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

Ms. Jennifer J. Johnson, 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
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.

[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

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[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			
	<u>Aggregate Write-ins for Invested Assets / Liabilities (Derivative Instruments)</u>				
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			
Other Invested Assets				
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
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	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		
										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			

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

Appendix E

(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 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 provides ~~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 jurisdictions;

(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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