Prudential

Mark B. Grier
Vice Chairman

Prudential Financial, Inc.
751 Broad Street, Newark, NJ 07102-3777
Tel 973 802-3398 Fax 973 802-3414
mark.grier@prudential.com

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The Honorable Mike Crapo
United States Senate
239 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Crapo,

I am writing in response to your June 16 letter requesting comments on proposals to alter the regulatory framework of over-the-counter (OTC) derivatives.

Prudential Financial Inc. appreciates and supports the efforts to ensure appropriate regulatory oversight of market participants and their derivative activities. Prudential further appreciates the opportunity to share with you how important customized bilateral contracts are for us in the over-the-counter derivatives market.

How does your company use customized over-the-counter derivatives to help stabilize prices and mitigate risk?

Prudential's use of OTC derivatives is essential to the product risk management and investment risk management of the assets and liabilities supporting all of its insurance and retirement products. Our products have complicated liability structures; we generally use customized OTC derivatives to tailor our asset portfolio to meet those liabilities. Additionally, customized OTC derivatives allow us precise hedging, which is required by the Financial Accounting Standard (FAS 133), and are the most effective means for mitigating risk and limiting undue volatility in Prudential's financial statements.

Specifically, Prudential uses customized OTC derivatives to mitigate common asset and liability mismatch risk that arises from our core business. For example, selling life insurance policies to individuals generates the need for Prudential to invest in a long, diverse fixed rate portfolio to fund future death benefits. Customized OTC interest rate swaps are purchased to align the future cash flows of the bond portfolio to the future liabilities. The more precisely we can match cash flows the more certainty we have in meeting our obligations. The customized OTC derivative market affords us that certainty.

Also, with a large fixed income portfolio diversification is essential to portfolio management. Some investments are made in currencies other than dollars to achieve this diversification. We use cross currency swaps to convert the foreign currency flows to dollars, and to align the assets with the corresponding liabilities. These customized OTC currency swaps match the material terms of the underlying bond: principle amount, floating index, spread, currency, payment dates and maturity date. There is no exchange–traded market for such a customized derivative because no two bonds are identical. Each corresponding hedge has unique terms and therefore is not fungible with others.

Many of our insurance and retirement products also contain minimum interest rate guarantees and/or minimum crediting rates. These portfolio risks are also mitigated using both standardized and customized derivatives.

As you know, Prudential has international operations. We protect our capital invested oversees by using asset swaps and currency forwards, thereby maintaining a US dollar capital base. We also convert foreign income to dollars using long dated currency forwards.

The final example to illustrate Prudential's use of customized OTC derivatives to help stabilize prices and mitigate risk relates to the tailored OTC derivatives hedges used in connection with our variable annuities and retirement products. Prudential offers annuity products with "high watermarks" tied to equity portfolios. These principal guarantees with guaranteed minimum incomes are all attractive features of our products, which serve to provide secure retirement income. It has been estimated that guaranteed annuity products such as ours collectively "saved" retirement savers $230 billion that otherwise would have been lost in the recent equity market collapse.

To hedge our exposure to these products, Prudential enters into "look-back" equity options with terms from one to ten years. These customized OTC derivatives have contractual terms that are carefully structured to manage the underlying risks of the products we sell. In each case the characteristics of the option will depend upon the amount of the risk to be hedged, the level and volatility of the referenced index (e.g., S&P, Russell), the look-back period, observation dates, etc. Once again, such customized OTC derivatives defy commoditization.

What are the possible effects of severely restricting access to customized OTC derivatives on your ability to manage risk and on the prices you charge your customers?

Without customized OTC derivatives, Prudential would be incapable of closely managing the risks created in selling life insurance, offering commercial loans, and providing annuities for retirement. Consequently without appropriate hedge tools the products we sell would have to be modified to place the additional risk on to the consumer or be eliminated from our product offerings. Even if Prudential and other insurers found a way to continue these core products, they would have to come at a higher cost to the consumer, because, absent precise risk- and volatility-reducing hedges, we would be subject to higher capital requirements. The higher costs of products would be passed on to consumers who would be buying an inferior product.

What safeguards are in place to ensure that your derivatives portfolio is a tool for hedging risk rather than a source of risk for your company?

There are several safeguards in place at Prudential to ensure derivatives are used for risk management and not a source of risk taking. Most importantly, all over-the-counter derivatives entered into by Prudential are managed and executed through one central entity, Prudential Global Funding (PGF). This unit acts as a central clearing house for the company, ensuring that the derivatives are used for their intended purpose and that the price movements of the derivative will move correspondingly with the asset or liability that is being hedged or replicated. PGF does not act as a dealer or market maker in derivatives but instead is part of our risk management culture. PGF measures the residual risk of the derivatives portfolio using a value at risk methodology. All positions are marked to market daily and their market value is stressed at two standard deviations. The risk of loss may not exceed $750,000 per day. This is monitored by both our Senior Financial Risk Management Officer, Treasurer and selected senior Investment professionals. Additionally, Prudential is subject to state (New Jersey, New York and Connecticut) regulatory oversight. PGF, as a wholly owned subsidiary of Prudential Insurance Company of America, is constrained by that regulatory oversight and its' parent balance sheet.

In your letter you address central counterparty clearing and exchange trading of relatively standardized contracts. At Prudential all derivative transactions are executed under master netting agreements and a credit support annex. Collateral is exchanged between us and our counterparty representing the net present value of the transactions, much the way daily variation margin is used by the futures exchanges. However, the exchanges require cash and government securities be posted for collateral. We post corporate bonds. Requiring standardized contracts to be centrally cleared would lead to increased cost of maintaining our collateral arrangements. Furthermore, having customized contracts separately collateralized with a counterparty may increase risk, since we will no longer have the correlation benefits of the standardized contracts to net down our total exposure.

Sincerely,

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