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Susan E. Voss, President
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

James R. Mumford, Chair
Receivership and Insolvency (E) Task Force
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

RE: NAIC Staff Considerations Regarding IRMA Section 711

Dear Commissioner Voss and Chairman Mumford:

The American Council of Life Insurers ("ACLI")[1] appreciates this opportunity to provide the following comments on the March 27, 2011 memo from NAIC staff to the Receivership and Insolvency (E) Task Force on considerations regarding Section 711 (Qualified Financial Contracts) of the *Insurer Receivership Model Act* ("IRMA").

Background

Life insurers use derivatives to prudently manage and mitigate risks (such as interest rate, foreign exchange and credit) associated with their assets and liabilities which often have longer durations than other financial institutions. The availability of risk management tools, like derivatives, allows life insurers to offer a broader array of products to consumers at reasonable prices while maintaining their financial stability despite constantly changing economic conditions.

Since the financial crisis, many insurers have experienced increasing resistance against doing additional business[2] from banks and other financial institutions ("counterparties") with respect to over-the-counter and exchange-traded derivative transactions, repurchase and reverse repurchase transactions, securities lending and other financial market transactions (collectively referred to as "qualified financial contracts" under IRMA Section 711). Specifically, counterparties point to the absence of legislative certainty in most states that collateral, netting and closeout provisions in these contracts will be respected and enforceable in an insurer's insolvency. While this risk has always existed, the financial crisis heightened scrutiny on the lack of certainty in the treatment of financial intermediaries in the event of the insolvency of state regulated insurers.

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[1] The ACLI is the primary trade association of the life insurance industry, representing more than 300 legal reserve life insurer and fraternal benefit society member companies that account for over 90% of the assets and premiums of the U.S. life insurance and annuity industry.

[2] Resistance has been in the form of limited credit lines from existing counterparties, difficulty identifying new counterparties willing to provide credit lines and/or unattractive pricing from counterparties who apply a credit valuation adjustment or additional "charge" for the risk.

Qualified Financial Contracts ("QFCs")

QFCs are typically, though not exclusively, documented under master agreements that enable the parties to enter into numerous individual transactions. Three provisions that are normally found in QFCs operate to reduce credit risk between the parties. First, netting provisions allow the parties to offset mutual obligations and liabilities arising under a single agreement. Since a party may be "in the money" on some transactions and "out of the money" on others, such amounts are netted against one another, creating a single net amount owing from one party to another. Second, collateral arrangements require the "owing" party to post collateral to support its net obligations to the other party. Collateral is computed and collected (or returned) frequently based on current market prices. If enforceable, collateral ensures that the "non-owing" party is substantially secured against the failure of the "owing" party.

Third, QFCs establish a right of the non-defaulting party to close out, liquidate and terminate the underlying transactions immediately upon the insolvency of the other party based on the net value owing. The ability of an institution to set off or to sell securities to immediately satisfy a claim against an insolvent counterparty is critical not only to reduce the parties' credit risk but to maintain liquidity in the securities markets. The imposition of a judicial or regulatory stay on the liquidation of these securities, as is normally the case in an insurer insolvency proceeding, undermines the efficacy of these provisions.

Protections for QFCs

The Federal Bankruptcy Code and the Federal Deposit Insurance Act (FDIA), as well as the laws of numerous foreign jurisdictions, allow a non-defaulting counterparty to promptly closeout, liquidate and terminate QFCs upon insolvency, realize on any collateral free of the bankruptcy stay and protect this right from avoidance. These safe harbor provisions for QFCs were adopted by Congress as an acknowledgement that financial markets are uniquely intertwined and move exceedingly quickly. Disruptions resulting from judicial intervention can cause unintended chain reactions and significant systemic impact. Prompt closeout of derivatives and other QFCs and enforcement of the terms of netting agreements in insolvency are intended to avoid these consequences.

Many states do not have IRMA Section 711 in their receivership statutes to allow for the termination and netting of QFCs with an insurer who has been placed in rehabilitation or liquidation. Accordingly, the treatment of QFCs entered into by insurers that become insolvent is uncertain in those jurisdictions. At best, counterparties face delay in receiving payment for an indefinite period and potential loss of collateral value. At worst, the netting agreements might not be treated as enforceable by the administrator. Cherry picking of desirable contracts might occur, and bona fide pre-insolvency trades and collateral settlements might be avoided, resulting in significant loss to the counterparty. Adoption of IRMA Section 711 will afford the necessary contractual certainty to counterparties that their netting, closeout and collateral rights under QFCs will be enforced, even if the insurer enters into rehabilitation or liquidation.

IRMA Section 711

The NAIC realized the importance of netting QFCs for insurers, counterparties and policyholders as it included Section 711 (which is modeled on the Federal Bankruptcy Code safe harbors allowing for netting and closing of QFCs during receivership) in its IRMA. While the ACLI had concerns with some of the IRMA's provisions, we fully supported Section 711 and continue to do so.

A growing number of states are enacting legislation based on IRMA Section 711. Since the IRMA was adopted in 2005, eleven states (Arizona, Delaware, Illinois, Indiana, Maine, Massachusetts, Minnesota, Missouri, Nebraska, Utah and Virginia) have enacted netting legislation that is substantially similar to Section 711, either as stand-alone bills or as part of guaranty association legislation or omnibus bills. All but one of these states (Utah) enacted their legislation after the financial crisis began in 2008. Five other states (Connecticut, Iowa, Maryland, Michigan and Texas) had already enacted netting legislation

before IRMA's adoption by the NAIC. Over 75% of the top 50 life insurers by premiums written are now covered by IRMA Section 711 type legislation.

Dodd-Frank Implications

The drive to adopt legislation similar to IRMA Section 711 has been further accelerated by Title VII of the *Wall Street Transparency and Accountability Act of 2010* ("Dodd-Frank") setting forth new federal oversight of derivatives markets. Under Dodd-Frank, insurers are characterized as financial entity end users and are subject to mandatory clearing for certain derivatives transactions, as well as initial and variation margin requirements for uncleared (traditional over-the-counter) derivatives transactions.

Proposed Commodity Futures Trading Commission ("CFTC") Rule 23.504(b)(1) sets forth documentation requirements for swap dealers and major swap participants requiring that agreements address "payment obligations, netting of payments, events or default or other termination events, calculation and netting of obligations upon termination, transfer of rights and obligations, governing law, valuation, and dispute resolution procedures." In addition, Proposed CFTC Rule 23.600(c)(4)(v)(A) requires that swap dealers and major swap participants have risk management procedures addressing legal risks including "determinations that transactions and netting arrangements entered into have a sound legal basis."

Most importantly, the proposed margin rules issued by the bank prudential regulators that oversee the banks who are the primary derivatives dealers provide that initial and variation margin for uncleared swaps must be calculated on a gross, rather than net, basis unless the parties are subject to a "qualifying master netting agreement" and obtain a legal opinion that key provisions of this agreement are enforceable, even in the case of bankruptcy or insolvency.[3] These margin rules will apply regardless of the rating of the insurer -- in other words, the margin rules depend solely on enforceability of the QFC against an insolvent insurer rather than the likelihood of an insurer's default. Since IRMA Section 711 will satisfy these requirements, insurers in states which have adopted IRMA Section 711 or comparable legislation will have their margin levels calculated on a net basis, while insurers in states which have not adopted IRMA Section 711 will become subject to higher margin requirements based on gross positions. Such insurers will be severely disadvantaged in the derivatives marketplace, and will have increasingly limited access to these important risk mitigation tools. The result will be reduced product offerings and increased pricing for consumers.

NAIC Staff's Considerations Regarding IRMA Section 711:

On page 1 of the NAIC's March 27 memo, NAIC staff state:

"Given this language [Section 711] was contemplated prior to [the] recent financial crisis, NAIC staff believes regulators should re-familiarize themselves with the underlying issues to ensure that they are comfortable with any adjustment to traditional claimant priority."

As stated above, ten of the eleven states that have recently enacted netting legislation based on IRMA Section 711 did so after the financial crisis began. In many instances, the legislation was developed in close consultation with state insurance regulators. Legislators had ample time during the legislative process to express concerns, if any, with regard to "any adjustment to traditional claimant priority." Indeed, IRMA Section 711 simply reaffirms that existing contractual rights between insurers and counterparties under their QFCs will be honored in an insurance insolvency proceeding – it does not

[3] For a master netting agreement to be a "qualified master netting agreement", (1) the agreement must give the non-defaulting party the right to (a) accelerate, terminate and close out on a net basis all transactions under the agreement, (b) liquidate or set off collateral promptly upon an event of default including upon an event of insolvency of their counterparty, (2) in all cases any exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions and (3) a clean legal opinion as to these matters must be obtained.

create new rights to the detriment of policyholders. For example, in the case of a simple contract for the purchase or sale of securities, if the contract permits termination, the counterparty may terminate the contract. In the case of a relationship that involves a master netting agreement, IRMA Section 711 permits netting and closeout under that agreement in accordance with the agreement's terms.

Furthermore, while we have not analyzed the insurance insolvency laws of each state, we believe that IRMA Section 711 does not in fact change traditional claimant priority. Our legal analysis shows that only the timing of the payment to the counterparty is advanced, while harm to the counterparty and market is avoided. Under typical QFCs, collateral is provided by the "owing" party to the other party. Accordingly, if a net amount is owing to a counterparty, that counterparty will be secured to the extent of collateral held. IRMA Section 711 changes the timing for payment of secured QFC counterparty claims so that resolution can occur quickly without risk of fluctuations in the value of posted collateral while a stay is in effect. Assuming that secured claims already have priority over policyholder claims under existing law, IRMA Section 711 does not alter the priority of a secured QFC claim; rather, it will only speed its settlement.

Absent a provision like IRMA Section 711, any lost collateral value due to market movements will leave the counterparty in the position of an unsecured claimant for that deficit. While effectively demoting the secured counterparty to the extent of that loss, it does not increase assets available to pay policyholder claims.

The timing and priority for resolving *unsecured* QFC claims is not changed by IRMA Section 711. To the extent a counterparty to a QFC is unsecured, its claim will be that of a general unsecured creditor and junior to policyholder claims.

On page 2 the memo states:

"However, some parties objecting to Section 711 believe the primary motivation of counterparties is to avoid various regulatory capital and collateral requirements. Additionally, there [are] some parties that believe the definition of "qualified financial contract" is too broad and numerous financial-related transactions could arguably be incorporated within this definition."

The capital rules applied to many bank counterparties following Basel II and also margin requirements under Dodd-Frank are dependent, in part, on whether an enforceable netting agreement exists between the parties. The absence of IRMA Section 711 provisions makes delivery of a bankruptcy/insolvency enforceability opinion impossible. Accordingly, the counterparties must compute their capital requirements and collect collateral and the newly required Dodd-Frank margin amounts on a gross basis rather than a contractually-based net basis. Because of the higher capital requirements, insurers in states without IRMA Section 711 are less attractive counterparties. An institution's preference to hold less capital and collect less margin, to the extent permitted under its governing rules, as well as to avoid assuming additional credit and market risk from dealing with institutions under a less certain insolvency regime, should hardly be characterized as "avoidance" of capital and margin requirements.

The definition of a QFC in IRMA Section 711 is aligned with the Federal Bankruptcy Code and the FDIA. The types of contracts covered are generally traded and valued based on readily ascertainable market prices which fluctuate rapidly. Investments such as loans, commercial mortgage loans, insurer private placements and leases would not be included. Furthermore, insurance regulators have the power to interpret IRMA Section 711, and could utilize the body of law developed under federal bankruptcy statutes to assist them.

Also on page 2 the memo states:

"Additionally, NAIC staff is aware of insurance companies requesting that Subsection 711.H be excluded from enactment, which would preclude an insurer's affiliate from exercising the counterparty rights allowed to third parties."

The allowance of netting in QFC transactions with affiliates is important to certain insurers who engage in, or may want to engage in, derivatives transactions through an affiliated entity (a "derivatives affiliate"). In these cases, the derivatives affiliate first enters into derivatives transactions with various external counterparties and then enters into back-to-back trades with one or more insurers within its holding company group. If netting between an insurer and its derivatives affiliate is not recognized, the derivatives affiliate may not be able to perform its obligations to the external counterparties and could jeopardize the whole arrangement. Engaging in derivative transactions through a derivatives affiliate benefits insurers and policyholders because it: (1) enables centralization and streamlining of risk management, (2) simplifies derivatives operations and documentation, and (3) potentially reduces costs of hedging for a group of insurance companies in a larger organization.

We note that the terms of the arrangements between the derivatives affiliate and its related insurers would always be subject to the supervision and approval of the insurer's domiciliary jurisdiction under the insurance holding company statutes and would be subject to a determination that they were fair and equitable. To date, one state (Delaware) allows for the use of netting by an affiliate of an insurer in receivership, but then only if the Commissioner pre-approves its use (which cannot be unreasonably or arbitrary withheld).

Thank you again for this opportunity to comment on this important issue. If you have any questions, please feel free to call me at (202) 624-2135 or email me at waynemehlman@acli.com.

Sincerely,

Wayne A. Mehlman
Senior Counsel, Insurance Regulation

cc: Ann Farr, NAIC Senior Financial Analyst Life/Health
David Vacca, NAIC Assistant Director