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Commodity Futures Trading Commission
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February 21, 2012

Re: *Proposed Capital Requirements of Swap Dealers and Major Swap Participants*
RIN 3038-AD54

COMMENT

Dear Secretary Stawick:

Swiss Re appreciates the opportunity to provide the Commodity Futures Trading Commission (the "Commission") with comments on the Commission's proposed capital requirements (the "Proposal") for swap dealers and major swap participants (collectively, "Swap Entities") as required under Section 731 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] Swiss Re is a global reinsurance group held by Swiss Re Ltd in Zurich, Switzerland and listed on the Swiss SIX Exchange. The company has been doing business in the United States since 1893 and has helped the United States rebuild after every major catastrophe since the 1906 earthquake. Swiss Re transacts in OTC derivatives on a global basis, including through a U.S. subsidiary ("Swiss Re U.S."). Swiss Re is supervised on a consolidated basis by the Swiss Financial Markets Supervisory Authority ("FINMA"), and is subject to regulation in many other jurisdictions throughout the world.

As discussed with the Commission's staff during our January 26, 2012 meeting, we are pleased to provide our suggestions for modifications to the Proposal. We generally support the steps that the Commission and the prudential regulators have taken to implement a risk-based approach to capital requirements that makes appropriate use of supervisory resources by leveraging existing regulatory regimes. In this letter, we respectfully suggest certain modifications to the Proposal intended to further achieve that objective in the cross-border context. In particular, we suggest that the Commission permit the use of internal models by non-bank entities regulated outside the U.S.

[1] Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27802 (May 12, 2011).

As described in more detail below, deferring to home-jurisdiction regulators to supervise such internal models is particularly important in the case of global reinsurance companies such as Swiss Re, given the highly customized swaps entered into and the complex non-financial risks hedged. Below, we describe, in particular, our insurance-linked derivatives activities then discuss how the Commission's Proposal, which would require Swiss Re to use grids to determine our capital requirements, is ill-suited to such insurance-linked derivatives, and would place Swiss Re at an unfair competitive disadvantage and harm our customers. We conclude by recommending that Swap Entities whose internal models are supervised by a reliable home jurisdiction regulator that applies sound capital methodology be eligible to use such models. Such an approach would limit the burden on the Commission by leveraging the Commission's foreign counterparts, while promoting more widespread use of safer capital modelling.

Swiss Re's Insurance-Linked Derivatives Activities

As a global reinsurance company, Swiss Re offers various types of customized risk management products to its clients.[2] While the vast majority of Swiss Re's business involves reinsurance and insurance products, some of the products Swiss Re U.S. deals in may take the form of OTC derivatives, and thus Swiss Re U.S. might be required to register as a swap dealer with the CFTC when the registration requirements become effective.[3] These derivatives provide buyers protection against the types of risks that underlie potential reinsurance or insurance claims and can be classified into three basic categories: (1) natural catastrophe derivatives, (2) mortality derivatives, and (3) environmental-commodity derivatives (collectively, "Insurance-Linked Derivatives" or "ILDs"). The underlying risks referenced in an ILD may consist of natural parameters, such as wind speeds, earthquake shake intensities, daily temperatures or rainfalls amounts, or large scale events, such as mortality rates of defined population sets, or indices of insurance industry-wide losses.

The total size of the ILD market is quite small, with private estimates ranging between $10 billion and $20 billion of notional amount. ILDs thus make up an extremely small portion of the $2.7 trillion of outstanding notional amount of "other commodities"—which itself constitutes less than 0.4% of the total $708 trillion of notional global OTC derivatives outstanding.[4] While dealing in ILDs constitutes a very small part of Swiss Re's overall business activities, it reflects the same risk profile as Swiss Re's other insurance activities, and is managed in accordance with Swiss Re's internal group policies and supervised on a global level.

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[2] Swiss Re is a leading and diversified global reinsurer with offices in more than 20 countries. Swiss Re offers a comprehensive range of reinsurance and insurance solutions to manage risk and capital. Its traditional reinsurance products and related services for property and casualty, together with its life and health business, are complemented by insurance risk-based capital markets solutions and supplementary services for comprehensive risk management.

[3] We note that it is not currently clear whether the particular OTC derivatives that Swiss Re U.S. deals in will be deemed to be "swaps." We await the publication of final rules regarding the definition of "swap" and "swap dealer," before determining whether these products will constitute "swaps" and whether Swiss Re U.S. will be required to register as a swap dealer.

[4] See BIS Quarterly Review, December 2011, available at http://www.bis.org/statistics/otcder/dt1920a.pdf.

Swiss Re has developed an internal risk management and capital model particularly well-suited to the types of exposures inherent in Insurance-Linked Derivatives (the "SR Model"). The SR Model captures group-wide risks throughout the firm, and is used to calculate capital requirements under the Swiss Solvency Test (and in the future will be used under Solvency II) as required by FINMA, Swiss Re's primary regulator, as well as by the UK's Financial Services Authority ("FSA") and Luxembourg's *Commissariat aux Assurances* ("CAA"), for Swiss Re's UK and Luxembourg operating companies, respectively. The SR Model captures all types of material risks to which Swiss Re is subject, including the risks inherent in ILD, which comprise essentially the same risk profile as found in Swiss Re's main re/insurance businesses.

The Commission's Proposal Regarding the Use of Internal Models

The Commission proposes that Swap Entities be required to maintain sufficient capital to, among other things, account for (i) their OTC derivative credit risk exposure (i.e., the risk of the swap counterparty defaulting) and (ii) their market risk exposure (i.e., the risk of market losses to the value of the swap). The Proposal segregates Swap Entities into "Model-Eligible Swap Entities" that will be eligible to apply to the Commission to use internal models to calculate their capital requirements and "Non-Model-Eligible Swap Entities" that must calculate their capital by applying generic preset formulae to each swap position (the "fallback grid" approach).

Under the Proposal, Model-Eligible Swap Entities would include only Swap Entities that are (i) subsidiaries of U.S. bank holding companies ("BHCs") that have had their internal models reviewed and approved by the Federal Reserve, (ii) SEC-registered security-based swap dealers or major security-based swap participants that have had their internal models approved by the SEC or (iii) Commission-registered futures commission merchants that are also SEC-registered broker-dealers that have been approved for alternative net capital treatment and had their internal models approved by the SEC. All other types of Swap Entities are ineligible to use models to calculate their capital, but must calculate their capital according to the fallback grid. Non-Model-Eligible Swap Entities will be at a significant competitive disadvantage compared to Model-Eligible Swap Entities. Although the Proposal permits the Commission to consider approving the use of risk-based models by Non-Model-Eligible Swap Entities at some later time, the Commission currently would only permit Model-Eligible Swap Entities to use risk-based models in capital calculations. As explained in the Proposal, the Commission was compelled to propose this bifurcated approach for the time-being because it has insufficient resources to itself undertake a review and approval process for Swap Entities' models.

Model-Based Capital Regimes are Superior to Grids

It is both generally accepted and acknowledged by the Commission that model-based computations of capital requirements are more effective at managing the risks to the financial system and the Swap Entity than grid-based capital approaches. The Commission itself recognized as much in the Proposal, noting that "internal models ... can provide a more effective means of recognizing the potential economic risks or exposures from complex trading strategies involving OTC derivatives and other investment instruments."[5]

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[5] Proposal at 27802.

Grid-based approaches lack a number of attributes of a sound capital methodology.[6] First, grids aggregate individual capital charges by product rather than viewing an entity's risk across its full complement of investments, activities and diversification. As a result, grids lack accuracy, which penalizes well-hedged and well-risk-managed entities with higher than necessary capital requirements. Second, entities required to use standardized grids must calculate capital requirements without the ability to leverage existing risk-management data, processes and systems upon which their internal risk models are based. As a result, grids do not align with the way in which firms view and manages their risk and require duplicative work. Third, grid-based approaches are inflexible and cannot easily accommodate evolving trading strategies, which is likely to be particularly problematic in the ILD market. Finally, forcing use of a grid which is inconsistent with models used in a firm's internal risk management processes may lead to inconsistency across entities under the jurisdiction of different regulators.

A Grid Based Approach Is Particularly Ill-Suited To ILDs

In addition to the other drawbacks and limitations of grid-based capital, the fallback grid contained in the Proposal is primarily focused on calculating capital for *financial* derivatives and is largely incompatible with non-financial derivatives, such as ILDs. ILDs are categorically different than financial derivatives. The underlying risks that ILDs reference relate to the occurrence of events that could lead to large insurable claims, while financial derivatives typically reference financial metrics such as rates, credit and equities. While, if forced, ILDs may fall into the general "commodity" grid category of derivatives described in the Proposal, the risks addressed by ILDs have little in common with the risks addressed by swaps on, for example, energy or precious metals.

The grid approach also assumes a highly liquid market. However, ILDs are highly customized towards counterparties' specific needs and have not grown large or standardized enough to form a readily liquid market. In addition, ILDs typically reflect remote "far out-of-the money" risks, which can have sudden triggering events and binary payouts. For example, an earthquake can occur with no warning, and a pandemic can spread very quickly throughout a population. Pricing of ILD can move very quickly in relation to such events, but may not leave much time for adjustment prior to the occurrence of such events. Moreover, given their illiquidity, unwinding of ILD positions over a relatively short timeframe would be unrealistic.

Because a grid approach would fail to account for the unique nature of ILDs, Swiss Re manages its risk and its capital using its proprietary SR Model, discussed above, subject to the regulatory oversight of FINMA, the FSA and the CAA.

Non-Model-Eligible Swap Entities will Suffer Capital Inefficiencies and be Placed at Competitive Disadvantage Harming Customers

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[6] See Letter from John M. Damgard, President, Futures Industry Association; Robert G. Pickel, Chief Executive Officer, International Swaps and Derivatives Association; Kenneth E. Bentsen, Jr., Executive Vice President, Securities Industry and Financial Markets Association to David A. Stawick, Secretary, Commodity Futures Trading Commission (July 7, 2011), available at http://www.federalreserve.gov/SECRS/2011/December/20111220/R-1415/R-1415_070711_81859_480947073359_1.pdf.

Although the relative size of the ILD market is small, Swiss Re competes in this market with subsidiaries of BHCs, which will be Model-Eligible Swap Entities under the Proposal. The requirement that Non-Model-Eligible Swap Entities, such as Swiss Re, use fallback grids to calculate capital will introduce significant capital inefficiencies that will hamper their ability to provide customers with products to hedge insurance-related risks, raising costs for these customers and increasing the concentration of risk in the swaps market in a way that is at odds with the goals of Dodd-Frank.

As discussed above, grid-based approaches to capital calculations are far less accurate and capital efficient than model-based approaches. As a result, Swap Entities forced to use them will be placed at a distinct market disadvantage compared to competitors, such as BHC-subsidiaries, that are permitted to use internal models. While Swiss Re appreciates the current limitations on the Commission's resources, we believe it is inherently unfair and counterproductive to restrict the ability of a broad portion of the Swap Entity marketplace from competing effectively.

Model Use Should be Available to Swap Entities Whose Models are Subject to Reliable Foreign Regulatory Supervision

Recognizing that the Commission's limited resources may prevent it from conducting model review and approval, Swiss Re believes that, at least until it is in a position to fully vet such models, the Commission should include as Model-Eligible Swap Entities those Swap Entities that already have capital models examined and monitored by a reliable foreign regulator that applies sound capital methodology—such as FINMA.[7] Many Swap Entities that are subsidiaries of foreign financial institutions already have capital models examined and monitored by reliable foreign regulators. Such an approach would maximize the safety of the financial system and Swap Entities and would limit the burden on the Commission by leveraging the Commission's foreign counterparts, while promoting the more widespread use of safer capital modelling.[8]

This approach would also bring the Commission's proposed rules more in line with the prudential regulators' proposed capital requirements.[9] With respect to Swap Entities that are foreign banks, the prudential regulators have proposed to apply the Federal Reserve's existing rules, and permit such Swap Entities to calculate their capital in accordance with the requirements imposed by certain home country regulators.[10]

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[7] For example, the Commission has recognized FINMA as a reliable foreign regulatory counterpart and entered into a memorandum of understanding relating to cooperative enforcement with Switzerland. See Memoranda of Understanding, available at http://www.cftc.gov/international/memorandaofunderstanding/index.htm. FINMA is also a member of the International Organization of Securities Commissions, the Basel Committee on Banking Supervision, the International Association of Insurance Supervisors, and various other international regulatory organizations and associations.

[8] Swiss Re believes that, ideally, the Commission should revise the Proposal to allow for the direct review and approval internal of capital models of all Swap Entities. The Commission could still limit the burden on its resources by relying on the SEC's and Federal Reserve's prior review and approval of Swap Entity models, for those entities that have received prior approval.

[9] See Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564, 27582 (May 11, 2011).

[10] See 12 CFR 225.2(r)(3).

Swiss Re strongly urges the Commission to revise its Proposal to allow Swap Entities to use internal capital models subject to the examination and monitoring of reliable foreign regulators applying sound capital standards. Recognizing these foreign supervised capital models would further promote the safety and soundness of the Swap Entity and reduce risk to the financial system, while limiting any additional strain on Commission resources.

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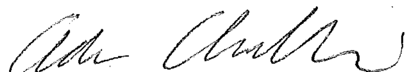
Swiss Re appreciates the opportunity to submit these comments in connection with the Proposal. Please let us know if you have any questions or would like additional information.

Yours sincerely,



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