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May 22, 2009

The Honorable Joseph Morelle, Chair
Task Force on Credit Default Swaps Regulation
National Conference of Insurance Legislators
c/o Mike Humphreys and Susan Nolan, NCOIL National Office

Re: NCOIL Model Credit Default Swap Bill

Dear Mr. Morelle:

The American Council of Life Insurers (ACLI) respectfully submits these preliminary comments on the Model Bill exposed on May 14, 2009 by the National Conference of Insurance Legislators (NCOIL) Task Force on Credit Default Swaps Regulation. ACLI is a national trade association with 340 members that account for 93 percent of the industry's total assets, 93 percent of life insurance premiums, and 95 percent of annuity considerations. Our industry greatly appreciates the opportunity to offer input on these important matters.

The NCOIL Task Force has developed a model bill that seeks to regulate credit default swap agreements. The draft model bill:

- contains definitions of terms;
- authorizes the creation of "credit default insurance corporations;"
- establishes financial requirements for "credit default insurance corporations;"
- creates standards for contingency, loss, and unearned premium reserves;
- assigns regulatory jurisdiction to state insurance commissioners;
- defines permitted uses of "credit default insurance;"
- sets aggregate and single risk limits for "credit default insurance corporations,"
- notes policy form filing procedures; and
- addresses limits on rates for "credit default insurance."

Life insurers are very interested in the matters covered within the bill exposed by the NCOIL Task Force. The bill involves detailed issues and merits careful study. In view of the eight day comment period, we offer general, preliminary observations. It would be constructive to offer more detailed supplemental input after we have an opportunity to more thoroughly evaluate the Task Force bill. This important NCOIL endeavor warrants thoughtful analysis from a wide spectrum of the financial services community. Input from other interested parties may be reduced or absent because the bill and its comment deadline were not broadly publicized or posted on the NCOIL website.

Life insurers use derivative instruments to prudently manage the risks of their assets and liabilities, as permitted under state insurance codes and regulations. Credit default swaps are one form of derivative

that can be used in risk reduction and risk management by life insurance companies. Some basic background reflecting 2008 data¹ may provide useful scope and context:

- life insurance industry assets were invested in: corporate bonds (42%); stocks (24%); government bonds (14%); commercial mortgages (7%); other assets (13%);
- life insurers provide the single largest U.S. source of corporate bond financing;
- approximately 56 percent of life insurers' \$4.6 Trillion total assets in 2008 were held in bonds, with 42 percent composed of corporate bonds; and,
- over 41 percent of corporate bonds purchased by life insurers have maturities in excess of 20 years (at time of purchase).

The composition of life insurers' assets reflects the long-term commitments and stability necessary for life insurers to provide products, such as life insurance and annuities, that are significantly different from other financial institutions.² Credit default swaps allow life insurers to prudently manage the credit risk of their significant bond portfolios, and to fulfill their obligations to contract owners. The regulatory status of credit default swaps, therefore, is critically important to the life insurance industry.

We understand NCOIL's focus on credit default swaps in light of the economic developments over the last year. It is extremely important, however, that NCOIL proceed in a deliberative manner with careful awareness of other coextensive state and federal endeavors to examine and regulate credit default swaps.

In addition to NCOIL's initiative, there are a number of significant ongoing state and federal developments concerning credit default swaps, including:

- Proposed [Amendments](#) to the NAIC Derivatives Instruments Model Regulation³;
- [Plans](#) of the NAIC Investments of Insurers Model Act Revision (E) Working Group⁴;
- NAIC [Survey](#) of State Insurance Departments Concerning Effectiveness of Model Investment Laws;⁵
- Senate [Bill No. 961](#) (Authorizing the Regulation of Swaps Act)⁶;

¹ These calculations are based on data from the NAIC and the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S. See American Council of Life Insurers, *Life Insurers Fact Book* (2009).

² Life insurers' financial products protect millions of individuals, families and business through guaranteed lifetime income, life insurance, long-term care and disability income insurance. The long-term nature of the products requires insurers to match long-term obligations with assets of a longer duration than other types of financial institutions.

³ The NAIC Financial Condition (E) Committee and its VOS Task Force strongly advocate the adoption of the proposed amendments to the model law by a two-thirds or more majority of NAIC members and will urge all members to implement this amended regulation into their respective state regulation. It is the belief of these financial regulators that this regulation is a necessary component of financial solvency regulation as derivative instruments will continue to spread through portfolios of regulated entities.

⁴ The NAIC Investments of Insurers Model Act Revision (E) Working Group was formed to consider whether the NAIC Model Acts (Defined Limits and Defined Standards) should be revised. In furtherance of this objective, the Working Group is soliciting information, opinions and perspective on how financial instruments, capital markets and the investment climate has changed from that envisioned in the NAIC Model Acts.

⁵ The NAIC plans to conduct a survey of all state insurance departments to ascertain whether the existing NAIC Investments of Insurers Model Acts provide sufficient regulatory tools to govern life insurers use of derivatives, including credit default swaps. Based on the states' input, the NAIC may revise the model acts accordingly. The NAIC Valuation of Securities Office has also prepared an extensive [analysis](#) of areas in the model laws that merit careful analysis and scrutiny for change.

⁶ This bill:

- Amends the Gramm-Leach-Bliley Act, the Securities Act of 1933, the Securities Exchange Act of 1934, the Commodity Futures Modernization Act of 2000, the Legal Certainty for Bank Products Act of 2000, and the Commodity Exchange Act to repeal prohibitions against regulation of credit default swaps and other swap agreements, whether traded on an exchange or over-the-counter, including commodity, equity, foreign currency, and interest rate swaps.

- H. R. [Bill No. 977](#) (Derivatives Markets Transparency and Accountability Act of 2009);⁷
- Department of the Treasury Over-the-Counter Derivatives [Regulatory Reform](#)⁸

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- Authorizes the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), and specified other federal financial regulators to: (i) exercise oversight over any swap agreement entered into, purchased, or sold by any financial institution, entity, or person (for its own account or for the account of others), and any swap agreement, that is subject to the regulator's jurisdiction; and (ii) promulgate, interpret, and enforce regulations, issue orders of general applicability, and impose disclosure, reporting, or recordkeeping requirements relating to any such swap agreement; Grants the SEC sole oversight authority over: (i) any exchange or clearing agency; and (ii) any swap agreement traded on or cleared through such exchange or clearing agency;
 - Grants the CFTC sole oversight authority over: (i) any trading facility or registered entity; and (ii) any swap agreement executed on, traded on, or cleared through such trading facility or registered entity.

⁷ Among other things, this bill:

- Directs the CFTC to (i) define and classify index traders and swap dealers for purposes of data reporting requirements; and (ii) set routine detailed reporting requirements for any positions of such entities in contracts traded on designated contract markets, derivatives transaction execution facilities, foreign boards of trade, and electronic trading facilities with respect to significant price discovery contracts.
- Requires the CFTC, to the extent information is available, to disaggregate and make public monthly: (i) the number of positions and total notional value of index funds and other passive, long-only and short-only positions in all markets; and (ii) data on speculative positions relative to bona fide physical hedgers in those markets.
- Subjects persons involved in derivative and swap transactions, as well as large traders in over-the-counter contracts, to reporting and recordkeeping requirements.
- Directs the CFTC to assess whether certain derivative, swap, and similar agreements, contracts, or transactions that are fungible with agreements, contracts, or transactions traded on or subject to the rules of any board of trade or electronic trading facility with respect to a significant price discovery contract have the potential to (i) disrupt the liquidity or price discovery function on a registered entity; (ii) cause a severe market disturbance in the underlying cash or futures market; or (iii) prevent or otherwise impair the price of a contract listed for trading on a registered entity from reflecting the forces of supply and demand in any market. Authorizes the CFTC, upon a positive finding, to impose position limits.
- Authorizes the CFTC to: (i) suspend trading of credit default swaps; and (ii) initiate and conduct criminal litigation relating to a violation of the Commodity Exchange Act if the Attorney General has declined to do so.

⁸ According to the Treasury Department plan:

- Regulators must have the following authority to ensure that participants do not engage in practices that put the financial system at risk:
 - The Commodity Exchange Act (CEA) and the securities laws should be amended to require clearing of all standardized OTC derivatives through regulated central counterparties (CCP):
 - CCPs must impose robust margin requirements and other necessary risk controls and ensure that customized OTC derivatives are not used solely as a means to avoid using a CCP.
 - All OTC derivatives dealers and all other firms who create large exposures to counterparties should be subject to a robust regime of prudential supervision and regulation, which will include:
 - Conservative capital requirements
 - Business conduct standards
 - Reporting requirements
 - Initial margin requirements with respect to bilateral credit exposures on both standardized and customized contracts
 - To ensure regulators have comprehensive and timely information about the positions of each and every participant in all OTC derivatives markets, a new framework should:
 - Amend the CEA and securities laws to authorize the CFTC and the SEC to impose:
 - Recordkeeping and reporting requirements (including audit trails).
 - Requirements for all trades not cleared by CCPs to be reported to a regulated trade repository.
 - CCPs and trade repositories must make aggregate data on open positions and trading volumes available to the public. CCPs and trade repositories must make data on individual counterparty's trades and positions available to federal regulators.
 - The movement of standardized trades onto regulated exchanges and regulated transparent electronic trade execution systems.
 - The development of a system for the timely reporting of trades and prompt dissemination of prices and other trade information.
 - Encourage regulated institutions to make greater use of regulated exchange-traded derivatives.
- To prevent market manipulation, fraud, and other market abuses, the Commodity Exchange Act (CEA) and securities laws should be amended to ensure that the CFTC and the SEC have:

Collectively, these legislative and regulatory actions are formidable. Multiple different state and federal initiatives present a risk of profound regulatory conflicts and redundancies that could thwart responsible risk management of life insurers' assets and liabilities. Moreover, conflicting CDS regulation will erode investors' demand for public and private bonds, ultimately harming the ability of American businesses and governments to cost-effectively raise capital.

We strongly encourage the NCOIL Task Force to proceed in a deliberative manner mindful of the many complex regulatory and legislative actions under consideration. This approach will fulfill the 2009 [charge](#) of the Financial Services and Investment Products Committee to "explore the role of credit default swaps and other financial instruments, develop a position, and communicate to legislative colleagues regarding their public policy implications." A thorough analysis of the public policy implications of the Task Force CDS bill is an important element of this charge.

As a primary source of long-term capital for American businesses and governments, life insurers must be able to responsibly manage portfolio risks within a rational regulatory environment. Under these circumstances, life insurers can continue to successfully serve the nation's retirement and financial security with life insurance, annuities and other products.

We greatly appreciate your attention to our views. Please let me know if you have any questions.

Sincerely,



Carl B. Wilkerson

Cc: Members of the NCOIL Task Force on Credit Default Swaps Regulation:
The Honorable Joseph Crisco
The Honorable Ralph Hidgens
The Honorable Vi Simpson
The Honorable Robert Damron
The Honorable George Keiser
The Honorable Carroll Leavell
The Honorable Neil Breslin
The Honorable James Seward
The Honorable Hubert Vo
The Honorable Mike Hall

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- o Clear and unimpeded authority for market regulators to police fraud, market manipulation, and other market abuses.
 - o Authority to set position limits on OTC derivatives that perform or affect a significant price discovery function with respect to futures markets.
 - o A complete picture of market information from CCPs, trade repositories, and market participants to provide to market regulators.