FINANCIAL SERVICES FLASH REPORT

Federal Reserve issues capital standards for U.S. insurance companies, with SIFIs subject to additional enhanced prudential standards

June 8, 2016

The Federal Reserve Board published an advance notice of proposed rulemaking (ANPR) on June 2 that set out the conceptual frameworks for capital standards that could apply to insurance companies that are systemically important financial institutions (SIFIs) and to those that own a bank or thrift.[1]

As desired by the industry, the rules adopt a two-tier approach to setting capital requirements, which will apply the toughest standards to SIFIs under the so-called consolidated approach (CA). This strategy will be supplemented by a softer "building block" approach (BBA) for less complex insurance companies that also own a bank or thrift, which are now overseen by the Federal Reserve. The rules will also apply to insurers that hold bank charters, even if they are not operating as a bank.

"The frameworks we are considering would address all the risks across an insurance company's regulated and unregulated subsidiaries," Federal Reserve Chair Janet L. Yellen said. "I believe this proposal is an important step toward capital standards that are both appropriate for our supervised insurance firms and that enhance the resiliency and stability of our financial system."[2]

For SIFIs, the consolidated approach would categorize an entire insurance firm's assets and insurance liabilities into risk segments, apply appropriate risk factors to each segment at the consolidated level and then set a minimum ratio of required capital. There are two SIFIs supervised by the Federal Reserve: American International Group (AIG) and Prudential Financial. MetLife's SIFI designation was rescinded by a court decision at the end of March, although the U.S. Department of the Treasury's Financial Stability Oversight Council (FSOC), the government agency that designated MetLife a SIFI in 2014, has appealed the decision.[3]

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[1] *Capital Requirements for Supervised Institutions Significantly Engaged in Insurance*, Federal Reserve System, June 3, 2016: www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a1.pdf
[2] Press release, Board of Governors of the Federal Reserve System, June 3, 2016: www.federalreserve.gov/newsevents/press/bcreg/20160603a.htm
[3] *MetLife Statement on U.S. District Court Ruling*, March 30, 2016: investor.metlife.com/phoenix.zhtml?c=121171&p=irol-newsArticle&ID=2151836, and *Statement from Treasury Secretary Jacob J. Lew On MetLife V,* Financial Stability Oversight Council, April 7, 2016: www.treasury.gov/press-center/press-releases/Pages/jl0410.aspx

Under an additional proposed rule, SIFIs will also be subject to enhanced prudential standards that cover liquidity, corporate governance and risk management.[4] These firms are further required to employ both a chief risk officer and a chief actuary to help ensure that firmwide risks are properly managed. Further details of these proposed changes are set out below.

The Federal Reserve supervises 12 insurance companies that own a bank or a thrift. These entities will be subject to the BBA under the proposed ruling on capital standards, which would aggregate existing capital requirements across a firm's legal entities to arrive at a combined, group-level capital requirement. (This ruling is subject to adjustments to reflect the Federal Reserve’s own supervisory objectives.)

The Federal Reserve maintains that both the BBA and the CA “recognize the distinct differences between insurance companies and banks, and would use insurance-focused risk weights and formulas that reflect the appropriate nature of insurance liabilities.”[5]

“The dual approach … is another example of our efforts to tailor capital regulation to the different risks posed by financial intermediaries of varying types and complexity,” said Daniel K. Tarullo, a Federal Reserve governor.[6]

Initial Market Reaction

These proposals have taken six long years to be finalized and published. In response to wide industry criticism that the Federal Reserve lacks adequate knowledge of the industry, the supervisor has been strengthening its understanding of the insurance market by hiring additional resources and developing insurance expertise. Indeed, such criticism is acknowledged throughout the proposal papers, and the Federal Reserve appears to have taken great care not to apply the capital requirements developed for bank holding companies to insurers.

The proposals have so far garnered a restrained response. The Property Casualty Insurers Association of America (PCI) has applauded the proposals as a “major step forward in developing a group capital approach for domestic insurance holding companies subject to the Fed’s supervision,” but it emphasized the importance for regulators to get this right, because the approach to capital standards “may set a precedent for the state-based U.S. regulatory system and may also impact the international deliberations.”[7]

Leigh Ann Pusey, president and CEO of the Washington-based American Insurance Association, also welcomed the proposals for providing “additional clarity on the Federal Reserve’s underlying rationale and sets the stage for public input on its intended approach,”[8] although she did not opine on the impact of the proposed rules.

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[4] *Enhanced Prudential Standards for Systemically Important Insurance Companies,* Federal Reserve System, June 3, 2016: www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a2.pdf

[5] Press release, Board of Governors of the Federal Reserve System, June 3, 2016: www.federalreserve.gov/newsevents/press/bcreg/20160603a.htm

[6] *Ibid.*

[7] “PCI Applauds Fed’s Proposal as a Major Step in the Right Direction,” Property Casualty Insurers Association of America, June 3, 2106: www.pciaa.net/pciwebsite/cms/content/viewpage?sitePageId=45596

[8] *AIA Statement on the Federal Reserve Board’s Advanced Notice of Proposed Rulemaking Related to Insurers*, American Insurance Association, June 6, 2016: www.aiadc.org/media-center/all-news-

In a statement, Charles M. Chamness, president and CEO of the Indianapolis-based National Association of Mutual Insurance Companies, said, "For any additional regulation or standards for American insurers to be effective, it's vital that they be based on the state regulatory system. Relying on risk-based capital standards and allowing the use of statutory accounting principles will provide everything the Fed needs to monitor the solvency of those insurance companies under its jurisdiction not labeled systemically important."[9]

SIFI Status Implications

One initial market reaction has been the welcome recognition that the Federal Reserve has softened its stance toward smaller insurers with banking units, allowing them to be regulated based on existing rules. However, under the CA, SIFIs will be forced to comply with much more strict and complex regulatory requirements that will be expensive to implement and that many in the market view generally as a heavy burden.

The new SIFI capital requirements will be based on risk segments, which categorize assets and liabilities based on the Federal Reserve's determination of risk for that type of asset and liability. Those segments deemed to have higher risk will require higher capital reserves. This may lead to SIFIs avoiding business units and products that will be associated with the higher-risk segments of assets and liabilities. As a result, such business units or products may appear far less attractive and could potentially be sold off, reduced or shut down. Alternatively, those products and business units could be housed in smaller non-SIFI insurers.

As mentioned, SIFIs are also required to adhere to heightened liquidity, governance and risk management standards. As a result, SIFIs may seek to strategically transform their businesses in an attempt to shed the SIFI designation. Indeed, there is already evidence that this is occurring in the wake of the MetLife ruling.

In 2013, when the FSOC identified MetLife, AIG and Prudential Financial as SIFIs, MetLife had disputed that finding vigorously and succeeded in having a court rule in its favor. However, AIG and Prudential did not publicly dispute being a SIFI, though the management of both companies will eagerly await the outcome of the FSOC's appeal against the decision of the U.S. District Court of the District of Columbia on the MetLife case.

The result will likely influence the Federal Reserve's authority to designate institutions as systemically important. If the original MetLife court decision is upheld, AIG and Prudential may decide to follow suit and deny their own SIFI status. If the ruling is overturned and MetLife returns to SIFI status, the Federal Reserve's position will be strengthened. In the interim, MetLife is further reducing its size by selling its U.S. agency (U.S. captive sales agents) to MassMutual and spinning off its U.S. life insurance and annuity business, which will further reduce MetLife's scale in the United States and therefore theoretically add support to its position that it should not be a SIFI.

releases/2016/june/aia-statement-on-the-federal-reserve-board-s-advanced-notice-of-proposed-rulemaking-related-to-insurers

[9] *NAMIC Cautiously Optimistic on Fed's Proposed Capital Standards*, National Association of Mutual Insurance Companies, June 3, 2016: www.namic.org/newsreleases/160603fd01.asp

Despite not appealing its SIFI designation, AIG is in the midst of a challenge from activist shareholders to break up or sell off its business units at least in part to change the SIFI designation and the high cost consequences of regulation.[10]

Summary of the Proposed Frameworks

The Federal Reserve proposed capital standards have been designed to ensure the framework is as standardized as possible, which echoes the general regulatory desire for firms to reduce their reliance on internal capital models in order to "produce more consistent capital requirements, enhance comparability across firms and promote greater transparency."[11] The dual approach the Federal Reserve has proposed attempts to quell industry fears that capital standards imposed generally on insurance firms would create an unlevel playing field for the smaller players.

The Building Block Approach (BBA)

Although the Federal Reserve has traditionally set capital requirements for holding companies on a consolidated basis to deter firms from placing assets in legal entities that may be subject to lower capital requirements, or no requirements at all, such an approach would be difficult for smaller insurers to comply with, because many own depository institutions that do not produce consolidated financial statements.

To address this challenge in a bid to avoid unnecessary regulatory burden, the Federal Reserve suggests using the BBA, which would aggregate capital resources and capital requirements across various legal entities in the group to calculate combined qualifying and required capital. Under this approach, a firm's aggregate capital requirements generally would be the sum of the capital requirements at each subsidiary.

The capital requirement for each regulated insurance or depository institution subsidiary would be based on the regulatory capital rules of that subsidiary's functional regulator. The BBA would then build on and aggregate legal entity (insurance, noninsurance financial, nonfinancial and holding company) qualifying capital and required capital, subject to adjustments.

The BBA may require the use of several types of adjustments in the calculation of a firm's enterprisewide capital requirement, while adjustments may be necessary to conform or standardize the accounting practices under statutory accounting principles, or SAP, among U.S. jurisdictions and between SAP and foreign jurisdictions. Similarly, adjustments may be necessary to eliminate intercompany transactions.

Additionally, the BBA may require consideration of cross-jurisdictional differences, which would be achieved through the use of scalars. These may be appropriate to account for differences in stringency applied by different insurance supervisors and to ensure adequate reflection of the safety and soundness and financial stability goals, as opposed to policyholder protection, that the board is charged with achieving.

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[10] "AIG Faces Push to Break Up," by Leslie Scism, Joann S. Lublin and David Benoit, *Wall Street Journal*, October 28, 2015: www.wsj.com/articles/icahn-says-he-has-taken-large-stake-in-aig-encourages-company-to-split-1446038362?mg=id-wsj

[11] *Capital Requirements for Supervised Institutions Significantly Engaged in Insurance*, Federal Reserve System, June 3, 2016: www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a1.pdf

The ratio of aggregate qualifying capital to aggregate required capital would represent capital adequacy at a consolidated level.

Represented in an equation, the BBA could be summarized as follows:

$$\text{Capital Ratio (BBA)} = \frac{\sum Qualifying\ Capital(i)}{\sum[Adj.Required\ Capital(i) \cdot Scalar(i)]}$$

The Federal Reserve paper highlights the efficient use of existing legal-entity-level regulatory capital frameworks as a major strength of the BBA, adding that such an approach could be developed and implemented expeditiously, involving relatively low regulatory costs and burdens for the institutions while also producing regulatory capital requirements tailored to the risks of each distinct jurisdiction and line of business of the institution.

At the top-tier level, the BBA is an aggregated, but not a consolidated, capital framework, which would not discourage regulatory arbitrage within an institution due to inconsistencies across jurisdictional capital requirements and may be vulnerable to gaming through techniques such as double leverage. Another identified weakness with this approach is that it would need to account for intercompany transactions, which may result in extensive adjustments.

It will also require the firm to determine scalars regarding a large number of state and foreign insurance regulatory capital regimes and would require legal-entity-level stress tests, presenting challenges to appropriate reflection of diversification and intercompany risk transfer mechanisms and other transactions.

Overall, the Federal Reserve maintains that the strengths of the BBA are maximized and its weakness minimized if the BBA is applied to insurance depository institution holding companies, which it describes as generally less complex, less international and not systemically important. "In this context, incremental safety and soundness benefits would appear to be complemented by the lower compliance costs due to the smaller number of scalars involved," says the paper.[12]

The standardization of the BBA is emphasized again as a major advantage, as is the fact that it is executable, applies U.S.-based accounting principles for U.S. legal entities, accounts for material insurance risks, strikes a balance between risk sensitivity and simplicity and is well tailored to the business model and risks of insurance. What the Federal Reserve maintains that it does not do well, however, is capture the full set of risks SIFIs impose on the financial system without significant use of adjustments and scalars, thereby negating any potential burden reduction from the approach for SIFIs.

The Consolidated Approach

The Federal Reserve is also proposing a consolidated approach to capital with risk segments and factors appropriate for supervised insurance institutions.

The CA is a capital framework designed for supervised institutions significantly engaged in insurance activities that would categorize insurance liabilities, assets and certain other

[12] *Capital Requirements for Supervised Institutions Significantly Engaged in Insurance*, Federal Reserve System, June 3, 2016: www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a1.pdf

exposures into risk segments; determine consolidated required capital by applying risk factors to the amounts in each segment; define qualifying capital for the consolidated firm; and then compare consolidated qualifying capital to consolidated required capital.

Unlike the BBA, which fundamentally aggregates legal-entity-level qualifying capital and required capital, the CA would take a fully consolidated approach to qualifying capital and required capital. Mindful of industry criticism that capital regimes designed for bank holding companies are inadequate for insurance companies because liability structures, asset classes and asset-liability matching of insurance companies differ substantially, the paper proposes that the CA use risk weights and risk factors that are appropriate for the longer-term nature of most insurance liabilities.

The foundation of the CA for SIFIs would be consolidated financial information based on U.S. generally accepted accounting principles (GAAP), with adjustments for regulatory purposes. Application of the CA to insurance depository institution holding companies that do not file U.S. GAAP financial statements would require the development of a consolidated approach based on SAP. The Federal Reserve paper suggests that initially, the CA could be simple in design, with broad risk segmentation, but that it could evolve over time to have an increasingly granular segmentation approach with greater risk sensitivity.

Represented as an equation, the CA could be summarized as:

$$\text{Capital Ratio (CA)} = \frac{Qualifying\ Capital}{\sum[Exposure\ Amount(i) \cdot\ Risk\ Factor(i)]}$$

The Federal Reserve paper views the simple and transparent factor-based design of the CA as one of its key strengths and one of its main weaknesses. The paper warns that the initially simple design of the CA would result in relatively crude risk segments and thus limited risk sensitivity. However, a main advantage is that the CA covers all material risks of supervised institutions significantly engaged in insurance activities and it is a fully consolidated framework with the potential to reduce regulatory arbitrage opportunities and the risk of double leverage.

The Federal Reserve believes that the CA would be relatively expeditious for it to develop and for institutions to implement, particularly in light of its broad risk segmentation. It is also described as providing a solid basis on which to build consolidated supervisory stress tests of capital adequacy for institutions subject to stress testing requirements.

One weakness of the approach is that substantial analysis would be needed to design a set of risk factors for all the major segments of assets and insurance liabilities of supervised institutions significantly engaged in insurance activities. In addition, a separate SAP-based version of the CA would need to be developed for the insurance depository institution holding company population if CA were ever applied to an insurance depository institution holding company that uses only SAP.

Taking all of these points into account, the paper advises that this approach is an appropriate regulatory capital framework for SIFIs because it would more easily enable supervisory stress testing and other macroprudential features for them. The paper acknowledges that such benefits may be outweighed by the additional implementation costs for smaller firms.

SIFIs Enhanced Prudential Standards

Concurrently, the Federal Reserve has proposed enhanced prudential standards for SIFIs for liquidity, governance and risk management. SIFIs are required to employ a chief risk officer and a chief actuary as well as maintain a risk committee, which approves and periodically reviews the risk management policies of the company's global operations and oversees the operation of the company's global risk management framework.

The risk committee would oversee the firm's enterprisewide risk management framework, which should be commensurate with the SIFI's structure, risk profile, complexity, activities and size. The risk management framework would be required to include policies and procedures for establishing risk management governance and procedures and risk control infrastructure for the company's global operations.

SIFIs are further required to ensure that processes and systems are put in place that have mechanisms to identify and report risks and risk management deficiencies, including emerging risks, and ensure effective and timely implementation of actions to address such risks and deficiencies. These systems should also establish managerial and employee responsibility for risk management, ensure the independence of the risk management function and integrate risk management and associated controls with management goals and its compensation structure for its global operations.

The proposal would require that a SIFI implement a number of provisions to manage its liquidity risk. SIFIs will need to meet key internal control requirements with respect to liquidity risk management, generate comprehensive cash-flow projections, establish and monitor liquidity risk tolerance and maintain a contingency funding plan to manage liquidity stress events when normal sources of funding may not be available.

The proposed rule also would introduce liquidity stress-testing requirements for a SIFI and would require the company to maintain liquid assets sufficient to meet net cash outflows for 90 days over the range of liquidity stress scenarios used in the internal stress testing. Although large bank holding companies are required to use a 30-day period for the liquidity buffer requirement, the proposed 90-day period for systemically important insurance companies is consistent with the generally longer-term nature of insurance liabilities.

Under the proposed rule, SIFIs would be required to conduct liquidity stress tests that, at a minimum, involve macroeconomic, sector-wide and idiosyncratic events (for example, including natural and artificial catastrophes) affecting the firm's cash flows, liquidity position, profitability and solvency. Liquidity stress tests will be conducted monthly or more frequently, as required by the Federal Reserve.

SIFIs will be granted a phase-in period to comply with the enhanced prudential standards, which has been set as the first day of the fifth quarter following the effective date of the proposal, although SIFIs are encouraged to comply earlier, if possible.

Next Steps

The paper states that the Federal Reserve is continuing to analyze whether the BBA is appropriate as a regulatory capital framework for all firms or whether SIFIs should be subject to a regulatory capital framework other than the BBA, such as the proposed CA.

Comments on both the ANPR and the proposed rule are due by August 2, 2016. After that, the preliminary notice of proposed rulemaking (NPR) will be issued and open for further comment before the rules are finalized and the implementation period can begin. In the paper's conclusion, the Federal Reserve emphasizes, as it did throughout the paper, the need for comments on its approaches to insurance regulatory capital.

The regulator plans to take its time with finalizing these proposals into firm rules in a bid to avoid insurance industry backlash, because these changes may significantly impact the U.S. insurance business in whichever final form they take, with the largest and most prominent insurers facing the most impact.

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