ACLI
Financial Security for Life

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Via CFTC Comments Portal

29 June 2022

Christopher Kirkpatrick, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington DC 20581

RE: 17 CFR Part 50, RIN 3038-AF18, 87 Fed.Reg. 32898 (5/31/22); Clearing Requirement Determination Under Section 2(h) of the Commodity Exchange Act for Interest Rate Swaps to Account for the Transition From LIBOR and Other IBORs to Alternative Reference Rates

Dear Mr. Kirkpatrick,

The American Council of Life Insurers (ACLI) appreciates the opportunity to share its views on the captioned Notice of Proposed Rulemaking (the "Proposal"). The ACLI is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. Ninety million American families rely on the life insurance industry for financial protection and retirement security. ACLI member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of life insurance industry assets in the United States.

The ACLI contributes frequently to regulatory proposals and requests for information relating to life insurer use of swaps and derivatives. Life insurers are significant end-users of derivatives that enable the prudent management of asset and liability risks, as permitted under state insurance codes and regulations.[1] The long-term nature of the industry's life and retirement products requires insurers to match long-term obligations with assets of a longer duration than most other financial institutions, leading to directional portfolios of long-dated interest rate swaps.

We share the Commission's commitment to safe, robust derivatives markets and to a smooth transition from certain IBORs to alternative rates. We submitted comments on the Commission's *Request for Information re Swap Clearing Requirements to Account for Transition From LIBOR and Other IBORs to Alternative Reference Rates* on 24 January 2022 (our "January Letter"). We appreciate that several of our comments were considered and are reflected in the current

[1] The National Association of Insurance Commissioners' (NAIC) Derivatives Instruments Model Regulation:
- Limits derivative transactions to hedging (with limited exceptions) and for prudent uses;
- Requires effectiveness testing to monitor uses over time;
- Requires internal control procedures;
- Establishes counterparty exposure limits and credit quality standards;
- Establishes documentation and trading requirements;
- Achieves transparency through statutory reporting (Schedule DB).

Proposal. We continue to have concerns around certain aspects of the Proposal and, for the reasons laid out more fully below, we write to urge the Commission to:

1. Leave SOFR-LIBOR basis swaps outside of an expanded clearing requirement;

2. Re-consider whether expanding the clearing requirement to include SOFR OIS swaps mitigates systemic risk, as required under Section 2(h)(2)(D)(ii)(III) of the Commodity Exchange Act; and

3. If the Commission determines to expand the clearing requirement to include SOFR OIS swaps, delay the effective date of the expanded clearing requirement to no earlier than 30 June 2023 to provide additional incentives for market participants to transition their cleared LIBOR swaps to bilateral SOFR swaps, further reducing overall LIBOR exposures in the marketplace.

We Agree That SOFR-LIBOR Basis Swaps Should Not Be Added to the Clearing Requirement

We agree with the Commission that SOFR-LIBOR basis swaps should not be added to the clearing requirement. As we mention in our January Letter, SOFR-LIBOR basis swaps require bilateral OTC treatment for their limited and dwindling use cases, given their low liquidity and limitations on electronic execution.

Adding SOFR OIS Swaps to the Clearing Requirement in the Context of Uncleared Swap Margin Does Not Mitigate Systemic Risk

The Commission discusses its Proposal in light of each of the five factors it must consider under Section 2(h)(2)(D)(ii) of the Commodity Exchange Act. The third factor – the effect of the clearing requirement on mitigation of systemic risk – is a critical concern. We urge the Commission to reconsider whether the Proposal meets this test in light of fundamental changes in the marketplace, including the uncleared swap margin rules. Indeed, the Commission specifically requests comment on how it should consider the ongoing implementation of uncleared swap margin requirements in assessing this factor.

In our view, expanding the clearing requirement to include SOFR OIS swaps is unlikely to further mitigate systemic risk in the broader context of a marketplace in which (1) many participants – including many ACLI member companies - are already subject to uncleared swap margin rules that have transformed the systemic risk profile of the bilateral derivatives market and (2) there are ample incentives to clear standardized products outside of any clearing requirement. To the extent the Commission determines that an expanded clearing mandate decreases credit risk, it must also consider whether it merely substitutes counterparty credit risk for liquidity risk, rather than reducing systemic risk in the aggregate. In addition, we urge the Commission to take into account end users' credit concerns with future commission merchants (FCMs) and the continued difficulties many end-users face in accessing clearing. We discuss each of these points in more detail below.

Risk Mitigation Effects of an Expanded Clearing Requirement Are Decreased by the Uncleared Margin Rules

The uncleared swaps market has undergone a monumental change since the Commission last considered its clearing requirement. Market participants, including large life insurance companies with notional swap exposures exceeding the Material Swap Exposure threshold for Phase 5 of the uncleared swap margin rules, are currently required to post and collect initial margin on their uncleared swaps. Additional ACLI member companies in scope for Phase 6 of the uncleared margin rules will be in scope for initial margin on uncleared swaps by 1 September 2022. According to the ISDA Margin Survey,[2] the 20 largest market participants collected $286.0 Billion of bilateral initial margin related to uncleared swaps at the end of 2021 and that number has surely grown in the first half of 2022. This compares favorably with the $323 Billion posted by all market participants in connection with cleared swaps at the end of 2021.

As we discussed in our January Letter, the Commission's original clearing requirement was enacted before either the prudential regulators' or the Commission's uncleared margin rules were finalized. The Commission explicitly stated that its clearing requirement was considered "in light of existing market practice" at that time (81 FR 71202 at 71219). In its 2016 expansion of the clearing requirement, the Commission noted that "[g]oing forward, the requirement to margin uncleared swaps in certain circumstances will mitigate the accumulation of risk between counterparties in a manner similar to that of central clearing." (Id.) Appended to this letter is a tabular comparison of margin requirements under cleared and bilateral arrangements to illustrate this point. We encourage the Commission to consider further whether an expanded clearing requirement mitigates systemic risk in light of this substantial increase in uncleared swap margin.

The Commission should also give some weight in their analysis to the strong incentive the uncleared margin rules provide to voluntarily clear trades in the most liquid and standardized products. A market participant subject to the uncleared swap margin rules must post initial margin sufficient to cover a 99% risk horizon calculated over a 10-day period while the same entity would post initial margin sufficient to cover a 5-day risk period for a cleared transaction. In addition, cleared swaps do not count toward a financial entity's average aggregate notional amount. This means that a market participant near the material swap exposure threshold for the uncleared margin rules could use cleared swaps instead of uncleared swaps to avoid being in scope for uncleared swap margin requirements altogether. In this environment, the necessity of a clearing requirement for liquid swaps is significantly lessened.

An Expanded Clearing Requirement Trades Credit Risk for Liquidity Risk

Posting margin on cleared trades in the form of cash (as required by FCMs and CCPs) imposes significant costs for life insurers. As the ACLI has noted in previous commentary on the clearing

[2] ISDA Margin Survey Year-End 2021 (available at https://www.isda.org/2022/05/10/isda-margin-survey-year-end-2021/)

requirement, the need to post cash collateral to clearinghouses forces life insurers to liquidate higher yielding securities for cash. This results in higher hedging costs for products that may ultimately be borne by consumers, detrimentally impacting their retirement savings. In addition, the directional nature of life insurer portfolios do not afford them the netting benefits experienced by dealers and other financial end-users.[3] From this perspective, cash variation margin requirements exchange counterparty credit risk for liquidity risk. With longer-maturity transactions hedging long-term liabilities to policyholders, life insurers must hold incrementally more cash to address potential liquidity needs associated with higher daily market value margin volatility on such positions. This increases costs relative to fully invested portfolios and creates duration mismatches against liabilities. These perhaps unintended factors increase rather than reduce risks, introduce a lack of pricing competition, and enlarge transaction costs.

We also note that regulators have consistently drawn attention to the potentially procyclical nature of margin calls in times of financial turmoil. The Basel Committee on Banking Supervision, the Committee on Payments and Market Infrastructures and the Board of the International Organization of Securities Commissions recently published a review of margining practices during the Covid-19 market turmoil of March 2020 that identified "review[ing] … the effectiveness of tools that lessen the procyclicality of margin models" as a potential area for further work.[4]

Were life insurers free to choose between uncleared or cleared interest rate swaps, for example, they would weigh the benefits and detriments of OTC initial and variation margin versus that required by CCPs. In either case, counterparty risk would be reduced by initial margin (IM) and variation margin (VM). If an end user believes that the flexibility of choosing from a wider range of eligible collateral under the uncleared margin rules provides a better overall cost profile than clearing, while the overall reduction in systemic risk is equal to or greater than that achieved through an otherwise identical cleared transaction, the end-user should have the option to choose, given that systemic risk is reduced in a comparable manner in both frameworks.

Direct and Indirect Costs of an Expanded Clearing Requirement Must Also Be Taken Into Account

Mandatory clearing elevates concentration of risk in both central counterparties (CCPs) and in the shrinking number of futures commissions merchants (FCMs) active in cleared swaps. This contrasts with a much larger number of swap dealers trading OTC swaps, which allows for greater diversification of credit risk.

When a large FCM faces financial difficulties, end users that clear swaps through that FCM face elevated credit risk, with few options for spreading the risk. End-users face significant difficulties porting positions on short notice in the case of an FCM default or should a large FCM decide to significantly scale back or exit the business, e.g., as Credit Suisse did after the Archegos default. The process of negotiating new FCM arrangements, completing operational setup, and porting positions from one FCM to another takes significant time and is burdensome operationally. In addition, some smaller life insurers have difficulty finding FCMs willing to take on their business at

[3] *See* ACLI Input in Response to CFTC Project KISS-Clearing Issues (September 26, 2017).
[4] *See* BCBS-CPMI-IOSCO – Review of Margining Practices – Consultative Report, October 2021, at p. 4.

competitive costs. Practical solutions to allow end-users to directly clear at CCPs do not currently exist, and we see significant operational and regulatory hurdles to their creation.

Declining to extend the clearing requirement to new products where the uncleared regime provides comparable risk mitigation would help to alleviate some of these concerns and allow end-users to assess the optimal risk structure for their business needs.

Postpone the Expansion of the Clearing Requirement to Include SOFR OIS Swaps Until 30 June 2023 to Further Incentivize the Transition Away from Swaps Referencing LIBOR

The Commission should consider postponing the inclusion of SOFR OIS swaps in the clearing requirement to 30 June 2023. Postponing the expansion of the clearing mandate to include SOFR OIS swaps to 30 June 2023 would coincide with the date that LIBOR swaps are removed from the requirement. It would also create an incentive for market participants concerned about clearing trades for the reasons articulated above to move out of cleared LIBOR-referencing swaps into uncleared SOFR-referencing swaps, thereby further reducing legacy LIBOR-referencing instruments in the marketplace. The CFTC, along with other regulators, has offered significant regulatory relief to smooth the transition from LIBOR to SOFR as part of the overall LIBOR transition. Postponing the inclusion of SOFR OIS swaps in the clearing requirement would be consistent with that broader project.

Thank you for your consideration.

Sincerely,

THE AMERICAN COUNCIL OF LIFE INSURERS

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Appendix: Tabular Summary Demonstrating Systemic Risk Impact of Cleared & Uncleared Margin (next page)

Appendix
Tabular Summary Demonstrating Systemic Risk Impact of Cleared and Uncleared Margin

	Cleared	Uncleared	Systemic Risk Impact
Variation Margin	Yes, first dollar	Yes, subject to threshold of no more than $500k	Similar risk mitigation
Initial Margin	Yes	Yes, if Phase 6 (AANA >$8 billion); subject to $50mm threshold No, if AANA <$8 billion, but means that uncleared derivative usage is small	Similar risk reduction for larger firms; for uncleared swaps, existence of a threshold is offset by larger IM calculation (10-day vs. 5-day) Smaller firms who are not subject to IM on uncleared swaps do not have material outstanding exposures from a systemic risk standpoint
IM Methodology	5-day	10-day (SIMM)	
VM Eligible Collateral	Cash only	More flexibility, including securities, with appropriate haircuts	Similar risk mitigation
IM Eligible Collateral	Typically, cash, Treasuries, and other very high quality collateral; very limited availability of corporates per FCM	More flexibility, including securities, with appropriate haircuts	Similar risk mitigation

For example: uncleared swaps under a Standard Initial Margin Model (SIMM) are subjected to initial margin based on a 10-day Value-at-Risk (VaR) calculation, versus cleared swaps that are subject to initial margin based on a 5-day VaR calculation. Both cleared and uncleared swaps are subject to first dollar variation margin (subject to a small threshold on uncleared swaps).

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