Principal Financial Group

Principal Life
Insurance Company

August 16, 2011

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Mr. David Stanwick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, D.C 20581
RIN 3038-AC97

Re: Request for Comment on Margin and Capital Requirements for Covered Swap Entities

Ladies and Gentlemen:

Principal Life Insurance Company ("Principal Life") respectfully provides comments to the proposed rules on Margin and Capital Requirements for Covered Swap Entities by the Department of the Treasury, Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation ("FDIC"), the Farm Credit Administration (the "FCA") and the Federal Housing Finance Agency ("FHFA" and together with the OCC, Board, FDIC and FCA, the "Prudential Regulators"), and separately, the Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants by the Commodity Futures Trading Commission (the "CFTC" and together with the Prudential Regulators, the "Regulators"), both proposals together the "proposed rules," to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank Act").

Principal Life's insurance products protect individuals, families and businesses through a variety of life, annuity and pension products, as well as dental and disability income insurance. These products provide consumers with financial security through various stages of life and enable them to plan for their financial future, including retirement and estate planning, and assist companies in offering valuable benefits to their employees. Accordingly, many insurance obligations of Principal Life, as well as the corresponding assets purchased to support its insurance and retirement product liabilities, have durations that extend for one or more decades. Derivatives are used by Principal Life primarily for hedging purposes to reduce risks associated with existing or anticipated assets or liabilities. Such risks include the risk of changes in value, yield, price, cash flow or quantity of assets or liabilities and currency exchange risk. Due to the long-term nature of Principal Life's assets and liabilities, as well as accounting rules governing its business, the vast majority of Principal Life's derivatives transactions are over-the-counter ("OTC") bilaterally negotiated transactions with highly-rated counterparties.

Principal Life anticipates it will be regulated as a low risk financial end user under the derivatives reforms and therefore subject to the new margin requirements for non-cleared swaps under the proposed rules. Principal Life, like most insurance companies, traditionally trades with high quality counterparties and does not post (or collect) initial margin or independent amounts on OTC derivatives trades[1].

Impact of Proposed Rules on Margin for Financial End Users

The new initial margin requirements will substantially increase the amount of Principal Life's assets required to be posted as margin on uncleared trades and, therefore, will impose significant additional costs on Principal Life's future hedging activities. The proposed rules are a significant departure from current industry practices and will impose considerable additional costs on life insurers conducting risk reducing hedging activities. These costs could have a significant impact on the industry's business models and profitability, and necessitate changes to investment portfolios. As a result, Principal Life (like other insurers) may face difficult choices concerning whether it can continue to conduct its traditional hedging transactions under the new regulatory regime, and/or whether it must raise the prices it charges for its products sold to American consumers, employers and employee benefit plans. Moreover, where profit margins cannot withstand increased hedging costs, Principal Life, like other insurers, may be forced to decide whether it can continue to provide certain products at all.

The cost burdens of the new initial margin requirements are compounded by the proposed rules that restrict the asset types that may be used for initial and variation margin. Principal Life, like many life insurers, is predominately a fixed income investor whose investment and hedging activities are subject to comprehensive state insurance regulation. As a fixed income investor, Principal Life makes significant investments in high quality, liquid corporate bonds and mortgage-backed securities ("MBS"), and is currently able to post these assets as

[1] Principal Life's ISDA master agreements, however, have other contractual arrangements that have been carefully crafted and negotiated to mitigate counterparty risk.

collateral under its ISDA contracts, as are many similarly situated life insurers.[2] In contrast to the current market practice, the Regulators' proposed rules restrict the assets life insurers may post for initial margin on uncleared swap transactions to just cash, U.S. treasuries and agency debt, and further restrict variation margin to just cash and treasuries. Principal Life believes that an expanded list of assets eligible as margin would greatly ameliorate the negative impact associated with new margin regulations while meeting the Regulators' goals of improving soundness in the derivatives market.

Request for Reconsideration on Proposed Rules

Therefore, this letter respectfully requests the Regulators reconsider the range of assets eligible for posting as initial and variation margin on uncleared swaps under the proposed rules. Of key importance to Principal Life is the ability to post high quality corporate bonds and MBS. We believe it is possible to develop criteria that satisfy the Regulators' concerns, yet permit financial end users to post highly liquid and high quality corporate bonds and MBS as eligible collateral for initial and variation margins. In addition, we believe the Regulators' rules limiting the scope of assets permitted or eligible as margin could have unintended consequences to the financial markets, which can be alleviated by expanding the list of assets eligible as variation and initial margin. Finally, we believe the current industry practice of bilateral collateral support arrangements provides an important risk management tool for insurers conducting derivatives trades, and the ability of insurers to demand collateral from its dealer counterparties should be preserved.

General Background

In general, life insurers' investment portfolios contain a broad spectrum of fixed income securities, including sizeable allocations to corporate bonds and Agency RMBS. Life insurers have traditionally provided the largest U.S. source of corporate bond financing, holding 13.5 percent of total U.S. corporate debt outstanding, which totaled over $2 Trillion at end of 2010.[3] Over 41 percent of corporate bonds purchased by life insurers have maturities in excess of 20 years (at the time of purchase). Approximately 56 percent of life insurers' $4.6 Trillion total assets in 2008 were held in bonds, with 42 percent composed of corporate bonds.[4] These investments by life insurers are indispensable to many American businesses in allowing them to cost-effectively raise capital. Moreover, these investments support life insurers' obligations that provide retirement and financial security for millions of Americans. In sum, the life insurance industry serves a key role in providing credit for U.S. businesses -- one especially crucial in the current economic climate--and these investments are of critical importance to the U.S. economy.

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[2] As general background to this discussion, we refer to the information provided by the American Council of Life Insurers in its comment letter submitted to the Regulators dated July 11, 2011 on the proposed rules. In particular, Appendix D contains a chart of the collateral commonly posted by its members under ISDA credit support annex (CSA) agreements.

[3] Statistics based on data from the NAIC and the U.S. Federal Reserve Board, Flow of Funds Accounts of the U.S. *See also,* American Council of Life Insurers, *Life Insurers Fact Book (2009).*

[4] See sources cited *supra* Note 3.

Currently, the OTC derivatives market permits life insurance companies like Principal to post a range of high quality and highly marketable securities as collateral for transactions documented under ISDAs.[5] This industry practice of pledging high quality and highly marketable securities to collateralize and secure "out-of-the-money" positions to "in-the-money" counterparties, permits insurers to minimize the investment performance drag it would otherwise have were it required to maintain cash and U.S. government securities availability in its portfolio to post as margin. Further, this industry practice performed well in the financial crisis, providing evidence that high quality corporate bond and Agency RMBS collateral do not jeopardize the stability of the financial markets. Other restrictions commonly found in such credit support arrangements, such as those addressing quality, liquidity, diversity, as well as the haircuts customarily applied to such collateral under credit support agreements,[6] mitigate risk factors associated with use of such assets as collateral.

Unintended Consequences of Limiting Securities Eligible as Margin

Rules permitting only cash and government securities as eligible collateral, while well-intended, may lead to undesirable and unintended consequences. It is critical that a broader range of securities be permitted as eligible initial and variation margin for non-cleared trades[7] to reduce volatility and improve market stability in times of stress. With appropriate criteria, including haircuts and risk management techniques, we believe it would be in the best interests of all market participants if dealers, FCMs, and DCOs were permitted to accept a broader range of high quality, readily marketable securities than simply cash and government securities. Further, the proposed rules requiring initial margin and limiting the assets eligible for initial and variation margin on uncleared trades will inevitably increase the cost of OTC derivatives transactions for all end users.

As drafted, the proposed rules for eligible collateral will to push life insurers to: 1) alter investment portfolio allocations--i.e., divest part of normal investment holdings in Agency RMBS and corporate bonds in order to establish and maintain a pool of cash and low-yielding assets eligible to meet expected margin needs; and/or 2) convert non-eligible assets into assets eligible for margin as needed--i.e., maintain existing investment portfolio allocations in corporate bonds and Agency RMBS and rely on secondary transactions (such as repo transactions, etc.) to "transform" non-eligible assets into eligible collateral only when needed.

Each of these two alternatives increases risk to life insurers and their policyholders, adds unnecessary costs to the prudent use of derivatives for risk mitigation, and introduces additional risk to the broader economy that may lead to unintended and undesirable consequences.

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[5] See *supra* Note 2.

[6] See Appendix D to ACLI comment letter cited *supra* Note 2.

[7] In addition, it is essential that life insurers and other financial end users be permitted to post a broader range of securities for initial margin on cleared trades as well, and many of the grounds set forth herein with respect to broadening eligible securities for uncleared swap margin equally apply towards broadening the range of securities eligible for margin on cleared trades.

Altering Investment Portfolio Allocations to Margin-Eligible Assets

Life insurers' investment management strategies are designed to create portfolios that will generate sufficient yields to satisfy obligations to policyholders without undue risk. Under the first scenario described above, life insurers might be forced to divest a portion of their investments in corporate bonds and Agency RMBS in order to increase holdings of assets that qualify as eligible collateral. Because the assets that qualify as margin under the proposed rules are near non-yielding (as in the case of cash) or very low yielding assets (as in the case of Treasuries), insurers may be forced to increase allocations of high yield, riskier assets and/or raise prices to make up for lost yield in order to meet their policyholder obligations. In addition, insurers may choose to reduce their hedging activities to decrease costs, which would increase risk and also adversely impact consumers of their products.

The divestiture of corporate bonds and Agency RMBS to non-productive or idle cash and low yielding Treasuries will divert capital from the private business sector that could otherwise contribute to economic growth and recovery and job creation. This inefficient use of capital will tighten credit flow, and reduce overall demand for high-quality corporate bonds and Agency RMBS, thus removing sources of funding and capital for U.S. businesses and the residential housing market. Consequently, this policy will lead to higher borrowing costs for corporations and residential homeowners alike and a less efficient and less competitive economy. During the recent financial crisis, lawmakers strongly criticized banks and large corporations for sitting on large reserves of cash rather than investing or extending credit to facilitate economic growth. The proposed rules will potentially exacerbate this situation by diverting assets that could otherwise provide much needed credit for corporations trying to grow and expand and for individuals seeking credit to finance the purchase or refinance of a home.

Converting Assets into Eligible Collateral "As Needed"

Under the second scenario, insurers would continue to maintain portfolio allocations in high quality corporate bonds and Agency RMBS (thereby reducing the yield drag of holding eligible collateral in reserve), but they would be required to convert such assets into eligible margin when initiating new hedge trades and as necessary to meet margin calls on existing trades. Such conversion will occur through outright bond sales or through a variety of financing arrangements or "secondary transactions"[8] such as repurchase transactions, securities lending, etc. These conversion transactions will provide profit for dealers and their affiliates in normal stable markets (at the expense of life insurers and their policyholders[9]), but they could make insurers more dependent on the availability of such secondary financing transactions--and the willingness and ability of dealers to continue such activity during times

[8]Indeed, the Regulators recognize such secondary transactions would occur. See Federal Register proposed rules at page 27578: "[C]ounterparties that wish to rely on other non-cash assets to meet margin requirements could pledge those assets with a bank or group of banks in a separate arrangement, such as a secured financing facility, and could draw cash from that arrangement to meet margin requirements."

[9]As in the first scenario, these additional costs will be passed to consumers in the form of higher prices, less risk mitigation through hedging and/or reduced product offerings at a time when Americans need additional assistance securing their financial futures.

of market turmoil. And, even though dealers may profit from such asset conversion activities, it is not at all certain that they will be able or willing to continue to provide such conversions, converting insurer investment portfolio assets into the few margin-eligible assets in all circumstances, particularly during periods of market stress. Such market stress could be increased as insurers and other financial end users simultaneously seek liquidity for non-eligible assets in a market that is unable to absorb the demand for asset conversions efficiently. Such liquidity pressure could be further exacerbated if market conditions create additional margin calls[10] which in turn result in even more demand for liquidity, continuing the downward spiral.

To the extent that insurers are using derivatives trades (cleared or uncleared) solely for hedging purposes, any loss in the market value of swap contracts should be offset by gains in the underlying assets/liabilities they are hedging. Therefore, the overall net risk positions of hedged insurers should not change due to derivatives activities, even in stressed market conditions. The problem is that, by not permitting a broader range of securities, such as high quality corporate bonds and MBS as margin-eligible, the regulations force insurers into the financial system for additional liquidity for collateral transformation. Such liquidation and transformation activities cause additional distortion in the market in times of stress, and would worsen liquidity demands on insurers and on the financial system as a whole during the most inopportune time. Therefore, margin related transformation or asset liquidation activities should be limited to those circumstances where there is actual counterparty default, rather than a need to secure margin-eligible assets (from the narrow list of margin-eligible assets) for ordinary derivatives margin purposes.

Actions taken on secondary transactions to comply with cash margin requirements (i.e., to sell or repo corporate bonds or MBS) across the derivatives markets during periods of market stress would only increase market sell offs and distort markets further, creating even more uncertainty. These chain reactions could set off a classic downward spiral (similar to the 1987 crisis caused by portfolio insurance rebalance strategies) and, in extreme scenarios, could lead to a full blown market crisis – the very scenarios the legislation is trying to prevent. As discussed earlier, the posting of high quality corporate bonds and MBS in OTC transactions has proven to have worked well during the last financial crisis. Accordingly, broadening the eligible margin classes in the proposed rules, to include high quality corporate bonds and Agency RMBS, would alleviate these liquidity issues, reducing systemic liquidity crunch in the financial markets in situations of market stress, which is consistent with the goals of the Dodd Frank Act.

At the end of the day, life insurers (and other similar investors) will need to find a way to use corporate bonds and MBS securities to meet margin requirements, whether the regulations permit dealers to accept them directly or not, because these are the assets such investors have in their portfolios. It's really a matter of whether the extra step and expense of transforming or selling those high quality and readily marketable securities will be required to convert them into cash and government securities, or whether this interim machination can be avoided by

[10] Such margin calls could occur in both uncleared derivatives transactions as well as the secondary transactions used to acquire margin-eligible assets, thereby causing even more market pressure.

posting such assets directly under prudent risk management standards. Not allowing their use is equivalent to removing liquidity from the system during market stress and may induce or further provoke a liquidity crunch. Indeed, a regulatory requirement of allowing only cash and Treasury securities seems to counteract likely public policy action to calm market crisis, which is to inject liquidity to the system.

The Proposed Rules Should Expand Securities Eligible as Margin to Include MBS and High Quality Corporate Debt

We recognize that it is challenging to develop requirements for investment grade debt without reference to traditional ratings, in light of the Act's requirement to remove ratings of nationally recognized statistical rating organizations (NRSROs) from federal regulations. Broadening the types of liquid and marketable securities as eligible collateral for initial and variation margins, so as to include U.S. Agency MBS, would satisfy this concern regarding references to traditional credit ratings. Agency MBS (having an implicit guarantee by the U.S. government) are high quality, and are some of the most liquid and highly marketable securities in the market. Similarly, with appropriate risk management techniques and haircuts, we believe the Regulators could also address the challenge of not using traditional credit rating references for corporate bonds.

Principal Life asks that you consider the proposal on this point made by the American Council of Life Insurers ("ACLI") in its letter submitted to the Regulators on July 11, 2011. The ACLI letter provides an analysis and methodology for use of corporate bonds, based on one of the most severe, if not the most severe, economic downturns in history. ACLI's proposal demonstrates (almost to the level of statistical certainty) that the proposed margin positions would provide enough cushion even against some of the most severe economic downturns. Permitting a broader list of eligible collateral for both initial and variation margins achieves the need to secure derivatives positions and minimizes the liquidity stress and other unintended consequences described above.

Should the Regulators disagree with some particular aspect of the ACLI proposal, we hope that the Regulators would remain open to investigating other alternative criteria for corporate bonds, such as using (in whole or in part) regulatory capital standards already in existence for market participants, such as state insurance reserves standards adopted by the NAIC, or Tier One capital criteria for federally regulated banking entities, or other alternatives which can also provide reasonable criteria for determining whether a corporate bond is of high quality and sufficiently liquid to satisfy regulatory concerns. This might include CDS spreads on issuers of corporate bonds, issuer financial criteria, etc. Principal Life is committed to working with the Regulators to address their concerns with the alternatives available and to establish criteria that would broaden the classes of securities eligible as margin.

Consistency Among Regulators

Principal Life respectfully requests that the Regulators, to the extent possible, coordinate final rules so that margin posting requirements are consistent across dealers. Consistency will reduce complexity attributable to implementation and compliance with the new uncleared margin rules. Such efforts will reduce potential confusion and operational errors, and costs of implementation attributable to systems, training, documentation, accounting, as well as such ongoing accounting and operational costs. It will be more difficult for end users to build and operate internal systems where there are differing requirements amongst dealers. Consistency will also reduce the impact on end users of bank "push out" activities. Finally, to the extent practicable, the U.S. regulations should be consistent with foreign regulations, in particular those of the European Union.

Uncleared Swaps Should Not Be Discouraged During Evolution of Cleared Swap Market

The proposed rules establish initial margin requirements for uncleared swaps that are designed to incentivize market participants to move OTC transactions to clearinghouses. While Principal Life supports reducing risk to the financial system through the use of clearinghouses, the Regulators must consider that during the near-term evolution of the cleared swaps market, there will be a limited number of cleared swap transactions available to life insurers to mitigate the risks inherent in their asset and liability portfolios. Accordingly, Principal Life will need to continue to rely on liquid, efficient and cost effective OTC markets for a large portion of their hedging activities. Such swaps enable Principal Life to more exactly match the underlying asset or liability that it is hedging, while addressing hedge accounting standards.

Principal Life requests that the Regulators adopt an implementation approach that promotes risk mitigation transactions during this evolutionary period. The Regulators should implement initial margin rules for financial end users in a manner that does not penalize use of uncleared swaps to hedge risks while awaiting the development of the cleared product market. As such, initial margin formulas designed to drive hedging transactions to cleared swap markets should only apply when a reasonable cleared swap alternative exists.

To the extent the proposed rules are designed to incentivize end users to clear trades by imposing higher initial margin levels on uncleared trades, implementation of the new margin rules should be delayed to permit and reflect a realistic time-frame for clearinghouses to develop and list a range of transactions available for clearing. It would be unfair for insurers and other financial end users to incur new and increased levels of initial margin for transacting uncleared trades if realistic cleared transaction alternatives do not exist to meet the needs of companies conducting hedging transactions. Further, to the extent the final rules on margin for uncleared swaps require (or permit) reference to or incorporation of initial margin models for similar cleared transactions (or multiples thereof), and require even higher levels of initial margin where a similar cleared model does not exist, the rules should be phased in before imposing these additional margin requirements on low risk financial end users, to allow time for clearinghouses to develop, and regulators are able to approve, a wide range of margin models. Similarly, end users should not be forced on to clearinghouses before the clearinghouses are fully operational, end users have had adequate time to build necessary infrastructure, and systems for clearing have been implemented across the broader market, with adequate volumes to promote liquidity. Therefore, implementation of initial margin rules for uncleared trades should parallel the implementation of clearing, to the extent that it is phased in by asset class or type of counterparty.

Phase In of Effective Date of Rules Implementation Requested

Principal Life respectfully requests that the Regulators delay the effective date, implementation or enforcement of the final rules regarding margin on uncleared swaps, to allow Regulators time to fully develop and approve criteria for an expanded list of securities eligible as margin. To the extent Prudential Regulators are able to broaden the range of securities eligible as initial and variation margin on uncleared trades, life insurers' needs to establish margin "transformation" relationships will be diminished. If Prudential Regulators are unable to grant such relief to the life insurance industry, and to the extent the levels of initial margin increase for uncleared trades over that required for cleared trades, Principal Life respectfully requests a longer phase-in period of the uncleared margin rules to permit the development and listing of an expansive range of OTC trades for clearing and to permit life insurers time to adapt their investment portfolios, and reflect these increased costs in their product pricing and otherwise adapt their business models.

Finally, we ask you to consider the following additional issues and factors in setting the effective date for low-risk financial end users:

- The final rules for margin on uncleared swaps should be consistent, to the extent possible, across the various regulators. It is anticipated that these rules will be enduring and will have a significant and lasting impact on the financial markets and end users. Prudential Regulators should take time to consider, deliberate and coordinate with the CFTC and SEC before issuing final rules on margin for uncleared trades.

- Delayed implementation would permit life insurers opportunity to study the final rules and determine the impact of the new regulatory regime from legal, compliance, as well as accounting and financial reporting standpoints, and reconcile issues arising from implementation of the new rules regimes, including conflicting state law or insurance regulation.

- Financial end users will struggle to meet the overwhelming cumulative documentation load required across the derivatives reforms once final rules are released. To the extent financial end users have OTC trading relationships with numerous dealer counterparties (including, in some cases, with various affiliated entities or newly created affiliates as a result of the bank "push out" rule), they will need adequate time to negotiate new agreements or amendments to existing master trading agreements (and, if applicable, related segregated account documentation) that conform with the new requirements. If any processes are outsourced, onboarding demands and documentation will further strain market participant staffs. During this time, documentation must also be negotiated to establish new clearing and SEF trading relationships and address margin segregation requests. Special entities may need to document engagement of an independent representative. Further delays may result when foreign regulatory reforms are finalized, should foreign counterparties be forced to reconcile and address aspects of local derivatives reforms in their trading agreements. The aggregation of documentation and resulting strain on market participant resources and should not be underestimated. Delayed or phased-in implementation will ease this burden.

- All financial end users will have to reallocate resources to implement the new, sweeping reforms. Some market participants will be required to set up and test new internal systems, or outsource core or ancillary processes to implement the new rules, and clearing of trades, and the broader regulatory regime. Additional staff may need to be hired, trained and be incorporated into existing systems. Internal control plans may need to be revised and subject to review or approval of state regulators. Delaying implementation or phasing in low risk financial end users last will not only permit insurers to address the legal and operational challenges ahead, it will permit them to assess and undertake a deliberate plan and steps towards implementation which will reduce potential confusion and errors and minimize the cost burden.

Conclusion

The proposed rules establishing initial margin amounts and limiting the scope of eligible collateral for uncleared swaps are major concerns for Principal Life. We respectfully request that the Regulators (i) expand the definition of eligible collateral to include both high quality corporate bonds and Agency RMBS, and (ii) reconsider their position on initial margin to ensure that such requirements do not penalize life insurers' continued use of uncleared swaps while the cleared swap market evolves and (iii) formulate an implementation plan that takes into consideration the strain on market participants and eases market disruption during this historic change in derivatives regulation.

We greatly appreciate this opportunity to share our concerns. Please let me know if you have any questions concerning these comments, or if we can provide additional information.

Sincerely,

Julia Lawler
Chief Investment Officer