Client Update
Federal Reserve Provides Guidance on Supervisory Approach to Insurance

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On May 20, Federal Reserve Board ("FRB") Governor Tarullo delivered remarks at the National Association of Insurance Commissioners (the "NAIC") International Insurance Forum spelling out the FRB's supervisory approach to insurance and in particular the expected framework for capital standards it will impose on the insurance companies it regulates.[1]

Tarullo's remarks indicated that the capital requirements the FRB will impose on the insurance companies it regulates: those that own a depository institution and are thus savings and loan holding companies ("SLHCs"), and those designated as non-bank systemically important financial institutions ("NB-SIFIs") under the Dodd-Frank Act, will follow in many important respects the approaches favored by U.S. insurance companies. In that respect, the FRB's standards may represent an important counterweight to the approaches followed in the international capital standards being developed by the International Association of Insurance Supervisors ("IAIS") and may have a significant impact as those are finalized by the end of 2019.

- Bifurcated Approach to Supervision. Tarullo stressed in his remarks that the supervisory mandate applicable to the FRB requires it to distinguish between SLHCs and NB-SIFIs.[2] In so stating, Tarullo signals a bifurcated approach to the supervision of NB-SIFIs and SLHCs, with the former subject to a more rigorous supervisory regime based on their greater systemic importance.

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1 *Available at* http://www.federalreserve.gov/newsevents/speech/tarullo20160520a.htm.

2 There are more than a dozen SLHCs subject to Federal Reserve supervision including some very large insurance groups such as Mutual of Omaha, Nationwide, TIAA and USAA. The insurance company NB-SIFIs are currently American International Group, Inc. and Prudential Financial, Inc.

- Regulatory Capital. The speech provides important guidance on how the FRB will proceed to establish regulatory capital requirements for NB-SIFIs and SLHCs under the bifurcated approach.

  - Consideration of Alternative Standards. Tarullo's remarks included a discussion of the viability of various alternative approaches to regulatory capital for insurance firms, in which he took a somewhat surprisingly negative view as to the appropriateness of using international and European standards in a U.S. context. Among other things, he stated that:

    - a Solvency II-based framework would be "pro-cyclical" and "inconsistent with [the FRB's] strong preference for building a predominantly standardized risk-based capital rule that enables comparisons across firms without excessive reliance on internal models";

    - approaches based on internal cash flow stress testing are of a "novel… and untested nature" and "would, in any case, necessitate extensive development, likely over a period of years" (though he noted that such stress testing will be an important feature as it builds the supervisory stress testing program for systemically important insurance companies);

    - slow progress in the development of the IAIS insurance capital standard ("ICS") "have, as a practical matter, rendered the ICS insufficiently developed to be an option as the Federal Reserve moves forward with capital requirements applicable to the insurance companies we supervise"; and

    - the "somewhat provisional" nature of the IAIS Basic Capital Requirement ("BCR") for global systemically important insurers ("G-SIIs") makes it unfit as a practical matter for an FRB standard.

  - Bifurcated Approach to Regulatory Capital Standards. Rejecting these alternatives, Tarullo states that the FRB will establish separate and distinct regulatory capital standards for NB-SIFIs and SLHCs.

    - *Building Block Approach for SLHCs*. SLHCs will be made subject to regulatory capital standards based on the "building block approach" ("BBA"), which would "aggregate capital resources and capital requirements across the different legal entities in the [SLHC] group to calculate combined, group-level capital resources and requirements." The BBA appears to be based in substantial part on the so-called "Aggregation and Calibration" approach previously put forward as a potential capital standard for U.S. firms.

- *Consolidated Approach for NB-SIFIs*. Stating that "application of an aggregated approach like that of the BBA could pose significant risks to the Federal Reserve's statutory aims of safety and soundness and financial stability," Tarullo indicates that the FRB will likely seek comment on a "consolidated approach" ("CA") regulatory capital standard for NB-SIFIs. The CA would "categorize all of the consolidated insurance group's assets and insurance liabilities into risk segments, apply risk factors to the amounts in each segment, and then set a minimum ratio of required capital comparing the consolidated capital requirements to the group's consolidated capital resources." Tarullo notes specifically that the CA would "use risk weights or risk factors that are more appropriate for the longer-term nature of most insurance liabilities." The building block for establishing the capital requirements would be U.S. GAAP consolidated financial statements of the insurance group ("with appropriate adjustments for regulatory purposes"). In this way, it appears it may be similar to the "GAAP plus adjustments" approach generally favored by U.S. insurance companies for the ICS being designed by the IAIS. The IAIS's preferred approach currently for the ICS (as well as the BCR applicable to G-SIIs) follows a market approach to valuing assets and liabilities, which many criticize as being subject to excessive volatility in the capital models.

- Process. The speech lays out the FRB's anticipated process for implementing capital and supervisory standards for SLHCs and NB-SIFIs. In addition, on May 27, the FRB announced a June 3 open meeting to approve and promulgate:

  - an Advanced Notice of Proposed Rulemaking ("ANPR"), proposing the BBA and CA regulatory capital standards described above; and

  - a notice of proposed rulemaking applying enhanced governance, risk-management and liquidity standards to NB-SIFIs. According to Tarullo, the proposed standards "will likely build on the core provisions of [the FRB's] consolidated supervisory framework for large domestic and foreign banking organizations, with appropriate adjustments to reflect these firms' predominantly insurance business model."[3]

- Implications. The speech and forthcoming ANPR represent an important milestone in the FRB's multiyear process for establishing regulatory and supervisory standards for U.S. insurance groups under its jurisdiction.

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[3] *See https://www.federalreserve.gov/aboutthefed/boardmeetings/20160603open.htm*.

- *NAIC*. The FRB's formal promulgation of proposed regulatory capital standards will likely impact the ongoing efforts of the NAIC to develop a group capital measurement or standard for U.S. insurance groups, adding to the already-complex interplay between the federal and state insurance regulatory schemes that has characterized the post-Dodd-Frank era. However, by following approaches favored by U.S. insurers, the FRB's approach may alleviate concerns of some that they will be subject to new and inconsistent capital requirements once the group standards are developed.
- *International*. The FRB's dismissal of the ICS and the BCR as workable bases for U.S. capital standards may have a significant impact on the development by the IAIS of international capital standards for G-SIIs, and a knock-on effect on the developing ICS for the next group of "internationally active insurance groups" ("IAIGs") as well. Group-wide standards for both G-SIIs and IAIGs are currently expected to be finalized by 2019. With his criticisms of the Solvency II and BCR frameworks, the FRB might be seen as throwing its weight behind similar criticisms raised by many U.S. insurers, particularly the market-based approaches currently preferred by the IAIS. Tarullo suggests as much, stating that "adoption by the Federal Reserve of a fully consolidated capital requirement for systemically important insurance companies might also help advance the international development of appropriate and effective capital requirements." This may mean – if the FRB's concerns (and the concerns of others in the United States) are to be recognized in the final design of the international standards – that the international standards will follow a more localized approach, and lose some of the consistent application across jurisdictions. On the other hand, if the standards continue to adopt a framework which differs from the FRB approach, the insurance groups subject to both may face additional layers of sometimes inconsistent capital requirements.

The FRB's issuance of the ANPR will signal the formal beginning of the regulatory capital standard-setting process, and should provide additional clarity (while raising novel questions) regarding the still infant process of fully developing global capital standards for the insurance sector.

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Please do not hesitate to contact us with any questions.