



IRMA Section 711: Background and Context

Presentation to Receivership and Insolvency Task Force--Section 711 Subgroup
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Overview

Use of Derivatives/Qualified Financial Contracts by Insurers is Limited by Statute

IRMA Section 711 Aligns Treatment of Derivatives/Qualified Financial Contracts in Insurance Insolvency with Federal Insolvency Regimes, Generally

- Provides certainty to parties' rights in insolvency
- Without IRMA Section 711, insurers experience higher hedging costs and limited access to markets
- Leads to reduced risk mitigation and increased product pricing

Dodd-Frank Presumes Continuation of Federal Insolvency Regime

Policyholders Benefit from IRMA Section 711

Reflections on AIG, Lehman and Washington Mutual

Derivatives Use by Insurers

- Virtually all states expressly permit insurers to use derivatives by statute
 - Limited to hedging asset and liability risks (interest rates, equity, currency, etc.) and asset replication
 - Credit exposure reduced or eliminated by collateral
- Over-the-Counter (OTC) derivatives are documented under ISDA Master Agreements that are “master netting agreements”
 - Bilateral contracts where parties execute multiple transactions that are treated as part of a single agreement
 - To reduce credit risk, values owing under all trades are netted down to a single amount owing by one party to the other
 - Typically, collateral is provided by the “owing” party on a net basis – usually daily
 - If insolvency or other default occurs, agreement can be terminated and closed out on a net basis

Special Treatment for Qualified Financial Contracts

- Strong preference for netting qualified financial contracts and prompt closeout despite automatic stay that accompanies insolvency
 - Reduces systemic risk resulting from interconnectedness
 - Improves ability to isolate market value of transaction which may fluctuate if stay enforced
 - Increases liquidity among unaffected parties
 - Reduces bilateral credit risk through netting
- 37 countries recognize close-out netting for derivatives
- Federal Bankruptcy Code and Federal Deposit Insurance Act “safe harbor” provisions for qualified financial contracts adopted beginning in the 1980s
- Basel committee reaffirmed importance of close-out netting, but also called for short delays to transfer contracts to a solvent firm
- Dodd-Frank rules assume continuation of safe harbors and enforceable netting
- 1997 and 2005 NAIC Model Insolvency Laws mirror Federal law

Insolvency Treatment of Derivatives Under Federal Bankruptcy Law

- Federal Bankruptcy Code gives special treatment to derivatives and other specified financial contracts in insolvency
- Allows counterparty to close out transactions and realize on collateral despite automatic stay
- Allows providing additional or replacement collateral to protect the interest of the secured creditor – e.g. to avoid deterioration in market value
- Protects the exercise of rights to liquidate from avoidance
- Exempts transactions from preference and fraudulent transfer avoidance (mark-to-market settlements, additional collateral payments, etc.)
- Permits avoidance if actual fraud present

Insolvency Treatment of Derivatives Under IRMA Section 711

- IRMA Section 711 treats derivatives and other qualified financial contracts in an insurance insolvency consistent with Federal Bankruptcy Code
- Allows counterparty to terminate, liquidate or close out a contract, including a master netting agreement, despite the stay
- Allows counterparty to setoff and realize on collateral despite the stay
- Protects the exercise of rights to liquidate from avoidance
- Bars “cherry-picking” – receiver may not accept some and reject other contracts with the same counterparty
- 19 states have adopted IRMA Section 711

Financial Impact on Insurers: Dealer Credit Charges

Because of enforceability concerns and resulting increased capital requirements, dealers currently limit their risk to insurers in non-IRMA Section 711 states or charge more to transact with those insurers

- At least four major derivative dealers have limited or no appetite to transact derivatives, repurchase agreements or securities lending contracts with such insurers
- Several other dealers impose additional Credit Valuation Adjustment (CVA) charges when facing such insurers

Trade Type	Tenor	CVA Charge (in BPPA)
Interest Rate Swaps	2-year	0.2
	5-year	3.2
	10-year	8.6
	30-year	15.2
Cross-Currency Swaps	5-year	10.4
	10-year	15.0
	30-year	19.0

Source: Bank of America Merrill Lynch

Dodd-Frank Act: Qualified Master Netting Agreement

Dodd-Frank Introduces Concept of “Qualified Master Netting Agreement” which

- Creates single legal obligation for all transactions under the agreement in the event of default, including insolvency
- Provides the right to:
 - Accelerate, terminate and close out all transactions on a net basis
 - Liquidate or set off collateral promptly upon event of default including insolvency
 - Exercise of rights under the agreement will not be stayed or avoided under applicable law in the relevant jurisdictions
- Party must have completed and documented a legal review concluding that:
 - Netting agreement meets the foregoing requirements
 - “in the event of a legal challenge, including one resulting from default or from bankruptcy, insolvency or similar proceeding, the relevant court and administrative authorities would find the agreement to be legal, binding and enforceable under the law of the relevant jurisdiction”

Effect of Dodd-Frank Act: Margin

- Dodd-Frank Act requires derivative dealers and clearinghouses to collect both initial (upfront) and variation (on-going) margin on uncleared and cleared swaps
- Under proposed rules, calculation of initial margin is either
 - On a fixed schedule (% of notional amount); or
 - Based on an “approved” model offering portfolio offset benefits, but only if the swaps are covered under a “qualifying master netting agreement” (QMNA)
- Variation margin is calculated based upon the changes in the market value of the contracts
 - If agreement is a QMNA, variation margin can be settled on a net basis
 - If no QMNA exists, variation margin will be required based on the gross value of the positions

Effect of Dodd-Frank Act: Insurers Penalized

- Absent IRMA Section 711, an insurer faces poor outcomes
 - With respect to uncleared swaps, banks are likely to be compelled to treat insurers as a higher risk counterparty because there is no enforceable netting agreement; and
 - With respect to cleared swaps, the intermediary (FCM) is compelled to guaranty its customer (the insurer) to the clearinghouse absent the assurance that the insurer will actually perform its obligations to the FCM
 - Greater costs to the insurer are sure to follow
 - Insurer cannot opt out of compulsory clearing and the FCM has all the leverage

Policyholders Benefit From IRMA Section 711

- Derivatives are important risk mitigation tools that allow insurers to provide dynamic, cost-effective products to policyholders
- Statutory limits on derivatives ensure that insurers use prudently and not excessively
- IRMA Section 711 does not result in “claim jumping” advantaging counterparties over policyholders.
 - Only timing of payment to counterparty is advanced, while harm to counterparty and market is avoided
- Under most state laws, holders of secured claims can discharge their claim against security ahead of policyholders
- If net amount owing is due from insurer and is not collateralized, or if collateral is inadequate, counterparty becomes an unsecured general creditor whose claim is junior to policyholders
- IRMA Section 711 only changes timing of payment process, rather than improving of counterparty’s position vis a vis policyholders
- Without IRMA Section 711, insurers access to derivatives is limited and significantly more expensive

Criticism of Bankruptcy Safe Harbors

- Allowed excessive risk-taking without concerns for credit risk (e.g., AIG and Bear Stearns)
- Contributed to systemic risk when collateral assets were rapidly liquidated (e.g., Lehman)
- Increased likelihood of large, opaque derivatives books and interconnectedness that make parties “too big to fail.” (e.g., AIG, LTCM and Lehman)
- By preferring counterparties, safe harbors penalize other creditors, shareholders and potentially, policyholders

Safe Harbor Critique Does Not Apply to Insurers

- Safe harbors do not blind insurers and their counterparties to risk
- Currently, insurers and counterparties require bi-lateral, mark-to-market collateral flows on a frequent basis
 - Large payables do not build up, stressing liquidity
 - Insurers do not ignore counterparty credit risk because there is collateral and visa versa (especially if IRMA is not applicable)
- Under Dodd-Frank:
 - Standardized swaps will clear centrally with initial margin and mark-to-market collateral flows on nearly real-time basis; and
 - Non-cleared, OTC derivatives will be collateralized by law (with respect to bank exposure to insurers) or by contract (with respect to insurer exposure to banks)

Insurers Are Not Lehman, AIG or Bear Stearns

- State laws and regulations carefully constrain an insurer's use of derivatives to non-speculative, hedging activities and limited, unlevered portfolio replication
- Under Dodd-Frank, the markets will be transparent with transactions centrally reported and cleared
- Dealers like Lehman, AIG Financial Products or Bear Stearns will have registration, reporting, capital and compliance requirements
- Large hedge funds like LTCM will be similarly regulated and subject to new transparency standards

Assuming Counterparties Conflict with Policyholders Is Inappropriate

- Policyholders benefit from derivatives activities that manage portfolio risk;
- Without the benefit of IRMA Section 711, when Dodd-Frank takes effect:
 - Insurers will become uniquely unattractive counterparties to banks and FCMs
 - Insurers will be heavily handicapped in their derivatives activities to the detriment of policyholders
- Choosing IRMA Section 711 over the alternative
 - Protects the “living” insurance company
 - Concomitantly benefits policyholders
 - Conforms with widespread legislative, regulatory and financial market precedent and practice

Appendix

Cost Comparison: IRMA vs. Non-IRMA States

- Present value cost based on CVA charge assessed on a per-annum basis over life of trade
- Assumes \$50B affected notional, credit support annex with zero thresholds and daily collateral posting

Trade Type	IRMA State	Non-IRMA State
Cross Currency Swaps	\$0MM	\$75MM
Interest Rate Swaps	\$0MM	\$180MM
Total	\$0MM	\$255MM

Dodd-Frank Act: Comparison of Initial Margin Requirements

Two Calculation Methods

Asset Class	Standardized “Grid” (% of Notional) ¹	“Approved Model” (% of Notional) ²
Credit: 0-2 year duration	1 – 3%	2 – 6%
Credit: 2-5 year duration	2 – 8%	3 – 8%
Credit: 5+ year duration	5 – 15%	4 – 12%
Commodity	10 – 20%	N.A.
Equity	10 – 20%	10 – 15%
Foreign Exchange / Currency	3 – 9%	2 – 4%
Interest Rate: 0-2 year duration	0 – 2%	0 – 0.5%
Interest Rate: 2-5 year duration	1 – 3%	1 – 2%
Interest Rate: 5+ year duration	2 – 6%	2 – 11%
Other	10 – 20%	N.A.

¹On trade by trade basis

²On netted basis

Note: Approved model numbers are portfolio specific, given the potential reduction from off-setting trades. For this comparison, we have used exchange/clearinghouse numbers and adjusted for longer default window required in proposed rule.

Example: Dodd-Frank Impact on Hypothetical Derivative Portfolio in IRMA and Non-IRMA States

Pre / Post Dodd-Frank Enactment

Asset Class	Hypothetical Derivatives Portfolio	Non-IRMA State	IRMA State
Pre-Dodd Frank Act	\$100MM 5-year pay fixed swap	Initial Margin: \$0 CVA Charge: \$0.04MM	Initial Margin: \$0 CVA Charge: \$0
	\$100MM 30-year receive fixed swap	Initial Margin: \$0 CVA Charge: \$2.61MM	Initial Margin: \$0 CVA Charge: \$0
		----- Total Initial Margin: \$0 Total CVA Charge: \$2.65MM	Initial Margin: \$0 CVA Charge: \$0
Post Dodd-Frank Act	\$100MM 5-year pay fixed swap	Initial Margin: \$3.00MM CVA Charge: \$0.04MM	Net Initial Margin: \$3.00MM CVA Charge: \$0
	\$100MM 30-year receive fixed swap	Initial Margin: \$6.00MM CVA Charge: \$2.61MM	
		----- Total Initial Margin: \$9.00MM Total CVA Charge: \$2.65MM	