American Council of Life Insurers

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Re: Financial Stability Board Consultative Document[1] on Incentives to Centrally Clear OTC Derivatives.

The American Council of Life Insurers (ACLI) appreciates the opportunity to provide input on the Financial Stability Board's *Consultative Document on Incentives to Centrally Clear OTC Derivatives*. The consultative document follows the Financial Stability Board's *Framework for Post-Implementation Evaluation of the Effects of the G20 Financial Regulatory Reforms* that analyzes whether the G-20 financial reforms achieved their intended outcomes, and identifies material unintended consequences that should be addressed, without compromising the objectives of the reforms.

ACLI is a national trade association representing 290 life insurers that hold over 95 percent of the industry's total assets. dedicated to providing products and services that promote consumers' financial and retirement security. Our members serve 90 million American families and provide life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits.

We have offered substantive input on several global standard setters' regulatory initiatives involving derivatives.[2] Life insurers have also actively participated in the important regulatory dialog leading to

[1] The Consultative Document was jointly issued by The Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures, the Financial Stability Board and the International Organization of Securities Commissions [http://www.fsb.org/wp-content/uploads/P070818.pdf].

[2] On July 5, 2016, ACLI filed comments on the BCBS Revised Basel III Leverage Ratio Framework-Consultative Document published April 25, 2016. The submission explained that life insurers are among the financial end users affected by the leverage ratios under consideration in the Consultative Document. ACLI previously filed a submission dated September 20, 2013, with the Basel Committee on Banking Supervision (BCBS) on its initial consultative document that proposed a revised Basel III leverage ratio framework through a supplementary measure of the Risk Based Capital ("RBC") requirements for Banks.

On August 4, 2015, ACLI filed comments on the Prudential Regulators' net stable funding ratio proposal. finalized by the Basel Committee on Banking Supervision as part of Basel III, as Regulatory Agencies were considering a similar proposal for entities under their authority.

ACLI submitted comments on the initial BCBS-IOSCO Consultative Document for Non-Centrally Cleared Derivatives, published by the Basel Committee on Bank Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) (May 2012) ("BCBS-IOSCO Consultative Paper") [http://www.bis.org/publ/bcbs226/acoli.pdf] [BCBS-IOSCO], and the BCBS-IOSCO Second Consultative Document on Margin Requirements for Non-Centrally Cleared Derivatives (Feb. 2013) ("Second BCBS-IOSCO Consultative Paper") [http://www.bis.org/publ/bcbs242.pdf].

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implementation of Title VII of the Dodd–Frank Wall Street Reform and Consumer Protection Act in the United States.[3]

The Consultative Document invites input on 14 groups of questions that have 33 sub-questions. Rather than respond to each question individually, our submission addresses the list as a whole and provides responses reflecting our views on the most important matters for life insurers in the Consultative Document.

A brief background on life insurers' use of derivatives may help set the stage for our comments below. Life insurers are significant end-users of derivative instruments that enable the prudent management of asset and liability risks, as permitted under state insurance codes and regulations.[4] The long-term nature the industry's life and retirement products requires insurers to match long-term obligations with assets of a longer duration than most other financial institutions. Like other commercial end-users, life insurers hedge their risks. Life insurers cannot, by law, engage in market speculation, and hedge risks to to fulfill their obligations to policy and contract owners.

Life insurer derivative portfolios do not pose systemic risk. Life Insurers' derivative notional is a small component of overall derivative notional totals. The total notional value of derivatives position for the U.S. life insurance industry is roughly $3.68 trillion[5], while the total notional amounts of outstanding U.S. OTC derivatives contracts is around $229 trillion.[6] Life insurers' derivatives transactions are subject to reporting and swap execution requirements.

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[3] For example, ACLI submitted detailed comments on the following related and parallel regulatory proposals developed by the U.S. Prudential Regulators, the U.S. Commodity Futures Trading Commission ("CFTC"), and the U.S. Securities and Exchange Commission ("SEC") governing margin and capital requirements:

- Supplemental Request for Comments on Proposed Margin and Capital Requirements for Covered Swap Entities; [http://www.fhfa.gov/webfiles/24691/95_American%20Council%20of%20Life%20Insurers%20ACLI.pdf] [Prudential Regulators];
- Supplemental Request for Comments on Proposed Margin Requirements Governing Uncleared Swap Transactions for Swap Dealers and Major Swap Participants [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=58806&SearchText=wilkerson] [CFTC ];
- CFTC Proposal on Protection of Cleared Swaps Customer Contracts and Collateral [http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=48045&SearchText=wilkerson] [CFTC];
- SEC proposal on margin, capital and segregation for security-based swap dealers and major security-based swap participants [http://www.sec.gov/comments/s7-08-12/s70812-25.pdf ]; and,
- Request for Comments on Retroposed Rule for Margin and Capital Requirements for Covered Swap Entities [http://www.federalreserve.gov/SECRS/2015/January/20150127/R-1415/R-1415_112414_129786_278794149594_1.pdf].

ACLI filed comments on a draft ISDA Variation Margin Protocol on July 29, 2016. ACLI suggested that parties adhering to the VM Protocol should be given additional options for items such as Notification Time, Independent Amount, Transfer Timing and Collateral Eligibility, among other things.

[4] Under the National Association of Insurance Commissioners' (NAIC) Derivatives Instruments Model Regulation:

- Limits derivatives transactions to hedging (with limited exceptions) and for prudent uses;
- Requires effectiveness testing to monitor uses over time;
- Requires internal control procedures
- Establishes counterparty exposure limits and credit quality standards
- Establishes documentation and trading requirements
- Achieves transparency through Statutory reporting (Schedule DB)

[5] NAIC Derivatives Update, as of Year-end 2015 (2/06/2018).

[6] BIS OTC Derivatives Statistics at end-December 2017 (5/3/18).

## Mandatory Clearing

The Consultative Document elicits input on market participants' opinion of the "incentives" for clearing OTC derivatives. In the United States, regulation implemented under the Dodd-Frank Act require life insurers (as financial end-users) to clear derivatives mandated for clearing. Accordingly, legal compliance occurs largely due to regulatory requirements more than "incentives." ACLI is on record in discussions with U.S derivatives regulators that clearing should be optional rather than mandatory, although some companies may choose to make use of clearing.

Notwithstanding this distinction, however, we have advocated with U.S. derivatives regulators that mandatory central clearing should be optional for life insurers due to the success of other coextensive regulatory reforms under the Dodd-Frank Act in the United States and the facts that life insurers' derivatives transactions are: transparent to regulators, heavily regulated under state insurance laws and federal swaps regulation, limited to hedging, and fully collateralized under state insurance law requirements.

We have emphasized to U.S. regulators that current mandatory clearing requirements present a variety of unintended consequences.[7] Mandatory clearing generates elevated concentration of risk in central counterparties (CCPs) because a shrinking number of futures commissions merchants (FCMs) currently exist. Some smaller size life insurers have difficulty finding FCMs willing to take on their business at competitive costs. End-users have increasing concern over CCP recovery and resolution processes. ACLI opposes aspects of the CCP recovery and resolution mechanics because end-users do not have a choice on whether to clear, are outside of the CCP governance process, and variation margin gain haircuts (VMGH) is arbitrary as to what parties are impacted (right way versus wrong way risk). Being subject to the waterfall should allow those faced with exposure to voluntarily make credit decisions related to a CCP. We have advocated that end-users should be excluded from the CCP waterfall due to the unreasonable lack of input and control end-users have in the operational and recovery process.

Posting margin on cleared trades in the form of cash (as required by FCMs and CCPs) imposes significant costs for life insurers. Cash variation margin requirements exchanges counterparty credit risk for liquidity risk. Life Insurers must hold incrementally more cash to address potential liquidity needs, which increases costs relative to fully invested portfolios and creates duration mismatches against liabilities. These perhaps unintended factors increase rather than reduce risks, introduce a lack of pricing competition, and enlarge transactional costs.

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[7] Our views parallel those expressed in *Swaps Regulation 2.0-An Assessment of the Current Implementation of Reform and Proposals for Next Steps published* on April 26, 2018, by CFTC Chairman Giancarlo and CFTC Chief Economist Bruce Tuckman at the International Swaps and Derivatives Association (ISDA) annual meeting. According to the CFTC's press release, Chairman Giancarlo and Chief Economist Tuckman "seek to optimize the CFTC's implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) so as to strike a balance between systemic safety and stability and market vibrancy and economic growth." This White Paper discussed a range of academic research, market activity and the agency's regulatory experience with implementing current swaps reform, to assess the agency's implementation of swaps reform, determine its strengths and deficiencies and recommend improvements to the current swaps market reform framework. Among other things, the White Paper observed that:

- The Dodd-Frank Act envisioned a robust end user-exception from clearing and margin requirements and did not intend margin rules to favor cleared products;
- Material swaps exposure thresholds should be established, below which entities would be excepted from clearing and margin requirements, to reduce the burdens on end users that are not sources of systemic risk and, in some cases, to reduce their liquidity risk; and,
- Rules governing uncleared initial margin should be reworked to be less prescriptive and to be unbiased with respect to cleared and uncleared products.

Were life insurers free to choose between uncleared or cleared interest rate swaps, for example, they would weigh the benefits and detriments of OTC initial and variation margin versus that required by CCPs. In either case, counterparty risk would be reduced by initial margin (IM) and variation margin (VM), but the life insurer might choose between clearing and traditional bilateral relationships. Of course, in this case – when insurers are free to choose - "incentives" to centrally clear actually become relevant.

**Leverage Ratio Issues**

We understand that market participants have also argued that under the current regulatory scheme the treatment of margin raises the costs imposed upon intermediaries through the leverage ratio requirements. We believe that policy adjustments in this area should be seriously considered as a means of incentivizing client clearing services. Next to relief from the clearing mandate, reforms in this area are likely to have the greatest impact towards expanding the availability of clearing and reducing its costs.

On July 5, 2016, ACLI filed comments on the BCBS Revised Basel III Leverage Ratio Framework-Consultative Document published April 25, 2016. The submission explained that life insurers are among the financial end users affected by the leverage ratios under consideration in the Consultative Document. ACLI previously filed a submission dated September 20, 2013, with the Basel Committee on Banking Supervision (BCBS) on its initial consultative document that proposed a revised Basel III leverage ratio framework through a supplementary measure of the Risk Based Capital ("RBC") requirements for Banks.

The 2016 Consultative Document largely reflects the substance and concepts of the initial Revised Leverage Ratio Framework. ACLI's 2013 submission recognized that the purposes of the Basel III reform included restricting the inappropriate build-up of leverage in the banking sector, which can destabilize the broader financial markets. ACLI emphasized, however, that aspects of the proposal would significantly impair market functionality, liquidity, and transaction costs in markets that the insurance industry relies upon. ACLI explained that the proposed change would unnecessarily reduce market liquidity and increase costs in the fixed income and derivative markets, in its attempt to mitigate broader systemic risks. ACLI expressed the same concerns about the 2016 Consultative Document.

The submission noted that life insurers remain concerned about the potential impact to the fixed income and derivative markets. The netting of Securities Financing Transactions (SFTs) will impact large portions of the fixed income and derivatives markets. Additionally, the derivatives markets will also suffer an unnecessarily negative impact through the inclusion of collateral in the Exposure Measure. Finally, the credit derivatives markets are likely to be adversely affected from more restrictive off-sets for purchased credit derivatives.

As ACLI indicated in its 2013 submission, the submission acknowledged that the Basel III reform introducing a simple, transparent, non-risk-based leverage ratio is intended as a credible supplementary measure to RBC requirements. ACLI recognized that the leverage ratio is intended to restrict the inappropriate build-up of leverage in the banking sector, which can destabilize the broader financial markets. Nonetheless, several aspects of the proposal will significantly impair market functionality, liquidity, and transaction costs in markets on which life insurers rely. ACLI recommend that the Basel Committee deliberatively consider the following modifications:

- Continued allowance of netting for Securities Financing Transactions when the underlying securities consist of Government Securities;
- Exclusion of collateral posted or received in connection with derivatives transactions; and

- Recognition of maturity mismatches on a proportional basis in respect of credit derivatives.

In 2013, ACLI submitted comments on proposed leverage ratio standards for large interconnected banks jointly issued by the OCC, the FDIC, and the Board of Governors of the Federal Reserve[8] (the "Enhanced Supplementary Leverage Ratio Proposal"). The submission acknowledged the importance of a regulatory structure facilitating more resilient banks and banking systems but noted that the Enhanced Supplementary Leverage Ratio Proposal could cause several negative market consequences in its attempt to mitigate broader systemic risks. ACLI explained that the joint proposal could adversely affect economic growth, reduce lending capacity, and increase the costs of lending, among other things.

In several instances, the approaches of the BCBS Consultative Paper are different from the joint proposal issued by the OCC, FDIC and the Board. ACLI recommended coordination and collaboration among the global regulators on similar initiatives to achieve harmony and to avoid regulatory arbitrage.

**Direct Clearing**

Finally, we have noted efforts being made to provide access to direct clearing membership at certain CCPs. We believe that such an initiative will be of interest to some life insurers if the costs and benefits are better aligned. To date, we have not observed that to be the case.

**Conclusion**

We appreciate your detailed interest in the markets' receptivity to mandated central clearing. After our lengthy experience with this new arrangement we fully agree with the Consult's implication that some "mid-flight" corrections are in order. It is constructive to look back on global regulatory initiatives to address unintended consequences and achieve an appropriate regulatory balance.

Thank you for your attention to our views. If any questions develop, please let me know.

Sincerely,

*Carl B. Wilkerson*

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[8] http://www.gpo.gov/fdsys/pkg/FR-2013-08-20/pdf/2013-20143.pdf