June 3, 2011

Susan E. Voss, President
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

James R. Mumford, Chair
Receivership and Insolvency (E) Task Force
National Association of Insurance Commissioners
2301 McGee Street, Suite 800
Kansas City, MO 64108-2604

Re: NAIC Receivership and Insolvency Task Force
Insurer Receivership Model Act (#555) Section 711 – Request for Comment

Dear Commissioner Voss and Chairman Mumford:

The International Swaps and Derivatives Association, Inc. (ISDA)[1] appreciates this opportunity to provide comments on Insurer Receivership Model Act (#555), Section 711 and the issues noted in the March 27, 2011 memorandum to the Receivership and Insolvency (E) Task Force from NAIC Staff.

The topic of 'close-out netting' with respect to derivatives transactions is an important issue not only in the United States, but worldwide, and is an issue for both end-users and dealers alike. Further, as the derivatives market has grown the implications of close-out netting and its impact on the worldwide financial markets and economies around the world have grown in importance too.

Close-out netting is a concept that has long been recognized in jurisdictions that follow English law traditions. It was the advent of statutory laws – such as the U.S. Bankruptcy Code –that altered these established legal principals by seeking to restrict the ability of creditors in insolvency situations. In order to restore these long been recognized principals and to serve the policy goal of reducing 'systemic risk' in the banking system

1 Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers. Information about ISDA and its activities is available on the Association's web site: www.isda.org.

and financial marketplace, [2] over thirty-seven countries have enacted legislation that expressly recognizes close-out netting for derivatives transactions, including the U.S. with respect to debtors under the U.S. Bankruptcy Code and banks and broker-dealers. Further, in the wake of the 2008 financial crisis, many, including the Basel Committee on Banking Supervision, have reaffirmed their support for close-out netting. In fact, while Congress has carefully considered and debated nearly every facet of the derivatives market over the past year, culminating in the Dodd-Frank Wall Street Reform and Consumer Protection Act, the "safe harbor" provisions enacted by Congress to exempt the exercise of contractual rights under swap agreements from restrictions imposed by bankruptcy law in the event of a counterparty's bankruptcy remain unchanged.

Close-out netting refers to the process in which the obligations of two parties under an agreement, where one of the parties has defaulted, are terminated as of the same time and the positive or negative replacement values of all of the transactions between the parties under such agreement are netted into a single net amount which is then payable.

Close-out netting provides certainty to the financial markets, both in terms of valuation and timing. From a timing perspective, if a jurisdiction imposes a stay on the ability to terminate a derivatives transaction following a party's insolvency, then the counterparty's ability to isolate the market-value of the transactions by terminating them is impaired since the value of the transactions could fluctuate during the period of the stay, thus potentially exacerbating the credit impact of the default. Further, the inability to net the positive and negative values of transactions between the parties results in increased credit exposure between the parties. Based on statistics published by the Bank for International Settlements, as of June 30, 2010 the total notional amount of all outstanding OTC derivatives transactions was $582.7 trillion. The total gross market value of such transactions was $24.7 trillion (4.2% of the notional amount), and, after applying close-out netting, the total credit exposure of such transactions was only $3.6 trillion (0.6% of the notional amount), or a reductions of 85.5% from the gross market value. A similar study in the United States by the U.S. Office of the Comptroller of Currency in the 4th quarter of 2010 concluded that close-out netting reduced counterparty exposure at U.S. banks by 91.1%.

---

[2] "U.S. bankruptcy law has long accorded special treatment to transactions involving financial markets, to minimize volatility. Because financial markets can change significantly in a matter of days, or even hours, a non-bankrupt party to ongoing securities and other financial transactions could face heavy losses unless the transactions are resolved promptly and with finality." *see* H.R. Rep. No. 101-484, at 2 (1990), *reprinted in* 1990 U.S.C.C.A.N. 223, 224; "The bankruptcy of a swap market participant could cause significant market disruption. This arises from the risk that an outstanding swap transaction would be held open during the bankruptcy, despite contractual provisions for its termination. Also, there is the risk that a defaulting party or a trustee in bankruptcy could assume favorable swap transactions and reject unfavorable ones—so-called cherry picking—even though the swap contract calls for liquidation of these obligations by netting. The exposure created by these risks takes on special significance in a volatile market." *see* 136 Cong. Rec. S7536 (1990) (statement of Sen. Grassley).

In jurisdictions where close-out netting is not available, parties to derivatives transactions are forced to evaluate their transactions on a gross basis. This frequently results in much higher collateral requirements for the parties, since each positive or negative valued transaction is accounted for separately. Additionally, for the dealer counterparty, if it is a regulated banking entity, then it would also be subject to higher capital reserve requirements due to the increased credit risk associated with the counterparty and the gross close out position. The costs associated with such higher capital reserve requirements are then passed on to the end-user, to the extent that dealer counterparties are even willing to engage in such higher-risk transactions. As a result, counterparties located in jurisdictions where close-out netting is not available find it not only more difficult to execute derivatives transactions, but it is also more costly to execute such transactions.

In jurisdictions where close-out netting is not available, the higher costs and lack of liquidity in the derivatives market may lead some market participants to simply elect not to utilize derivatives. However, because derivatives are a tool to hedge particular risks that a party may otherwise face, they have the effect of reducing or negating the risks. Thus, for entities who elect not to hedge because of the higher cost or lack of access to products, the end result may be that such entities end up retaining risk that could have otherwise been hedged or reduced. In the U.S., it is our understanding that this currently is an issue for insurers domiciled in states that have not adopted IRMA Section 711 (the "Non-Model States"). As a result, insurers in Non-Model States find themselves at an economic disadvantage to entities, such as corporates and regulated entities such as banks and broker-dealers (all of whom have the benefit of close-out netting under either the U.S. Bankruptcy Code, or their applicable regulatory insolvency regime), since they don't have access to the same hedging and financial instruments, or, to the extent they do, they are more costly. Finally, it is also our understanding that the use of derivatives by insurers is already regulated under the insurance investment laws in most, if not all states. Accordingly, for insurers domiciled in Non-Model States, even though their local laws would otherwise permit them to engage in certain types of derivatives transactions, they may not able to, or may not be able to cost-effectively, utilize the same financial tools that their peers domiciled in other states have access to.

Finally, for your reference, we have included a copy of an ISDA Research Note on "The Importance of Close-Out Netting" which was prepared by ISDA in 2010 and provides a more in-depth analysis of close-out netting issues.

For the reasons stated above, ISDA urges the Task Force to carefully consider the implications of any modifications to IRMA Section 711 and the impact that it will have on the U.S. insurers. We would also welcome the opportunity to further discuss and/or elaborate on these issues with the Task Force at its convenience.

Sincerely,

Katherine Darras
General Counsel, Americas
kdarras@isda.org

cc: David Vacca
Ann Farr

[Enclosure]