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Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581
Via Agency Web Site: <http://www.cftc.gov>

Re: **Comments on Swap Dealer De Minimis Exception Preliminary Report**

The American Insurance Association (AIA) appreciates the opportunity to submit comments on the *Swap Dealer De Minimis Exception Preliminary Report* (Preliminary Report), issued November 18, 2015, by the staff of the U.S. Commodity Futures Trading Commission (CFTC). For the reasons set forth below, we recommend that the CFTC maintain the current swap dealer *de minimis* threshold.

AIA represents approximately 325 major U.S. insurance companies that provide all lines of property-casualty insurance to consumers and businesses across the United States and around the world. AIA members write more than \$127 billion annually in U.S. property-casualty premiums and approximately \$225 billion annually in worldwide property-casualty premiums.

AIA's membership includes U.S. insurers that write insurance only within the U.S., U.S. insurers that write insurance inside and outside the U.S., and the U.S. subsidiaries of multi-national insurers. This diversity gives AIA the ability to analyze issues from many perspectives and enables us to draw on the global experience and expertise of our companies with many forms of insurance regulation.

Every day, property-casualty insurers enable our economy to function by helping individuals and businesses address the various risks they face. In doing so, insurers take in premiums based on anticipated loss costs, keeping a small portion to cover operating expenses, and investing the rest until needed to pay claims or to hold aside to cover extraordinary losses.

As insurers and reinsurers, our member companies must engage in a variety of strategies in order to manage the dual sides of their business: underwriting and investing. Swap transactions are effective tools for managing such risks. Therefore, AIA and its members have a strong interest in ensuring that the CFTC maintains a regulatory framework that provides ready access to the swaps market, while also guarding against activities that can produce systemic risk. Understanding and managing complex risks is what our members do and as a result, insurers enhance financial stability of the global marketplace.

Property-Casualty Insurance Business

To manage underwriting risks, property-casualty insurers aggregate similar contract risks into portfolios of risk, and spread the estimated cost of those portfolios to the policyholders who comprise the respective risk portfolios. Relying on the law of large numbers and the historical behavior of the risk portfolios, actuarially based forecasts are made about the behavior of the portfolio and estimates are made about the cost to underwrite the insurance portfolio. From this estimate of cost, insurers can develop pricing by which the premium payment is determined.

In addition to handling the risk of policyholders and the larger society, insurance companies also must be prudent and careful investors by managing the risk of the invested premium dollars. Because of the uncertainty and volatility of underwriting results, these investment returns can be an important source of financial stability for insurers in a competitive market. Offsetting of risks through diversification is also an important strategy for insurance industry, given that not all risks will materialize at the same time. The industry's conservative investment practices are geared toward preserving capital, allowing policyholders to be quickly and efficiently compensated for their losses. Though generating earnings on the investments is not the primary focus of insurers, those earnings of course can be used to compensate policyholders and to build capital for unforeseen events.

The primary use of derivative instruments in the insurance industry is to hedge against risks on both sides of the balance sheet. Insurers utilize derivatives in a variety of ways to manage and mitigate risks that are inherent in their investment portfolios or liability structure. On the investment portfolio side of the balance sheet, insurance firms typically strive to hedge exposures from interest rates, currencies, credit risk and other financial factors, and they utilize registered swap dealers or other intermediaries to execute or arrange the relevant hedge transactions for them. Most insurance firms do not consider themselves to be engaged in swap dealing activity when engaged in such hedging activity.

With respect to the liability structure, insurance firms can engage in both hedging activity and in a limited amount of ancillary dealing activity. For some insurance risks – natural catastrophes, for example – the amount and timing of fulfillment cash flows may be uncertain. Thus, entering into a natural parametric or event derivative, such as a weather (temperature or rainfall), hurricane (wind speed), earthquake (ground shaking intensity), or large scale event such as insurance industry loss or power outage swap (collectively, “Insurance Risk

Derivatives”) may be a hedging strategy to offset the corresponding catastrophe underwriting risk.

In other cases, insurance firms may negotiate with businesses to enter into Insurance Risk Derivatives in order to provide such business clients with coverage very similar to coverage they might receive under insurance contracts. In certain instances, coverage can be sold in either insurance or derivative format; however, there are cases when clients prefer derivative format due to, for example, increased speed of recovery, more transparent pricing, more precise definitions of loss event, etc. Likewise, reinsurance firms can provide protection to insurance firms on a similar basis. It is this subset of Insurance Risk Derivatives activity, ancillary to the main business of providing insurance in insurance form, which raises the issue of exceptions to registration from swap dealing activity.

This narrow subset of Insurance Risk Derivatives activity is a tiny portion of the derivatives market, with private estimates ranging between \$10 and \$20 billion of notional value. Such Insurance Risk Derivatives thus make up an extremely small portion of the \$1.4 trillion of the outstanding notional value of "other commodity" derivatives, which, in turn, constitutes less than 0.25% of the total \$553 trillion of notional global OTC derivatives outstanding.¹ Nevertheless, if the swap dealer *de minimis* exception threshold were to fall to \$3 billion, it is possible that a small number of individual insurance firms might find themselves above such threshold and therefore facing a decision as to whether to register as a swap dealer or to cease engaging in such ancillary business.

Maintaining the current *de minimis* threshold at \$8 billion

The basic issue raised by the Preliminary Report is whether certain persons should register with, and incur the compliance burden of being regulated by, the CFTC, by virtue of having engaged in swap transactions. CFTC Regulation 1.3(ggg) defines a “swaps dealer” and also provides for a *de minimis* exception from registration as a swaps dealer if the 12-month aggregation of swaps transactions does not exceed \$3 billion. At the time this regulation was adopted, the CFTC provided for a “phase-in” *de minimis* amount of \$8 billion; that phase-in amount is due to expire in December 2017 and the \$3 billion threshold would then apply if the CFTC does not adopt a new *de minimis* rule.

The \$8 billion *de minimis* threshold was adopted with the understanding that it would be later evaluated based on the availability of additional data and information at a later time. The Preliminary Report is staff’s initial effort to evaluate that threshold. However, the Preliminary Report repeatedly indicates that data was insufficient for the analysis that was undertaken for the five asset classes (interest rate swaps, credit default swaps, foreign exchange derivatives, non-financial commodity swaps, and equity swaps) that are discussed in the report. For example, in the Section III(B) portion of the report, data and methodology, a number of data concerns were raised, including the following:

¹ See BIS Statistical Bulletin, December 2015, available at <http://www.bis.org/statistics/bulletin1512.pdf#page=226>.

- The swaps data repository (SDR) did not include data fields to indicate whether a transaction is entered into for dealing purposes, so assumptions were made about potential dealing activity;
- Swaps not subject to the threshold count were not always readily identifiable, suggesting that there could be over-counting of transactions;
- The lack of correct legal entity identifier (LEI) resulted in inaccurate counterparty count statistics; and
- There were multiple unique swap identifiers due to mismatching of elements of the swaps, due to cleared trades, bunching, and compression.

The data shortcomings also affected the calculation of the 12-month gross notional value. As noted in Section III(B)(4) of the Preliminary Report, certain entities and certain transactions should be excluded from the calculation, specifically, the exclusions for inter-affiliate transactions and cross-border transactions involving non-US persons. Though allowances for these transactions were attempted, staff acknowledged that the analysis was inaccurate due to the inadequacy of the SDR. Thus, there can be no assurance that the evaluation of the \$8 billion threshold properly excluded transactions that the CFTC has already determined to not constitute swap dealing.

Because of the inadequacy of the data and the over-reliance by the staff on assumptions that cannot be validated, there is insufficient empirical basis for lowering the threshold to \$3 billion. As noted in a separate statement by CFTC Commissioner Giancarlo, the \$3 billion and \$8 billion thresholds are both arbitrary. However, AIA believes the market has adjusted to the \$8 billion threshold level, and therefore, any reduction in the threshold could be disruptive, could increase regulatory friction, and could discourage otherwise appropriate risk management strategies.

In order to satisfy the initial expectation of the CFTC (assessing the effectiveness of the *de minimis* exception based on additional information), staff should identify the relevant information needed for evaluating swaps activity within the five classes of assets, collect that information, and conduct further analysis before it will be in a position to formulate a recommendation to the CFTC. The timeframe for conducting this study may extend past the December 2017 time period; if so, the CFTC can and should approve an extension of the \$8 billion threshold in order to facilitate a thorough and meaningful analysis of the *de minimis* exception.

Insurance Risk Derivatives are not specifically mentioned in the Preliminary Report; however, they are so fundamentally different from all other classes of derivatives mentioned in the Preliminary Report, that further analysis is needed. While not all of the questions posed by CFTC can be applied to the context of insurance related derivatives, we have attempted to provide the CFTC with information for such further analysis, where applicable.

Conclusion

To provide further assistance, AIA has attempted to respond, in the attached appendix, to some of the questions raised by staff in the Preliminary Report. We hope staff and the CFTC find the responses helpful as you continue your review of the *de minimis* exception.

Thank you again for the opportunity to comment, and AIA looks forward to participating in future reviews of the *de minimis* exception. Please feel free to contact AIA with any questions.

Respectfully submitted,

A handwritten signature in black ink that reads "Phillip L. Carson". The signature is written in a cursive style with a large initial "P" and "C".

Phillip L. Carson | American Insurance Association

Associate General Counsel & Director of Financial Regulatory Policy

APPENDIX

Response to Certain Staff Questions

Page 33 of the Preliminary Report

(2) Is it reasonable to assume that the following types of entities are not likely engaged in swap dealing?

c. Insurance companies (including their subsidiaries).

Some swaps activities involving insurance companies include natural parametric or event derivatives, such as weather (temperature or rainfall), hurricane (wind speed), earthquake (ground shaking intensity), or large-scale events such as insurance industry loss or power outage swaps. These transactions are designed with insurance-specific parameters and thus involve a relatively small market, in which risks are uncorrelated. AIA believes that these transactions often exhibit characteristics that are not applicable to swap dealing in other asset classes. AIA believes that the regulatory approach for evaluating who qualifies as a swap dealer and which transactions are subject to the de minimis exception merits additional consideration for possible exclusion. In the meantime, the de minimis threshold should remain at \$8 billion.

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(1) Are there additional policy considerations underlying swap dealer regulation or the *de minimis* exception that the Commission should consider?

(2) Are any of the policy considerations discussed above more or less important than the others?

AIA agrees with CFTC staff that the de minimis exception must be appropriately calibrated to achieve regulatory certainty, to allow limited swap dealing in connection with other client services, to encourage new participants to enter the market, and to provide greater regulatory efficiency.² With respect to Insurance Risk Derivatives, allowing limited ancillary dealing would accommodate existing clients' risk management needs, while also conserving finite CFTC resources for entities whose swap dealing activity is sufficient in size and scope to warrant oversight.

(4) Are entities curtailing their swap dealing activity to avoid swap dealer registration, and if so, what impact does that have on the swap market?

The cost of regulatory compliance is always factored into business decisions. As AIA has already noted in our letter, the market for these ancillary activities is relatively small in terms of notional value. Registration would create ongoing compliance costs for staffing, systems maintenance, recordkeeping and reporting. The additional costs could outweigh the benefit of

² See Section IV(A)(2) of the Preliminary Report, p. 36.

continuing these activities, so yes, swap activity could be curtailed to avoid swap registration.

(5) What are the specific costs of swap dealer registration?

As previously mentioned, Insurance Risk Derivatives are an ancillary activity and registration would be undertaken solely to cover this activity; therefore, the set-up costs and ongoing maintenance costs may be uneconomical to sustain this activity.

More importantly, the swap dealer capital requirements for non-banks are still not finalized by the CFTC, thus making it difficult to understand precisely the full range of costs. Assuming no model approach is available, the "standard grid" approach proposed would require 15% of notional value for the "other/commodities" class, into which Insurance Risk Derivatives would fall. AIA believes 15% is far in excess of typical, modeled risks, thus making the offering of Insurance Risk Derivatives as a swap dealer uneconomical. AIA believes insurers/reinsurers would therefore curtail this ancillary activity and insurance clients would effectively become under-insured and unable to adequately manage their insurance-related operating risks.

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(2) Have participants in the Non-Financial Commodity swap market limited their swap dealing activity to remain below the *de minimis* threshold?

*We are not aware of any re/insurance companies offering Insurance Risk Derivatives having registered as swaps dealers, suggesting that either the collective industry is very small and therefore immaterial for regulatory attention at the swap dealer registration level, or that some participants are curtailing their activity in order to remain below the *de minimis* threshold. We have heard initially that activity for municipalities has been curtailed until the CFTC makes adjustments for "utility special entities", so that transactions will not count against the lower municipality swap dealer threshold amount.*

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General response to the questions regarding ramifications of raising the \$8 billion threshold:

With respect to Insurance Risk Derivatives, AIA believes raising the threshold level above \$8 billion would continue to serve the policy objectives of encouraging new participants, allowing limited ancillary dealing, providing greater regulatory certainty, and providing for greater regulatory efficiency would all be strengthened. In fact, AIA believes Insurance Risk Derivatives should not be counted at all towards the threshold for the following reasons: these activities constitute a small size of market, these transactions do not create systemic risk to the overall financial system, and they are visible to the CFTC because they are already reported pursuant to the Part 45 transaction reporting requirements.

General response to the four identified alternative approaches:

The alternative proposals would not fit the Insurance Risk Derivatives context unless the notional value of these transactions is not counted towards the threshold. Alternative 1 could work if Insurance Risk Derivatives were differentiated as a separate asset class (within commodities/other) and a higher threshold were established to avoid swap dealer registration.