**Carl B. Wilkerson**
*Vice President & Chief Counsel, Securities & Litigation*

August 5, 2016

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Re: Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions (the "Proposed Rule").[1]

By Electronic Submission

Dear Mr. Frierson:

The American Council of Life Insurers (ACLI) is a national trade association with 280 member companies that represent 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Our members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance that 75 million American families rely on for financial and retirement security.

Life Insurers have actively participated in the dialogue surrounding the regulation of domestic and international financial markets, and have provided constructive input on a myriad of proposed rulemaking, including the implementation of Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act" or DFA). We greatly appreciate the opportunity to share our views on the above-captioned Request for Comment from the Board of Governors of the Federal Reserve Board (the "Board").

## Summary of Position

The Proposed Rule, applicable to US Global systemically important banking organizations (a "GSIB"), their affiliates and US subsidiaries of foreign GSIBs (a "Foreign GSIB") (collectively the "Covered Entities"), would, if adopted in its current form, prohibit trading counterparties of such Covered Entities (the "QFC Counterparties") from exercising certain termination rights in respect of Qualified Financial Contracts ("QFC's"). Specifically, the Proposed Rule would; (i) prevent QFC Counterparties from exercising "cross-default" termination rights with a GSIB affiliate (the "GSIB Affiliate") resulting from the insolvency of its GSIB parent holding company, and (ii) impose a 48 hour stay on the termination of QFC's guaranteed by a GSIB parent to the extent such parent becomes insolvent. The Board has also solicited commentary regarding the restriction of default rights by QFC Counterparties that are

[1] 81 Fed. Reg. 29169 (May 11, 2016) [https://www.gpo.gov/fdsys/pkg/FR-2016-05-11/pdf/2016-11209.pdf]

***American Council of Life Insurers***
*101 Constitution Avenue, NW, Washington, DC 20001-2133*
*(202) 624-2118 t (866) 953-4096 f carlwilkerson@acli.com*
***www.acli.com***

related directly or indirectly to the insolvency of a Covered Entity, including a default based on the financial condition of such Covered Entity.

We acknowledge that the intent of the Proposed Rule is to "improve the orderly resolution of a GSIB by limiting the disruptions to a failed GSIB through its financial contracts with other companies," and recognize that "the failure of one entity within a large financial firm can trigger disruptive terminations of [QFC's"].[2] However, we have strong concerns that the Proposed Rule, while mitigating certain risks to the banking system, would have the consequence of undermining the safety and stability of the broader financial markets by increasing market and credit risk to the QFC Counterparties of a GSIB. As other industry groups have indicated, there are serious consequences for end-users of derivatives in circumventing the legislative process. We would also like to respond to your invitation for comment on specific points relating to the scope and application of the rule to default rights, cleared swaps and the safe harbor offered for use of the ISDA Universal Stay Protocol.

## Detailed Comments

### I. The Proposed Rule's Modification of QFC Cross Default rights exposes non-defaulting QFC Counterparties to additional market and credit risk, usurps legislative authority and violates public policy procedures.

***"Specified Entity" Cross Default***.

Most master agreements between a QFC Counterparty and a GSIB Affiliate contain a "Specified Entity" cross default provision (the "Cross Default Termination") that allows a QFC Counterparty to terminate and close out all transactions under such master agreement upon the insolvency of the GSIB parent, irrespective of whether such GSIB parent is providing a guarantee for the GSIB Affiliate. This protection is important to QFC Counterparties as most GSIBs utilize a GSIB Affiliate to execute QFC transactions. The Proposed Rule would eliminate this Cross Default Termination and thereby force the QFC Counterparty to await the default or insolvency of the GSIB Affiliate before terminating a QFC. We believe that eliminating Cross Default Termination rights materially undermines the ability of QFC Counterparties to effectively manage and mitigate their exposure to market and credit risk as the risk of default by the GSIB Affiliate accretes over time.

In the context of defining the credit risk of a debtor's ability to repay an obligation, the strong correlation between affiliates and the primary debtor have made cross default provisions a cornerstone of bank financing transactions. This rationale applies equally in the context of a QFC Counterparty with a significant "in the money" QFC position against a GSIB Affiliate. Cross Default Termination rights act as an early warning barometer for the gathering storm of default, and have been used effectively by QFC Counterparties to reduce market exposure in deteriorating credit environments. Indeed, the mitigation of market exposure benefits both the QFC Counterparty and the GSIB Affiliate, allowing for a reduction of QFC positions over time through orderly unwinds. The Proposed Rule, however, would require QFC Counterparties to sit idly and without recourse in an environment of increased market and credit risk while waiting for the GSIB affiliate to default or declare insolvency. We recognize that the Board has focused primarily on the risks concentrated within GSIBs and their affiliates. However, we believe that the Board has not adequately assessed

[2] Id. at 6.

the magnitude of potential ancillary risk that the Proposed Rule could inflict on QFC Counterparties and the broader financial markets.

By way of example, we note that QFC Counterparties of Lehman Brothers Special Financing, Inc. ("LBSF") (the primary swap dealer within the Lehman enterprise) whose master agreements contained a Cross Default Termination linked to the insolvency of Lehman Brothers Holdings Inc. ("LBHI"), were able to terminate their QFC's on September 15, 2008 (the date of LBHI's bankruptcy filing) prior to the insolvency of LBSF on October 3, 2008. Had the Proposed Rule been in effect during the Lehman Bankruptcy in September of 2008, the non-defaulting QFC Counterparties of LBSF would have been exposed to the attendant market risk between September 15 and October 3, 2008. There is no evidence to suggest that the orderly liquidation of appropriately margined QFC positions contributes to the financial distress of Covered Entities.

While the Proposed Rule directly regulates only 8 GSIBs and 21 Foreign GSIBS[3], its ancillary impact will affect countless QFC Counterparties that are foreclosed from exercising their Cross Default Termination rights. The contagion that the Board seeks to control within the banking system would be shifted to the broader financial markets as the ability to immediately terminate QFC transactions with GSIB Affiliates of an insolvent GSIB parent is forestalled and market conditions deteriorate. We recognize that the Cross Default Termination rights create competing demands between the banking system and larger financial markets which requires an appropriate and thoughtful balancing of risks. The US Congress, however, has already carefully considered this balance when enacting the various exemptions to the Automatic Stay in the US Bankruptcy Code, including the contractual rights of Cross Default Terminations.

For federally regulated banks and QFC Counterparties, Cross Default Termination provisions are important rights in bilaterally negotiated commercial contracts between sophisticated market participants. These rights should not so easily be waived for a single class of commercial entities in the name of risk mitigation when there are other market neutral risk mitigation solutions available that do not shift credit risk of transactions inequitably from one party over to another. Accordingly, we urge the Board to consider the broader financial market effects of this component of the Proposed Rule and the additional market and credit risk that QFC Counterparties would incur as a consequence.

**48 Hour Temporary Stay.**

Similarly, the Proposed Rule would impose a temporary 48 hour stay (the "Temporary Stay") on the termination and liquidation of any QFC's executed between a QFC Counterparty and a GSIB Affiliate that is guaranteed by the GSIB parent. This provision, like the exclusion of the Cross Default Termination rights, exposes the non- defaulting QFC Counterparty to an additional 48 hours of credit risk while it awaits a direct default by the GSIB affiliate or a lifting of the Temporary Stay. The purpose of the Temporary Stay, similar in concept to the temporary 1 day stay period for QFC's under the orderly liquidation authority (the "OLA") in Title II of the Dodd-Frank Act, allows the Board to transfer obligations of an insolvent GSIB or Foreign GSIB to a "bridge bank," including any obligations to guarantee a GSIB Affiliate. However, a Temporary Stay under the Proposed Rule would be imposed without any assurance that immediate remedial measures to enhance the creditworthiness of the insolvent GSIB parent in support of the GSIB Affiliate guarantee would be forthcoming. Indeed, the success of any temporary stay, whether under the Proposed Rule or the OLA, turns on the immediate and guaranteed availability assets in a "bridge bank" to assume the obligations of a failed GSIB. Without articulating or assuring the appropriate measures to strengthen the financial condition of the

[3] Id. at 68.

failing GSIB, the Temporary Stay is an empty endeavor and merely allows the accumulation of additional market risk by both QFC parties during its pendency.

The OLA represents a formidable tool available to the Board for resolving an insolvent GSIB. To the extent that a financially troubled GSIB poses systemic risk to the financial markets we agree that the most appropriate measure is for the regulator avail itself to the powers and remedies provided for in the OLA. However, the ability to balance the interests of the GSIB and the QFC Counterparty depends largely on the strength of the "bridge bank" facility. We have strong concerns that the Board has not provided adequate assurances regarding the nature of the resources they are willing to commit to ensure the efficacy of a "bridge bank" facility, or the specific timing regarding the deployment of such resources. As stated previously, an efficient market is predicated on the predictable and rational behavior among market participants. Until such time that the Board provides specific guidelines pertaining to the financial strength and powers of a "bridge bank," the financial markets will view such facility, and the associated Temporary Stay provision, with a large degree of uncertainty that will create market inefficiencies and instability. Accordingly, we urge the Board to eliminate the Temporary Stay provision from the Proposed Rule.

**Proposed Rule Usurps Legislative Authority and is Contrary Public Policy.**

Both the Cross Default Termination exclusion and Temporary Stay provisions of the Proposed Rule violate public policy and circumvent the legislative process by creating a defacto amendment to the US Bankruptcy Code. Although the Proposed Rule applies to only 8 GSIBS and 21 foreign GSIBs, countless QFC Counterparties will be foreclosed from exercising their rights of cross default protected under Section 362 of the US Bankruptcy Code.[4] We believe that the suspension of a QFC Counterparty's right of cross default, emanating from the US Bankruptcy proceeding of a GSIB parent holding company,[5] represents a legislative change that is the province of the US Congress and not the Prudential Regulators. Consequently, any modification to the cross default rights of a QFC Counterparty that is subject to the US Bankruptcy Code must necessarily be effected through an amendment to the Bankruptcy Code by the US Congress.

The Proposed Rule creates potential unintended risks to the orderly functioning of the US financial markets and, from a procedural perspective, is contrary to established public policy. We strongly urge the Board to eliminate the Cross Default Termination and Temporary Stay provisions of the Proposed Rule. In reassessing this provision, we respectfully suggest that the Board consider the additional safeguards that have been established to ensure market stability during the liquidation of QFC's, including the robust variation and initial margin provisions of the Dodd-Frank Act[6] as well as the remedies available in the OLA.

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[4] See U.S. Bankruptcy Code, 11 U.S.C. Section 362(b)(6),(7), and (17), which excludes contractual rights related to certain "qualified financial contracts" from the automatic stay in Section 362(a). the term "qualified financial contracts" includes commodity contracts, forward contracts, securities contracts, repurchase agreements, and swap agreements, which for each excluded contract or agreement also includes the right to offset or net out any terminate value, payment amount, or other transfer obligation.

[5] ACLI s' understanding is that the exclusion for "qualified financial contracts" under Section 362(b) of the US Bankruptcy Code from the automatic stay under Section 362(a) applies to rights resulting from direct defaults as well as rights arising from some (but possibly not all cross defaults).

[6] See Final Rule, Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 81 Fed. Reg. 636 (Jan. 6, 2016).

## II. Rules promulgated by the Board to restrict the exercise of default rights by QFC Counterparties related directly or indirectly to the insolvency of a Covered Entity, including a default based on the financial condition of such Covered Entity, would undermine a QFC Counterparty's ability to mitigate credit exposure.

The Board solicited commentary regarding the promulgation of rules that may seek to restrict the exercise of default rights by QFC Counterparties that are related directly or indirectly to the insolvency of a Covered Entity, including a default based on the financial condition of such Covered Entity. We urge the Board to withhold taking any regulatory action that would require QFC Counterparties to surrender the power to anticipate and avert impending market risks before they become a crisis. In particular, the ability to terminate a QFC with a GSIB Affiliate based upon a direct credit rating downgrade or the downgrade of its GSIB parent.

Inclusion of default provisions in QFCs that are linked to the pre-insolvency credit rating downgrade of a counterparty is a common market practice and an invaluable risk mitigation tool for financial market participants. The continued viability of any QFC following its execution is inexorably linked to the financial stability of each counterparty to the transaction. An efficient market creates incentives and disincentives among market participants and results in predictable market behavior. When the market perceives that an institution is vulnerable, market participates are incentivized to move away from these institutions and reduce their outstanding credit exposure. Likewise, the "invisible hand" of an efficient market benefits the vulnerable institution, as market forces reduce the total risk profile of such institution until it reaches acceptable levels.

QFC credit rating downgrade triggers are one such component of an efficient market and create predictable and rational behavior among market participants. Credit rating downgrade default provisions act as an early warning signal of impending financial trouble and allow institutions to act prudently in a pre-crisis environment. The inability of a QFC Counterparty to exercise its right to terminate a QFC upon a credit rating downgrade creates inefficiency in the market which exacerbates the accumulation of credit risk for QFC Counterparties and the broader financial markets. Further, the Board has failed to adequately make the case that credit downgrade triggers in QFC transactions increase the risk that a downgraded GSIB will become insolvent as a result of the unwind of QFC's containing these credit protections where such transactions have been appropriately collateralized. In the absence of such evidence, removal of these important risk mitigation tools for QFC Counterparties, including insurance companies, increases the market and credit risk to those counterparties that rely on such rights to protect their customers.

Moreover, insurers are subject to the various state insurance laws that govern their QFC transactions, most of which impose strict counterparty credit rating guidelines and limits. If an insurer was precluded from terminating QFC transactions upon the credit rating downgrade of a bank counterparty it may find itself in violation of the state insurance law counterparty credit limits. Similarly, the claims paying ability of an insurance company is critical to its business model and the ability to sell products. Any provision that could significantly limit an insurance company's ability to manage the ratings quality of its investments after a downgrade event by QFC counterparty could have a direct negative impact on an insurer's own ratings.

The credit rating downgrade default mechanism is an invaluable tool that allows QFC counterparties to reduce market risk in a declining credit environment as well as incentivizing efficiency in the overall financial markets. For insurers, this mechanism is an essential component for ensuring compliance

with state mandated counterparty credit limits as well as appropriately managing assets and liabilities for the benefit of its customers. Any provision in the Proposed Rule that seeks to limit a QFC Counterparty's ability to terminate a QFC transaction based on additional termination events such as the credit rating downgrade of a covered Entity would severely disrupt the efficiency and safety of the financial markets. Accordingly, we strongly oppose any regulatory initiative that would alter or suspend these important contractual rights.

## III. The Universal Protocol has several undesirable features that would make adherence a burden for life insurers and that do not provide significant policy benefits to the Board.

We appreciate the invitation to comment on the Proposed Rule's approach to treat as compliant with section 252.84 of the proposal any covered QFC that has been amended by the ISDA 2015 Universal Resolution Stay Protocol ("Universal Protocol"). In describing this safe harbor, the Board catalogues significant differences between the Universal Protocol and the Proposed Rule. It points out that the Universal Protocol:

> (1) Requires adherents to give up fewer rights than what is required under the Proposed Rule;
> (2) Allows non-defaulting counterparties to exercise default rights in a broader range of circumstances than does the Proposed Rule; and,
> (3) Provides additional credit protections to adherents to the Universal Protocol not obviously available under the Proposed Rule.

The Board determined, however, that these features "do not appear to materially diminish the prospects for the orderly resolution of a GSIB entity because the Universal Protocol includes a number of desirable features that the Proposed Rule lacks."[7] For example, the mechanics of the Universal Protocol require adherents to adhere to the Universal Protocol with respect to all Covered Entities. The Board has determined then that, on balance, the benefits of the Universal Protocol are significant.

The Board's discussion of the benefits and costs of the Universal Protocol fails to consider several undesirable features of the Universal Protocol that would make adherence a burden for life insurers without providing any significant policy benefits to the prudential regulators or the U.S.-based GSIBs over which they have jurisdiction.

For example, adherence to the Universal Protocol requires the adherent to give up rights in "Protocol-eligible Jurisdictions," which include jurisdictions that have not yet adopted the laws to which our adherence would make us subject. Asking life insurers and other buy side firms to agree to be bound by rules that have yet to be written in jurisdictions outside the U.S. introduces significant market, compliance and geopolitical risk into life insurers' ability to manage their global business, while providing no obvious countervailing benefits. In addition, adherence to the Universal Protocol requires an adhering party to amend its contracts with all other adhering parties. Since new adherents

[7] Footnote 106 of the Proposal also mentions that ISDA is expected to develop a United States module for its ISDA Resolution Stay Jurisdictional Modular Protocol (the Modular Protocol) and specifies that - if that module is "substantively identical to the Protocol in all respects aside from exempting QFCs between adherents that are not covered entities or covered banks" – such a module would be "consistent with the current proposal."

can join at any time, this feature makes it difficult for firms to track which of its contracts have been amended on a day-to-day basis and results in substantial over compliance, the cost of which is not considered by the Board.[8] It is no surprise that the Universal Protocol is a bad fit for buy side entities in the market. Indeed, it was not crafted with the buy side in mind. The ISDA website for the Universal Protocol itself admits that **"[w]hile any entity may adhere to the ISDA 2015 Universal Protocol, it is expected that the buy side generally will not adhere to the ISDA 2015 Universal Protocol, but instead to the ISDA Resolution Stay Jurisdictional Modular Protocol (ISDA JMP)."**

Accordingly, we ask that the Board clarify expressly that adherence to a Modular Protocol containing substantially the same features as the Universal Protocol but that allows buy side firms to adhere on a jurisdiction-by-jurisdiction basis and on a dealer-by-dealer basis would also qualify for the same safe harbor treatment given to the Universal Protocol. In the alternative, a Modular Protocol that allowed adherents to adhere with respect to a known universe of Covered Entities (rather than adhering with respect to all other adhering entities) would have the benefit of allowing life insurers to know the universe of contracts affected, while still allowing the Board to gain each adherent's compliance with respect to all Covered Entities rather than one or a subset of them.

## IV. The Proposed Rule Should Not Apply to Cleared Swaps, which are already subject to Default Management Practices and Procedures at the Clearinghouses.

In response to the Board's question regarding the proposed exclusion of cleared QFCs, we believe that the Proposed Rule should have the narrowest application necessary to achieve its goals. The goal of creating central counterparties was to introduce greater financial stability in times of crisis impacting the derivatives market by imposing clearing requirements on participants. The Clearinghouses have their own regulatory regime, risk management and governance systems, including default management procedures that would allocate risk among its members, which mitigates against the type of close-out risk that the Proposed Rule is attempting to address in the OTC derivatives market. This reduction of risk greatly reduces the need for including cleared swaps within the scope of the Proposed Rule. In addition, inclusion of cleared swaps may only result in increased compliance costs to Clearinghouses which will be passed on to those entities trading on the relevant exchanges without any material offsetting benefit in terms of risk reduction. Accordingly, the Clearinghouses should have flexibility, in accordance with their own rules and regulatory guidance under the oversight of their own regulators, to address these risks by implementing those plans and procedures currently in place. We do not believe it is necessary to impose the Proposed Rule on cleared swaps in order to achieve the desired regulatory goals.

In addition, we would ask that the scope of the clearing exemption be clarified to explicitly cover the entire clearing relationship, including the customer leg of an agency clearing relationship.

[8] Any Modular Protocol that was "substantively identical" to the Protocol would contain these same features.

**Conclusion**

Thank you for your attention to our views. If any questions develop, please let me know.

Sincerely,

Carl B. Wilkerson

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