STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

ON

REFORM OF THE OVER-THE-COUNTER DERIVATIVE MARKET: LIMITING RISK AND ENSURING FAIRNESS

October 7, 2009

Statement Made by

Mr. Scott Sleyster, CFA

Chief Investment Officer, Domestic

Prudential Financial

Statement of the American Council of Life Insurers on

Reform of the Over-the-Counter Derivatives Market

Introduction

Mr. Chairman and members of the Committee, my name is Scott Sleyster. I am Chief Investment Officer of Prudential Financial's U.S. Operations and I appear here today as a representative of the American Council of Life Insurers (ACLI).

ACLI is a national trade association with 340 members that account for 93 percent of the industry's total assets, 94 percent of life insurance premiums, and 94 percent of annuity considerations. In addition to life insurance and annuities, ACLI member companies offer pensions, including 401(k)s, long-term care insurance, disability income insurance, and other retirement and financial protection products.

Members of the ACLI use the Over-the-Counter ("OTC") derivatives markets to protect their assets and to hedge risks inherent in the policies and products they issue to customers. Life insurers' use of derivatives is carefully and prudently regulated by state insurance departments pursuant to state laws and regulations. These laws and regulations uniformly prohibit life insurers from using derivatives as a means of speculation or proprietary trading. In short, life insurers are key "end users" of derivatives who will be immediately affected by regulatory changes in these markets mandated by new federal laws and policies.

The composition of life insurers' assets is significantly different from other financial institutions, and reflects the long-term commitments and stability necessary for life insurers' obligations. 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 their products requires insurers to match long-term obligations with assets of a longer duration than other types of financial institutions. Derivatives allow life insurers to prudently manage the credit, interest rate, and market risk in their portfolios, and concomitantly to fulfill their obligations to contract owners. The regulatory status of derivatives, therefore, is critically important to the life insurance industry.

As the largest class of investors in the debt of U.S. corporations[1], life insurers need the ability to prudently manage the risks inherent in these asset categories through the

[1] Some basic background reflecting 2008 data 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).

derivatives markets. Efficient and cost-effective derivatives markets, therefore, are very important to life insurers as end-users, as well as to our corporate borrowers, their employees and their local business communities.

We have evaluated the Discussion Draft (dated October 2, 2009) to enact the Over-the-Counter Derivatives Markets Act of 2009, as well as the Department of the Treasury's draft legislation and its whitepaper, *Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation*. We offer the following views on these important legislative developments.

Comprehensive Federal Regulation of the OTC Derivatives Markets Is Appropriate

ACLI supports comprehensive federal regulation of OTC derivatives markets and products. The proper operation of these markets and the continued availability of OTC products are major concerns to ACLI members as end users of derivatives. Given that the derivatives markets are national and international in scope and inter-related with many other federally-regulated investment and financial markets and institutions, with potential systemic impacts, these markets and products should be regulated at the federal level, rather than by states. This federal pre-emption of market and product regulation should leave intact state and federal functional regulators' jurisdiction over derivatives usage by insurers and other financial institutions.

Continued Availability of Customized OTC Derivatives is Important

ACLI supports continued recognition of different classes of OTC derivatives – standardized and customized. Insurers use a diverse group of financial derivatives, from standardized derivatives, like single name Credit Default Swaps (CDS), to customized derivatives, like structured interest rate and currency swap transactions. Although standardized derivatives are a core hedging tool for life insurers, they do not offer the flexibility and cost efficiency needed to properly manage risks associated with the full range of insurers' assets and liabilities. Consequently, customized derivatives account for a large portion of insurers' OTC derivatives usage and are utilized to provide a closer offset to the market risks of insurance products that are tailored to fit customer needs and to precisely hedge risk in assets held to manage insurance liabilities. For example:

- Many insurance products such as long term care insurance, traditional life insurance, and fixed annuity products are of very long duration, characterized by payments to customers that can range from 15 to 25 to even 50 years. These products require insurers to manage interest rate risk that is much longer in duration than what can be effectively hedged through the exchange-traded futures markets. Customized OTC derivatives are utilized to better manage the cash flow timing and maturities of the policyholder obligations.

- Under certain variable annuity contracts that contain equity guarantees, a policyholder has the ability to withdraw funds at a guaranteed minimum market

---

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)*.

value, regardless of stock market performance and interest rate movements. These guarantees, tied to market performance, are prudently hedged with a combination of customized swaps and options.

- In order to diversify investment portfolios, insurers at times purchase fixed income securities issued by non-U.S. companies. An investment that is attractive from a credit perspective could be denominated in a foreign currency. If the policies supported by these investments are dollar-denominated liabilities, these foreign currency investments will be "swapped" to dollars to reduce exposure to fluctuations in currency values. Customized currency swaps are utilized to exactly match the rate, payment periods, and maturity of the foreign currency assets to convert the foreign currency amounts into U.S. dollars.

Burdensome restrictions on customized OTC derivatives could create unnecessary, non-economic frictional costs for delivering life insurance, long term care and retirement savings products to millions of Americans. In some instances, insurers' products may be removed from the market altogether if risks cannot be effectively hedged. Ultimately, additional costs to derivatives can lead to an increase in product pricing or the inability to purchase products to manage customers' retirement savings, estate planning, or long-term care coverage.

In sum, therefore, we support the approach taken in the Discussion Draft that does not present a bias in favor of standardized derivatives and acknowledges the continued need for customized derivates in managing end-users' risks.

Increased Costs for Hedge Protection Should be Carefully Evaluated

Insurers' cost of obtaining necessary hedge protection could be increased through aspect of the different legislative proposals. An increase in hedging costs could produce higher prices to consumers for insurance products or might frustrate prudent hedging that becomes too expensive. If insurers cannot adequately hedge market risks due to the cost of obtaining hedges, they may need to reduce the product guarantees or even stop offering the product altogether. Increased hedging costs could arise in a number of different ways. A regulatory bias driving customized derivatives onto clearinghouses or exchanges could substantially increase the cost to end users of obtaining hedge protection. Further, regulatory measures which reduce liquidity in markets (such as bans on naked CDS) will increase the cost of buying credit protection. Finally, the costs of transaction fees or taxes, fees charged to dealers for transacting in customized derivatives or punitive capital charges for these transactions, will not actually be borne by the dealers, but will be passed on by the dealers to end-users in their transaction pricing. It is critically important, therefore, to carefully balance burdens against the benefits of revised derivatives regulation.

Centralized Clearing for Standardized OTC Derivatives Appropriate, but not for Customized OTC Derivatives

ACLI supports centralized clearing of standardized OTC derivatives. Plain vanilla OTC derivatives such as single-name and index credit default swaps fall into this category. Clearinghouses and particularly exchanges operate on the basis of numerous, precisely off-setting, transactions that net down the clearinghouse risk to an amount that is effectively margined by deposits from members and customers. Margin levels are set based on risk modeling, which is fairly straightforward in the case of highly standardized products such as exchange-traded futures, or certain types of OTC credit derivatives.

By their unique nature, however, customized OTC derivatives are not capable of being off-set on this basis, and the risk modeling of these contracts at a clearinghouse would be extremely complex and challenging. Accordingly, market users of customized OTC derivatives would face the risk of prohibitively expensive collateral and margin levels if these contracts are forced into a central clearinghouse. For example, a clearinghouse might for its own protection require both parties of a trade to post super-sized-margins based upon the full potential value (risk) of their transaction.

Life insurers that are active in OTC derivatives markets currently execute their customized derivatives through prudent collateral agreements with their counterparties under which exposures are netted and collateral must be posted between the parties. In this manner, insurers and their counterparties are able to effectively reduce and control the counterparty credit risk arising from customized OTC derivatives.

An impetus toward creation of clearinghouses in the OTC derivatives market is not desirable for several reasons:

- The creation of multiple single product clearinghouses could increase, rather than decrease risks in these markets. Under insurers' current netting and collateral agreements with their counterparties, multiple diverse and offsetting risks (e.g., interest rate, credit, equity, and currency risks) can be netted off and these risks reduced bilaterally. Likewise, in an ideal efficient clearing system, the clearinghouse will recognize and credit the offsetting risk of multiple derivative classes, which will have the benefit of reducing margin flows and capital requirements. But this positive feature of clearing would be lost if the number of clearinghouses proliferate, especially for individual products, so that offsetting risks are not recognized. Also, the insolvency risk may be higher for small specialist clearinghouses.

- Clearinghouses could decrease collateral flexibility for end users, increasing frictional costs at minimal benefit to the stability of the financial system. At the present time, insurers' collateral arrangements with their direct OTC counterparties normally allow for the posting as collateral of a range of investment securities typically held by insurers, such as corporate bonds (subject to an appropriate "haircut" to reflect the counterparty's evaluation of the collateral credit risk). This flexibility is not available in exchanges and clearinghouse systems, where cash and U.S. Treasury securities are normally required to be posted. A clearinghouse system which does not have the current OTC market's flexibility and requires the posting of cash and Treasuries exclusively, or imposes onerous haircuts on other collateral classes would greatly increase the hedging costs of our members and could force them to abandon hedge strategies that are too costly or alternatively increase insurance product pricing or reduce the benefits to policyholders.

ACLI supports exploration by market participants and regulators about additional clearing solutions to reduce systemic risk, and believes that any bias toward compulsory clearing for the current well-understood and risk-constrained contractual approach should be avoided. Regulatory bias toward clearing of OTC derivatives without regard to the cost involved in the case of complex, difficult-to-price transactions could result in an inefficient use of capital, high transactional costs and the potential loss to our industry and other end users of critically important risk management tools. We support the approach of the Discussion Draft that does not mandate compulsory clearing.

OTC Derivatives Trade Reporting Appropriate

ACLI endorses greater market transparency and prevention of market manipulation, fraud, and other market abuses. To this end, we support recommendations that will require OTC derivatives transactions to be reported to a central trade information repository and to financial regulators, provided that that timing of required reporting is reasonable and takes into consideration the hedging needs of market participants. Like other hedgers, insurers frequently execute integrated hedging strategies involving a series of individual trades which may require one or two days to complete. Premature public reporting of individual trades in these circumstances would likely make the strategy's accomplishment more expensive and might jeopardize its completion. For this reason, we would oppose a requirement of public (rather than confidential regulatory) reporting of individual trades prior to the completion of a hedging program.

Safe-harbor for Intra-Group Derivatives Transactions Needed

Complex insurance organizations operate through various insurance company affiliates. It would be counterproductive to require OTC derivatives trades among companies within the same holding company system to clear through a central clearinghouse. Such a requirement would have the burdensome consequence of requiring affiliates to post collateral/margin at a clearinghouse for their related-party risk, even though this risk is presumably well-managed within the existing holding company system under applicable insurance regulation. We note that the American Clean Energy and Security ("ACES") bill recently passed by the U.S. House of Representatives could be read to require standardized transactions among affiliated companies to be cleared through a central clearinghouse. State insurance laws and the Administration's proposed systemic risk measures are adequate to control any risks associated with this intra-group activity. The Discussion Draft should be amended to allow intra-group transactions without clearing through a central clearinghouse.

Prohibition of "Naked" Derivatives Transactions Is Inappropriate

There have been some proposals to ban or limit the entry into "naked" derivatives positions, most recently in the ACES bill, which would prohibit entry into a credit default swap transaction by a party that does not hold the underlying investment. U.S. life insurers generally enter into non-hedging CDS transactions only for "replication" purposes, an unleveraged and fully-funded conservative derivatives strategy permitted under insurance law for creating synthetic asset positions. While we are concerned that a prohibition of "naked" derivatives could affect this strategy, ACLI has broader concerns with this prohibition.

These proposals reflect a potentially harmful misunderstanding of the dynamics of financial markets, particularly derivatives markets. A healthy, robust market is a two-sided market, where both positive and negative views of a particular risk or investment may be taken. A buyer and a seller are required for every trade. The existing futures and options markets are a good example of markets in which "naked" derivatives positions are utilized to express investment views. In order for insurers and other hedgers to obtain the necessary protection or for OTC derivatives dealers to manage the risk of protection they sell, additional market participants are needed to take the other side of the market.

Prohibition of "naked" derivatives transactions could cripple the OTC derivatives marketplace by eliminating a necessary market segment. The counterparty risk of "naked" derivatives is properly controlled through appropriate margining and collateralization at the contractual or clearinghouse level and systemic risk regulation, not through wholesale prohibition of the activity. Credit default swaps are critical to life insurers in managing the credit risk of our investment portfolios. The Discussion Draft prudently avoids bans on naked derivatives transactions.

Summary

I greatly appreciate the opportunity to present ACLI's views in today's hearing before the Committee. Life insurance products help Americans manage their financial risk and plan for their financial future. Life insurers can offer these products given their ability to manage large pools of assets and manage risk. Customized derivatives play a vital role in both asset and liability risk management. Therefore, it is very important to the life industry that derivatives oversight and regulation are reasonable and cost-effective.