MEMORANDUM

TO: File
FROM: Aaron Foxman
RE: Meeting with the representatives of the American Council of Life Insurers
DATE: November 8, 2010

On November 8, 2010, Cristie March and Leah Drennan of the Securities and Exchange Commission* and David Aron, Phyllis Cela, Lee Ann Duffy, Mark Fajfar, Steve Kane, Greg Kuserk, Somi Seong, and Rose Troia of the Commodity Futures Trading Commission met with Carl Wilkerson (American Council of Life Insurers (ACLI)), John Ewing (Prudential Financial), Richard Miller (Prudential Financial), Gary Neubeck, (Prudential Global Funding), Patricia Merrill (Genworth Financial), Helene Rayder (Genworth Financial), Thomas Samoluk (John Hancock), Malcolm Pittman (John Hancock), Jason Manske (MetLife), Kristen Smith (MetLife), Deborah Hayes (Lincoln Financial Group), and Stephen Martinie (Northwestern Mutual Life Insurance) (collectively, the "ACLI representatives").

The ACLI representatives discussed various matters pertaining to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act, including the definitions of "Swap", "Security-Based Swap", "Swap Dealer", "Security-Based Swap Dealer", "Major Swap Participant", and "Major Security-Based Swap Participant."

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* Ms. March and Ms. Drennan attended via phone.

ACLI Position on Key Terms in Title VII of the Dodd-Frank Act

Life insurers are significant *end-users* of derivative instruments that are used to prudently manage the risks of their assets and liabilities, as permitted under state insurance codes and regulations. Life insurers' financial products protect millions of individuals, families, and businesses through guaranteed lifetime income, life insurance, long-term care, and disability income insurance. The long-term nature of these products requires insurers to match long-term obligations with assets of a longer duration than most other financial institutions. Derivatives allow life insurers to prudently manage the credit and market risk of their portfolios and to fulfill their obligations to policy and contract owners. The regulatory status of derivatives, therefore, is critically important to the life insurance industry.

ACLI previously submitted a comment letter in response to the CFTC's and SEC's request for input on key definitions in Title VII of the Dodd-Frank Act, and reiterate some of our key points as follows:

- Major Swap Participant/Major Security-Based Swap Participant (MSP): For each MSP category, a determination of whether an end-user's swap positions are of a magnitude to pose a risk to the U.S. banking system or financial system is key to the regulatory decision as to whether to regulate that end-user as an MSP. Congress has recognized clearing and collateralization as risk mitigants and potential offsetting factors in the risk determination. Quantitative thresholds established for determining what is a "substantial position" and what constitutes "substantial counterparty risk" should therefore be at levels at which such systemic risk is likely to be present as the result of the bankruptcy or failure to perform of a market end-user, taking into consideration the risk mitigation benefits of netting, collateral, and clearing.

- Commercial Risk: The term "commercial risk" should be construed to include risks of financial as well as non-financial end-users of derivatives. This would be consistent with the historic approach that the CFTC has taken in the past, including through its interpretations of the Reg. 1.3(z) definition of "bona fide hedging". In other words, the CFTC and SEC should not operate under a presumption that a company does not hedge or mitigate commercial risk just because a company is a financial company.

- Highly Leveraged: We submit that the concept of "highly leveraged relative to the amount of capital it holds" should not be a mechanical concept but should relate to the types of risk potentially posed by a financial entity. Use of a simple balance sheet test or resort to the capital rules relevant to banks might be ultimately be determined to be workable. However, application of overly simplistic tests to diverse entities with different risk profiles might result in the regulatory net capturing an excessive number of non-systemically risky entities. We therefore urge careful development of this standard, supported by appropriate economic and financial analysis, including without limitation, review of leverage levels and standards prevailing in differing financial market sectors, and the risk posed by different business models and structures, to avoid such unintended consequences.

- Insurance: Some commentators on the "core" definition proposal have observed that a very expansive reading of the "swap" definition could include insurance products and related agreements. We do not agree with this view. Insurance products are not "swaps" in form or substance. Insurance products are governed by a comprehensive regulatory and reporting framework for insurers. This framework include mutually reinforcing accounting standards for reporting financial results and actuarial standards for ongoing evaluation of the proper reserve liability associated with the policies. The definitions of "swaps" and "securities-based swaps" should specify that insurance products are excluded.

Financial Security. For Life.

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November 12, 2010

Mr. Julian Hammar, Assistant General Counsel
Office of General Counsel
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20851

Re: Clarifying the Status of Insurance Products under the Definition of "Swap" in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act

Dear Mr. Hammar:

ACLI greatly appreciates the courtesy of your CFTC and SEC colleagues to meet with representatives of the life insurance industry on November 8, 2010, to discuss the definition of the terms "Major Swap Participant," "Major Security-Based Swap Participant," "Swap," and "Security-Based Swap." The dialog was constructive and informative.

During the meeting, CFTC staff indicated that it would be helpful for ACLI to address the status of insurance products under the definitions of Swap and Security-Based Swap in writing. In an effort to respond promptly to the suggestion, we quickly convened our policy groups and developed the material below as a preliminary endeavor. We would be happy to discuss this letter further with the CFTC or SEC staff, and to answer any questions that may develop.

I. Need for Clarification

The Dodd-Frank Act includes within clause (A)(ii) of the swap definition any contracts that "provides for any purchase, sale, payment, or delivery . . . that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence."[1]

Nothing occurred during countless meetings with Congressional staff and others during the lengthy process leading up to the adoption of the Act that ever suggested Congressional intent to regulate insurance products.[2] The specific terms used in the above-quoted swap definition, in the eyes of

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[1] Dodd-Frank Act Section 721(a)(47).
[2] In fashioning the Federal Insurance Office, for example, Congress was careful to make sure that the Office had no general supervisory or regulatory authority over the business of insurance. The CFTC or the SEC should not use the intentionally broad term "swap" under the Dodd-Frank Act Title VII as an indirect means to regulate insurance, an authority that was expressly denied in Dodd-Frank Act Title V.

some observers[3], have injected a degree of uncertainty concerning the application of Congress's intentionally broad swap definition to life insurance products.

Moreover, the Act's very clear preemption of the authority of states to regulate swaps as insurance further increases the demand for clarity.[4] Any traditional insurance contract offered by an insurer that falls on the swap-side of the dividing line will fall out of the state regulatory scheme and come under the Commissions' regulations, and could be deemed as an unlawful non-insurance contract for an insurer to offer in the first instance, even assuming that the swap complied with federal law.[5] In short, it is important to eliminate any potential suggestion that traditional, decades-old forms of insurance that fulfill consumer demands for financial and retirement security may unreasonably be exposed to unclear legal status.

To achieve legal certainty and avoid unnecessary disruption to a broad range of insurance products, we recommend that the CFTC and the SEC issue parallel guidance aimed at clarifying the scope of the swap definition. Such guidance should draw a more explicit line between swaps, on the one hand, and insurance, on the other. The potential disruption to the traditional insurance marketplace posed by an unclear application of the swap definition warrants interpretive clarification or rulemaking to prevent disruption of the insurance marketplace.[6] We do not believe Congress intended to provoke a disruption to the marketplace for insurance products. The proper test of what is "insurance" should be premised on state-level authorization and regulation of insurance products and life insurers.[7]

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[3] Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010 at http://sec.gov/comments/s7-16-10/s71610-63.pdf.

[4] Dodd-Frank Act Section 722(b). States may be inclined to amend their insurance laws to define the permissible kinds of insurance that may be transacted by an insurer to exclude any contracts that are determined to be federally regulated swaps. This would be necessary given the core functions of insurance regulators to supervise the solvency of insurance companies and determine the sufficiency of assets supporting insurance company contract obligations, which would be impossible with preemption of state insurance law for these products.

[5] State insurance laws often regulate the kinds of derivative instruments that an insurer may use and the specific derivative transactions with which they may be used. New York Insurance Law Section 1410 (with applicable definitions found in Section 1401(a)) is illustrative, especially since New York imposes its derivative regulation on not just New York domestic insurers but all insurers licensed to do insurance business in New York. Under New York law, a "swap" is a permitted derivative instrument (Section 1401(a)(7)), but it can only be used in a hedging transaction (Section 1401(a)(12)), a replication transaction (Section 1401(a)(18)) or limited kinds of income generation transactions (see Sections 1410(c), 1410(l) and 1410(d), respectively). Sale of an insurance policy or annuity would constitute none of these permissible kinds of derivative transactions, and therefore it would not be an authorized use of derivatives for life insurers under New York law.

[6] The preemption was specifically designed to preclude the opportunity for state legislatures to regulate the issuance of credit default swap as financial guarantee insurance subject to state insurance laws. The development that precipitated Congressional concern was a model law developed by the National Conference of Insurance Legislators (NCOIL), to regulate the issuance of credit default swap as financial guarantee insurance subject to state insurance laws. Congress wanted to prevent expansion of states' jurisdiction over the issuance of CDS, but did not act to cut back on existing state regulatory authority to govern the activities of life insurers. Congress did not intend to overturn greater than 150 years of state regulation of insurance. State insurance regulation has been and remains capable of protecting the public against abusive insurance products. But if the CFTC or the SEC are concerned that state insurance regulators might license insurers intent upon circumventing the rules, the SEC and CFTC both have means at their disposal under the Dodd-Frank Act to thwart any such efforts through direct and specific rulemaking as contemplated by proposed clarifying language set forth in this letter.

[7] Nothing in this letter about the swap definition, or our November 8, 2010, discussion with your CFTC and SEC colleagues, relates to any existing exclusions provided by the Dodd-Frank Act or to stable value contracts that will be the subject of a study mandated by the Act within 15 months of enactment.

II. Clarification of Swap Definition

The CFTC and the SEC should clarify the swap definition in order to exclude an insurance contract or transaction from the definitions of swap and security-based swap based on a three part test. First, under the mechanics of our proposal below, the contract must be issued by an insurance company and subject to state insurance regulation[8] as described in paragraph (1) of the exclusion. Second, the contract must be type of contract issued by insurance companies as described in section (2) of the exclusion. Third, the insurance contract must not be a type of contract that the CFTC or the SEC wishes to regulate.

A. Proposed Clarification of the Swap Definition Concerning Insurance Contracts[9]

"The terms 'swap' and 'security-based swap' do not include any agreement, contract or transaction that:

(1) Is issued or engaged in by an insurance company (as defined by Section (2)(a)(17) of the Investment Company Act of 1940)(15 U.S.C. 80a-2(a)(17) in respect of which the sale, reserving, payment or performance of such agreement, contract or transaction is subject to supervision by an insurance commissioner or similar official or agency of a State, or any receiver or similar official or liquidating agent for such company, in his capacity as such;
(2) Is an insurance contract, including, without limitation, a life insurance contract, annuity contract, endowment, funding agreement, guaranteed investment contract, settlement option , long-term care insurance contract, disability insurance contract, or any reinsurance contract in respect thereof, that is issued on an individual, group or other basis, whether fixed, variable or otherwise, and is supported by such insurance company's general assets or separate accounts, as permitted under state insurance law; *and*,
(3) The CFTC or the SEC has not determined by rule or regulation to be a swap or security-based swap, based on an individual determination that state regulation of the contract is insufficient to warrant the exclusion following a notice and opportunity for a hearing on the record under the Administrative Procedure Act.

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[8] ACLI's September 20, 2010, submission on the "core" definitions under the advance notice of proposed rulemaking provided a discussion about the comprehensive nature of state insurance regulation over life insurers' investments at Appendix B. ACLI also provided a larger discussion about the extensive scope of state insurance regulation in an August 20, 2010 submission with the SEC on aspects of Title IX of the Dodd-Frank Act in a section entitled A Comprehensive System of Regulation Governs the Distribution of Insurance and Annuity Contracts at page 204 of http://sec.gov/comments/4-606/4606-2669.pdf . *See also* page 27 *Id.*

[9] A parallel revision to the term "security-based swap" should also be implemented along these lines.

III. Analysis of other Commentators' Observations in the Advanced Notice of Proposed Rulemaking on "Core" Definitions

One comment letter on the "core" definition proposal attempted to prescribe tests for defining the functional distinction between federally-regulated swaps and state-regulated insurance products.[10] The commentator's suggested multi-part definitions of insurance that rely on linking payments to loss contingencies and insurable interests are unworkable and fall well short of covering a wide range of common insurance products, particularly those used in the retirement markets. For example, using the following factors to validate that an insurance product is not a "swap" would be incompatible with many traditional insurance products:

- *Contingent payment does not vary with the price of any asset.* This factor is not consistent with common variable life insurance and variable annuity products, which deliver insurance guarantees that do vary with the performance of specified assets, generally specific assets allocated to insurance company separate accounts. Also, equity indexed annuities promise a payment based on the performance of an index or other basket of assets.
- *Contract owner has an "insurable interest" or reasonable expectation of loss upon the occurrence of the contingency.* Insurable interest is a term of art used in the insurance industry to avoid wagering or gambling to profit from an insurance contract. It is the insurance principle, for example, that prevents any person from taking life insurance on a stranger or insuring the property of a stranger for speculative gain. However, this insurance principle is not universally applied to other types of insurance products, such as annuity contracts, where the moral hazard of gaining from someone's loss is not present. The absence of uniform insurable interest standards that apply to all traditional insurance products makes this an unworkable measure for distinguishing between a swap and insurance.
- *Contract limits payment or performance to the actual loss arising.* This insurance concept of indemnification is standard for property/casualty contracts and reinsurance transactions, which attempt to put the insured in the same position as prior to the insured loss (i.e., "make whole"). But this factor does not apply generally to wide range of insurance products that provide for payments not directly connected to the amount of any loss incurred. For example, long-term care policies may provide for payment of a fixed amount per day, regardless of the amount of actual losses arising from the inability to perform activities of daily living. The same is true for disability income insurance policies, which may pay a periodic benefit without regard for the actual losses arising from the disability. Annuity products may provide for guaranteed lifetime payments or withdrawal benefits, which are not

[10] Letter of Cleary Gottlieb Steen & Hamilton, dated September 21, 2010. http://sec.gov/comments/s7-16-10/s71610-63.pdf . ACLI fully disagrees with the conclusions in this letter that insurance contracts fall within the definition of the term swap; the letter appears to be based solely on the intentionally broad wording, without regard to the extensive deliberative context that provides much greater basis for interpreting Congressional intent. Following the near economic collapse of 2008, the administration and Congress worked for over 18 months to develop comprehensive reform that would prevent future similar incidents. The scope of the task facing Congress was profound, and in order for Congress to complete the legislation before the summer 2010 recess and campaigns for fall 2010 mid-term elections, many aspects of the legislation were left intentionally broad and unfinished, with significant details delegated to regulatory agencies for implementation. Interpretation of the legislation, therefore, must consider the legislative environment and the broad approach taken by Congress with the explicit instruction for implementing regulations. A simple review of the language alone is insufficient.

in the form of an indemnity for any loss event. Similarly, ordinary life insurance death benefits under a term or whole life insurance policy generally are not directly related to the specific economic losses of a beneficiary; not only does the purchaser of the life insurance simply select the death benefit amount but the beneficiary can be changed after the policy has been purchased so there may be absolutely no nexus between the payment of the death benefit and anything that could be labeled an "actual loss."

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In conclusion, we greatly appreciate your accessibility, and your attention to our views. Please let me know if you have any questions

Sincerely,

Carl B. Wilkerson

Carl B. Wilkerson

//ACLI
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MEMORANDUM

To: Julian Hammar, CFTC Assistant General Counsel
Date: November 12, 2010
From: Carl B. Wilkerson
Subject: Response to CFTC Inquiry Whether A.M. Best Ratings Consider Leverage

During the November 8, 2010 meeting between representatives of the life insurance industry and the staff of the CFTC and the SEC, the CFTC staff asked whether the ratings provided by A.M. Best consider an entity's leverage. We have provided information below from A.M. Best documentation that addresses this question. Please let me know if you have any further questions on this matter. Thank you.

[Extracted without editing from Best's Credit Rating Methodology]
(http://www.ambest.com/ratings/methodology/bcrm.pdf)

In determining a company's ability to meet its current and ongoing senior obligations, the most important area to evaluate is its balance sheet strength. An analysis of a company's underwriting, financial, operating and asset leverage is very important in assessing its overall balance sheet strength.

Balance sheet strength measures the exposure of a company's surplus to its operating and financial practices. A highly leveraged or poorly capitalized company can show a high return on equity/surplus, but may be exposed to a high risk of instability. Conservative leverage or capitalization enables an insurer to better withstand catastrophes, unexpected losses and adverse changes in underwriting results, fluctuating investment returns or investment losses, and changes in regulatory or economic conditions.[1]

A.M. Best reviews a company's ***financial leverage*** in conjunction with its underwriting leverage[2] in forming an overall opinion of a company's balance sheet strength. Financial leverage through debt or

[1] A.M. Best's assessment of balance sheet strength includes an analysis of an organization's regulatory filings, including the GAAP or IFRS balance sheet, at the operating insurance company, holding company, and consolidated levels. To assess the financial strength and financial flexibility of a rated entity, a variety of balance sheet, income statement, and cash flow metrics are reviewed, including corporate capital structure, financial leverage, interest expense coverage, cash coverage, liquidity, capital generation, and historical sources and uses of capital.

[2] Underwriting leverage is generated from current premium writings, annuity deposits, reinsurance and loss or policy reserves. A.M. Best reviews these forms of leverage to analyze changes in trends and magnitudes. To measure exposure to pricing errors in its book of business, we review the ratio of gross and net premiums written to capital. To measure credit exposure and dependence on reinsurance, we review the credit quality of a company's reinsurers and ratio of reinsurance premiums and reserves ceded and related reinsurance recoverables to surplus. To measure exposure to unpaid obligations, unearned premiums and exposure to reserving errors, we analyze the ratio of net liabilities to surplus. In order to assess whether or not a company's underwriting leverage is prudent, a number of factors unique to the company are taken into

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debt-like instruments (including financial reinsurance) may place a call on an insurer's earnings and strain its cash flow. Similar to underwriting leverage, excessive financial leverage at the operating or holding company can lead to financial instability. As such, the analysis is conducted both at the operating company and holding company levels, if applicable.

To supplement its assessment of financial leverage, A.M. Best also reviews a company's ***operating leverage***. A.M. Best broadly defines operating leverage as debt (or debt-like instruments) used to fund a specific pool of matched assets. Cash flows from the pool of assets are expected to be sufficient to fund the interest and principal payments associated with the obligations, substantially reducing the potential call on an insurer's earnings and cash flow. In other words, the residual risk to the insurer would be insignificant as long as the insurer possesses sound asset/liability, liquidity and investment risk management capabilities; exhibits low duration mismatches; and minimizes repayment and liquidity risk relative to these obligations. Best has established specific tolerances for operating leverage activities that are applied at each operating company, as well as at the consolidated level. Generally, debt obligations viewed by A.M. Best as eligible for operating leverage treatment would be excluded from the calculation of financial leverage, unless one of the tolerance levels is exceeded.

A.M. Best also evaluates ***asset leverage***, which measures the exposure of a company's surplus to investment, interest rate and credit risks. Investment and interest rate risks measure the credit quality and volatility associated with the company's investment portfolio and the potential impact on its balance sheet strength. A company's underwriting, financial and asset leverage is also subjected to an evaluation by Best's Capital Adequacy Ratio (BCAR) which calculates the net required capital to support the financial risks of the company. This encompasses the exposure of its investments, assets and underwriting to adverse economic and market conditions such as a rise in interest rates, decline in the equity markets and above-normal catastrophes. This integrated stress analysis evaluation permits a more discerning view of a company's relative balance sheet strength compared to its operating risks. The BCAR is based on audited financial statements and supplemental information provided by companies. The BCAR result is an important component in determining a company's balance sheet strength. A.M. Best also views insurance groups on a consolidated basis and assigns a common BCAR result to group consolidations or multiple member companies that are linked together through intercompany pooling or reinsurance arrangements.[3]

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consideration. These factors include type of business written, spread of risk, quality and appropriateness of its reinsurance program, quality and diversification of assets, and adequacy of loss reserves.

[3] There are other barometers of leverage that may be of interest to the CFTC or SEC staff concerning evaluation of this issue. The prudential regulator's definition of leverage may be the most relevant basis for identifying "highly leveraged" participants in the derivatives market. For many bank holding companies, asset managers and finance companies, it is common practice to use a simple ratio of capital to assets. For life insurers, however, the National Association of Insurance Commissioners has already established an effective leverage metric, the Risk-Based Capital Ratio (RBC ratio). The RBC ratio is used by state insurance regulators to identify weak, leveraged insurance companies and determine a course of remediation, including potentially assuming control of the insurer for the benefit of policyholders. These numbers are readily available, from the 5-year historical data exhibits of each insurer's statutory annual statements. Life insurers must hold statutory capital equal to at least 200% of the "authorized control level" of capital. Capital adequacy measurement is by definition a complex exercise. It would be in the interest of regulators to make use of an established, consistent metric rather than to introduce a calculation procedure that has not already been applied successfully across the insurance sector.