Margin Requirements for Uncleared Swaps

Presentation to

CFTC Staff

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101 Constitution Ave., NW, Washington, DC 20001-2133

ACLI
Financial Security. For Life.

American Council of Life Insurers ("ACLI")

- **ACLI is a national trade association with 300 members representing more than 90 percent of the assets and premiums of the life insurance and annuity industry in the U.S.**
- **ACLI members offer life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, and reinsurance.**
- **Life insurers provide the largest U.S. source of corporate bond financing, holding 20% of total U.S. corporate debt outstanding ($2.3 trillion at the end of 2013).**
  - **In 2013, approximately 51% of life insurers' $6.2 trillion of total assets were held in bonds, divided between corporate bonds (38%) and government bonds (13%).**
  - **Over 37% of bonds purchased by life insurers for their general accounts have maturities in excess of twenty years at the time of purchase.**

Sources: ACLI tabulations of NAIC data (year-end 2013), used by permission; Federal Reserve Board, Z.1 Financial Accounts of the United States, Second Quarter 2014.

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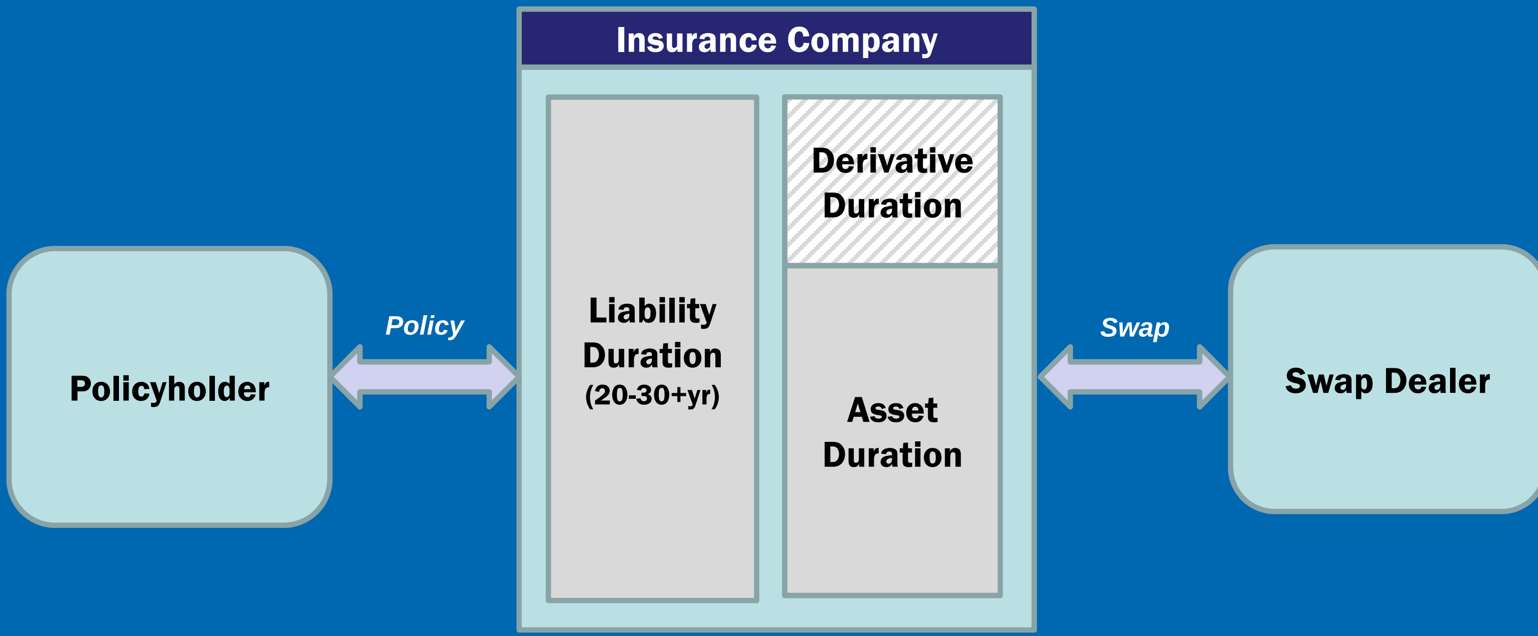
Summary

- ACLI submitted comment letters on the Prudential Regulators' and the CFTC's Proposed Margin Rules for Uncleared Swaps in 2014.
- Uncleared swaps remain a key component of Life Insurers' hedging programs.
  - More effective Asset/Liability matching (ALM)
  - Increased flexibility of customer product offerings
  - Increased hedge effectiveness
- Several aspects of the Proposed Rules have the potential to limit Life Insurers' abilities to manage assets and liabilities in a prudent manner:
  - Elimination of non-cash collateral for variation margin (VM)
  - Characterization of VM as settlement payments
  - Creation of significant operational risk through accelerated implementation
  - Lack of consistency and transparency in initial margin (IM) models
  - Market fragmentation due to inconsistency with BCBS-IOSCO Framework

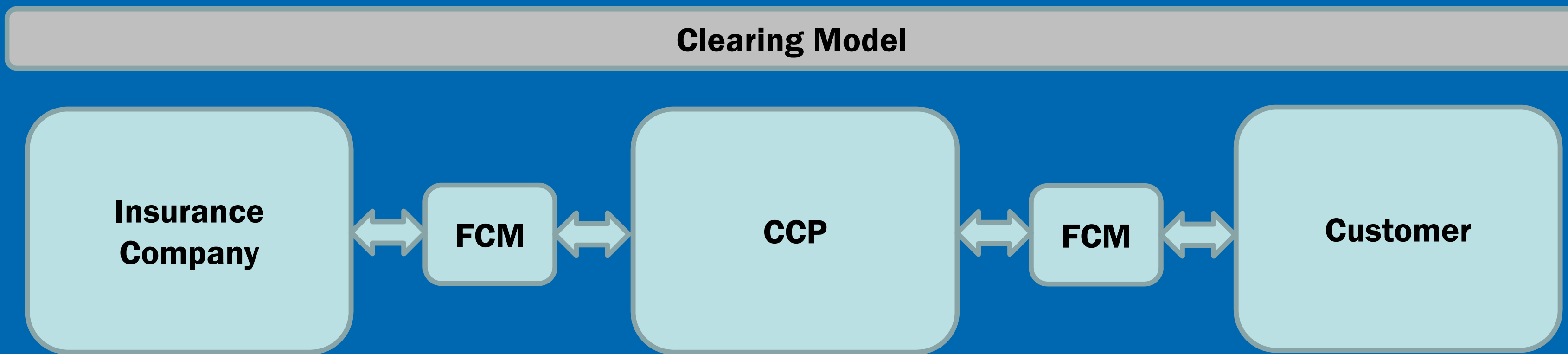
Eligible Collateral for Variation Margin (VM)



- **Over 95% of Ins Co's derivative usage is to hedge assets and liabilities***
- **Long duration high-quality assets can be difficult to source**
- **Large amounts of cash reduces portfolio income and *inhibits* effective ALM**
- **Non risk-free assets enable Ins Co's to offer affordable products to policyholders**

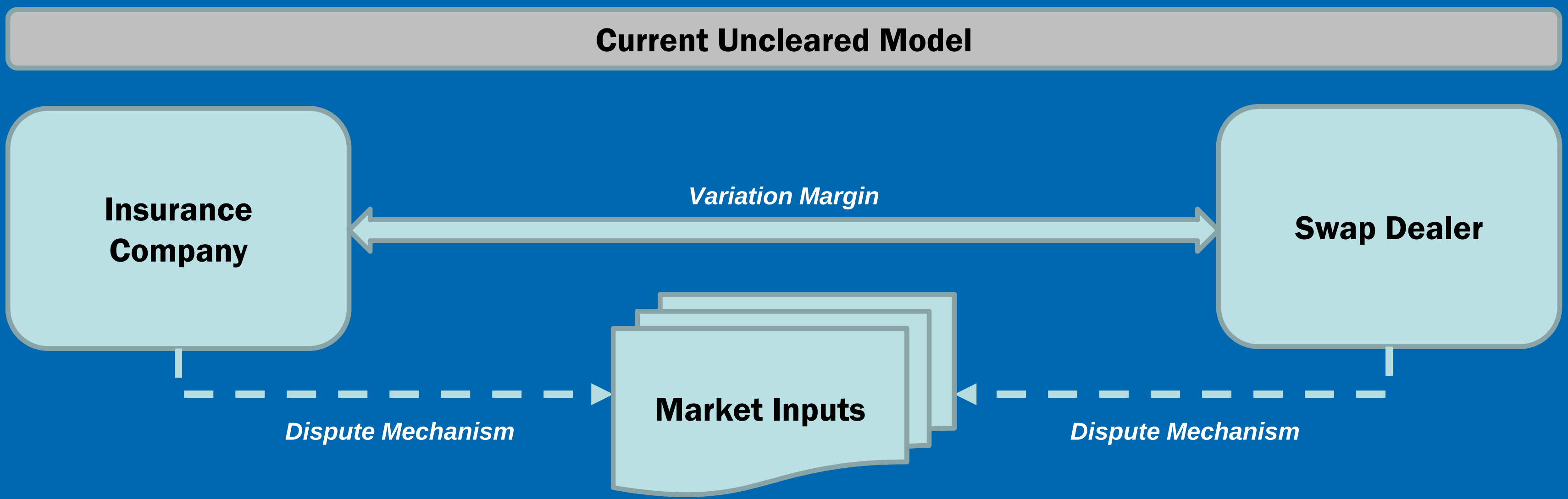
* Source: 2014 NAIC Capital Markets Special Report on the Insurance Industry's Derivative Exposure at Year-End 2012

VM Treatment: Clearing Model



- CCP is a third party to trade, whose functions include:
  - Serving as *credit intermediary* to the transaction
  - *Transferring* VM between parties
  - *Sole arbiter* for end of day pricing, IM and VM
  - *Establishing* minimum margin requirements uniformly for participants

VM Treatment: Current Uncleared Model



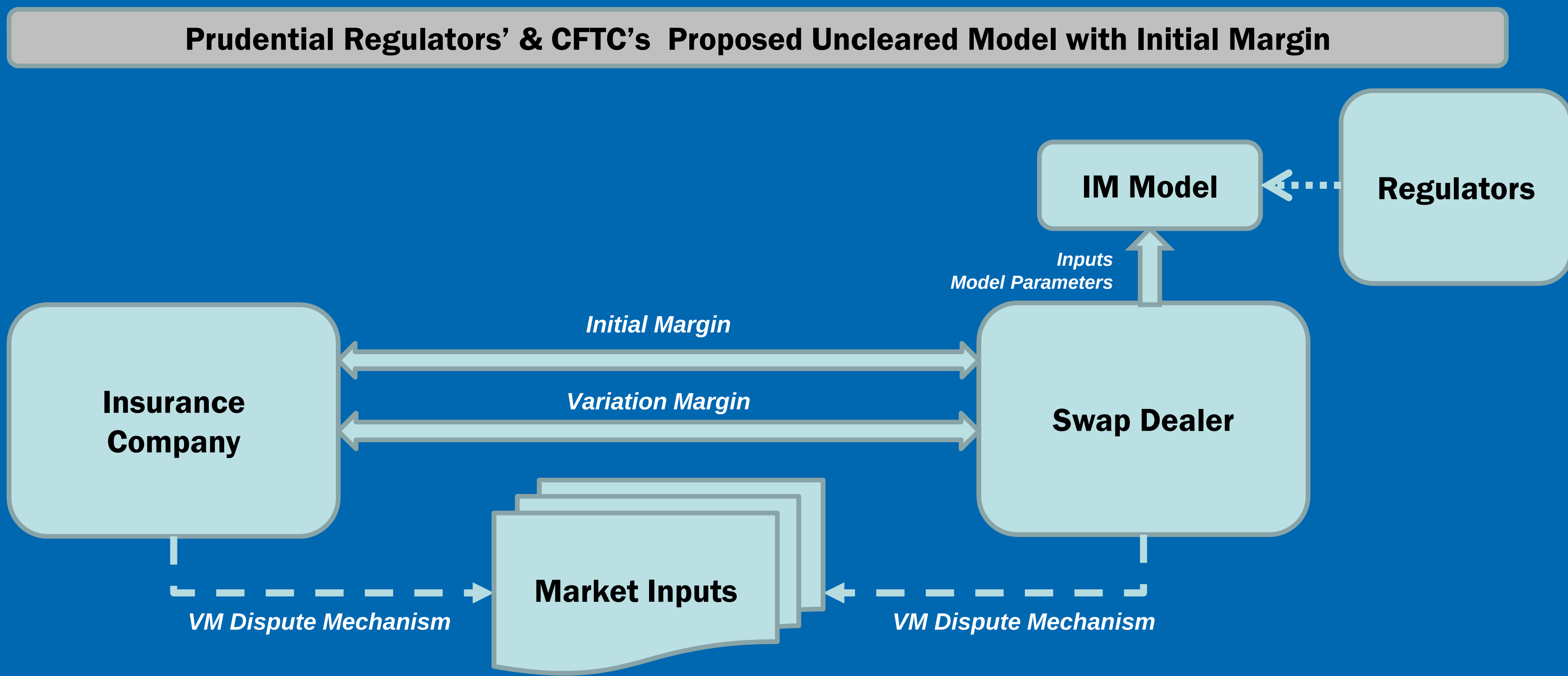
- VM is not characterized as a settlement payment
- Collateral *pledged as security interest* against performance
- Market Mid Prices are agreed to by both parties with dispute rights
- Values do not reflect actual execution levels in a close-out situation

Eligible VM Requirements should be phased-in per the Initial Margin Schedule

ACLI Proposed VM Phase-In Schedule	
December 2015	**IM Phase-In Schedule**
Broad Requirement that VM is exchanged between parties	Any Restrictions on VM Collateral Types Incorporate EMNAs Thresholds Minimum Transfer Amounts

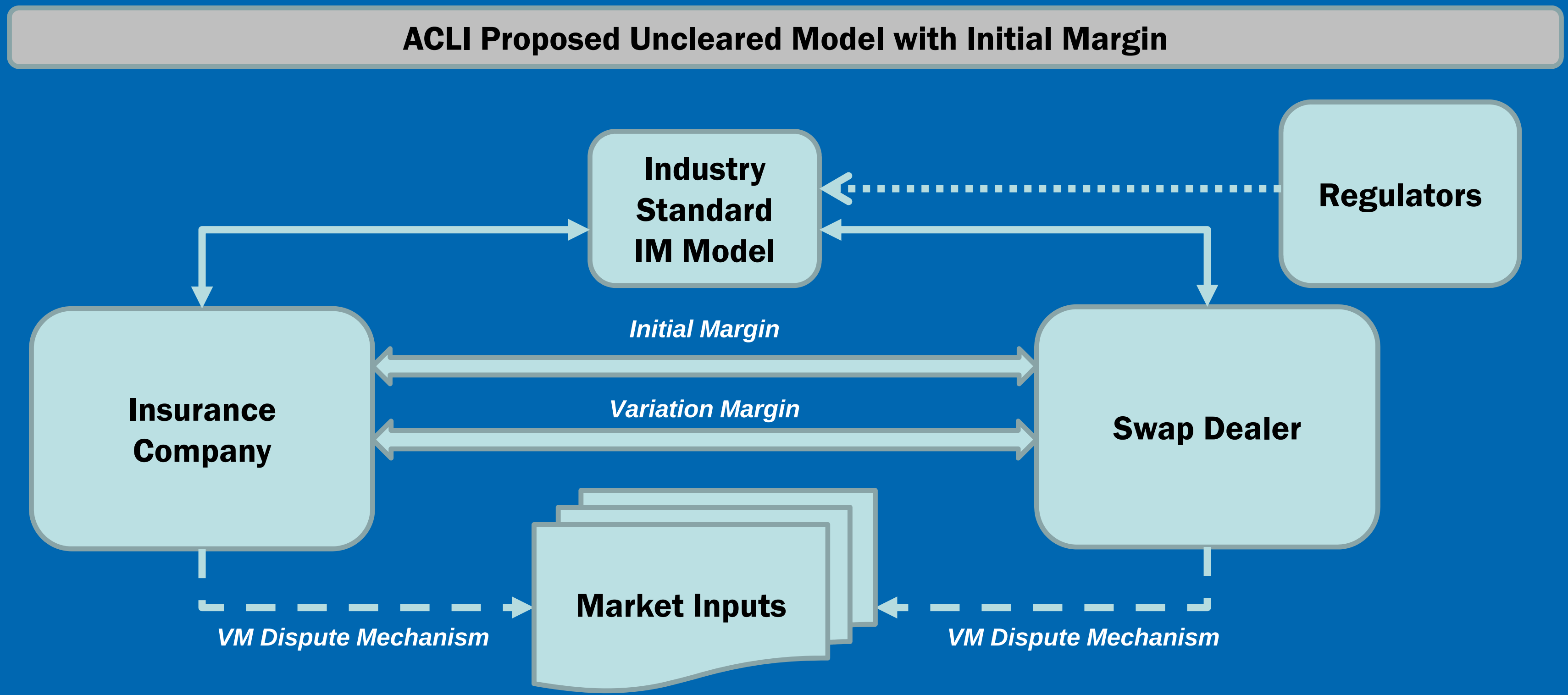
- Currently, exchanging VM is broad based among market participants
- However, the Proposed Rules will require:
  - Legal documentation changes requiring bi-lateral negotiation
  - Changes to portfolio asset allocation
  - Changes to trading & collateral management systems
- Separate phase-in for IM will require multiple sets of changes

Initial Margin Models Require Transparency



- Ins Cos have no mandated *transparency* into IM Models
- Ins Cos have no specific *dispute rights* in regards to IM calculation
- IM Model *consistency and transparency* is essential

Initial Margin Models Require Transparency



- **Advantages:**
  - **One consistent model for all market participants**
  - **IM model transparency to all facilitates dispute resolution**

Conclusions

- Eligible Collateral for Variation Margin should include non-cash collateral consistent with the BCBS-IOSCO Framework.
- Variation Margin for uncleared swaps should continue to be characterized as a pledge/security interest.
- Any restrictions on collateral types should be phased-in concurrently with IM requirements.
- Initial Margin Models should be consistent and transparent to all market participants.