy Balsawer, Assistant General Counsel-Office of General Counsel
Federal Housing Finance Agency
400 Seventh Street, SW
Washington, DC 20024

Appendix 1

ACLI
Financial Security. For Life.

Carl B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation
(202) 624-2118 t (866) 953-4096 f
carlwilkerson@acli.com

July 11, 2011

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
RIN 1557-AD43
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Ms. Jennifer J. Johnson, Secretary
Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
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Docket No. R–1415

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064–AD79

Mr. Alfred M. Pollard, General Counsel
Attention Comments/ RIN-AA45
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552
RIN 2590-AA43

Mr. Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090
RIN 3052–AC69

Mr. David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
RIN 3038—AC97

Re: Request for Comment on Margin and Capital Requirements for Covered Swap Entities

Ladies and Gentlemen:

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry. Life insurers actively participated in the legislative dialogue concerning regulation of derivatives markets and have provided constructive input on proposed rulemaking implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

The ACLI respectfully submits the following comments in response to the notices of proposed rulemaking to implement the Dodd-Frank Act (collectively, "proposed rules") by (i) the Department of the Treasury, Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Farm

Credit Administration ("FCA") and the Federal Housing Finance Agency ("FHFA" and together with the OCC, Board, FDIC and FCA, the "Prudential Regulators") on Margin and Capital Requirements for Covered Swap Entities and (ii) the Commodity Futures Trading Commission ("CFTC" and together with the Prudential Regulators, the "Regulators") on Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants.

Life insurers' financial products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care insurance and disability income insurance, among other products. These products provide consumers with financial security through various stages of life and enable them to plan for their financial future, including retirement. Accordingly, many life insurer obligations to policyholders as well as the assets that are purchased to support those liabilities have durations that extend for one or more decades.

Life insurers' use of derivatives is strictly limited and subject to comprehensive state insurance regulation.[1] Consistent with such regulations and the needs of their business and policy and contract holders, life insurers predominantly use derivatives for hedging transactions to reduce risks associated with existing or anticipated assets or liabilities. Such risks include the risk of changes in value, yield, price, cash flow or quantity of assets or liabilities as well as foreign currency exchange risk. In order to mitigate such risks, life insurers actively participate in both the exchange-traded futures and options markets and over-the-counter ("OTC"), bilaterally negotiated markets.

Life insurers are among the financial end users that will be subject to mandatory clearing requirements and margin requirements for non-cleared swaps under the Dodd-Frank Act. For most of insurers' existing OTC transactions, no initial margin or independent amount is required and variation margin is exchanged on a daily basis. Furthermore, in response to the financial crisis, many life insurers renegotiated their OTC agreements to reduce or eliminate thresholds for posting collateral. As a result, their derivatives exposures are generally fully collateralized with the exception of one day market value movements. Very simply, life insurers are financial end users of derivatives that pose minimal risk to the financial markets – their trades are risk reducing in nature and almost fully collateralized.

Life insurers appreciate that the Dodd-Frank Act requires adoption of margin requirements for Covered Swap Entities ("CSEs") in order to offset perceived greater risk associated with non-cleared swaps. Nevertheless, ACLI and its members believe it is important for the Regulators to recognize that the proposed rules will impose significantly greater costs on life insurers due to both substantial initial margin requirements and narrowing of the security categories eligible to be used as margin. As more particularly described in this letter, rules limiting the asset types that may be pledged by financial end users as margin and failing to require bilateral pledging of margin by CSEs

[1] To provide further context for the Regulators on the state regulation of insurers' derivatives activities, we attach as Appendix A an outline of the National Association of Insurance Commissioners' ("NAIC") Investments for Insurers Model Act which shows the breadth and depth of regulatory oversight of derivatives transactions. In addition, as Appendix B we provide portions of the NAIC's Financial Condition Examiner's Handbook that provides guidance to examiners in reviewing an insurer's derivatives activities. Finally, as Appendix C we show sample pages from an insurer's annual statutory financial statements where all derivatives transactions must be reported. These documents demonstrate that insurers' use of derivatives is already carefully regulated and routinely examined by, as well as transparently reported to, state insurance regulators.

and financial end users threaten to undermine numerous conservative, risk-mitigating OTC arrangements that have been carefully negotiated between life insurers and their counterparties, potentially exacerbating systemic risk rather than reducing it.

Summary of ACLI Position

As described below, we recommend the following modifications to the proposed rules to preserve life insurers' ability to provide the financial products on which their contract and policy holders depend:

- Reduction of initial margin requirements to be more consistent with comparable cleared trades and consistent with the actual risk of the particular transaction;

- Expansion of the types of eligible collateral that can be used as margin to include high-quality corporate bonds and U.S agency-backed, residential mortgage-backed securities ("Agency RMBS");[2]

- Mutual, two-way margin posting requirements applicable to both CSEs and financial end users;

- Netting of initial margin across product types with the same derivatives counterparty; and

- Flexibility for CSEs and financial end users to negotiate and determine standardized trading terms including selection of margin models, segregation of margin, and margin timing, frequency and thresholds.

Absent these changes, we believe the proposed rules will ultimately result in life insurers facing serious risk management and economic choices in assessing whether they can afford to continue to hedge their business risks as effectively as they have prior to the Dodd-Frank Act. That dilemma could, in turn, lead life insurers to take on increased risk due to reduced or less efficient hedging of their assets and liabilities, or offer fewer, or more expensive, products just as millions of hard-working Americans need increasing assistance to plan for and protect their financial futures, particularly their retirement. Either result is contrary to the Dodd-Frank Act's goal of reducing risk. Finally, we believe the rules proposed by the Prudential Regulators and the CFTC (as well as the Securities and Exchange Commission ("SEC")) must be consistent. Failure to achieve consistency will only exacerbate the adverse impact on life insurers and will incentivize regulatory arbitrage among market participants.

Margin Requirements for Uncleared Swaps

The proposed rules establishing initial margin amounts and limiting the scope of eligible collateral for uncleared swaps are major concerns for life insurers. As more particularly described below, the ACLI and its members strongly urge that the Regulators (i) reconsider their position on initial margin to ensure that such requirements do not penalize life insurers' continued use of uncleared swaps

[2] Agency RMBS would include securities issued by the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac") and the Government National Mortgage Association ("Ginnie Mae").

while the cleared swap market evolves and (ii) expand the definition of eligible collateral to include both high quality corporate bonds and Agency RMBS.

Uncleared Swaps Should Not Be Discouraged During Evolution of Cleared Swap Market

The proposed rules establish initial margin requirements for uncleared swaps that are designed to incentivize market participants to move OTC transactions to clearinghouses. While life insurers support reducing risk to the financial system through the use of clearinghouses, the Regulators must consider that during the evolution of the cleared swaps market, there will be a limited number of cleared swap types available to life insurers to mitigate the risks inherent in their assets and liabilities. Accordingly, life insurers will need to continue to rely on liquid, efficient and cost effective OTC markets for a large portion of their hedging activities. Such swaps enable insurers to more exactly match the underlying asset or liability that they are hedging and satisfy hedge accounting standards.

Life insurers have not typically posted or received initial margin in OTC transactions, largely because they have been vigilant in collateralizing actual exposure. Accordingly, it is important to life insurers that the amounts of initial margin be appropriately sized to reflect the potential exposure during the close-out of a defaulting counterparty. Initial margin calculations that include amounts designed to drive transactions to cleared swap markets should only apply when a reasonable cleared swap alternative exists. As drafted, the proposed rules would require initial margin that, in some instances, is at least double the amounts that apply to comparable exchange-traded futures.[3] We believe that these amounts are excessive, particularly where there is no alternative for clearing or no CSE margin model has been approved by the Prudential Regulators or developed by clearinghouses in accordance with the CFTC proposed rules.[4] The Regulators must adopt an approach that promotes existing, risk mitigation efforts. The approach should implement initial margin rules for financial end users in a manner that is consistent with the evolution of the cleared swap market and that does not discourage use of uncleared swaps. Implementation of initial margin rules should closely track the implementation of clearing to the extent that it is phased in by asset class or type of counterparty. Alternatively, the Regulators must allow market participants to implement valuation methodologies that accurately and even-handedly measure transaction risk.

Expansion of Asset Types for Eligible Collateral

In general, life insurers' investment portfolios contain a broad spectrum of fixed income securities, including sizeable allocations to corporate bonds and Agency RMBS.[5] In the existing OTC market, life insurers have carefully negotiated their ISDA Master Agreements and related Credit Support

[3] For example, under the Prudential Regulators' proposed initial margin look-up table, a non-cleared, 10-year interest rate swap could have initial margin of up to 6% of the notional amount. By contrast, a 10-year, exchange-traded interest rate future typically has initial margin of approximately 3% of the notional amount.

[4] We presume that margin models will require lower initial margin amounts, but that remains uncertain.

[5] Life insurers have traditionally provided the largest U.S. source of corporate bond financing, holding 13.5% of total U.S. corporate debt outstanding, which totaled over $2 Trillion at end of 2010. At the time of purchase, over 41% of corporate bonds purchased by life insurers have maturities in excess of 20 years. Approximately 56% percent of life insurers' $4.6 Trillion total assets in 2008 were held in bonds, with 42 percent composed of corporate bonds. *See* Statistics based on data from the NAIC and the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S. *See also,* American Council of Life Insurers, *Life Insurers Fact Book (2009)*.

Annexes (collectively, "ISDA Agreements") to allow a diverse range of securities to be used as collateral.[6] The proposed rules limit eligible collateral to cash, U.S. Treasuries and certain U.S. government-guaranteed agency debt ("Agencies") for initial margin, and further limit eligible collateral for variation margin to cash and U.S. Treasuries.[7] These restrictions represent a significant departure from current practices and will impose considerable additional costs on life insurers conducting hedging activities by requiring life insurers to hold larger amounts of U.S. Treasuries and Agencies that yield substantially less than other high quality, fixed income investments. In addition, as discussed below, such restrictions may lead to unintended and undesirable market impacts. Accordingly, the ACLI and its members strongly advocate expanding the definition of eligible collateral to include high quality corporate bonds and Agency RMBS.

Unintended Consequences of Limiting Asset Types for Eligible Collateral

As drafted, the proposed rules for eligible collateral will encourage life insurers to:

1) Reduce their existing investment portfolio allocations to corporate bonds and Agency RMBS in order to establish and maintain a pool of lower-yielding assets to be used as eligible collateral; and/or

2) Increase their existing investment portfolio allocations to lower quality, higher yielding corporate bonds (so called "high yield bonds") in order to offset reduced yield received on their increased allocation to U.S. Treasuries and Agencies; and/or

3) Maintain their existing investment portfolio allocations to corporate bonds and Agency RMBS and utilize capital market mechanisms to convert such assets into eligible collateral as needed.

Each of these alternatives increases risk to life insurers and their policyholders, introduces additional risk to the broader economy, and adds unnecessary costs to the prudent use of derivatives for risk mitigation.

Altering Investment Portfolio Allocations

Life insurers' investment management strategies are designed to create portfolios that will generate sufficient yields to satisfy obligations to policyholders. Under the first scenario described above, life insurers might reduce their exposures to corporate bonds and Agency RMBS in order to increase exposures to assets that qualify as eligible collateral. Because the assets that qualify as eligible collateral under the proposed rules are lower yielding, insurers may be forced to raise prices to make up for lost yield in order to meet their policyholder obligations.[8] In addition, insurers may choose to reduce their hedging activities which could also adversely impact consumers of their products.

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[6] Appendix D contains a chart *of Sample Collateral and Haircuts in Existing OTC Agreements Between Life Insurers and their Derivative Dealer Counterparties*.

[7] Proposed Rule - § __.6 Eligible collateral.

[8] Insurers might also react by reducing their capital and, for mutuals and participating products, lowering dividends.

Under the second scenario described above, life insurers would increase their exposures to high yield bonds in order to offset increased exposure to lower-yielding U.S. Treasuries and Agencies required for eligible collateral. While this "barbell" approach offsets lost yield, it introduces additional credit risk in investment portfolios.

Either of the first two scenarios will reduce life insurer's demand for high-quality corporate bonds and Agency RMBS, which are important sources of funding for U.S. businesses and the residential housing market. Such reduced demand will tighten credit flow and increase borrowing costs to corporations and individual homeowners, further impairing economic activity and job creation. During the recent financial crisis, lawmakers strongly criticized banks and large corporations for sitting on large reserves of cash rather than investing or extending credit to facilitate economic recovery. The proposed eligible collateral rules potentially exacerbate this condition and will dampen much needed liquidity for corporations trying to grow and expand and individuals seeking to finance the purchase of a home.

Converting Assets into Eligible Collateral

Under the third scenario, although insurers would continue to hold high quality corporate bonds and Agency RMBS thereby reducing the yield drag of holding eligible collateral in reserve, they would have to convert such assets into eligible collateral when required. Such conversion may occur through a variety of financing arrangements, such as repurchase transactions, securities lending or bond sales, most likely with CSEs or their affiliates. In addition, some insurers will be restricted in their ability to use conversion tools by state insurance laws that limit the amount of assets they may pledge or encumber, and by adverse capital treatment for these types of transactions. Furthermore, such conversion transactions will generate profit for CSEs and their affiliates at the expense of life insurers[9] and their policyholders and would make insurers dependent on the willingness and ability of CSEs to complete such conversions.

While CSEs will profit from conversion activities in stable markets, there is no certainty that they will be willing to provide such liquidity in all circumstances, particularly during periods of market stress. Such stress could be increased as insurers sought liquidity for non-eligible assets in a market that was unable to absorb the demand for asset conversion efficiently. Such liquidity pressure could be further exacerbated as market conditions result in additional margin calls[10] which, in turn, result in even more demand for the narrow class of eligible assets. Furthermore, market turmoil caused by margin requirements in the derivatives markets would negatively impact the overall markets for both eligible and non-eligible assets. Accordingly, allowing high quality corporate bonds and Agency RMBS as eligible collateral would alleviate these liquidity issues and reduce systemic risk in the financial markets which is consistent with the intent of the Dodd Frank Act.

Limiting non-cash eligible collateral to U.S. Treasuries and guaranteed agency securities may also alter the markets for these securities -- artificially increasing prices due to rising demand and suppressing yields for investors in these securities. There could be new sensitivity in the markets for these securities which could lead, in times of market stress, to increased volatility which could

[9] As in the first scenario, these additional costs will be passed to consumers in the form of higher prices, less risk mitigation through hedging and/or reduced product offerings at a time when Americans need additional assistance securing their financial futures.
[10] Such margin calls could occur in both uncleared derivatives transactions as well as the conversion transactions used to acquire eligible collateral, thereby causing even more market pressure.

ripple across the financial markets. Increased demand for U.S. Treasuries as eligible collateral would be exacerbated by the "flight to quality" in times of market turmoil or distress. Otherwise sound firms could potentially be placed into a scenario where they are forced to liquidate other high quality asset types to fulfill increasing margin requirements with a narrowly defined collateral universe. Being able to avoid this type of scenario is arguably a primary reason behind the wide range of eligible collateral types available at the Federal Reserve Discount Window. To the extent possible, collateral liquidation scenarios should be limited to those circumstances where there is an actual derivatives counterparty default, rather than a need to obtain eligible collateral for derivatives margin purposes.

OTC Transactions Collateralized with Corporate Bonds and Agency RMBS Performed During the Crisis

The life insurance industry's practice of posting high quality corporate bonds and Agency RMBS in OTC transactions did not create or magnify problems that emerged in the financial crisis. We are aware of no life insurer[11] that defaulted on its OTC transactions during the financial crisis, which serves as further evidence that high quality corporate bonds and Agency RMBS collateral do not jeopardize the stability of the financial markets.

Proposal and Analytic Support for Expansion of Eligible Collateral Types

The ACLI has developed a proposal based on an analytic framework that utilizes basic portfolio diversification techniques on corporate bonds to demonstrate, almost to the level of statistical certainty, that high quality corporate collateral would provide enough cushion even against some of the most severe economic downturns. Permitting a broader list of eligible collateral for both initial and variation margins would achieve the intent of securing derivatives positions and minimizing the liquidity stress on the marketplace and other unintended consequences described above.

In light of the Dodd Frank Act's prohibition on relying on credit ratings provided by nationally recognized statistical rating organizations (NRSROs), the ACLI's proposal uses the Barclays U.S. Credit Index, a broad-based index containing 4,430 issues/CUSIPs representing an outstanding amount of $3.4 trillion. The Barclays U.S. Credit Index (together with its predecessor, the "Barclays Index") has many advantages, including clearly defined eligibility rules, a defined list of eligible CUSIPs limited to large liquid issues and a ready source of daily pricing and historical data. The Barclays Index is also widely benchmarked by money managers evidencing wide acceptability by other financial end users. In addition, the Barclays Index is one of many indices that are available to reference high-quality, U.S. corporate bonds and our analysis could be applied to other indices as well.

Following the Prudential Regulators' position that termination (close out) of uncleared derivatives and liquidation of collateral could take ten days in a stress scenario, we analyzed individual CUSIPs from the Barclays Index during 2008 and found that nearly 20% of CUSIPs experienced a ten-day price decline in excess of 20% with a maximum decline in excess of 90% in 0.2% of the CUSIPs, leading to the conclusion that tail events, though rare, do occur. Thus, a collateral pool consisting of one CUSIP is not advisable.

[11] The defaults connected to AIG were at its AIG Financial Products, Inc. subsidiary, not within its regulated insurance companies, and were due in large part to the lack of capital and collateral backing its credit default swaps business, as opposed to the risk-mitigating hedging more typical of life insurers.

In expanding the analysis to look at the impact of adding additional CUSIPs to the collateral pool, ACLI chose a single month (September 2008) to ensure a continuous set of CUSIPs and selected a random portfolio as of September 1, 2008, subject to diversification rules limiting each issuer to a specified percentage and each broad sector (Financial Institutions, Industrials, Utilities, Transportation, Agencies, Local Authorities, Sovereign and Supranational) to no more than 45% of the portfolio. The market value of the equally weighted portfolio was calculated as it evolved through the month, including the largest 10-day (rolling) price drop that occurred during the month.

The analysis shows that corporate bond tail risk can be controlled with basic diversification rules (e.g., minimum of 20 CUSIPs and 45% concentration limit per High Level Sector) and that collateral haircuts of 15-20% provide a high degree of protection upon the occurrence of a CSE default. The maximum decline at the 99th percentile was 10.25% in our portfolio simulation. We also learned that further diversification beyond these rules provided little incremental benefit while substantially increasing operational burdens.

Our analysis shows that high quality corporate bonds, appropriately haircut and diversified, can be prudently included as eligible collateral for cleared and uncleared derivative exposure. We also suggest that other high-quality collateral types such as Agency Debentures and Agency RMBS should also be included as eligible collateral. Permitting a broader list of eligible collateral for both initial and variation margin would achieve the intent of securing the derivatives positions and minimizing the liquidity stress and other unintended consequences described above.

Expansion of the Two-Way Margin Posting Requirement

The Regulators' margin requirements focus exclusively on the collection of margin by CSEs from their counterparties. The Prudential Regulators have preliminarily determined that the safety and soundness of CSEs and of the financial system as a whole are enhanced by requiring CSEs to collect, but not necessarily to post, margin in support of the uncleared swap transactions to which they are party.[12]

Although the CFTC's rule proposal regarding margin for uncleared swaps preliminarily adopts an approach consistent with that of the Prudential Regulators, it does so with reservations, particularly in the context of swaps between CSEs and financial end users.[13] Specifically, the CFTC notes that two-way variation margin is an important and effective risk-mitigation tool for clearinghouses.[14] In fact, the CFTC suggests that the imposition of a two-way margin requirement will *enhance* the stability of CSEs and the financial system for a number of reasons, including:

- Two-way margin removes each day's exposure from the marketplace for all products and all participants and prevents CSEs from accumulating obligations they cannot fulfill.
- Unchecked accumulation of exposures was a contributing factor to the financial crisis that led to the enactment of the Dodd-Frank Act.

We respectfully submit that the CFTC presents the more compelling position on this issue. Moreover, the absence of a two-way posting requirement may serve as an incentive for CSEs to

[12] 76 Fed. Reg. 27564, 27567 (May 11, 2011).
[13] 76 Fed. Reg. 23732, 23736 (April 28, 2011).
[14] *Id*.

structure transactions, where possible, to avoid central clearing so that they may retain higher levels of margin. This result would be inconsistent with the ultimate objectives of Title VII.
Finally, we note that two-way posting between CSEs and financial end users is of particular significance to the life insurance industry. It is customary practice for life insurers to require two-way posting of collateral in the OTC market. The two-way posting requirement preserves the market practice typically observed by life insurers in their swap transactions. This market practice enhances the safety and soundness of life insurance companies in a manner consistent with the regulatory scheme to which they are subject, thereby enhancing the stability of the financial system as a whole. Although the Regulators' approach presumably permits financial end users to require two-way posting as a matter of contract, we are concerned that only the largest insurance companies will be in a position to require this provision from their CSE counterparties. This result could require smaller market participants to accept uncollateralized exposure to their CSE counterparties as a cost of mitigating business risks for which no cleared swap is available. This result is clearly undesirable, and we request that the Prudential Regulators adopt an approach consistent with that suggested by the CFTC and require two-way posting of initial margin between CSEs and low risk financial end users and two-way posting of variation margin by CSEs and all financial end users as a means of promoting safety and soundness in the financial markets.

Initial Margin Models

We are concerned that the Regulators' proposed rules for initial margin models reflect a bias in favor of CSEs to the detriment of financial end users that does not enhance overall market stability. For example, the proposed rules are drafted to give the CSE discretion in choosing certain calculation methods. In some instances where discretion is granted to the CSE, we believe the counterparty to the transactions should be involved in the decision-making processes. In other instances, we suggest that certain obligations should be mandatory, as opposed to discretionary, as described in more detail below.

The Prudential Regulator's proposed rule Section __.8(b) permits the CSE to choose between an initial margin model that meets the rule's criteria and the calculation method set out in Appendix A of the proposed rules. Similarly, in CFTC proposed rule 23.155(a)(2), the CSE selects the margin calculation method that they desire to use. The financial end user should have a role in determining which method is used to prevent frequent changes between methods which may cause operational burdens and to prevent the CSE from choosing the method that automatically generates the most initial margin for it. The financial end user should also be able to review the model being proposed and have an approval right over its selection to ensure that the CSE is not requiring collateral in excess of the requirements of the model as a consistent practice.

The same section of the Prudential Regulators' proposed rules states that a CSE "may" use its initial margin model to calculate margin on a portfolio basis if there is a qualifying master netting agreement in place. The CSE should have an affirmative obligation to develop initial margin models that calculate margin on a portfolio basis if there is a qualifying master netting agreement in place. The CFTC's proposed rule 23.155(c)(2)(i) also permits netting on a portfolio basis, but does not require it. We believe a CSE should have an affirmative obligation to offset where possible.

Additionally, under the Prudential Regulators' proposed Section __.8(b)(1), the CSE currently has the choice whether to include transactions entered into prior to the effective date. Similar to our concerns above, we believe that a financial end user should have an approval right over this decision to prevent the CSE from electing the approach more favorable to it. At the very least, the

Regulators should require a transparent process for making such decisions and clear path for raising and resolving counterparty disputes and methodological concerns.

With regard to the quantitative requirements set forth in the Prudential Regulators' proposed Section __.8(d)(1) and the CFTC's proposed rule 23.155(b)(2)(vi), we believe that the proposed ten day period in the initial margin model calculations is too long. Based on industry experience in the Lehman Brothers' bankruptcy, where the majority of trades were terminated or transferred in three business days, initial margin calculated to cover potential future exposures generated in a five-day period should be sufficient to protect the CSEs as well as the financial system. Moreover, the Prudential Regulators' requirement in proposed Section __.8(d)(1) tying the calculation of initial margin to addition of an offsetting swap or security-based swap ought to be clarified to address the termination of a swap or security-based swap, and the related release and return of any associated initial margin.

The Regulators' proposed rules permit the CSE to collect additional collateral if appropriate.[15] The ACLI believes that the posting of additional collateral in excess of amounts required under the proposed rules should explicitly be the subject of negotiation and should not override contract provisions between the parties.

The Prudential Regulators specifically seek comment on whether derivative transactions that pose no counterparty risk (such as options or swaptions where full premium is paid at inception of the trade) should be excluded from any initial margin calculation. We believe such exclusion is appropriate.

Finally, with regard to quantitative requirements set forth in Section __.8(d)(4), even in cases where the initial margin model does not explicitly reflect offsetting exposures, where two trades directly offset each other, offset should nonetheless be required.

Netting of Initial Margin Across Product Types

According to the proposed rules, any model for the calculation of initial margin permitted by the Prudential Regulators and CFTC may anticipate the ability to net across product types.[16] However, under the Prudential Regulators' proposed rule ___.8(d)(3), the initial margin models may only permit offsetting exposures under a Qualifying Master Netting Agreement within each broad risk category (commodity, credit, equity and foreign exchange/interest rate), but not across broad risk categories. In addition, the alternative methods permitted by both rules do not permit netting across multiple types of swaps, other than between currency and interest rate swaps under CFTC proposed rule Section 23.155(c)(2)(i), where any such reduction may not exceed 50% of the amount that would be required for the uncleared swap in the absence of a reduction.[17]

Netting among all types of swaps and security-based swaps should be permitted for the calculation of initial margin as long as all such swaps and security-based swaps[18] are governed by the same qualifying master netting agreement because, in case of termination, all obligations on the swaps under such agreement would be consolidated into a single payment from one party to the

[15] Section 23.155(c)(3) and Section ___.8(d)(15).
[16] *See* CFTC Rule Section 23.155(b)(2)(v) and FR Rule Section __.8(b).
[17] Section 23.155(c)(2)(iii).
[18] Including where swaps are regulated by the CFTC and security-based swaps are governed by the SEC.

other. Without the ability to net initial margin, a party may be required to substantially over-collateralize its exposure, a result that would be further magnified if the transactions were subject to one-way margining where a financial end user could end up with a large claim for the return of excess initial margin from the CSE upon a CSE default. The inability to net initial margin across product types would also create additional operational difficulties for tracking and exchanging margin for each class of products across multiple counterparties.

Qualifying Master Netting Agreement

The ACLI recommends several changes to the Prudential Regulators' definition of Qualifying Master Netting Agreement.[19] As mentioned previously in this letter, posting of margin should be two-way. Therefore, references in the definition of Qualifying Master Netting Agreement should refer to both CSEs and their counterparties.

The proposed definition should clarify that such agreement does not exclusively need to address the provisions set forth in the definition, but rather may also include any agreement that at a minimum contains the required provisions. This modification is necessary to ensure that other agreements, such as ISDA Master Agreements, which contain the required netting provisions, would be Qualifying Master Netting Agreements. A conforming change would need to be made to the requirement of enforceability in paragraph (t)(3)(ii), so that this requirement runs only to the provisions set out in paragraphs (t)(1) and (2) instead of to the entire agreement, to prevent unrelated provisions from disqualifying an agreement from the definition.

As payments due under some counterparties' derivative transactions may be subject to a temporary suspension under Title II of the Dodd-Frank Act[20], we suggest that the language in paragraph (t)(2) be qualified to permit suspensions of payments required by a counterparty's regulators. Where an agreement is subject to enforcement in multiple jurisdictions, a party should only be required to conduct the legal review set out in paragraph (t)(3) in the jurisdiction where that party has a reasonable belief that it would seek enforcement. In addition, the provision in paragraph (t)(4) requiring the monitoring of all "possible" changes in law is too broad and places too large a burden on parties to maintain a prospective review procedure. More appropriately, the requirement should be to monitor *changes* as they occur, as opposed to monitoring *possibilities*.

Finally, the requirement in paragraph (t)(5) is not clear enough with regard to which types of provisions are prohibited. For example, can payments be reduced for interest and fees? We suggest that the requirement be clarified so that the prohibition extends to provisions that either do not create a payment obligation on a party or extinguish a payment obligation of a party in whole or in part solely because of a party's status as a non-defaulting party. This approach would work to restrict standard "walkaway" clauses while permitting standard ISDA provisions permitting reductions of payments for interest and fees.

The ACLI agrees with the CFTC's analysis that proposed rules 23.501 and 23.600 are sufficient to accomplish the same goals that the Prudential Regulators seek to achieve in the definition of Qualifying Master Netting Agreement. Nevertheless, we encourage the Regulators to adopt a consistent approach in order to avoid unnecessary confusion and unintended gaps.

[19] Attached as Appendix E is a mark-up of the proposed definition of qualifying master netting agreement that reflects ACLI's suggestions.
[20] Dodd Frank Act Section 210(c)(8)(F)(ii).

Segregation of Initial Margin

The Regulators have proposed robust systems for segregating initial margin posted by CSEs to other CSEs, citing the need to protect the safety and soundness of the CSE.[21] Similarly, financial end users, who are being asked to provide unprecedented amounts of initial margin for the first time, have a sincere interest is ensuring that their initial margin is not used simply as a source of liquidity for the CSEs. Rather, financial end users should have the right to require that margin posted by them to a CSE be held in third-party custodial accounts which allow substitution of assets in the ordinary course of business but that secure the out-of-the-money counterparty in the event of a default. Accordingly, we are supportive of the requirement under Section 724(c) of the Act[22], requiring swap dealers to provide upon request the segregation of margin with a third-party custodian. In keeping with Congressional intent with respect to the protections given to end users, we respectfully urge the Prudential Regulators to include a provision for the segregation of end users' uncleared initial margin in the final rule, similar to the CFTC's proposed rule 23.158(a).[23] As an industry, life insurers are quite willing to provide reciprocal treatment for initial margin posted by CSEs, which margin may, in any event, be required to be collected by our own regulators.

Variation Margin Timing and Frequency

The Prudential Regulators' proposed rule requires variation margin to be collected from financial end users at least once per day.[24] The Prudential Regulators invited comment with respect to the consistency of such requirement with current market practice[25]. While the life insurance industry is extremely supportive of daily two-way margining of the market value of uncleared swaps, as has been its practice for many years, we are concerned about specifically requiring the timing of any such payments. Current market standards included in ISDA Agreements provide for the parties to pay collateral calls received before an agreed notification time by the close of business on the next local business day. Such time frames allow a life insurer to accomplish security sales or purchases as well as repurchase transactions or other financing arrangements in order to meet collateral calls. Unless the ability to post a wide variety of securities as variation margin is permitted, same day requirements will require life insurance companies to hold significantly more cash which constrains life insurance cash management and results in higher costs and reduced guarantees to policyholders. Additionally, any requirement to settle margin calls on the same day would diminish the ability to conduct late-day trading or trades with international dealers located in different time zones. Furthermore, the existence of initial margin should mitigate any risks associated with additional time to post variation margin. The established market practice of permitting counterparties to negotiate the timing and frequency of margin transfers provides the best balance between practical concerns regarding prudent cash and collateral management and prudent risk management of current market exposures, and we ask that this practice be allowed to continue.

[21] 76 Fed. Reg. 27579 (May 11, 2011).
[22] Dodd-Frank Wall Street Reform and Consumer Protection, Pub. L. No 111-203, §724, 124 Stat. 1376 (2010).
[23] The ACLI request the addition of "financial entities" to proposed rule 23.158(a)(3) which is consistent with the reference to financial entities in proposed rule 23.158(b)(1) as well as a similar provision in the Prudential Regulators' rule.
[24] 76 Fed. Reg. 27589 (May 11, 2011); 23.153(b)(1).
[25] 76 Fed. Reg. 27576 (May 11, 2011).

Margin Thresholds

We support the Prudential Regulators general approach to margin thresholds - permitting a threshold where appropriate for low-risk financial end users. We also agree with setting a low minimum transfer amount, however, we believe that $250,000 is more consistent with prevailing market practice among our members and is still sufficiently low to protect the financial system.[26] Consistent with our overall requested approach to margin requirements, we expect that these requirements would be imposed on both the CSEs and their financial end user counterparties, and that the parties would be permitted, subject to the limitations in the final rules, to establish appropriate thresholds as a matter of contract.

We support initial margin threshold upper limits, up to which dealers and qualifying market participants could negotiate the appropriate threshold, based on traditional credit parameters. For ease of calculation and administration, we suggest avoiding references to the CSE's capital ratios and other opaque and continuously variable measures (unless measured annually, based on published figures).

Definition of Low-Risk Financial End User

The proposed rules allow CSEs to establish margin threshold amounts greater than zero for entities characterized as "low-risk financial end users." In order to be characterized as "low-risk", a financial entity:

1. Must predominantly use swaps to hedge or mitigate the risks of its business;

2. Must not have a significant swaps exposure; and

3. Must be subject to capital requirements established by a Prudential Regulator or a state insurance regulator.[27]

The proposed rules set "significant swaps exposure" at approximately half the level required for an entity to be characterized as a major swap participant.

Although we support this general concept, we believe that the test for a low-risk financial end user is sufficiently robust as long as a financial entity satisfies element 1 and <u>either</u> of elements 2 <u>or</u> 3 above. As discussed in the introductory section of this letter, the use of derivatives by life insurers and their subsidiaries is heavily regulated. Insurance companies have historically been vigilant in collateralizing their open swap positions, and these procedures have helped insurers emerge from

[26] One of our larger members reviewed their portfolio and determined that a minimum transfer amount of $100,000 as compared to $250,000 would result in (i) daily collateral transfers to or from 20% more of their counterparties and (ii) an over 45% increase in the number of daily collateral transfers. Such an increase would be a significant additional burden on small middle office staffs while providing minimal systemic enhancement.

[27] 76 Fed. Reg. 27587 (May 11, 2011).

the financial crisis in a stronger position than that of some other financial entities that were not regulated.[28]

Nevertheless, there can be no question that the margin requirements under the new regulatory regime will exceed those historically posted by life insurers.[29] Imposition of these higher margin requirements must be considered against the potential increase in product costs to the consumers who rely on insurers for their financial security. Life insurers have demonstrated an ability to use derivatives prudently, as required by state insurance laws (and federal securities laws with respect to individual variable products), in the management of both their general and separate account portfolios. We believe that their "low-risk" status should be established as long as their use meets the risk mitigation and regulatory oversight prongs of the test without an additional restriction on the magnitude of that use. We believe that such an approach provides adequate protection to the financial system without adding additional, unnecessary costs to the products life insurers provide to American families. With respect to entities that are not so regulated as required under element 3, we believe that the additional protection afforded by the requirement set forth in element 2 above is an appropriate limitation on the availability of "low-risk" status.

Inter-affiliated Swaps

As we understand the proposed rules, non-cleared inter-affiliated swaps will be treated logically. When neither of the counterparties to an inter-affiliated swap is a "covered swap entity," nor subject to the regulatory jurisdiction of the SEC or CFTC as, for example, a Major Swap Participant, the proposed rules will not mandate any required margin. This conclusion holds true whether or not a party to the inter-affiliated swap happens to be a "financial end user," as defined by proposed rules.

We endorse the proposed rule's implicit conclusion that (a) inter-affiliated swaps are not in within its scope; and (b) that non-cleared, inter-affiliated swaps should not be compulsorily margined. We would also note that the same logic should be extended to swaps eligible for clearing; namely, inter-affiliated swaps should not be compelled to clear and centrally trade, even where one or both affiliated entities is a financial end user. Imposing margin requirements on inter-affiliate trades would cut against the explicit, systemic risk-based standards as set forth in the Dodd-Frank Act for promulgating margin rules.

Among other benefits, inter-affiliated swaps, which often flow through a central, street-facing, conduit company, allow enterprise companies to centralize their financial and operational risk management; mitigate their collateral and liquidity requirements; and net their counterparty risk to third-parties. We fully understand the regulators' interest in compelling the clearing of street-facing swaps and the collateralization of non-cleared, street-facing swaps when the street's counterparty is

[28] Once again, we feel compelled to note that AIG's challenges during the financial crisis arose in its derivatives dealer subsidiary (which would be a regulated entity under the Dodd-Frank Act) and not in the regulated life companies. In fact, the regulated businesses proved to be a source of financial stability and value for the AIG enterprise as a whole, due in substantial part to detailed, substantive insurance regulation that precludes speculative derivatives positions, imposes significant reserving and risk-based capital requirements, and requires transparent reporting of derivatives positions.

[29] Specifically, many life insurers have been deemed sufficiently creditworthy that they do not post an independent amount or initial margin in their OTC transactions. Moreover, many insurers have had the flexibility to post a broader range of collateral than may ultimately be permitted under the new rules.

a "financial end user." Conversely, however, we believe that extension of these requirements to any inter-affiliated swaps is counterproductive and unwarranted.

Consistency Among Regulators

ACLI and its members respectfully request that the Regulators ensure that the rules concerning margin are consistent across agencies. Consistency will reduce complexity attributable to implementation and compliance with the new margin rules. This will reduce potential confusion and error and reduce costs of both implementation and operations. It will be more difficult for end users to set up and operate internal systems where there are differing requirements among dealers based on differing regulatory requirements. Further, consistency will assist end users in setting up secondary transaction arrangements (to the extent necessary) to transform assets into eligible margin. In addition, consistency will reduce the impact on end users upon the implementation of bank "push out" rules. Finally, to the extent possible, the U.S. regulations should be consistent with foreign regulations, in particular those of the European Union.

Phase-in for Rules Implementation

ACLI and its members respectfully request that the Regulators consider the following issues and factors in setting the effective date of the new margin rules for financial end users:

- It is anticipated that life insurers may need to seek revisions to state law and address accounting issues in implementing the new reforms. Delayed implementation would allow life insurers to study and determine the impact of the new regulatory regime from legal and compliance, as well as accounting and financial reporting perspectives in the U.S. and other jurisdictions. Life insurers may need to work with their regulators to avoid conflicts with state laws or confusion regarding compliance.[30] They will also have to coordinate applicable changes to derivatives controls or accounting standards to amend or clarify the operation of such standards as applied to the new margin requirements. Some market participants may even have to reconcile conflicts with existing foreign regulation or coordinate their operations to deal with simultaneous U.S. and foreign reforms. We recommend at least an 18-month phase-in period to coincide with expected foreign regulations.

- To the extent that the derivatives reforms are designed to incentivize financial end users to clear trades by imposing sizable initial margin levels on uncleared trades, implementation of the new margin rules should reflect a realistic time frame for clearinghouses to develop and list a range of transactions available for clearing. It would be unfair for financial end users to incur the new levels of initial margin for transacting uncleared trades if realistic cleared transaction alternatives do not exist in the market. Further, to the extent the final rules on margin for uncleared swaps require (or permit) reference to or incorporation of initial margin models for similar cleared transactions, and require even higher levels of initial margin where a similar cleared model does not exist, it will be unfair to impose these additional margin requirements on financial end users before clearinghouses are able to develop, and regulators are able to approve, a wide range of margin models. Similarly, financial end

[30] For example, some insurers may need to seek adoption of Section 711 of the Insurance Receivership Model Act ("IRMA 711") or similar legislation in their domiciliary state. IRMA 711 protects termination and netting provisions in derivative agreements in the case of insolvency by an insurance company. Without such legislation, an insurer's derivatives agreements may not qualify as Qualifying Master Netting Agreements.

users should not be forced on to clearinghouses before the clearinghouses are fully operational with adequate volumes to promote liquidity.

- Dealers and financial end users will need additional time to amend their contractual arrangements (primarily ISDA Agreements) to conform with all new requirements after final rules are released. Realistically, the flood of documentation that will be required to bring existing agreements into compliance will take at least eighteen months to complete. It will be more difficult for smaller financial end users to negotiate new documentation within this time frame, as dealer negotiation staff will presumably focus on larger financial end users first (where there is competition for more volumes and profit). It is generally expected that, unless end users are prepared to execute one-sided dealer template documentation, negotiations on any one set of amendments for an agreement could take months, and that is assuming prioritization on the dealer end. It would be unfair to penalize financial end users who are attempting good faith negotiations with their CSE counterparties, to prevent them from executing uncleared trades due to delays in documentation of required amendments. In addition, during this time, as a result of the banking industry implementing the "push out" rule, financial end users will also be required to negotiate new ISDA Agreements with their new, non-bank dealer counterparties. Delays may worsen as CSE staffs are further stretched to negotiate amendments necessitated by foreign financial reforms.

- Financial end users will also likely need to negotiate arrangements that will enable transformation of assets into eligible collateral. Many insurers and, indeed, many other financial end user companies, will likely need to negotiate amendments to existing credit lines, to modify so-called "negative pledge clauses" and other applicable restrictions, which limit the amount of assets companies can pledge as collateral. Such changes will be necessary to permit the posting of increased margin levels contemplated by the new margin rules. The need to set up or amend liquidity facilities to meet demands related to the new margin requirements will add to the negotiation and documentation burden of financial end users. As discussed earlier in this letter, to the extent that the Prudential Regulators are able to broaden the range of securities eligible as initial and variation margin on uncleared trades, these concerns may be diminished.

- All financial end users will have to reallocate resources to implement the new, sweeping reforms. It is likely most market participants have or will be required to set up and test new internal systems, or outsource core or ancillary processes that may be required to implement the new margin rules, clearing mandate and the broader regulatory regime. Additional staff may need to be hired, trained and be incorporated into existing systems. Internal control plans will need to be revised and may be subject to review or approval of state regulators. Delaying implementation or phasing in financial end users will not only permit insurers to address the legal and operational challenges ahead, it will permit them to assess and undertake a deliberate plan and steps towards implementation which will reduce potential confusion and errors and minimize the cost burden.

- Delayed implementation of the new margin rules will also assist in reducing the disadvantages and costs faced by U.S. companies, in contract to their foreign competitors whose countries have not yet placed additional margin requirements on uncleared swaps, nor imposed restrictions on the use of assets which will be permitted to be posted as margin on uncleared swaps.

- Finally, a delayed and/or phased in implementation of the uncleared margin rules will help reduce market disruptions. There will be legal uncertainty and operational issues to address across the marketplace as implementation occurs. There may be scarcity of U.S. Treasuries or other non-cash collateral at times, or wide swings in these markets. Phasing in new margin requirements over time for financial end users will reduce volatility in the markets attributable to these changes.

Conclusion

The ACLI and its member companies appreciate the thoughtful approach that the Regulators have taken in formulating proposed rules under the Dodd-Frank Act. We are particularly grateful for the continuing opportunity to provide commentary in the process, given the significant effect these new rules will have on our business and on the customers who rely on our products to secure their financial futures.

On a fundamental level, we agree with the Regulators in the basic proposition that margin requirements are intended to reduce market risk. However, we respectfully submit that many aspects of the proposed rules discussed above have the potential to increase risk in unintended ways. By modifying the proposals in the manner we have suggested, to preserve two-way margining, to expand the range of eligible collateral for initial and variation margin, to preserve netting arrangements consistent with current market practice, and to provide a measure of flexibility in the calculation of initial margin and the phasing-in of new margin requirements, we believe the potential for enhancement of systemic stability will be significantly improved.

We greatly appreciate your attention to our views. Please let me know if any questions develop, or if we can provide additional information.

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson

Appendix A

The Use of Derivative Financial Instruments by Life Insurers Under State Insurance Law

Carl B. Wilkerson, Vice President & Chief Counsel- Securities & Litigation
American Council of Life Insurance

I. The National Association of Insurance Commissioners (NAIC) Investments of Insurers Model Acts Govern Derivatives Transactions by Life Insurers

A. Purpose of Investment Law Provisions, as noted in the NAIC Investments of Insurers Model Act (*Defined Limits Version*) (1996):

1. The development of regulation of the investments of insurers requires an analysis of the complexities, uncertainties, competitive forces and frequent changes in the investment markets and in the insurance business, the diversity among insurers, and the need for a balance among risk, reward and liquidity of an insurer's investments. NAIC Model Reporting Service, Vol. II, Section 1, at 280-1.

2. It also requires an analysis of how to safeguard the financial condition of domestic insurers and at the same time to permit domestic insurers to be competitive with insurer's domiciled in other states and with other financial industries that operate under different regulatory regimes. *Id.*

3. The NAIC advises each state to determine through independent study which methods are best suited to its needs and whether its existing regulatory structure may be improved by using provisions of model laws recommended by the National Association of Insurance Commissioners (NAIC) or existing regulatory structures in other states or industries. *Id.*

4. This model law is not considered by the NAIC to exhaust regulatory methods to address the regulation of investments of insurers. Nor is this model law recommended by the NAIC to be used as a standard for the examination of insurers unless *substantially similar* provisions are found in the statutes and regulations of the state of domicile of the insurer. *Id.* (emphasis added).

B. The NAIC has addressed these goals with two different approaches:

1. The NAIC Investments of Insurers Model Act (*Defined Limits Version*) sets forth specific limits on insurers investments, including derivatives, and is discussed below.

2. A second alternate choice exists in the NAIC Investments of Insurers Model Act (*Defined Standards Version*) which implements modern portfolio management practices.

   a. The Defined Standards version serves as an alternative to the Defined Limits version of the Investments of Insurers Model Act which requires that investments be made only in assets that are specifically identified and with quantitative limits for assets invested in each category.

b. The Defined Standards version provides a "prudent person" approach to investments that implements modern portfolio theory, and establishes the following type of investment authority:

(1) An insurer is obligated to fulfill the "minimum asset requirement" as that term is defined in the model act.

(a) The minimum asset requirement is made up of an insurer's liabilities and what is called the "financial security benchmark."

(b) This benchmark equals either the company's minimum capital surplus as required by statute or the authorized control level risk-based capital which applies to the insurer as set forth in the risk-based capital law of the state, whichever is greater; and,

(2) An insurer invests its assets after fulfilling the minimum asset requirement according to a prudence standard. The Defined Standards version establishes factors that must be evaluated and considered by the insurer in determining whether its investment portfolio is prudent.

C. **Overview of the Investments of Insurers Model Act (Defined Limits Version) and its application to derivatives**

1. **Scope**

a. That applies only to investments and investment practices of domestic insurers and United States branches of alien insurers entered through the individual states.

b. The Act does not apply to investments for separate accounts of an insurer except to the extent the provisions of the NAIC Model Holding Compact so provide.

2. **Purpose to the defined limits version**

a. The purpose of this Act is to protect the interests of insureds by promoting insurer solvency and financial strength. This will be accomplished through the application of investment standards that facilitate a reasonable balance of the following objectives:

(1) To preserve principal;

(2) To assure reasonable diversification as to type of

investment, issuer and credit quality; and

(3) To allow insurers to allocate investments in a manner consistent with principles of prudent investment management to achieve an adequate return so that obligations to insureds are adequately met and financial strength is sufficient to cover reasonably foreseeable contingencies.

3. **Treatment of Derivatives**

a. Article II Section 18 governs derivative transactions

b. The NAIC Commentary indicates that derivatives by insurers should be limited to hedging and, to a limited extent, income generation transactions.

4. **Definitions**

a. "Derivative instrument" [Article I, Section 2 (V)] means an agreement, option, instrument or a series or combination thereof:

(1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

(2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

b. “Derivative instruments” include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof and any agreements, options or instruments permitted under regulations adopted under Section 8. *Id.*

c. "Derivative transaction" means a transaction involving the use of one or more derivative instruments. [Article I, Section 2 (W)].

5. Substantive provisions permitting life insurers to engage in derivative transactions.

a. **General conditions**

(1) Limitations on Hedging Transactions

(a) An insurer may use derivative instruments under

Section 18 of the Model Act to engage in hedging transactions and certain income generation transactions, as these terms may be further defined in regulations promulgated by the commissioner.

(b) An insurer shall be able to demonstrate to the commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analyses.

(2) An insurer may enter into hedging transactions under Section 18 of the Model Act if, as a result of and after giving effect to the transaction :

(a) The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;

(b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and

(c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

(3) **Limitations on Income Generation Transactions**

(a) An insurer may only enter into the following types of income generation transactions if as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of its admitted assets:

i) Sales of covered call options on non-callable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the noncallable period or derivative instruments based on fixed income securities;

ii) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;

iii) Sales of covered puts on investments that the insurer is permitted to acquire under this Act, if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or

iv) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding.

(4) **Counterparty Exposure**

(a) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations of Section 10 of the Model Act, which governs diversification standards and certain foreign investments.

(b) Additional Transactions

i) Pursuant to regulations to implement the Model Act which may promulgated under the authority of Section 8, the insurance commissioner may approve additional transactions involving the use of derivative instruments in excess of the limits imposed by Section 8(B) or for other risk management purposes under regulations promulgated by the commissioner, but replication transactions shall not be permitted for other than *risk management* purposes.

(c) Definition: "Counterparty Exposure Amount" means:

i) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse ("over-the-counter derivative instrument")

ii) The amount of credit risk equals:

a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or

b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

iii) If over-the-counter derivative instruments are entered into under a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

a) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer; and

b) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

a. **Written Agreement and Conditions Required Under the Act**

(1) The insurer shall enter into a written agreement for all transactions authorized in this section other than dollar roll transactions.

(a) "Dollar roll transaction" means two (2) simultaneous transactions with different settlement dates no more than ninety-six (96) days apart, so that in the transaction with the earlier settlement date, an insurer sells to a business entity, and in the other transaction the insurer is obligated to purchase from the same business entity, substantially similar securities of the following types:

i) Asset-backed securities issued, assumed or guaranteed by the Government National Mortgage Association, the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their respective successors; and

ii) Other asset-backed securities referred to in Section 106 of Title I of the Secondary Mortgage Market Enhancement Act of 1984 (15 U.S.C. s 77r- 1), as amended.

(2) The written agreement shall require that each transaction terminate no more than one year from its inception or upon the earlier demand of the insurer.

(3) The agreement shall be with the business entity counterparty.

D. **NAIC Derivative Instruments Model Regulation, NAIC Model Reporting Service, Volume III at 282-1(1996).**

1. This model regulation was adopted together with the NAIC Investments of Insurers Model Act (Defined *Limits* Version).

2. It provides additional guidance and clarification for application of the model law.

3. **Selected provisions**

a. Guidelines and Internal Control Procedures are set forth at Section 4

(1) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:

(a) Address investment or, if applicable, underwriting objectives, and risk constraints, such as credit risk limits;

(b) Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and

(c) Require compliance with internal control procedures.

(2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective.

(3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

b. Documentation Requirements are set forth at Section 5

(1) An insurer shall maintain documentation and records relating to each derivative transaction, such as:

(a) The purpose or purposes of the transaction;

(b) The assets or liabilities to which the transaction relates;

(c) The specific derivative instrument used in the transaction;

(d) For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount; and

(e) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

(2) **Trading Requirements** are set forth at Section 6, which mandates that each derivative instrument shall be:

(a) Traded on a qualified exchange;

(b) Entered into with, or guaranteed by, a business entity;

(c) Issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or

(d) Entered into with a qualified foreign exchange.

4. **Overview of the Defined Standards Version of the NAIC Investments of Insurers Model Act**

a. This Model Act is premised on specific capital standards, and provides a framework in which these standards relate to the investment laws, and established consequences for failure to meet capital standards. To the extent an insurer's investment program is imprudent, the insurer is deemed unsound.

b. The minimum financial security benchmark and the minimum asset requirement jointly form the foundation for regulating life insurer investments according to a modern portfolio or prudence standard.

(1) These twin tools allow a high level of investment discretion above the minimum asset requirement while still providing meaningful regulatory protections for policyholders and claimants from adverse investment management.

(2) Section 3 of the Defined Standards Proposal creates limitations and restrictions on investments counted toward the minimum asset requirement; Assets in excess of the minimum asset requirement would not be subject to these limitations and restrictions and may be invested according to the insurer's individual written investment policy.

c. Three philosophies to capital requirements are central to the Act's approach to regulating investments according to a prudence standard.

(1) The Act's "minimum capital" (for stock insurance companies) and "minimum surplus" (for mutual insurance companies) ensure financial stability at the inception of a new insurance enterprise. The amount of capital or surplus needed depends on what types of business the insurer intends to conduct, and are established based on the information the insurer gives the insurance commissioner at the time of formation. See, Annotations to Section 3 of NAIC Investments of Insurers Model Act

(Defined Standards Version) at 17 (1997).

(2) The “minimum financial security benchmark” measures the minimum capital requirements of an established enterprise, and expand as the financial needs to the enterprise expand, but may also contract with them. *Id.*

(3) The “proper surplus” appropriate for a particular company’s operation is determined by the insurer’s board of directors in consultation with management. *Id.*

d. The fundamental enforcement mechanism under the defined standards proposal appears in Section 11 which provides that if an insurer does not meet the minimum asset requirement, them under Section 11D, the insurer may be deemed to be in financially hazardous condition, and the commissioner may initiate liquidation and rehabilitation proceedings against the insurer. *Id.* at 21.

(5) Status of Investments of Insurers Model Acts in the States

(A) A state by state chart follows this section.

STATE	LAWS AND REGULATIONS
Alabama	ALA. CODE §§ 27-41-1 to 27-41-41 (1977/1993) (Life).
Alaska	ALASKA ADMIN. CODE tit. 3, §§ 21.201 to 21.399 (2001/2005). ALASKA STAT. §§ 21.21.010 to 21.21.420 (1966/2001) (Includes authority to adopt regulations consistent with defined limits version).
Arizona	ARIZ. REV. STAT. ANN. §§ 20-531 to 20-561 (1954/2000).
Arkansas	ARK. CODE ANN. §§ 23-63-801 TO 23-63-841 (1959/2009).
California	CAL. INS. CODE §§ 1170 to 1212 (1935/2009). CAL. CODE REGS. Tit. 10, §§ 2690.90 to 2690.94 (2007); BULLETIN 95-5A (1995).
Colorado	COLO. REV. STAT. §§ 10-3-213 to 10-3-242 (1969/2000).
Connecticut	CONN. GEN. STAT. §§ 38a-102 to 38a-102*i* (1991/2009); BULLETIN FS-14c-00 (2000).
Delaware	DEL. CODE ANN. Tit. 18, §§ 1301 to 1332 (1953/2002).
District of Columbia	D.C. CODE §§ 31-1371.01 to 31-1375.01 (2002).
Florida	FLA. STAT. §§ 625.301 to 625.340 (1959/1993).
Georgia	GA. CODE ANN. §§ 33-11-50 to 33-11-67 (2000).
Guam	GUAM GOV’T. CODE § 43166 (1951).
Hawaii	HAW. REV. STAT. §§ 431:6-101 to 431:6-501 (1987/2009); §§431:6-601 to 431:6-602 (1987/2008).
Idaho	IDAHO CODE ANN. §§ 41-701 to 41-736 (1961/2006).
Illinois	215 ILL. COMP. STAT. 5/126.1 to 5/126.32 (1997). ILL. ADMIN. CODE tit. 50, §§ 806.10 to 806.60 (1998/2001). Company Bulletin 92-2 (1992).
Indiana	IND. CODE §§ 27-1-12-2 to 27-1-12-3.5 (1935/2004) (Life); §§ 27-1-13-3 to 27-1-13-3.5 (1935/2004) (P/C).
Iowa	IOWA CODE §§ 511.8 to 511.8A (1868/2000) (Life); § 515.35 (1868/1997) (P/C). IOWA ADMIN. CODE r. 191-93.6; BULLETIN 2008-18 (2008).

STATE	LAWS AND REGULATIONS
Kansas	KAN. STAT. ANN. §§ 40-2a01 to 40-2a28 (1972/2005) (P/C); §§ 40-2b01 to 40-2b29 (1972/2005) (Life).
Kentucky	KY. REV. STAT. ANN. §§ 304.7-010 to 304.7-473 (2000).
Louisiana	LA. REV. STAT. ANN. §§ 22:581 to 22:601 (2007/2010).
Maine	ME. REV. STAT. ANN. Tit. 24-A, §§ 1101 to 1137 (1969/2000) (P/C); §§ 1151 to 1161 (1987/2000) (Life).
Maryland	MD. CODE ANN., INS §§ 5-501 to 5-512 (1922/2003) (Life); §§ 5-601 to 5-609 (1943/1997) (P/C); MD. ADMIN. CODE CH. 650 §§ 1 to 011 (1998/2008).
Massachusetts	MASS. GEN. LAWS. Ch. 175 §§ 63 to 68 (1817/1996).
Mississippi	MISS. CODE ANN. §§83-19-51 to 83-19-55 (1892/2010).
Missouri	MO. REV. STAT. §§ 375.325 TO 375.355 (1939/2002); §§ 375.532 TO 375.534 (1991/2005) (All insurers); §§ 376.300 to 376.311 (1939/2002) (Life) §§ 376.311, 379.083 (1997/2002); § 375.345 (2002); MO. CODE REGS. ANN. Tit. 20, § 200-12.020 (2009).
Montana	MONT. CODE ANN. §§ 33-12-101 to 33-12-312 (1999/2001).
Nebraska	NEB. REV. STAT. §§ 44-5101 to 44-5154 (1991/2009).
Nevada	NEV. REV. STAT. §§682A.010 to 682A.290 (1971/2003).
New Hampshire	N. H. REV. STAT. ANN. §§ 402:27 to 402:29-d (1917/1991) (All insurers); §§ 411-A:37 (1978/1990) (Life).
New Jersey	N.J. STAT. ANN. §§ 17:24-1 to 17:24-16 (1902/1995) (P/C); §§ 17B:20-1 to 17B:20-8 (1971/2005) (Life).
New Mexico	N.M. STAT. ANN. §§ 59A-9-1 to 59A-9-27 (1984/1988).
New York	N.Y. INS. LAW §§ 1401 to 1413 (1984/2008). N.Y. COMP. CODES R. & REGS. Tit. 11, §§ 178.0 to 178.10 (Regulation 168) (2001).
North Carolina	N.C. GEN. STAT. §§ 58-7-165 to 58-7-205 (1991/2005).
North Dakota	N.D. CENT. CODE §§ 26.1-05-18 to 26.1-05-22 (1983/2001).

STATE	LAWS AND REGULATIONS
Ohio	OHIO REV. CODE ANN. §§ 3907.14 to 3907.141; §§ 3925.20 to 3925.21 (1953/2001) (Life); §§ 3925.05 to 3925.06 (1953) (P/C).
Oklahoma	OKLA. STAT. tit. 36, §§ 1601 to 1629 (1957/2005).
Oregon	OR. REV. STAT. §§ 733.510 to 733.780 (1959/2006).
Pennsylvania	40 PA. STAT. ANN. §§ 504.1 to 506.1 (1986/2004) (Life).
Puerto Rico	P. R. LAWS ANN. tit. 26, §§ 648-662 (2003).
Rhode Island	R.I. GEN. LAWS §§ 27-11-1 to 27-11-3 (1947/1956); §§ 27-11.1 to 27-11.1-8 (1984/2002).
South Carolina	S.C. CODE ANN. §§ 38-12-10 to 38-12-510 (2002).
South Dakota	S.D. CODIFIED LAWS §§ 58-27-1 to 58-27-111 (1966/2005); S.D. ADMIN. R. 20:06:26:01 (2005/2008). S.D. ADMIN. R. 20:06:26:01 (1995/2008).
Tennessee	TENN. CODE ANN. §§ 56-3-301 to 56-3-409 (1907/1998) (Life); §§ 56-3-401 to 56-3-409 (1979/1984) (P/C).
Texas	TEX. INS. CODE ANN. §§ 424.001 to 424.218 (2005/2007).
Utah	UTAH CODE ANN. §§ 31A-18-101 to 31A-18-110 (1985/2006).
Vermont	VT. STAT. ANN. tit. 8, §§ 3461 to 3472 (1967/2000).
Virginia	VA. CODE ANN. §§ 38.2-1400 to 38.2.1447 (1986/2002).
Washington	WASH. REV. CODE ANN. §§ 48.13.010 to 48.13.360 (1947/2004).
West Virginia	W. VA. CODE §§ 33-8-1 to 33-8-32 (1957/2004).
Wisconsin	WIS. STAT. §§ 620.01 to 620.25 (1971/1992).
Wyoming	WYO. STAT. ANN. §§ 26-7-101 to 26-7-116 (1967/2001).

Appendix B

FEH

Financial Condition

Examiners Handbook

NAIC

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National Association of Insurance Commissioners

		Exam Obj.	Identified Risk	Examiner/ Completion Date	Work Paper Ref.
15.	Scan the cash receipts/disbursements journal and bank statements for unusual debits or credits.	CO AC			
16.	Test whether account balances and disclosures comply with the NAIC *Accounting Practices and Procedures Manual* and *Annual Statement Instructions*.	PD			
17.	Review the Notes to the Financial Statements and General Interrogatories and evaluate the completeness of information.	PD			
18.	Consider the reasonableness of accrued interest and interest received during the year based on prior years.	VA			
19.	Select a sample of interest payments included on the bank statements. Trace those amounts to the cash receipts journal.	CO AC			
20.	Trace the total accrued interest to the detailed investment income exhibit and balance sheet.	CO AC			
21.	Trace the total interest received to the detailed investment income exhibit.	CO AC			
22.	Ensure that the net amounts of all cash accounts are reported jointly. If in the aggregate the insurer has a net negative cash balance, ensure that the amount is reported as a negative asset and not recorded as a liability, in accordance with **SSAP No. 2, paragraph 5**.	AC VA			
	Aggregate Write-ins for Invested Assets / Liabilities (Derivative Instruments)				
1.	Review available independent audit reports and management letters for evidence of inappropriate hedge accounting practices.	AC			
2.	Obtain contracts that the insurer has entered into and agree them to the documentation provided in the insurer's records and Schedule DB.	EX OB/OW			

Elements of NAIC Financial Examiners Handbook Regarding Derivatives Start Here

Examiner/ Completion Date	Work Paper Ref.

	Exam Obj.	Identified Risk	Examiner/ Completion Date	Paper Ref.
3. Obtain direct confirmation of all derivative instruments held at a custodian or a broker.	EX OB/OW			
4. Review hedging transactions to determine whether they are consistent with the category hedged, in accordance with **SSAP No. 86, paragraph 18:**	VA			
a. Fair value hedges (**SSAP 86, paragraph 19**);	VA			
b. Cash flow hedges (**SSAP 86, paragraph 20**);	VA			
c. Forecasted Transaction Hedges (**SSAP 86, paragraph 21**);	VA			
d. Foreign currency hedges (**SSAP 86, paragraph 22-31**).	VA			
5. Determine whether the appropriate accounting method was applied based on the type of derivative (e.g., swaps, options, forwards, etc.), in accordance with **SSAP No. 86**.	VA			
6. Review the hedging transactions to determine that ineffective hedges have been accounted for at fair value with changes in the fair value recorded as an unrealized gain/loss in accordance with **SSAP 86, paragraph 15**.	VA PD			
7. Select a sample of market values from Schedule DB and verify compliance with the guidelines set forth in **SSAP No. 86** and the *Purposes and Procedures Manual* of the NAIC SVO.	VA			
8. Review the state investment statutes related to derivative instruments for compliance.	VA			

	Exam Obj.	Identified Risk	Examiner/ Completion Date	Work Paper Ref.
9. Verify that the insurer has properly documented derivative instruments opened during the year, derivative instruments terminated, expired or exercised during the year and derivative instruments open at quarter-end in accordance with **SSAP No. 86, paragraphs 34-36**.	PD			
10. Select a sample of transactions and test whether all significant terms (e.g., maturity, expiration or settlement date, contractual payments, purchase and sale price) were specified and documented, and whether the amounts and terms are consistent with those established by the insurer's hedging techniques.	CO AC			
11. Select a sample of values from Schedule DB and trace to appropriate source documents.	CO AC			
12. Test transactions settled after year-end for recording in the proper period.	CT			
13. Verify that disclosure requirements for derivative contracts in accordance with **SSAP 86, paragraph 53** have been met.	PD			
<u>**Other Invested Assets**</u>				
1. Review investment committee minutes and determine whether investment transactions have been properly authorized.	EX			
2. Review available independent audit reports and management letters for joint ventures, partnerships and limited liability companies in which the insurer has an interest.	AC			
3. Make inquiries to ascertain any conflicts of interest or improprieties affecting the directors, officers or employees of the company. (Review conflict of interest statements.)	CM			

NAIC Annual (& Quarterly) Statement Blank
Schedule DB (Derivative Instruments).

Appendix C

SCHEDULE DB – PART A – SECTION 1

Showing all Options, Caps, Floors and Insurance Futures Options Owned December 31 of Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Acquisition	6 Exchange or Counterparty	7 Cost/ Option Premium	8 Book Value	9 *	10 Statement Value	11 Fair Value	12 Increase/(Decrease) by Adjustment	13 Used to Adjust Basis of Hedged Item	14 Other Investment / Miscellaneous Income
....	....	....	....	....	....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....	....	....	....	....	....
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....	....	....	....	....	....	....	....	....	....	....	....	....	....
....	....	....	....	....	....	....	....	....	....	....	....	....	....
2599999	Subtotal – Hedging Transactions							xxx					
2799999	Subtotal – Other Derivative Transactions							xxx					
9999999	Totals							xxx					

SCHEDULE DB – PART A – SECTION 2

Showing all Options, Caps, Floors and Insurance Futures Options Acquired During Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Acquisition	6 Exchange or Counterparty	7 Cost/ Option Premium
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
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....	....	....	....	....	....	....
....	....	....	....	....	....	....
....	....	....	....	....	....	....
2599999 Subtotal – Hedging Transactions						
2799999 Subtotal – Other Derivative Transactions						
9999999 Total						

SCHEDULE DB – PART A – SECTION 3

Showing all Owned Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

	2	3	4	5	6	7	8	9	10	11	12	13	Gain (Loss) on Termination			17
													14	15	16	
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry, or Settlement	Strike Price, Rate or Index	Date of Acquisition	Exchange or Counterparty	Cost/ Option Premium	Indicate Exercise, Expiration, Maturity or Sale	Termination Date	Book Value	*	Consideration Received on Terminations	Increase/ (Decrease) by Adjustment	Recognized	Used to Adjust Basis of Hedged Item	Deferred	Other Investment/ Miscellaneous Income
2599999 Subtotal – Hedging Transactions							xxx	xxx		xxx						
2799999 Subtotal – Other Derivative Transactions							xxx	xxx		xxx						
9999999 Totals							xxx	xxx		xxx						

SCHEDULE DB – PART B – SECTION 1

Showing all Options, Caps, Floors and Insurance Futures Options Written and In-Force December 31 of Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry, or Settlement	Strike, Price, Rate or Index	Date of Issuance/ Purchase	Exchange or Counterparty	Consideration Received	Book Value	*	Statement Value	Fair Value	Increase/ (Decrease) by Adjustment	Used to Adjust Basis	Other Investment/ Miscellaneous Income
2599999 Subtotal – Hedging Transactions								xxx					
2699999 Subtotal – Income Generation Transactions								xxx					
2799999 Subtotal – Other Derivative Transactions								xxx					
9999999 Totals								xxx					

SCHEDULE DB – PART B – SECTION 2

Showing all Options, Caps, Floors and Insurance Futures Options Written During Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Issuance/ Purchase	6 Exchange or Counterparty	7 Consideration Received
2599999 Subtotal – Hedging Transactions						
2699999 Subtotal – Income Generation Transactions						
2799999 Subtotal – Other Derivative Transactions						
9999999 Total						

SCHEDULE DB – PART B – SECTION 3

Showing all Written Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	Gain/(Loss) on Termination			17
													14	15	16	
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry, or Settlement	Strike Price, Rate or Index	Date of Issuance/ Purchase	Exchange or Counterparty	Consideration Received	Indicate Exercise Expiration, Maturity or Closing Purchase Transaction	Termination Date	Book Value	*	Consideration Paid on Terminations	Increase/ (Decrease) by Adjustment	Recognized	Used to Adjust Basis	Deferred	Other Investment/ Miscellaneous Income
2599999 Subtotal – Hedging Transactions							xxx	xxx		xxx						
2699999 Subtotal – Income Generation Transactions							xxx	xxx		xxx						
2799999 Subtotal – Other Derivative Transactions							xxx	xxx		xxx						
9999999 Totals							xxx	xxx		xxx						

SCHEDULE DB – PART C – SECTION 1

Showing all Collar, Swap and Forwards Open December 31 of Current Year

1 Description	2 Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index Rec (Pay)	5 Date of Opening Position or Agreement	6 Exchange or Counterparty	7 Cost or (Consideration Received)	8 Book Value	9 *	10 Statement Value	11 Fair Value	12 Increase/ (Decrease) by Adjustment	13 Used to Adjust Basis of Hedged Item	14 Other Investment/ Miscellaneous Income	15 Potential Exposure
2599999 Subtotal – Hedging Transactions								xxx						
2799999 Subtotal – Other Derivative Transactions								xxx						
9999999 Totals								xxx						

SCHEDULE DB – PART C – SECTION 2

Showing all Collar, Swap and Forwards Opened During Current Year

1 Description	2 Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index Rec (Pay)	5 Date of Opening Position or Agreement	6 Exchange or Counterparty	7 Cost or (Consideration Received)
2599999 Subtotal – Hedging Transactions						
2799999 Subtotal – Other Derivative Transactions						
9999999 Total						

SCHEDULE DB – PART C – SECTION 3

Showing all Collar, Swap and Forwards Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	Gain/(Loss) on Termination			17
													14	15	16	
Description	Notional Amount	Date of Maturity, Expiry, or Settlement	Strike Price, Rate or Index Rec (Pay)	Date of Opening Position or Agreement	Exchange or Counterparty	Cost or (Consideration Received)	Indicate Exercise, Expiration, Maturity or Sale	Termination Date	Book Value	*	Consideration Received or (Paid) on Terminations	Increase (Decrease) by Adjustment	Recognized	Used to Adjust Basis of Hedged Item	Deferred	Other Investment / Miscellaneous Income
2599999 Subtotal – Hedging Transactions							xxx	xxx		xxx						
2799999 Subtotal – Other Derivative Transactions							xxx	xxx		xxx						
9999999 Totals							xxx	xxx		xxx						

SCHEDULE DB – PART D – SECTION 1

Showing all Futures Contracts and Insurance Futures Contracts Open December 31 of Current Year

1	2	3	4	5	6	7	8	9	Variation Margin Information			13
									10	11	12	
Description	Number of Contracts	Maturity Date	Original Value	Current Value	Variation Margin	Date of Opening Position	Exchange or Counterparty	Cash Deposit	Recognized	Used to Adjust Basis of Hedged Item	Deferred	Potential Exposure
2599999 Subtotal – Hedging Transactions						xxx	xxx					
2799999 Subtotal – Other Derivative Transactions						xxx	xxx					
9999999 Totals						xxx	xxx					

SCHEDULE DB – PART D – SECTION 2

Showing all Futures Contracts and Insurance Futures Contracts Opened During Current Year

1 Description	2 Number of Contracts	3 Maturity Date	4 Original Value	5 Date of Opening Position	6 Exchange or Counterparty	7 Net Additions to Cash Deposits
2599999 Subtotal – Hedging Transactions				xxx	xxx	
2799999 Subtotal – Other Derivative Transactions				xxx	xxx	
9999999 Totals				xxx	xxx	

SCHEDULE DB – PART D – SECTION 3

Showing all Futures Contracts and Insurance Futures Contracts Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	Variation Margin Information		
Description	Number of Contracts	Maturity Date	Original Value	Termination Value	Variation Margin	Date of Opening Position	Exchange or Counterparty	Net Reduction to Cash Deposits	Termination Date	11 Gain (Loss) Recognized	12 Gain (Loss) Used to Adjust Basis of Hedged Item	13 Gain (Loss) Deferred
2599999 Subtotal – Hedging Transactions						xxx	xxx		xxx			
2799999 Subtotal – Other Derivative Transactions						xxx	xxx		xxx			
9999999 Totals						xxx	xxx		xxx			

Appendix D

Sample Collateral and Haircuts in Existing Over the Counter Derivative ("OTC") Agreements Between Life Insurers and their Derivative Dealer Counterparties

Collateral Type	Maturity	Valuation %
Cash	N.A.	100%
US Treasury Bonds	Less than 10-years	95-100%
US Treasury Bonds	10-years or Greater	90-98%
US Treasury Strips	Not Specified	90%
G 2 -5 Government Bonds*	Less than 10-years	95-100%
G 2-5 Government Bonds*	10-years or Greater	90-98%
Agency Debentures	Less than 5-years	98-100%
Agency Debentures	5-years to 10-years	95-98%
Agency Debentures	10-years or Greater	94-96%
Agency Pass-Through Securities	30-years or less	95-97%
Agency CMOs / REMICs	30-years or less	90-95%
Corporate Bonds	Less than 10-years	90-98%
Corporate Bonds	10-years or Greater	85-90%
Asset-backed Securities	30-years or Less	87-95%

***G 2-5 Government Bonds** means bonds issued by the federal governments of France, Germany, Japan, and the United Kingdom

(t) Qualifying master netting agreement means, with respect to a party, an agreement governing one or more swaps or security-based swaps to which a ~~covered swap~~ entity is a party that satisfies the following criteria—

(1) The agreement includes provisions that creates~~s~~ a single legal obligation for all individual transactions covered by the agreement upon an event of default, including bankruptcy, insolvency, or similar proceeding, of such party's ~~the~~ counterparty;

(2) The agreement includes provisions that provide~~s~~ ~~the covered swap entity~~such party the right to accelerate, terminate, and close-out on a net basis all transactions under the agreement and to liquidate or set off collateral promptly upon an event of default, including upon an event of bankruptcy, insolvency, or similar proceeding, of such party's ~~the~~ counterparty, provided that, in any such case, any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions other than under section 210(c)(8)(F)(ii) of the Dodd-Frank Wall Street Reform and Consumer Protection Act or as otherwise required by a regulator of such party's counterparty;

(3) ~~The~~ Such party ~~covered swap entity~~ has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that—

(i) The agreement meets the requirements of paragraph (t)(2) of this definition; and

(ii) In the event of a legal challenge (including one resulting from default or from bankruptcy, insolvency, or similar proceeding) in the jurisdiction where such party would be most likely to bring an enforcement proceeding as determined by such party, the relevant court and administrative authorities would find the provisions included under paragraph (t)(1) and (2) above ~~agreement~~ to be legal, valid, binding, and enforceable under the law of ~~the relevant~~such jurisdiction~~s~~;

(4) The such party ~~covered swap entity~~ establishes and maintains procedures to monitor ~~possible~~ changes in relevant law as they occur and to ensure that the agreement continues to satisfy the requirements of this definition; and

(5) The agreement does not contain a provision that ~~permits a non-defaulting counterparty to make a lower payment than it would make otherwise under the agreement, or no payment at all, to a defaulter or the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement.~~ suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of the status of such party as a nondefaulting party in connection with the insolvency of such party's counterparty, or the appointment of or the exercise of rights or powers by a receiver for such party's counterparty, and not as a result of

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the exercise by a party of any right to offset, setoff, or net obligations that exist under the contract, any other contract between those parties, or applicable law.[1]

[1] Note this language tracks the definition of "walkaway clause" in the Dodd-Frank Act Title II, section 210(c)(8)(F)(iii).

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Appendix 2

ACLI
Financial Security. For Life.

Carl B. Wilkerson
Vice President & Chief Counsel, Securities & Litigation
(202) 624-2118 t (866) 953-4096 f
carlwilkerson@acli.com

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

International Organization of Securities Commissions
C/ Oquendo 12
28006 Madrid
Spain

September 28, 2012

Re: Margin Requirements for Non-Centrally Cleared Derivatives: BCBS-IOSCO Consultative Document (July 2012)

To the Basel Committee on Banking Supervision and the International Organization of Securities Commissions:

The American Council of Life Insurers ("ACLI") is a national trade association with 300 members that represent more than 90 percent of the assets and premiums of the life insurance and annuity industry in the United States. Life insurers use derivatives to responsibly manage asset and liability risks. Life insurers actively participated in the U.S. legislative dialogue concerning regulation of derivatives markets and have provided constructive input on proposed rulemaking implementing Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Because many aspects of the BCBS and IOSCO Consultative Document endeavor to establish harmonized international standards governing derivatives transactions[1], we greatly appreciate the opportunity to share the views of the life insurance industry on these important matters.

Our submission discusses the following topics: (i) life insurers' use of derivatives to manage asset and liability risks; (ii) a summary and analysis of selected topics in the Consultative Document; and, (iii) responses to specific questions posed in the Consultative Document.

[1] The consultative document presents the initial policy proposals emerging from the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) joint Working Group on Margining Requirements. These proposals would establish minimum standards for margin requirements for non-centrally-cleared derivatives.

I. Life Insurers' Use of Derivatives to Manage Asset and Liability Risks

Life insurers' financial products protect millions of individuals, families and businesses through guaranteed lifetime income, life insurance, long-term care insurance and disability income insurance, among other products. These products provide consumers with financial security through various stages of life and enable them to plan for their financial future, including retirement. Many life insurer obligations to policyholders as well as the assets that are purchased to support those liabilities have durations that extend for one or more decades. Life insurers, therefore, carefully manage risks associated with long term assets and liabilities with derivatives.[2] The regulatory status of derivatives, thus, is critically important to the life insurance industry.

Insurers use a diverse group of financial derivatives, from standardized derivatives, exchange-traded government bond futures and over-the-counter ("OTC") vanilla interest rate swaps, to customized derivatives, like structured currency swap and equity option transactions. Although standardized derivatives are a core hedging tool for life insurers, they do not offer the flexibility and cost efficiency needed to fully manage risks associated with the full range of insurers' assets and liabilities. Such risks include the risk of changes in value, yield, price, cash flow, quantity of assets, liabilities, and foreign currency exchange risk. In order to mitigate such risks, life insurers actively participate in both the exchange-traded futures and options markets and OTC, bilaterally negotiated markets. Consequently, customized derivatives account for a large portion of insurers' OTC derivatives usage and are utilized to provide a closer offset to the market risks of insurance products that are tailored to fit customer needs and to precisely hedge risk in assets held to manage insurance liabilities.

Life insurers execute their customized derivatives with prudent credit support arrangements that require exposures to be netted and collateral to be posted between the parties. In this manner, insurers and their counterparties are able to effectively reduce and control the counterparty credit risk arising from customized OTC derivatives.[3] For most of insurers' existing OTC transactions, no initial margin or independent amount is required and variation margin is exchanged on a daily basis. Furthermore, in response to the financial crisis, many life insurers renegotiated their OTC agreements to reduce or eliminate thresholds for posting collateral. As a result, their derivatives

[2]Because they are unique, major institutional investors, life insurers are indispensable to American businesses and state and local governments, allowing them to cost-effectively raise capital. Moreover, these investments support life insurers' obligations to provide retirement and financial security for millions of Americans. The derivatives markets are instrumental to both of these functions. Many of the assets and risks insurers face cannot be managed with standardized or exchange traded derivatives. Efficient and cost-effective access to the OTC derivatives markets is fundamental to life insurers' ability to responsibly manage risks.

[3] Restrictions or prohibitions on the use of customized OTC derivatives would create unnecessary, non-economic frictional costs for delivering life insurance, long term care, and retirement savings products to millions of Americans. In some instances, products would need to be priced higher or removed from the market altogether if risks cannot be hedged effectively. Ultimately, policyholders would incur greater expenses or be unable to acquire products to manage their retirement savings, estate planning, or long-term care coverage.

[3] Restrictions or prohibitions on the use of customized OTC derivatives would create unnecessary, non-economic frictional costs for delivering life insurance, long term care, and retirement savings products to millions of Americans. In some instances, products would need to be priced higher or removed from the market altogether if risks cannot be hedged effectively. Ultimately, policyholders would incur greater expenses or be unable to acquire products to manage their retirement savings, estate planning, or long-term care coverage.

exposures are generally fully collateralized with the exception of one day market value movements and pose minimal risk to the financial markets.

Life insurers' use of derivatives is limited by detailed regulation in each state and jurisdiction in which insurers operate. These laws and regulations restrict life insurers' use of derivatives to hedging and replication transactions, and impose significant transparency and collateralization requirements. These long-standing regulatory mandates fully match the functional and operative core of Title VII of the Dodd-Frank Act and other comparable derivatives regulations that are designed to prevent financial and economic instability attributable to derivatives transactions.[4]

II. Summary and Analysis of Selected Topics in the Consultative Document

A. Impact of Margin Requirements on Liquidity

The Consultative Document states that the potential benefits of margin requirements must be weighed against the liquidity impact that would result from derivative counterparties' need to provide liquid, high-quality collateral to meet those requirements, including potential changes to market functioning as result of an increasing demand for such collateral in the aggregate. The document notes that financial institutions may need to obtain and deploy additional liquidity resources to meet margin requirements that exceed current practices. Moreover, the document observes that liquidity impact of margin requirements cannot be considered in isolation.

As a general matter, the Consultative Document emphasizes that all derivatives not centrally-cleared by a central clearing party (CCP) should be subject to margining requirements. In principle, the document indicates this includes all five major asset classes of derivatives (interest rate, credit, equity, foreign exchange and commodity) and all derivative products (both standardized and bespoke) that are not centrally cleared by a central counterparty for any reason.[5]

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[4] Through a network of statutes and regulations, state insurance departments heavily regulate the operations, products, solvency, market conduct and financial condition of life insurance companies. Life insurers must fulfill this regulatory structure in their state of domicile and in every jurisdiction in which they distribute their financial products. Uniformity of regulation is accomplished throughout the states by means of model statutes and regulations developed by the National Association of Insurance Commissioners (the "NAIC"). Many of the insurance statutes and regulations promulgated and enforced by state insurance departments fulfill regulatory goals parallel to federal regulators. The broad scope and comprehensiveness of these state insurance statutes and regulations achieves functional harmonization and prevents regulatory arbitrage. Each jurisdiction regularly examines life insurers on financial condition and market conduct, and ensures that laws and regulations are properly followed.
To provide further context for the Regulators on the state regulation of insurers' derivatives activities, we attach as Appendix A an outline of the National Association of Insurance Commissioners' ("NAIC") Investments of Insurers Model Act which shows the breadth and depth of regulatory oversight of derivatives transactions. In addition, as Appendix B we provide portions of the NAIC's Financial Condition Examiner's Handbook that provides guidance to examiners in reviewing an insurer's derivatives activities. Finally, as Appendix C we show sample pages from an insurer's annual statutory financial statements where all derivatives transactions must be reported. These documents demonstrate that insurers' use of derivatives is carefully regulated and routinely examined by, as well as transparently reported to, state insurance regulators.

[5] The Consultative Document establishes initial policy proposals for margin requirements for non-centrally-cleared derivatives through key principles addressing seven main elements:

1. Appropriate margining practices should be in place with respect to all derivative transactions that are not cleared by CCPs.

We fully agree with the Consultative Document's position that the potential benefits of increased margin requirements must be evaluated in light of the liquidity impact that would result from the substantial increase in derivative counterparties' obligation to provide liquid, high-quality collateral to meet those requirements and the potential market changes as a result of the increasing demand for such collateral.[6]

The Consultative Document's focus on the impact of margin requirements on liquidity reflects a prudent approach to designing margin requirements for uncleared swaps.

B. Eligible Collateral for Margin

The Consultative Document discusses two means to define eligible collateral. One approach would limit eligible collateral to only the most liquid, highest-quality assets, such as cash and high-quality sovereign debt, on the grounds that doing so would best ensure the value of collateral held as margin could be fully realized in a period of financial stress.

A second approach would permit a broader set of eligible collateral, including assets like liquid corporate bonds and equity securities, and address the potential volatility of such assets through

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2. All financial firms and systemically-important non-financial entities ("covered entities") that engage in non-centrally-cleared derivatives must exchange initial and variation margin as appropriate to the risks posed by such transactions.
3. The methodologies for calculating initial and variation margin that must serve as the baseline for margin that is collected from a counterparty should (i) be consistent across entities covered by the proposed requirements and reflect the potential future exposure (initial margin) and current exposure (variation margin) associated with the portfolio of non-centrally-cleared derivatives at issue and (ii) ensure that all exposures are covered fully with a high degree of confidence.
4. To ensure that assets collected as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect collecting entities covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default, these assets should be highly liquid and should, after accounting for an appropriate haircut, be able to hold their value in a time of financial stress.
5. Initial margin should be exchanged by both parties, without netting of amounts collected by each party (i.e. on a gross basis), and held in such a way as to ensure that (i) the margin collected is immediately available to the collecting party in the event of the counterparty's default; and (ii) the collected margin must be subject to arrangements that fully protect the posting party in the event that the collecting party enters bankruptcy to the extent possible under applicable law.
6. Transactions between a firm and its affiliates should be subject to appropriate variation margin arrangements to prevent the accumulation of significant current exposure to any affiliated entity arising out of non-centrally-cleared derivatives.
7. Regulatory regimes should interact so as to result in sufficiently consistent and non-duplicative regulatory margin requirements for non-centrally-cleared derivatives across jurisdictions.

[6] ACLI's July 11, 2011 submission to the CFTC and U.S. prudential regulators noted that limiting eligible collateral to cash and government securities could impose unintended negative consequences on the market for these securities, and could create liquidity log jams. *See* ACLI submission at 6. In the submission, ACLI emphasized that limiting non-cash eligible collateral to U.S. Treasuries and guaranteed agency securities may also alter the markets for these securities -- artificially increasing prices due to rising demand and suppressing yields for investors in these securities. There could be new sensitivity in the markets for these securities which could lead, in times of market stress, to increased volatility which could ripple across the financial markets. Increased demand for U.S. Treasuries as eligible collateral would be exacerbated by the "flight to quality" in times of market turmoil or distress. Otherwise sound firms could potentially be placed into a scenario where they are forced to liquidate other high quality asset types to fulfill increasing margin requirements with a narrowly defined collateral universe. Being able to avoid this type of scenario is arguably a primary reason behind the wide range of eligible collateral types available at the Federal Reserve Discount Window.

application of appropriate haircuts to their valuation for margin purposes. The Consultative Document observes that potential advantages of the second approach would include (i) a reduction of the potential liquidity impact of the margin requirements by permitting firms to use a broader array of assets to meet margin requirements and (ii) better alignment with central clearing practices, in which CCPs frequently accept a broader array of collateral, subject to collateral haircuts. After evaluating each of these alternatives, the BCBS and IOSCO have proposed the second approach allowing broader eligible collateral.

ACLI fully supports the second approach in the Consultative Document to broadly define collateral eligible for margin. The second approach dovetails with recommendations ACLI made to U.S. regulators on this matter.[7]
Permitting a broader list of eligible collateral for both initial and variation margin would achieve the intent of securing derivatives positions and minimizing the liquidity stress on the marketplace and other unintended consequences described above. In sum, therefore, we strongly support the Consultative Document's approach allowing broader categories of eligible.

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[7] In our July 11, 2011 comment letter to the CFTC and U.S. prudential regulators, we explained that ACLI developed a proposal based on an analytic framework that utilizes basic portfolio diversification techniques on corporate bonds to demonstrate, almost to the level of statistical certainty, that high quality corporate collateral would provide enough cushion even against some of the most severe economic downturns. A brief summary of ACLI's approach in our July 11, 2011 comment letter may provide helpful context. In light of the Dodd Frank Act's prohibition on relying on credit ratings provided by nationally recognized statistical rating organizations (NRSROs), ACLI's proposal uses the Barclays U.S. Credit Index, a broad-based index containing 4,430 issues/CUSIPs representing an outstanding amount of $3.4 trillion. The Barclays U.S. Credit Index (together with its predecessor, the "Barclays Index") has many advantages, including clearly defined eligibility rules, a defined list of eligible CUSIPs limited to large liquid issues and a ready source of daily pricing and historical data. The Barclays Index is also widely benchmarked by money managers evidencing wide acceptability by other financial end users. In addition, the Barclays Index is one of many indices that are available to reference high-quality, U.S. corporate bonds and our analysis could be applied to other indices as well.

Following the Prudential Regulators' position that termination (close out) of uncleared derivatives and liquidation of collateral could take ten days in a stress scenario, we analyzed individual CUSIPs from the Barclays Index during 2008 and found that nearly 20% of CUSIPs experienced a ten-day price decline in excess of 20% with a maximum decline in excess of 90% in 0.2% of the CUSIPs, leading to the conclusion that tail events, though rare, do occur. Thus, a collateral pool consisting of one CUSIP is not advisable.

In expanding the analysis to look at the impact of adding additional CUSIPs to the collateral pool, ACLI chose a single month (September 2008) to ensure a continuous set of CUSIPs and selected a random portfolio as of September 1, 2008, subject to diversification rules limiting each issuer to a specified percentage and each broad sector (Financial Institutions, Industrials, Utilities, Transportation, Agencies, Local Authorities, Sovereign and Supranational) to no more than 45% of the portfolio. The market value of the equally weighted portfolio was calculated as it evolved through the month, including the largest 10-day (rolling) price drop that occurred during the month.

The analysis shows that corporate bond tail risk can be controlled with basic diversification rules (e.g., minimum of 20 CUSIPs and 45% concentration limit per High Level Sector) and that collateral haircuts of 15-20% provide a high degree of protection upon the occurrence of a CSE default. The maximum decline at the 99th percentile was 10.25% in our portfolio simulation. We also learned that further diversification beyond these rules provided little incremental benefit while substantially increasing operational burdens. Our analysis shows that high quality corporate bonds, appropriately haircut and diversified, can be prudently included as eligible collateral for cleared and uncleared derivative exposure. We also suggest that other high-quality collateral types such as Agency Debentures and Agency RMBS should also be included as eligible collateral. Our proposal recommended prudent haircuts, portfolio diversification and concentration limits to further support an expanded list of eligible collateral.

D. Proposed Examples of Eligible Collateral

As a guide, the Consultative Document provides examples of the types of eligible collateral that satisfy the key principle would generally include:

- Cash;
- High quality government and central bank securities;
- High quality corporate bonds;
- High quality covered bonds;
- Equities included in major stock indices; and
- Gold.

The Consultative Document notes that

> The illustrative list above should not be viewed as being exhaustive. Additional assets and instruments that satisfy the key principle may also serve as eligible collateral. Also, in different jurisdictions, some particular forms of collateral may be more abundant or generally available due to institutional market practices or norms. Eligible collateral can be denominated in any currency in which payment obligations under the non-centrally-cleared derivative may be made, or in highly-liquid foreign currencies subject to appropriate haircuts to reflect the inherent FX risk involved.

ACLI strongly supports the examples of eligible collateral listed in the Consultative Document in fulfillment of the document's key principle, and endorses the statement that the illustrative list is not exhaustive. We agree that additional assets and instruments, such as Residential Mortgage-backed Securities and Commercial Mortgage-Backed Securities may also satisfy the Document's key principle, and should be evaluated by regulators as eligible collateral. A broad range of eligible high-quality collateral, with appropriate concentration limits, diversification constraints and haircuts, will prudently assure satisfaction of counterparty obligations while also enhancing liquidity in the market.

D. Key Principle on Margin in Consultative Document

To ensure assets pledged as collateral for initial and variation margin purposes can be liquidated in a reasonable amount of time to generate proceeds that could sufficiently protect secured parties covered by the proposed requirements from losses on non-centrally-cleared derivatives in the event of a counterparty default, the Consultative Document explains that these assets should be highly liquid and should, after accounting for an appropriate haircut, maintain their value in a time of financial stress.[8] The Consultative Document recommends that securities issued by the counterparty or its related entities should not be accepted as collateral. The document further notes that accepted collateral should also be reasonably diversified.

[8] The Consultative Document recommends the set of eligible collateral should recognize that assets that are liquid in normal market conditions may rapidly become illiquid in times of financial stress. In addition to having good liquidity, eligible collateral should not be exposed to excessive credit, market and FX risk. To the extent that the value of the collateral is exposed to credit, market, liquidity and FX risks (including through differences between the currency of the collateral asset and the currency of settlement), appropriately risk-sensitive haircuts should be applied. More importantly, the value of the collateral should not exhibit a significant correlation with the creditworthiness of the counterparty or the value of the underlying non-centrally-cleared derivatives portfolio in such a way that would undermine the effectiveness of the protection offered by the margin collected (i.e. the so-called "wrong way risk").

We support the concepts in the Consultative Document that assets pledged as collateral for initial and variation margin should be capable of being liquidated in a reasonable amount of time, even under adverse market conditions to protect collecting entities against a counterparty's default. As noted above, we support reasonable diversification in accepted collateral.

E. Consultative Document Commentary on Margin Standards Across Jurisdictions

The Consultative Document states that:

> Market conditions and asset availability differ across jurisdictions. National supervisors should develop their own list of eligible collateral assets based on the key principle, taking into account the conditions of their own markets and making reference to the list of examples of eligible collateral under the proposed requirement section. Allowing jurisdictions to develop their own list of eligible collateral assets is expected to reduce margining requirements' impact on the liquidity and prices of eligible assets, reduce concentration risk, and provide sufficient flexibility to permit new assets to serve as collateral in the future as markets evolve.
>
> Subject to meeting the key principle, the scope of eligible collateral assets should be kept broad, with appropriate haircuts. It is expected that demand for high quality liquid assets may increase with the implementation of various regulatory reforms, including central-clearing, margin requirements for non-centrally-cleared derivatives and Basel liquidity requirements. Keeping the scope of eligible assets broad may help relieve pressure on the supply of eligible collateral assets. It may also help avoid concentration risks.
>
> Haircut requirements should be transparent and easy to calculate, so as to facilitate payments between counterparties, avoid disputes and reduce overall operational risk. Haircut levels should be risk-based and should be calibrated appropriately to reflect the underlying risks that affect the value of eligible collateral, such as market price volatility, liquidity, credit risk and FX volatility, during both normal and stressed market conditions.
>
> Given the diversity of eligible collateral assets, there may be practical difficulties for supervisors to stipulate in advance the haircut level for each type of collateral. The pre-determined haircut levels may also become outdated as market conditions change. Adopting internal or third party models that have been approved by supervisors to calculate haircut level may, therefore, be desirable. However, some firms may be unable or unwilling to develop internal haircut calculation models that meet regulators' requirements. To provide a conservative alternative in those cases, the Consultative Document proposes a set of standardized haircuts that can be used in lieu of model-based haircuts.

ACLI strongly supports the recommendations in the Consultative Document that the scope of eligible collateral should be kept broad, with appropriate haircuts. Alternatives reflecting internal or third party haircut models coextensively with a set of standardized haircuts that can be used in lieu of model-based haircuts provide a sound and responsible flexibility.

F. Inter-Affiliate Swap Transactions

The Consultative Document suggests that transactions between a firm and its affiliates should be subject to appropriate variation margin arrangements to prevent the accumulation of significant current exposure to any affiliated entity arising out of non-centrally-cleared derivatives. The document expresses the view that requiring variation margin on inter-affiliate transactions is advisable as it presents no net cost to a corporate group but does protect against the possibility that one affiliate builds up a large and uncollateralized exposure to another affiliate or parent that could jeopardize the entire corporate group.

The Consultative Document notes, however, that despite the BCBS and IOSCO consensus view and proposal that variation margin be required on transactions between affiliates, some members believe that an exchange of variation margin is not necessary between affiliates, subject to compliance with specific criteria specified by the appropriate supervisory authority (e.g., requirements that the affiliates share the same appropriate centralized risk evaluation, measurement and control procedures, the affiliates are included in the same financial statements on a fully consolidated basis, and there is no current or foreseen material practical or legal impediment to the prompt transfer of funds or repayment of liabilities between the affiliates). In view of this equivocal reaction from its members, BCBS and IOSCO have requested input on the appropriate treatment of inter-affiliate trades.

We believe as a general matter that requiring variation margin between affiliates within a corporate group does not reduce systemic risk and does not increase safety and soundness of the financial system, provided of course, that the outward facing, net exposure of the corporate group is fully margined with initial margin and variation margin. Inter-affiliated entities that are by definition part of a corporate group should be responsible for management of their affiliate-facing credit risks without additional oversight from regulators. Transfer of variation margin between affiliates does not effect a substantive reduction of credit risk because there is no impact on outward facing credit risk. Rather, within a corporate group, liquidity should not be constrained and funds should be allowed to flow among the affiliates, subject to prudent risk management policies and procedures and in the case of regulated entities such as insurers, existing regulatory obligations. Requiring variation margin between affiliates would increase costs to the corporate group and be an exercise in form without substantive risk reduction.[9]

G. Universal Two-way Margin Requirements

The Consultative Document indicates that a majority of the BCBS and IOSCO members supported margin requirements that, in principle, would involve the mandatory exchange of both initial and

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[9] The CFTC has specifically addressed this matter in the context of potentially clearable swaps among affiliated entities. *See*, 77 Fed. Reg. 50425 (Aug. 21, 2012) [Clearing Exemption for Swaps Between Certain Affiliated Entities]. In its rule proposal, the CFTC distinguished between corporate groups that are 100% wholly-owned and commonly guaranteed and those that are not. According to the rule proposal, the former corporate group would be exempted from having to exchange variation margin and the latter type of group would not be. While we respectfully disagree with any variation margin requirement within a majority owned corporate group and also believe that the commonly guaranteed language is unnecessary, we suggest that the proposed 100% wholly-owned exception be extended to both clearable and non-clearable swaps with the corresponding deletion of the commonly guaranteed language that could restrict flexibility in how centralized derivatives entities are organized within the structure of a corporate group.

variation margins among parties to non-centrally cleared derivatives, which was labeled as "Universal Two-way Margin." BCBS and IOSCO recognized that two-way margining would impose substantial liquidity costs, and that the use of thresholds could potentially balance the policy goals of reducing systemic risk and promoting central clearing with mitigating the costs of bilateral margin exchange. BCBS and IOSCO considered a variety of options for implementing universal two-way margin. The Consultative Document, however, revealed that no unanimous view developed on the design and calibration of thresholds to achieve an optimal compromise between liquidity burdens and reduced systemic risk.[10]

Based on thorough discussions with market participants, ACLI believes that swap dealers and financial firms should have the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impacts of Initial Margin Requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over Initial or Variation Margin.

In sum, therefore, ACLI broadly supports two-way margin requirements between swap dealers and financial firms in variation margin, while providing flexibility for the parties to determine whether and to what extent Swap Dealers and Major Swap Participants should be required to pledge Initial margin to financial firms. We also recommend that the parties have the right to determine the protections afforded to initial margin pledged by financial firms to swap dealers and Major Swap Participants, which could include placement in third-party custodial or Tri-party Accounts, and note that liquidity concerns can be addressed in part by establishing appropriate initial margin requirements and broadening eligible collateral types.

[10] In our July 11, 2011 comment letter to the CFTC, ACLI emphasized that two-way posting between CSEs and financial end users is of particular significance to the life insurance industry. It is customary practice for life insurers to require two-way posting of variation margin in the OTC market, which enhances the safety and soundness of life insurance companies in a manner consistent with the regulatory scheme to which they are subject, thereby enhancing the stability of the financial system as a whole. In our comment letter, ACLI strongly supported the CFTC's approach to two-way variation margin over the prudential regulator's disinclination for two-way margining.

ACLI emphasized the CFTC's observation that the imposition of a two-way margin requirement will *enhance* the stability of CSEs and the financial system for a number of reasons, including:

- Two-way margin removes each day's exposure from the marketplace for all products and all participants and prevents CSEs from accumulating obligations they cannot fulfill; and,
- Unchecked accumulation of exposures was a contributing factor to the financial crisis that led to the enactment of the Dodd-Frank Act.

II. Responses to Specific Questions Posed in the Consultative Document

A. Implementation and Timing of Margin Requirements

Question 1. *What is an appropriate phase-in period for the implementation of margining requirements on non-centrally-cleared derivatives? Can the implementation timeline be set independently from other related regulatory initiatives (e.g. central clearing mandates) or should they be coordinated? If coordination is desirable, how should this be achieved?*

Response to Question 1. The implementation timeline can and should be set independently from central clearing mandates in order to allow financial end-users reasonable time frame to adapt to initial margin requirements and negotiate legal documentation changes with dealers who are likely to focus initially on swaps that are required to clear, and with onboarding other Swap Dealers and high volume end-users.

B. Element 1: Scope of Coverage – Instruments Subject to the Requirements

Question 2. *Should foreign exchange swaps and forwards with a maturity of less than a specified tenor such as one month or one year be exempted from margining requirements due to their risk profile, market infrastructure, or other factors? Are there any other arguments to support an exemption for foreign exchange swaps and forwards?*

Response to Question 2. There should be no distinction between physically settled and non-deliverable forwards.

Question 3. *Are there additional specific product exemptions, or criteria for determining such exemptions, that should be considered? How would such exemptions or criteria be consistent with the overall goal of limiting systemic risk and not providing incentives for regulatory arbitrage?*

Life insurers strongly support global harmonization of derivatives regulation and prevention of regulatory arbitrage. We strongly recommend an exclusion for products issued by life insurance companies that closely tracks the non-exclusive safe harbor provided by the CFTC in its recently adopted definition of the term "swap."[11] Additionally, like the CFTC swap definition, the rule should contain a flexible approach, such as a non-exclusive safe harbor exclusion, so that the regulatory provisions organically encompass newly developed products without the need for rule amendment.

C. Element 2: Scope of Coverage – Scope of Applicability

Question 4. *Is the proposed key principle and proposed requirement for scope of applicability appropriate? Does it appropriately balance the policy goals of reducing systemic risk, promoting*

[11] See the CFTC's adoption of its swap definition in Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping [http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister071012c.pdf] , which provided two approaches to excluding insurance products from the swap definition: (ii) based on a products test and an insurance company provider test, and alternatively,(ii) a non-exclusive safe harbor for "enumerated categories" of products issued by life insurers meeting the provider test. The enumerated categories of products issued by life insurers include life insurance, annuities, long term care insurance and disability insurance. Additionally, the new definition excludes reinsurance of products entitled to exclusion under the rule.

central clearing, and limiting liquidity impact? Are there any specific adjustments that would more appropriately balance these goals? Does the proposal pose or exacerbate systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?

Response to Question 4. Life insurers broadly support two-way variation margin between financial firms and Swap Dealers as a balance of policy goals. As explained above in Section III (G) of this letter, swap dealers and financial firms should have the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impacts of Initial Margin Requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over Initial or Variation Margin. Liquidity concerns can be addressed by setting appropriate initial margin requirements and broadening eligible collateral types as discussed above in Section III. Any initial margin should be placed in third-party custody. Variation margin should be allowed to flow through without restrictions.

Question 5. *Are initial margin thresholds an appropriate tool for managing the liquidity impact of the proposed requirements? What level of initial margin threshold(s) would be effective in managing liquidity costs while, at the same time, not resulting in an unacceptable level of systemic risk or inconsistency with central clearing mandates? Is the use of thresholds inconsistent with the underlying goals of the margin requirements? Would the use of thresholds result in a significant amount of regulatory arbitrage or avoidance? If so, are there steps that can be taken to prevent or limit this possibility?*

Response to Question 5. Market participants should have the ability to provide for Non-Zero margin thresholds. Margin thresholds are not inconsistent with a central clearing mandate because other factors exist, such as higher levels of initial margin for uncleared trades, that provide incentives to clear trades.

Question 6. *Is it appropriate for initial margin thresholds to differ across entities that are subject to the requirements? If so, what specific triggers would be used to determine if a smaller or zero threshold should apply to certain parties to a non-centrally-cleared derivative? Would the use of thresholds result in an unlevel playing field among market participants? Should the systemic risk posed by an entity be considered a primary factor? What other factors should also be considered? Can an entity's systemic risk level be meaningfully measured in a transparent fashion? Can systemic risk be measured or proxied by an entity's status in certain regulatory schemes, e.g. G-SIFIs, or by the level of an entity's non-centrally-cleared derivatives activities? Could data on an entity's derivative activities (e.g. notional amounts outstanding) be used to effectively determine an entity's systemic risk level?*

Response to Question 6. Although differing initial margin thresholds may impact pricing, such impacts should be reasonable based on the increased risk created by such thresholds. Life insurers do not believe that systemic risk can be measured based on notional size or amount of trades because some large trades may contain a feature that makes them unclearable, even though a liquid market may exist for such securities. Conversely, a smaller trade may be highly leveraged and illiquid creating more risk relative to its notional amount Standard initial margin requirements should apply to each counterparty regardless of their creditworthiness.

Question 7. *Is it appropriate to limit the use of initial margin thresholds to entities that are prudentially regulated, i.e. those that are subject to specific regulatory capital requirements and direct supervision? Are there other entities that should be considered together with prudentially-regulated entities? If so, what are they and on what basis should they be considered together with prudentially-regulated entities?*

Response to Question 7. Life Insurers do not agree that thresholds should be limited to prudentially regulated entities. As more fully discussed above in Section I of this letter and the accompanying Appendix materials, life insurers are comprehensively regulated under state insurance laws and regulations administered by state insurance departments. Collectively, these laws and regulations prevent regulatory arbitrage, achieve detailed functional regulation, and ensure that life insurers' derivatives transactions fulfill the goals of the Dodd-Frank Act, including transparency and collateralization. Accordingly, any definition of prudentially regulated entities must include life insurers subject to U.S. state insurance regulation.

Question 8. *How should thresholds be evaluated and specified? Should thresholds be evaluated relative to the initial margin requirement of an approved internal or third party model or should they be evaluated with respect to simpler and more transparent measures, such as the proposed standardised initial margin amounts? Are there other methods for evaluating thresholds that should be considered? If so what are they and how would they work in practice?*

Response to Question 8. Market participants should have the ability to determine the methodology for non-zero margin. Market participants that use standardized initial margin calculations should be able to use this methodology.

Question 9. *What are the potential practical effects of requiring universal two-way margin on the capital and liquidity position, or the financial health generally, of market participants, such as key market participants, prudentially-regulated entities and non-prudentially regulated entities? How would universal two-way margining alter current market practices and conventions with respect to collateralising credit exposures arising from OTC derivatives? Are there practical or operational issues with respect to universal two-way margining?*

Response to Question 9. As discussed more fully above in Section II of this letter, permitting a broader list of eligible collateral for both initial and variation margin would achieve the intent of securing derivatives positions and minimizing the liquidity stress on the marketplace and other unintended consequences. Life insurers currently engage in two-way margining that allows posting of high quality corporate debt and RMBS as collateral. These practices are critical to avoid draining capital and liquidity from the system while protecting financial end-users of derivatives. Not requiring or permitting two-way margining would be a significant change in market practice, and would be especially inimical to managing risks associated with life insurers' long-term assets and liabilities.

Question 10. *What are the potential practical effects of requiring regulated entities (such as securities firms or banks) to post initial margin to unregulated counterparties in a non-centrally-cleared derivative transaction? Does this specific requirement reduce, create, or exacerbate* *systemic risks? Are there any logistical or operational considerations that would make the proposal problematic or unworkable?*

Response to Question 10. As long as parties can post a broader range of collateral and net exposures across product types and between pre and post effective date uncleared swaps, these positions will mitigate the need to provide initial margin, which is a new practice for most market participants. Without these provisions, margining regardless of whether it is two-way or not, will become substantially more complex. It is important, therefore, to give swap dealers and financial firms the flexibility to determine whether swap dealers will be required to post initial margin on a case-by-case basis depending on the nature of the trade, product type or creditworthiness of the Swap Dealer or Major Swap Participant, in order to mitigate the impacts of initial margin requirements on liquidity. Moreover, financial firms should have the ability to choose the level of protection for initial or variation margin pledged to Swap Dealers and Major Swap Participants, which could include Tri-party or Custodial Arrangements as well as granting re-hypothecation rights over Initial or Variation Margin. This matter is more fully discussed above in Section II (G) of this letter.

D. Element 3: Baseline Minimum Amounts and Methodologies for Initial and Variation Margin

Question 13. *Are the proposed methodologies for calculating initial margin appropriate and practicable? With respect to internal models in particular, are the proposed parameters and prerequisite conditions appropriate? If not, what approach to the calculation of baseline initial margin would be preferable and practicable, and why?*

Response to Question 13. Life insurers support the principal that the selection of an initial margin model and changes to that model have to be transparent and agreed to by both parties, and that the methodology needs to be open to allow for the reciprocal calculation of margin requirements. Initial margin for purchased Credit Default Swaps and equity should be limited to the net present value (NPV) of premiums outstanding.

Question 14. *Should the model-based initial margin calculations restrict diversification benefits to be operative within broad asset classes and not across such classes as discussed above? If not, what mitigants can be used to effectively deal with the concerns that have been raised?*

Response to Question 14. The current practice for life insurers in transactions with counterparties is to net variation margin across asset classes. This process has worked well without problems for a considerable amount of time. Changing this long-standing practice would raise significant and unnecessary liquidity, capital and systemic risk concerns. We oppose, therefore, model-based initial margin calculations that mandate diversification benefits to be operative within broad asset classes and not across such classes.

Question 15. *With respect to the standardised schedule, are the parameters and methodologies appropriate? Are the initial margin levels prescribed in the proposed standardised schedule appropriately calibrated? Are they appropriately risk sensitive? Are there additional dimensions of risk that could be considered for inclusion in the schedule on a systematic basis?*

Response to Question 15. The time period of a 10-day horizon with a 99 percent confidence interval is too long, because nearly all swaps can be unwound in difficult market conditions within one business day, and the most complex swaps can be unwound within five business days. Margins calculated as a percentage of notional exposure, therefore, are not appropriate. Additionally, such time horizons would require approximately double the margin for swaps as for comparable futures.

Question 16. *Are the proposed methodologies for calculating variation margin appropriate? If not, what approach to the calculation of baseline variation margin would be preferable, and why?*

Response to Question 16. Life insurers strongly urge that methodologies for calculating variation margin must be transparent, agreed upon by both parties, open to allow for the reciprocal calculation of margin requirements.

Question 17. *With what frequency should variation margin payments be required? Is it acceptable or desirable to allow for less frequent posting of variation margin, subject to a corresponding increase in the assumed close out horizon that is used for the purposes of calculating initial margin?*

Response to Question 17. Life insurers support daily variation margin payments, but would oppose intra-day margin payments because of intra-day payments would impose burdensome, unnecessary logistics with inherent calculation disparities.

Question 18. *Is the proposed framework for variation margin appropriately calibrated to prevent unintended procyclical effects in conditions of market stress? Are discrete calls for additional initial margin due to "cliff-edge" triggers sufficiently discouraged?*

Response to Question 18. Additional Margin should be discouraged in all but the most severe circumstances, because the imposition of additional margin could be abused by Swap Dealers against financial end-users. Procyclicality is reduced by limiting or prohibiting financial issuers (e.g., banks) from the permitted basket of corporate bond collateral.

Question 19. *What level of minimum transfer amount effectively mitigates operational risk and burden while not allowing for a significant build-up of uncollateralised exposure?*

Response to Question 19. Life insurers support a minimum transfer amount of $1 million, which dovetails with requirements under New York law, and we support standards allowing counterparties to negotiate the minimum transfer amount based upon evaluations of operational risk and uncollateralized exposure in individual sets of circumstances.

E. Element 4: Eligible Collateral for Margin

Question 20. *Is the scope of proposed eligible collateral appropriate? If not, what alternative approach to eligible collateral would be preferable, and why?*

Response to Question 20. Life Insurers broadly agree with the expanded categories of collateral types in the Consultative Document. We recommend, however, revising the definition for corporate bonds to encompass corporate bonds included in high quality major bond indices. The demands for increased collateral due to initial margin accentuate the need for expanded collateral types, as discussed more fully above in Section II (A) and (B) of this letter.

Question 21. *Should concrete diversification requirements, such as concentration limits, be included as a condition of collateral eligibility? If so, what types of specific requirements would be effective? Are the standardised haircuts prescribed in the proposed standardised haircut schedule sufficiently conservative? Are they appropriately risk sensitive? Are they appropriate in light of their potential liquidity impact? Are there additional assets that should be considered in the schedule of standardised haircuts?*

Response to Question 21. Diversification requirements, and other specific requirements, are best handled through negotiations between counterparties who are best suited to judge the adequacy of haircuts. It is noteworthy to emphasize that the level of appropriate diversification is directly related to the haircut level set in the transaction.

F. Element 5: Treatment of Provided Margin

Question 22. *Are the proposed requirements with respect to the treatment of provided margin appropriate? If not, what alternative approach would be preferable, and why? Should the margin requirements provide greater specificity with respect to how margin must be protected? Is the proposed key principle and proposed requirement adequate to protect and preserve the utility of margin as a loss mitigants in all cases?*

Response to Question 22. Market participants should have the right to choose their level of protection Legally Segregated Operationally Commingled (LSOC) or Complete Segregation with minimum requirements. Flexibility should be permitted in appropriately achieving protection of margin (e.g. LSOC or complete segregation at the option of end users.)

Question 23. *Is the requirement that initial margin be exchanged on a gross, rather than net basis, appropriate? Would the requirement result in large amounts of initial margin being held by a potentially small number of custodian banks and thus creating concentration risk?*

Response to Question 23. Margin exchange on a gross basis will substantially increase margin levels and increase concentration risk. Life insurers strongly support, therefore, margin exchange on a net basis. Alternatively, initial margin netted by product class would make more sense.

Question 24. *Should collateral be allowed to be re-hypothecated or re-used by the collecting party? Are there circumstances and conditions, such as requiring the pledgee to segregate the re-hypothecated assets from its proprietary assets and treating the assets as customer assets, and/or ensuring that the insolvency regime provides the pledger with a first priority claim on the assets that are re-hypothecated in the event of a pledgee's bankruptcy, under which re-hypothecation could be permitted without in any way compromising the full integrity and purpose of the key principle? What would be the systemic risk consequences of allowing re-hypothecation or re-use?*

Response to Question 24. Parties should be allowed to negotiate re-hypothecation rights on Initial and variation margin with swap dealers based on an analysis of relevant individual facts and circumstances. Segregation of collateral from a dealer's proprietary assets worked well during the 2008-09 financial crisis and strikes a sensible balance between complete segregation with Control Accounts and unrestricted use of collateral.

G. Element 6: Treatment of Transactions with Affiliates

Question 25. *Are the proposed requirements with respect to the treatment of non-centrally-cleared derivatives between affiliated entities appropriate? If not, what alternative approach would be preferable, and why? Would giving local supervisors discretion in determining the initial margin requirements for non-centrally-cleared derivatives between affiliated entities result in international inconsistencies that would lead to regulatory arbitrage and unlevel playing field?*

Response to Question 25. As more fully discussed above in Section II (F) of this letter, we note as a general matter that requiring variation margin between affiliates within a corporate group does not reduce systemic risk and does not increase safety and soundness of the financial system, provided of course, that the outward facing, net exposure of the corporate group is fully margined with initial margin and variation margin.

Question 26. *Should an exchange of variation margin between affiliates within the same national jurisdiction be required? What would be the risk, or other, implications of not requiring such an exchange? Are there any additional benefits or costs to not requiring an exchange of variation margin among affiliates within the same national jurisdiction?*

Response to Question 26. See response to Question 25.

H. Element 7: Interaction of National Regimes in Cross-Border Transactions

Question 27. *Is the proposed approach with respect to the interaction of national regimes in cross-border transactions appropriate? If not, what alternative approach would be preferable, and why?*

Response to Question 27. Life insurers strongly support the elimination of regulatory arbitrage in all transactions through harmonized regulatory standards, including cross-border transactions.

Conclusion

ACLI supports harmonized international standards for initial and variation margin in uncleared swaps transactions.[12] We strongly support the concepts from the Consultative Document, including enlarging the scope of eligible collateral and focusing on the impact of margin requirements on liquidity. ACLI concurs with the Consultative Document's strong support for universal two-way variation margining and a flexible approach with respect to initial margin requirements for Swap

[12] The BCBS and IOSCO Consultative Document contains several important elements very relevant to the CFTC's proposed rule that would establish initial and variation margin requirements on uncleared swaps for Swap Dealers and Major Swap Participants. *See* 76 Fed. Reg. 82 (April 28, 2011) at 23732; http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2011-9598a.pdf . ACLI has encouraged the CFTC and U.S. prudential regulators to work carefully to incorporate the regulatory harmonization concepts discussed above from the consultative Document, with particular emphasis on enlarging the scope of eligible collateral in derivatives transactions in order to avoid unintended consequences.

Dealers and Major Swap Participants to mitigate the impact on liquidity. We support alignment of margin requirements for uncleared swaps globally, especially between major market jurisdictions. All of these matters will lower the risk of financial entities, and prevent regulatory arbitrage.

We greatly appreciate your attention to our views. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

CC: Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. Alfred M. Pollard, General Counsel
Attention Comments/ RIN-AA45
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Mr. Gary K. Van Meter, Acting Director
Office of Regulatory Policy
Farm Credit Administration
1501 Farm Credit Drive
McLean, VA 22102-5090

Mr. David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Appendix A

The Use of Derivative Financial Instruments by Life Insurers Under State Insurance Law

Carl B. Wilkerson, Vice President & Chief Counsel- Securities & Litigation
American Council of Life Insurance

I. The National Association of Insurance Commissioners (NAIC) Investments of Insurers Model Acts Govern Derivatives Transactions by Life Insurers

A. Purpose of Investment Law Provisions, as noted in the NAIC Investments of Insurers Model Act (*Defined Limits Version*) (1996):

1. The development of regulation of the investments of insurers requires an analysis of the complexities, uncertainties, competitive forces and frequent changes in the investment markets and in the insurance business, the diversity among insurers, and the need for a balance among risk, reward and liquidity of an insurer's investments. NAIC Model Reporting Service, Vol. II, Section 1, at 280-1.

2. It also requires an analysis of how to safeguard the financial condition of domestic insurers and at the same time to permit domestic insurers to be competitive with insurer's domiciled in other states and with other financial industries that operate under different regulatory regimes. *Id.*

3. The NAIC advises each state to determine through independent study which methods are best suited to its needs and whether its existing regulatory structure may be improved by using provisions of model laws recommended by the National Association of Insurance Commissioners (NAIC) or existing regulatory structures in other states or industries. *Id.*

4. This model law is not considered by the NAIC to exhaust regulatory methods to address the regulation of investments of insurers. Nor is this model law recommended by the NAIC to be used as a standard for the examination of insurers unless *substantially similar* provisions are found in the statutes and regulations of the state of domicile of the insurer. *Id.* (emphasis added).

B. The NAIC has addressed these goals with two different approaches:

1. The NAIC Investments of Insurers Model Act (*Defined Limits Version*) sets forth specific limits on insurers investments, including derivatives, and is discussed below.

2. A second alternate choice exists in the NAIC Investments of Insurers Model Act (*Defined Standards Version*) which implements modern portfolio management practices.

   a. The Defined Standards version serves as an alternative to the Defined Limits version of the Investments of Insurers Model Act which requires that investments be made only in assets that are specifically identified and with quantitative limits for assets invested in each category.

b. The Defined Standards version provides a “prudent person” approach to investments that implements modern portfolio theory, and establishes the following type of investment authority:

(1) An insurer is obligated to fulfill the “minimum asset requirement” as that term is defined in the model act.

(a) The minimum asset requirement is made up of an insurer’s liabilities and what is called the “financial security benchmark.”

(b) This benchmark equals either the company’s minimum capital surplus as required by statute or the authorized control level risk-based capital which applies to the insurer as set forth in the risk-based capital law of the state, whichever is greater; and,

(2) An insurer invests its assets after fulfilling the minimum asset requirement according to a prudence standard. The Defined Standards version establishes factors that must be evaluated and considered by the insurer in determining whether its investment portfolio is prudent.

C. **Overview of the Investments of Insurers Model Act (Defined Limits Version) and its application to derivatives**

1. **Scope**

a. That applies only to investments and investment practices of domestic insurers and United States branches of alien insurers entered through the individual states.

b. The Act does not apply to investments for separate accounts of an insurer except to the extent the provisions of the NAIC Model Holding Compact so provide.

2. **Purpose to the defined limits version**

a. The purpose of this Act is to protect the interests of insureds by promoting insurer solvency and financial strength. This will be accomplished through the application of investment standards that facilitate a reasonable balance of the following objectives:

(1) To preserve principal;

(2) To assure reasonable diversification as to type of

investment, issuer and credit quality; and

(3) To allow insurers to allocate investments in a manner consistent with principles of prudent investment management to achieve an adequate return so that obligations to insureds are adequately met and financial strength is sufficient to cover reasonably foreseeable contingencies.

3. **Treatment of Derivatives**

a. Article II Section 18 governs derivative transactions

b. The NAIC Commentary indicates that derivatives by insurers should be limited to hedging and, to a limited extent, income generation transactions.

4. **Definitions**

a. "Derivative instrument" [Article I, Section 2 (V)] means an agreement, option, instrument or a series or combination thereof:

(1) To make or take delivery of, or assume or relinquish, a specified amount of one or more underlying interests, or to make a cash settlement in lieu thereof; or

(2) That has a price, performance, value or cash flow based primarily upon the actual or expected price, level, performance, value or cash flow of one or more underlying interests.

b. “Derivative instruments” include options, warrants used in a hedging transaction and not attached to another financial instrument, caps, floors, collars, swaps, forwards, futures and any other agreements, options or instruments substantially similar thereto or any series or combination thereof and any agreements, options or instruments permitted under regulations adopted under Section 8. *Id.*

c. "Derivative transaction" means a transaction involving the use of one or more derivative instruments. [Article I, Section 2 (W)].

5. Substantive provisions permitting life insurers to engage in derivative transactions.

a. **General conditions**

(1) Limitations on Hedging Transactions

(a) An insurer may use derivative instruments under

Section 18 of the Model Act to engage in hedging transactions and certain income generation transactions, as these terms may be further defined in regulations promulgated by the commissioner.

(b) An insurer shall be able to demonstrate to the commissioner the intended hedging characteristics and the ongoing effectiveness of the derivative transaction or combination of the transactions through cash flow testing or other appropriate analyses.

(2) An insurer may enter into hedging transactions under Section 18 of the Model Act if, as a result of and after giving effect to the transaction :

(a) The aggregate statement value of options, caps, floors and warrants not attached to another financial instrument purchased and used in hedging transactions does not exceed seven and one half percent (7.5%) of its admitted assets;

(b) The aggregate statement value of options, caps and floors written in hedging transactions does not exceed three percent (3%) of its admitted assets; and

(c) The aggregate potential exposure of collars, swaps, forwards and futures used in hedging transactions does not exceed six and one-half percent (6.5%) of its admitted assets.

(3) **Limitations on Income Generation Transactions**

(a) An insurer may only enter into the following types of income generation transactions if as a result of and after giving effect to the transactions, the aggregate statement value of the fixed income assets that are subject to call or that generate the cash flows for payments under the caps or floors, plus the face value of fixed income securities underlying a derivative instrument subject to call, plus the amount of the purchase obligations under the puts, does not exceed ten percent (10%) of its admitted assets:

i) Sales of covered call options on non-callable fixed income securities, callable fixed income securities if the option expires by its terms prior to the end of the noncallable period or derivative instruments based on fixed income securities;

ii) Sales of covered call options on equity securities, if the insurer holds in its portfolio, or can immediately acquire through the exercise of options, warrants or conversion rights already owned, the equity securities subject to call during the complete term of the call option sold;

iii) Sales of covered puts on investments that the insurer is permitted to acquire under this Act, if the insurer has escrowed, or entered into a custodian agreement segregating, cash or cash equivalents with a market value equal to the amount of its purchase obligations under the put during the complete term of the put option sold; or

iv) Sales of covered caps or floors, if the insurer holds in its portfolio the investments generating the cash flow to make the required payments under the caps or floors during the complete term that the cap or floor is outstanding.

(4) **Counterparty Exposure**

(a) An insurer shall include all counterparty exposure amounts in determining compliance with the limitations of Section 10 of the Model Act, which governs diversification standards and certain foreign investments.

(b) Additional Transactions

i) Pursuant to regulations to implement the Model Act which may promulgated under the authority of Section 8, the insurance commissioner may approve additional transactions involving the use of derivative instruments in excess of the limits imposed by Section 8(B) or for other risk management purposes under regulations promulgated by the commissioner, but replication transactions shall not be permitted for other than *risk management* purposes.

(c) Definition: "Counterparty Exposure Amount" means:

i) The net amount of credit risk attributable to a derivative instrument entered into with a business entity other than through a qualified exchange, qualified foreign exchange, or cleared through a qualified clearinghouse ("over-the-counter derivative instrument")

ii) The amount of credit risk equals:

a) The market value of the over-the-counter derivative instrument if the liquidation of the derivative instrument would result in a final cash payment to the insurer; or

b) Zero if the liquidation of the derivative instrument would not result in a final cash payment to the insurer.

iii) If over-the-counter derivative instruments are entered into under a written master agreement which provides for netting of payments owed by the respective parties, and the domiciliary jurisdiction of the counterparty is either within the United States or if not within the United States, within a foreign jurisdiction listed in the Purposes and Procedures of the Securities Valuation Office as eligible for netting, the net amount of credit risk shall be the greater of zero or the net sum of:

a) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment to the insurer; and

b) The market value of the over-the-counter derivative instruments entered into under the agreement, the liquidation of which would result in a final cash payment by the insurer to the business entity.

a. **Written Agreement and Conditions Required Under the Act**

(1) The insurer shall enter into a written agreement for all transactions authorized in this section other than dollar roll transactions.

(a) "Dollar roll transaction" means two (2) simultaneous transactions with different settlement dates no more than ninety-six (96) days apart, so that in the transaction with the earlier settlement date, an insurer sells to a business entity, and in the other transaction the insurer is obligated to purchase from the same business entity, substantially similar securities of the following types:

i) Asset-backed securities issued, assumed or guaranteed by the Government National Mortgage Association, the Federal National Mortgage Association or the Federal Home Loan Mortgage Corporation or their respective successors; and

ii) Other asset-backed securities referred to in Section 106 of Title I of the Secondary Mortgage Market Enhancement Act of 1984 (15 U.S.C. s 77r- 1), as amended.

(2) The written agreement shall require that each transaction terminate no more than one year from its inception or upon the earlier demand of the insurer.

(3) The agreement shall be with the business entity counterparty.

D. **NAIC Derivative Instruments Model Regulation, NAIC Model Reporting Service, Volume III at 282-1(1996).**

1. This model regulation was adopted together with the NAIC Investments of Insurers Model Act (Defined *Limits* Version).

2. It provides additional guidance and clarification for application of the model law.

3. **Selected provisions**

a. Guidelines and Internal Control Procedures are set forth at Section 4

(1) Before engaging in a derivative transaction, an insurer shall establish written guidelines that shall be used for effecting and maintaining the transactions. The guidelines shall:

(a) Address investment or, if applicable, underwriting objectives, and risk constraints, such as credit risk limits;

(b) Address permissible transactions and the relationship of those transactions to its operations, such as a precise identification of the risks being hedged by a derivative transaction; and

(c) Require compliance with internal control procedures.

(2) An insurer shall have a system for determining whether a derivative instrument used for hedging has been effective.

(3) An insurer shall have a credit risk management system for over-the-counter derivative transactions that measures credit risk exposure using the counterparty exposure amount.

b. Documentation Requirements are set forth at Section 5

(1) An insurer shall maintain documentation and records relating to each derivative transaction, such as:

(a) The purpose or purposes of the transaction;

(b) The assets or liabilities to which the transaction relates;

(c) The specific derivative instrument used in the transaction;

(d) For over-the-counter derivative instrument transactions, the name of the counterparty and the counterparty exposure amount; and

(e) For exchange traded derivative instruments, the name of the exchange and the name of the firm that handled the trade.

(2) **Trading Requirements** are set forth at Section 6, which mandates that each derivative instrument shall be:

(a) Traded on a qualified exchange;

(b) Entered into with, or guaranteed by, a business entity;

(c) Issued or written by or entered into with the issuer of the underlying interest on which the derivative instrument is based; or

(d) Entered into with a qualified foreign exchange.

4. **Overview of the Defined Standards Version of the NAIC Investments of Insurers Model Act**

a. This Model Act is premised on specific capital standards, and provides a framework in which these standards relate to the investment laws, and established consequences for failure to meet capital standards. To the extent an insurer's investment program is imprudent, the insurer is deemed unsound.

b. The minimum financial security benchmark and the minimum asset requirement jointly form the foundation for regulating life insurer investments according to a modern portfolio or prudence standard.

(1) These twin tools allow a high level of investment discretion above the minimum asset requirement while still providing meaningful regulatory protections for policyholders and claimants from adverse investment management.

(2) Section 3 of the Defined Standards Proposal creates limitations and restrictions on investments counted toward the minimum asset requirement; Assets in excess of the minimum asset requirement would not be subject to these limitations and restrictions and may be invested according to the insurer's individual written investment policy.

c. Three philosophies to capital requirements are central to the Act's approach to regulating investments according to a prudence standard.

(1) The Act's "minimum capital" (for stock insurance companies) and "minimum surplus" (for mutual insurance companies) ensure financial stability at the inception of a new insurance enterprise. The amount of capital or surplus needed depends on what types of business the insurer intends to conduct, and are established based on the information the insurer gives the insurance commissioner at the time of formation. See, Annotations to Section 3 of NAIC Investments of Insurers Model Act

(Defined Standards Version) at 17 (1997).

(2) The “minimum financial security benchmark” measures the minimum capital requirements of an established enterprise, and expand as the financial needs to the enterprise expand, but may also contract with them. *Id.*

(3) The “proper surplus” appropriate for a particular company’s operation is determined by the insurer’s board of directors in consultation with management. *Id.*

d. The fundamental enforcement mechanism under the defined standards proposal appears in Section 11 which provides that if an insurer does not meet the minimum asset requirement, them under Section 11D, the insurer may be deemed to be in financially hazardous condition, and the commissioner may initiate liquidation and rehabilitation proceedings against the insurer. *Id.* at 21.

(5) Status of Investments of Insurers Model Acts in the States

(A) A state by state chart follows this section.

INVESTMENTS OF INSURERS MODEL ACT

STATE	LAWS AND REGULATIONS
Alabama	ALA. CODE §§ 27-41-1 to 27-41-41 (1977/1993) (Life).
Alaska	ALASKA ADMIN. CODE tit. 3, §§ 21.201 to 21.399 (2001/2005). ALASKA STAT. §§ 21.21.010 to 21.21.420 (1966/2001) (Includes authority to adopt regulations consistent with defined limits version).
Arizona	ARIZ. REV. STAT. ANN. §§ 20-531 to 20-561 (1954/2000).
Arkansas	ARK. CODE ANN. §§ 23-63-801 TO 23-63-841 (1959/2009).
California	CAL. INS. CODE §§ 1170 to 1212 (1935/2009). CAL. CODE REGS. Tit. 10, §§ 2690.90 to 2690.94 (2007); BULLETIN 95-5A (1995).
Colorado	COLO. REV. STAT. §§ 10-3-213 to 10-3-242 (1969/2000).
Connecticut	CONN. GEN. STAT. §§ 38a-102 to 38a-102*i* (1991/2009); BULLETIN FS-14c-00 (2000).
Delaware	DEL. CODE ANN. Tit. 18, §§ 1301 to 1332 (1953/2002).
District of Columbia	D.C. CODE §§ 31-1371.01 to 31-1375.01 (2002).
Florida	FLA. STAT. §§ 625.301 to 625.340 (1959/1993).
Georgia	GA. CODE ANN. §§ 33-11-50 to 33-11-67 (2000).
Guam	GUAM GOV'T. CODE § 43166 (1951).
Hawaii	HAW. REV. STAT. §§ 431:6-101 to 431:6-501 (1987/2009); §§431:6-601 to 431:6-602 (1987/2008).
Idaho	IDAHO CODE ANN. §§ 41-701 to 41-736 (1961/2006).
Illinois	215 ILL. COMP. STAT. 5/126.1 to 5/126.32 (1997). ILL. ADMIN. CODE tit. 50, §§ 806.10 to 806.60 (1998/2001). Company Bulletin 92-2 (1992).
Indiana	IND. CODE §§ 27-1-12-2 to 27-1-12-3.5 (1935/2004) (Life); §§ 27-1-13-3 to 27-1-13-3.5 (1935/2004) (P/C).
Iowa	IOWA CODE §§ 511.8 to 511.8A (1868/2000) (Life); § 515.35 (1868/1997) (P/C). IOWA ADMIN. CODE r. 191-93.6; BULLETIN 2008-18 (2008).

STATE	LAWS AND REGULATIONS
Kansas	KAN. STAT. ANN. §§ 40-2a01 to 40-2a28 (1972/2005) (P/C); §§ 40-2b01 to 40-2b29 (1972/2005) (Life).
Kentucky	KY. REV. STAT. ANN. §§ 304.7-010 to 304.7-473 (2000).
Louisiana	LA. REV. STAT. ANN. §§ 22:581 to 22:601 (2007/2010).
Maine	ME. REV. STAT. ANN. Tit. 24-A, §§ 1101 to 1137 (1969/2000) (P/C); §§ 1151 to 1161 (1987/2000) (Life).
Maryland	MD. CODE ANN., INS §§ 5-501 to 5-512 (1922/2003) (Life); §§ 5-601 to 5-609 (1943/1997) (P/C); MD. ADMIN. CODE CH. 650 §§ 1 to 011 (1998/2008).
Massachusetts	MASS. GEN. LAWS. Ch. 175 §§ 63 to 68 (1817/1996).
Mississippi	MISS. CODE ANN. §§83-19-51 to 83-19-55 (1892/2010).
Missouri	MO. REV. STAT. §§ 375.325 TO 375.355 (1939/2002); §§ 375.532 TO 375.534 (1991/2005) (All insurers); §§ 376.300 to 376.311 (1939/2002) (Life) §§ 376.311, 379.083 (1997/2002); § 375.345 (2002); MO. CODE REGS. ANN. Tit. 20, § 200-12.020 (2009).
Montana	MONT. CODE ANN. §§ 33-12-101 to 33-12-312 (1999/2001).
Nebraska	NEB. REV. STAT. §§ 44-5101 to 44-5154 (1991/2009).
Nevada	NEV. REV. STAT. §§682A.010 to 682A.290 (1971/2003).
New Hampshire	N. H. REV. STAT. ANN. §§ 402:27 to 402:29-d (1917/1991) (All insurers); §§ 411-A:37 (1978/1990) (Life).
New Jersey	N.J. STAT. ANN. §§ 17:24-1 to 17:24-16 (1902/1995) (P/C); §§ 17B:20-1 to 17B:20-8 (1971/2005) (Life).
New Mexico	N.M. STAT. ANN. §§ 59A-9-1 to 59A-9-27 (1984/1988).
New York	N.Y. INS. LAW §§ 1401 to 1413 (1984/2008). N.Y. COMP. CODES R. & REGS. Tit. 11, §§ 178.0 to 178.10 (Regulation 168) (2001).
North Carolina	N.C. GEN. STAT. §§ 58-7-165 to 58-7-205 (1991/2005).
North Dakota	N.D. CENT. CODE §§ 26.1-05-18 to 26.1-05-22 (1983/2001).

STATE	LAWS AND REGULATIONS
Ohio	OHIO REV. CODE ANN. §§ 3907.14 to 3907.141; §§ 3925.20 to 3925.21 (1953/2001) (Life); §§ 3925.05 to 3925.06 (1953) (P/C).
Oklahoma	OKLA. STAT. tit. 36, §§ 1601 to 1629 (1957/2005).
Oregon	OR. REV. STAT. §§ 733.510 to 733.780 (1959/2006).
Pennsylvania	40 PA. STAT. ANN. §§ 504.1 to 506.1 (1986/2004) (Life).
Puerto Rico	P. R. LAWS ANN. tit. 26, §§ 648-662 (2003).
Rhode Island	R.I. GEN. LAWS §§ 27-11-1 to 27-11-3 (1947/1956); §§ 27-11.1 to 27-11.1-8 (1984/2002).
South Carolina	S.C. CODE ANN. §§ 38-12-10 to 38-12-510 (2002).
South Dakota	S.D. CODIFIED LAWS §§ 58-27-1 to 58-27-111 (1966/2005); S.D. ADMIN. R. 20:06:26:01 (2005/2008). S.D. ADMIN. R. 20:06:26:01 (1995/2008).
Tennessee	TENN. CODE ANN. §§ 56-3-301 to 56-3-409 (1907/1998) (Life); §§ 56-3-401 to 56-3-409 (1979/1984) (P/C).
Texas	TEX. INS. CODE ANN. §§ 424.001 to 424.218 (2005/2007).
Utah	UTAH CODE ANN. §§ 31A-18-101 to 31A-18-110 (1985/2006).
Vermont	VT. STAT. ANN. tit. 8, §§ 3461 to 3472 (1967/2000).
Virginia	VA. CODE ANN. §§ 38.2-1400 to 38.2.1447 (1986/2002).
Washington	WASH. REV. CODE ANN. §§ 48.13.010 to 48.13.360 (1947/2004).
West Virginia	W. VA. CODE §§ 33-8-1 to 33-8-32 (1957/2004).
Wisconsin	WIS. STAT. §§ 620.01 to 620.25 (1971/1992).
Wyoming	WYO. STAT. ANN. §§ 26-7-101 to 26-7-116 (1967/2001).

NAIC

National Association of Insurance Commissioners

Appendix B- NAIC Financial Condition Examiners Handbook: Derivatives Provisions Extracted

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Financial Condition

Examiners Handbook

INTRODUCTION

This Handbook is a guide to assist state insurance departments in conducting risk-focused examinations, as a key component of establishing and operating an effective risk-focused surveillance process. The purposes of a risk-focused surveillance process are (1) to detect as early as possible those insurers with potential financial trouble; (2) to timely identify noncompliance with state statutes and regulations; (3) to compile the information needed for timely, appropriate regulatory action; (4) to provide a clearer methodology for assessing residual risk in each activity under review and to explain how that assessment translates into establishing examination procedures; (5) to allow the assessment of risk management processes in addition to those that result in financial statement line item verifications, for example, the effectiveness of the board of directors and other corporate governance activities, thus providing an introspective look at the operations and quality of the risk management processes of the insurer; and (6) to allow for the utilization of examination findings to establish, verify or revise the company's priority score determined through the department's analysis and utilization of the NAIC tools (e.g., Scoring System, ATS results, IRIS ratios). These elements allow for examinations that emphasize the analysis of an insurer's current or prospective solvency risk areas as well as the fair presentation of surplus. To conduct an effective risk-focused examination, examiners must have adequate training and experience and appropriately involve key regulatory functions in the department, to assist in exercising sound judgment at every stage of the examination process. Enhanced risk assessment is not intended to add additional hours to the examination process, but to assist the examination teams in better allocating their hours to the most critical risks facing the companies they regulate.

The concepts presented in this Handbook can be applied to all examinations; however, modifications may be warranted based upon the nature and size of specific entities. Risk-focused examinations allow flexibility for procedures to be added, modified, supplemented or reduced, in accordance with the overall risk assessment of the insurer. The NAIC acknowledges that considerable judgment will be required of the examiner in completing risk assessments.

A. History of Risk Assessment and Process of Conducting Examinations

In 2004, the NAIC Risk Assessment Working Group adopted the Risk-Focused Surveillance Framework, whose principles set the foundation for the enhancement of the risk assessment components of this Handbook. Although editions of the Handbook prior to 2007 already utilized a risk-focused approach, that approach focused only on financial reporting issues and audit risk. A broader, organization-wide business risk assessment including strategic and operational issues enhances the process for evaluating the entire solvency risks inherent in an insurer's operations. The enhancement in the risk assessment process and supporting tools will also improve the ongoing surveillance of the insurer. The risk-focused surveillance process includes a formal system for identifying risk, processes for assessing and documenting that risk, and recommendations for how the assessment can be applied in the examination process and to the ongoing monitoring of the insurer.

The revised risk-focused surveillance process was developed by the NAIC in response to a recommendation by the Risk Assessment Working Group. The recommendation was based on the need to enhance the qualitative aspects of examination and financial analysis functions. These enhancements will allow the financial solvency surveillance process to better incorporate prospective risk assessment in identifying insurers that have or will encounter solvency issues and bring focus to the broader issue of the ability of management to identify, assess and manage the business risks of the insurer. These enhancements are considered to be directly aligned with the NAIC Solvency Initiatives.

Historically, many solvency problems have been caused by inadequate management oversight. Inadequate management oversight typically results in inaccurate financial reporting which can prevent the regulator from taking timely remedial or regulatory actions and thus reduces the options available for corrective steps. Solvency issues generally result from business risks that were not mitigated to an acceptable level by company controls. Inadequately controlled operating risks may take several years to be reflected in the company's financial statements.

The Risk Assessment Working Group has determined solvency surveillance needs a broader risk focus to become more proactive in identifying emerging solvency issues. As the revised approach is implemented by state insurance departments, examination activities will be enhanced by a risk-focused methodology that:

- More clearly directs financial statement verification to only those key accounts and control objectives of those accounts with the greatest risk, and

- Directs the examination focus to the identification of significant strategic and operating risks, investigation of mitigation strategies for those risks, and recommendations for enhancements where appropriate to reduce residual risks to a more acceptable level.

B. Overview of Risk-Focused Surveillance Process

The intent of the risk-focused surveillance process is to broaden and enhance the identification of risk inherent in an insurer's operations and utilize that evaluation in formulating the ongoing surveillance of the insurer. This assessment could be completed on a legal entity basis or on an organization-wide basis depending on how the company structures its business. Through their activities, insurers assume a variety of risks, which is the essence of an insurance transaction. The type of risk and its significance varies by activity. Investment activities may involve credit risk, market risk and liquidity risk. In product sales, insurers may assume market risk, pricing/underwriting risk, strategic risk or liquidity risk in varying degrees, depending on the product. Over the years, state insurance regulators have developed numerous tools to address the risks insurers assume. Investment laws limit the market and credit risk insurers can assume. Limitations on net retentions help reduce catastrophe risk. Risk-based capital requirements establish capital levels in recognition of a variety of risks. Insurance regulators have always considered the risk profiles of licensed insurers and the activities that may pose risk to the company in the future. The risk-focused surveillance process utilizes an organization-wide risk assessment process to enhance evaluation and to better coordinate the activities of financial solvency surveillance through greater consistency within the department, and with other departments.

A risk-focused surveillance process includes identifying significant risks, assessing and analyzing those risks, documenting the results of the analysis, and developing recommendations for how the analysis can be applied to the ongoing monitoring of the insurer. This increased attention by regulators to risk assessment and risk management processes utilized by insurers will be a positive development.

The enhancements included in the risk-focused surveillance process intend to provide the following benefits:

1. Strengthen regulatory understanding of the insurer's corporate governance function by documenting the composition of the insurer's board of directors and the executive management team as well as the quality of guidance and oversight provided by the board and management.

2. Enhance evaluation of risks through assessment of inherent risks and risk management processes regarding weaknesses of management's ability to identify, assess and manage risk.

3. Improve early identification of emerging risks at individual insurers on a sector-wide basis.

4. Enhance effective use of regulatory resources through increased focus on higher risk areas.

5. Increase regulatory understanding of the insurer's quality of management, the characteristics of the insurer's business and the risks it assumes.

6. Enhance the value of surveillance work and establishment of risk assessment benchmarks performed by insurers and regulators, who have common interest in ensuring that risks are properly identified and that adequate, effective control systems are established to monitor and control risks.

7. Better formalize and document the risk assessment process via the use of the risk assessment matrix tool to assist in examination planning and resource assignment.

8. Expand risk assessment to provide a more comprehensive and prospective look at an insurer's risks through identification of the insurer's current and/or prospective high-risk areas.

9. Coordinate the results of the risk-focused examination process with other financial solvency surveillance functions (i.e., establishing/updating the priority score and supervisory plan).

In full, the risk-focused surveillance process provides effective procedures to monitor and assess the solvency of insurers on a continuing basis. The risk-focused surveillance process is embedded in the planning activities and throughout each phase of the risk-focused surveillance process discussed in detail within this Handbook. The revised approach consists of a structured methodology designed to establish a forward-looking view of an insurer's risk profile and the quality of its risk management practices. This approach permits a direct and specific focus on the areas of greatest risk to an insurer. Through this approach, state insurance regulators can be more proactive and better positioned to identify and respond to any serious threat to the stability of the insurance company from any current or emerging risks. This regulatory approach will benefit all participants in the insurance marketplace.

C. Risk-Focused Surveillance Cycle

The system of financial surveillance advocated by the Risk-Focused Surveillance Framework is designed to provide continuous regulatory oversight. The risk-focused approach requires fully coordinated efforts between the financial examination function and the financial analysis function. There should be a continuous exchange of information between the field examination function and the financial analysis function to ensure that all members of the department are properly informed of solvency issues related to the state's domestic insurers.

Responsibilities of the analysts in the Risk-Focused Financial Surveillance Framework are (1) to monitor the states' domestic insurers; (2) to provide updates to the Insurer's Profile Summary; (3) to provide input for the department's priority score for each insurer; and (4) to provide department management with timely knowledge of significant events relating to the domestic insurers. This information is used by the field examination function as input for scheduling and staffing of examinations. In anticipation of a field examination, the examiners and analysts should conduct a planning meeting to facilitate the exchange of relevant information between the analyst and the examination team. As the examiners conduct the financial examinations, they should inform the analyst of any significant examination findings. At the conclusion of the on-site examination, the examiners and analysts should work together to determine the company's priority score. The development of the management letter to the company should include contributions from the examiners and analysts. It is strongly recommended that the analyst be responsible for evaluating and following-up with the company responses to the management letter comments, as after the report of the examination has been issued, the analyst will be the primary regulatory contact with the company until the next examination.

The regulatory Risk-Focused Surveillance Cycle involves five functions, most of which are performed under the current financial solvency oversight role. The enhancements coordinate all of these functions in a more integrated manner that should be consistently applied by state regulators. The five functions of the risk assessment process are illustrated within the Risk-Focused Surveillance Cycle.

As illustrated in the Risk-Focused Surveillance Cycle diagram, elements from the five identified functions contribute to the development of an Insurer Profile Summary. Each state will maintain an Insurer Profile Summary for their domestic companies. Regulators that wish to review an Insurer Profile Summary for a non-domestic company will be able to request the Insurer Profile Summary from the domestic or lead state. The documentation contained in the Insurer Profile Summary is considered proprietary, confidential information that is not intended to be distributed to individuals other than state regulators.

Please note that once the Risk-Focused Surveillance Cycle has begun, any of the inputs to the Insurer Profile Summary can be changed at any time to reflect the changing environment of an insurer's operation and financial condition.

EXAMINATION REPOSITORY - INVESTMENTS

Annual Statement Blank Line Items

Listed below are the corresponding Annual Statement line items that are related to the identified risks contained in this exam repository:

Bonds
Stocks (Preferred and Common)
Mortgage Loans on Real Estate
Cash, Cash Equivalents and Short-Term Investments
Contract Loans
Derivatives
Receivables for Securities
Payable for Securities
Investment Income Due and Accrued *(P&C Companies)*
Other Invested Assets
Securities Lending – Reinvested Collateral Assets
Miscellaneous Liabilities – Asset Valuation Reserve
Contract Liabilities Not Included Elsewhere – Interest Maintenance Reserve

Other Annual Statement line items related to investments, whose risks are less common, have not been included in this examination repository. They include the following:

Real Estate
Aggregate Write-Ins for Invested Assets
Drafts Outstanding
Unearned Investment Income *(Life Companies)*
Liability for Deposit-Type Contracts *(Life Companies)*
Contract Liabilities Not Included Elsewhere – Surrender Values on Cancelled Contracts *(Life Companies)*

Relevant Statements of Statutory Accounting Principles (SSAPs)

All of the relevant SSAPs related to the investment process, regardless of whether or not the corresponding risks are included within this exam repository, are listed below:

No. 2	Cash, Drafts and Short Term Investments
No. 7	Asset Valuation Reserve and Interest Maintenance Reserve
No. 21	Other Admitted Assets
No. 23	Foreign Currency Transactions and Translations
No. 26	Bonds, excluding Loan-backed and Structured Securities
No. 30	Investments in Common Stock
No. 32	Investments in Preferred Stock
No. 34	Investment Income Due and Accrued
No. 37	Mortgage Loans
No. 38	Acquisition, Development, and Construction Arrangements
No. 39	Reverse Mortgages
No. 40	Real Estate Investments
No. 41	Surplus Notes
No. 43R	Loan-backed and Structured Securities—Revised
No. 44	Capitalization of Interest
No. 48	Investments in Joint Ventures, Partnerships and Limited Liability Companies
No. 49	Policy Loans

No. 56 Separate Accounts
No. 74 Accounting for the Issuance of Insurance-Linked Securities Issued by a Property and Casualty Insurer Through a Protected Sale
No. 77 Real Estate Sales
No. 83 Mezzanine Real Estate Loans
No. 86 Accounting for Derivative Instruments and Hedging Activities
No. 90 Accounting for the Impairment or Disposal of Real Estate Investments
No. 91R Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—Revised
No. 93 Accounting for Low Income Housing Tax Credit Property Investments

Sub-Activity	Identified Risk	Branded Risk	Exam Asrt.	Control Best Practices	Possible Test of Controls	Possible Detail Tests
					management framework.	has been performed by an investment specialist, review the results and perform necessary follow-up procedures.
N/A	The insurer is not properly implementing and monitoring derivative transactions. Provisions Addressing Life Insurers' Derivatives Transactions	MK CR ST OP	Other	The insurer has properly adopted a derivative use plan within the investment policy approved by the board of directors, which includes the following attributes: • Management controls • Type and use limits • Relationship to overall investment limits • Documentation and reporting requirements • Valuation procedures • Quantitative limits • Risk management standards • Compliance with state law, internal policy and NAIC practices. The insurer frequently reviews its derivative position to determine effectiveness of hedging and replication transactions and adjusts	Review how management ensures that its derivative use plan is complete and in compliance with applicable laws and best practices. Determine whether the insurer's derivative traders are part of its larger risk-management organization and not a profit center. Determine whether the company effectively implements its derivative strategy by performing a walk through with investment staff. Inquire as to how they ensure that derivative agreements are in-line with the strategy and objectives of the insurer. Review management control procedures for determining effectiveness of hedging and replication transactions for adequacy.	Review the insurer's derivative use policy guidelines for appropriateness. Perform a review of the insurer's derivative position to ensure it is in compliance with the hedging and replication strategies outlined in the derivative use plan. Select a sample of derivatives and review the following attributes for compliance with its plan: • Valuation • Effectiveness • Legal review • Accounting compliance • Maturity reasonableness (i.e., not long dated Review hedge performance for periods of market volatility. If a portfolio analysis has been performed by

Sub-Activity	Identified Risk	Branded Risk	Exam Asrt.	Control Best Practices	Possible Test of Controls	Possible Detail Tests
				where necessary.		an investment specialist, review the results and perform necessary follow-up procedures.
N/A	The insurer is not properly implementing and monitoring security lending, repurchase and reverse repurchase transactions	MK CR ST OP	Other	Insurer management implements controls over credit, market, and operational risk associated with lending securities, which include monitoring the following: • Percent and type of securities permitted to be loaned • Borrower concentration and credit worthiness • Amount of collateral and systematic true-up • Investment of cash collateral The insurer has established a securities lending framework based on its tolerance for market risks (including market price volatility, securities lending and interest rate risks) and has included guidelines as to the internal approvals required to approve agreements, counterparty balances, programs and strategies.	Review management's lending program and methods to compare it to actual operations. Determine how management ensures that the lending program complies with state laws, regulation, internal policy and NAIC practices. Review management controls to ensure that inordinate amounts of leverage and exposure to duration/liquidity risks are not created through reinvestment of collateral. Evaluate the following internal procedures for adequacy: • Internal approvals • Regulatory framework • Contractual agreements • Counterparty management • Program size and composition • Lending strategies	Review guidelines for any securities lending programs deemed off-balance sheet. Review duration of reinvested collateral in relation to lending agreements and potential liquidity shortfalls. Compare the maturity dates of the reinvested collateral in Schedule DL to the term of the lending agreement to determine whether there is any mismatch in the maturity considering the duration of when the lent securities and cash collateral are expected to be returned per contract.

NAIC

National Association of Insurance Commissioners

The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia and five U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review, and coordinate their regulatory oversight. NAIC staff supports these efforts and represents the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the U.S.

For more information, visit **www.naic.org**.

EXF-ZU-11

NAIC Annual (& Quarterly) Statement Blank
Schedule DB (Derivative Instruments).

Appendix C

SCHEDULE DB – PART A – SECTION 1

Showing all Options, Caps, Floors and Insurance Futures Options Owned December 31 of Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Acquisition	6 Exchange or Counterparty	7 Cost/ Option Premium	8 Book Value	9 *	10 Statement Value	11 Fair Value	12 Increase/(Decrease) by Adjustment	13 Used to Adjust Basis of Hedged Item	14 Other Investment / Miscellaneous Income
2599999	Subtotal – Hedging Transactions							xxx					
2799999	Subtotal – Other Derivative Transactions							xxx					
9999999	Totals							xxx					

SCHEDULE DB – PART A – SECTION 2

Showing all Options, Caps, Floors and Insurance Futures Options Acquired During Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Acquisition	6 Exchange or Counterparty	7 Cost/ Option Premium
2599999	Subtotal – Hedging Transactions					
2799999	Subtotal – Other Derivative Transactions					
9999999	Total					

SCHEDULE DB – PART A – SECTION 3

Showing all Owned Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

	2	3	4	5	6	7	8	9	10	11	12	13	Gain (Loss) on Termination			17
													14	15	16	
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry, or Settlement	Strike Price, Rate or Index	Date of Acquisition	Exchange or Counterparty	Cost/ Option Premium	Indicate Exercise, Expiration, Maturity or Sale	Termination Date	Book Value	*	Consideration Received on Terminations	Increase/ (Decrease) by Adjustment	Recognized	Used to Adjust Basis of Hedged Item	Deferred	Other Investment/ Miscellaneous Income
2599999 Subtotal – Hedging Transactions							xxx	xxx		xxx						
2799999 Subtotal – Other Derivative Transactions							xxx	xxx		xxx						
9999999 Totals							xxx	xxx		xxx						

SCHEDULE DB – PART B – SECTION 1

Showing all Options, Caps, Floors and Insurance Futures Options Written and In-Force December 31 of Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	14
Description	Number of Contracts or Notional Amount	Date of Maturity, Expiry, or Settlement	Strike, Price, Rate or Index	Date of Issuance/ Purchase	Exchange or Counterparty	Consideration Received	Book Value	*	Statement Value	Fair Value	Increase/ (Decrease) by Adjustment	Used to Adjust Basis	Other Investment/ Miscellaneous Income
2599999 Subtotal – Hedging Transactions								xxx					
2699999 Subtotal – Income Generation Transactions								xxx					
2799999 Subtotal – Other Derivative Transactions								xxx					
9999999 Totals								xxx					

SCHEDULE DB – PART B – SECTION 2

Showing all Options, Caps, Floors and Insurance Futures Options Written During Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Issuance/ Purchase	6 Exchange or Counterparty	7 Consideration Received
2599999 Subtotal – Hedging Transactions						
2699999 Subtotal – Income Generation Transactions						
2799999 Subtotal – Other Derivative Transactions						
9999999 Total						

SCHEDULE DB – PART B – SECTION 3

Showing all Written Options, Caps, Floors and Insurance Futures Options Terminated During Current Year

1 Description	2 Number of Contracts or Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index	5 Date of Issuance/ Purchase	6 Exchange or Counterparty	7 Consideration Received	8 Indicate Exercise Expiration, Maturity or Closing Purchase Transaction	9 Termination Date	10 Book Value	11 *	12 Consideration Paid on Terminations	13 Increase/ (Decrease) by Adjustment	Gain/(Loss) on Termination 14 Recognized	Gain/(Loss) on Termination 15 Used to Adjust Basis	Gain/(Loss) on Termination 16 Deferred	17 Other Investment/ Miscellaneous Income
2599999 Subtotal – Hedging Transactions							xxx	xxx		xxx						
2699999 Subtotal – Income Generation Transactions							xxx	xxx		xxx						
2799999 Subtotal – Other Derivative Transactions							xxx	xxx		xxx						
9999999 Totals							xxx	xxx		xxx						

SCHEDULE DB – PART C – SECTION 1

Showing all Collar, Swap and Forwards Open December 31 of Current Year

1 Description	2 Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index Rec (Pay)	5 Date of Opening Position or Agreement	6 Exchange or Counterparty	7 Cost or (Consideration Received)	8 Book Value	9 *	10 Statement Value	11 Fair Value	12 Increase/ (Decrease) by Adjustment	13 Used to Adjust Basis of Hedged Item	14 Other Investment/ Miscellaneous Income	15 Potential Exposure
2599999 Subtotal – Hedging Transactions								xxx						
2799999 Subtotal – Other Derivative Transactions								xxx						
9999999 Totals								xxx						

SCHEDULE DB – PART C – SECTION 2

Showing all Collar, Swap and Forwards Opened During Current Year

1 Description	2 Notional Amount	3 Date of Maturity, Expiry, or Settlement	4 Strike Price, Rate or Index Rec (Pay)	5 Date of Opening Position or Agreement	6 Exchange or Counterparty	7 Cost or (Consideration Received)
2599999 Subtotal – Hedging Transactions						
2799999 Subtotal – Other Derivative Transactions						
9999999 Total						

SCHEDULE DB – PART C – SECTION 3

Showing all Collar, Swap and Forwards Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	11	12	13	Gain/(Loss) on Termination			17
													14	15	16	
Description	Notional Amount	Date of Maturity, Expiry, or Settlement	Strike Price, Rate or Index Rec (Pay)	Date of Opening Position or Agreement	Exchange or Counterparty	Cost or (Consideration Received)	Indicate Exercise, Expiration, Maturity or Sale	Termination Date	Book Value	*	Consideration Received or (Paid) on Terminations	Increase (Decrease) by Adjustment	Recognized	Used to Adjust Basis of Hedged Item	Deferred	Other Investment / Miscellaneous Income
2599999 Subtotal – Hedging Transactions							xxx	xxx		xxx						
2799999 Subtotal – Other Derivative Transactions							xxx	xxx		xxx						
9999999 Totals							xxx	xxx		xxx						

SCHEDULE DB – PART D – SECTION 1

Showing all Futures Contracts and Insurance Futures Contracts Open December 31 of Current Year

1	2	3	4	5	6	7	8	9	Variation Margin Information			13
									10	11	12	
Description	Number of Contracts	Maturity Date	Original Value	Current Value	Variation Margin	Date of Opening Position	Exchange or Counterparty	Cash Deposit	Recognized	Used to Adjust Basis of Hedged Item	Deferred	Potential Exposure
2599999 Subtotal – Hedging Transactions						xxx	xxx					
2799999 Subtotal – Other Derivative Transactions						xxx	xxx					
9999999 Totals						xxx	xxx					

SCHEDULE DB – PART D – SECTION 2

Showing all Futures Contracts and Insurance Futures Contracts Opened During Current Year

1 Description	2 Number of Contracts	3 Maturity Date	4 Original Value	5 Date of Opening Position	6 Exchange or Counterparty	7 Net Additions to Cash Deposits
2599999 Subtotal – Hedging Transactions				xxx	xxx	
2799999 Subtotal – Other Derivative Transactions				xxx	xxx	
9999999 Totals				xxx	xxx	

SCHEDULE DB – PART D – SECTION 3

Showing all Futures Contracts and Insurance Futures Contracts Terminated During Current Year

1	2	3	4	5	6	7	8	9	10	Variation Margin Information		
										11	12	13
Description	Number of Contracts	Maturity Date	Original Value	Termination Value	Variation Margin	Date of Opening Position	Exchange or Counterparty	Net Reduction to Cash Deposits	Termination Date	Gain (Loss) Recognized	Gain (Loss) Used to Adjust Basis of Hedged Item	Gain (Loss) Deferred
2599999 Subtotal – Hedging Transactions						xxx	xxx		xxx			
2799999 Subtotal – Other Derivative Transactions						xxx	xxx		xxx			
9999999 Totals						xxx	xxx		xxx			