ACLI
Financial Security for Life

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Re: A Discussion Paper on Client Clearing: Access and Portability

The American Council of Life Insurers (ACLI) appreciates the opportunity to comment on the above-captioned CPMI-IOSCO Discussion Paper. The ACLI is the leading trade association driving public policy and advocacy on behalf of the life insurance industry. Ninety million American families rely on the life insurance industry for financial protection and retirement security. ACLI's member companies are dedicated to protecting consumers' financial wellbeing through life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, and dental, vision and other supplemental benefits. ACLI's 280 member companies represent 94 percent of industry assets in the United States.

The ACLI contributes frequently to regulatory proposals and requests for information relating to life insurer use of swaps and derivatives. The notional value of derivatives used by the insurance industry in the United States has risen by 45% over the past five years. Insurers use derivatives in hedging and portfolio management, setting the price of future purchases and sales to hedge against price fluctuations. Held predominantly by life insurers, their derivatives' notional value topped $3.3 trillion in 2020. Despite the increase, potential exposure has grown at a lesser rate of 30% during a five-year span, to $67.5 billion in 2020. Annuity products account for the largest portion of life insurer derivative hedging due to the nature of the products and returns they offer or guarantee. Furthermore, although derivative use throughout the insurance industry has grown, life insurers hold 98% of the total notional value.

As you are undoubtedly aware, U.S. life insurers are compelled by federal law to centrally clear their swaps that are legally designated as subject to a clearing requirement. Particularly with respect to financial derivatives (i.e., interest rate and credit swaps), life insurers are subject to the clearing requirement enacted into law in 2010 by the Dodd-Frank Act. Consequently, life insurers spent considerable resources to comply with the clearing requirement, including establishing new relationships with futures commission merchants (FCM), connecting to Swap Execution Facilities (SEFs), and putting in place new workflows to support cleared interest rate and credit swaps.

Compelled as they are to centrally clear most of their interest rate and credit swaps, life insurers have a strong interest in the safety, soundness and security of the clearing system. Life insurers have little or no flexibility to choose among central clearing counterparties ("CCP") and similarly, they must obtain the services of one or more central counterparty service providers ("CCSP"). In the U.S., CCSPs in this context are federally regulated FCMs. As the Discussion Paper accurately observes, there are a limited number of FCMs to choose among.

So, life insurers are seriously constrained in two interrelated respects. They are compelled to clear their financial swaps through CCPs and they are required to choose at least one FCM from a narrow selection of such firms.

Access

As we understand it, the Discussion Paper's central premise for public discussion is whether the narrow pathways to central clearing could be broadened by disintermediating FCMs and allowing life insurers and other end users to access a CCP directly on their own credit or in a sponsored model where a third-party provides a credit guaranty to the customer with direct access. While we believe these ideas are worthy of further consideration, they also raise several issues and potential problems for market users like life insurers.

From an operational point of view, direct access would require the customer to take on significantly increased operational responsibilities compared to traditional clearing arrangements, including heightened requirements for margining, liquidity and operational resources. As the clearing system is currently designed, an end-user with direct access would have to maintain a considerable reserve of immediately available funds (e.g., cash) that could be transferred to the CCP on a very short timetable, or risk their positions being closed out. We recommend that you consider if there are alternative ways for end-users to meet intra-day margin requirements while reducing the operational and liquidity burden that direct membership requires under the existing construct.

Absent some novel changes to the current clearing scheme for U.S. CCPs, it is not altogether certain that the advantage of direct access (disintermediation of the FCM as a conduit into clearing) outweighs the direct and indirect costs entailed in the direct access model. The largest life insurers do not have difficulty retaining FCMs and the playing field between them is relatively level. As the Discussion Paper notes, however, it is the smaller end users that have the greatest challenges finding and retaining FCM relationships; and they have the least amount of leverage. Counterintuitively, the direct access model's potential costs and operational challenges diminishes its attractiveness to the cohort that could use it the most.

We also anticipate that for life insurers there will be state-level regulatory impediments to implementing the direct access model dependent upon the terms of the relationship between the CCP and the customer. Life insurers are constrained by their state regulators from granting liens on their assets, which are held for life insurance policy beneficiaries. It is not clear how the direct

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access model, if it entails granting creditors' claims (e.g., the "sponsor" and/or the CCP) that are senior to those of policy holders, can be reconciled with state-level regulations. It might be possible to "ring fence" certain assets with regulatory approval but, again, that is a problem requiring further consideration.

Our preferred route to expanding the options now available in order to access clearing is more direct: Incentivize the addition of more FCMs to the available universe and incentivize FCMs to expand their clearing services, particularly for directional hedging activity that end-users often engage in. For example, capital requirements on clearing businesses have influenced FCMs' willingness to provide certain clearing services. For end-users who may have mostly one-directional positions to manage embedded product risks, these capital requirements can be impactful.

PORTABLITY

For life insurers, our ultimate concern is the availability of an alternate FCM(s) if their FCM defaults. We are supportive of the CCPs development of robust "Game Plans" that deal with such circumstances and suggest that (i) CCPs prioritize porting to successor FCMs with whom the customers already have existing clearing agreements, as opposed to "bulk transfers" that overlook customer preferences; and (ii) that such porting occur on the same terms as the existing clearing agreements with such FCMs. Adding these principles to a transparent and well-described Game Plan would incentivize customers to diversify their FCM relationships and provide much needed certainty that their trades will likely be ported to FCMs with whom they have existing relationships and without an undue increase in cost to the customer.

More generally, we endorse the Discussion Paper's objective of insuring rapid, accurate and complete position porting in the event of an FCM's failure.

Thank you for your consideration.

Sincerely,

THE AMERICAN COUNCIL OF LIFE INSURERS

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