Client Update

Federal Reserve Proposes Enhanced Prudential Standards for Insurance SIFIs

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On June 3, 2016, the Board of Governors of the Federal Reserve System (the "Federal Reserve") issued a notice of proposed rulemaking (the "Proposed Rule") to establish certain management- and liquidity-related enhanced prudential standards (the "EPS") under Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act for non-bank financial institutions with significant insurance activities which have been designated as systemically important ("Insurance NB-SIFIs") by the Financial Stability Oversight Counsel.[1] The Federal Reserve concurrently issued an advance notice of proposed rulemaking (the "ANPR") setting out the contours of regulatory capital standards for Insurance NB-SIFIs and insurance savings and loan holding companies ("Insurance SLHCs").[2] The ANPR is discussed in a separate Client Update.[3] Comments on both the Proposed Rule and the ANPR are due by August 2, 2016.

Large U.S. bank holding companies ("BHCs") already are subject to the EPS addressed by the Proposed Rule (and the ANPR) by virtue of a series of Federal Reserve rulemakings.[4] To draft the EPS in the Proposed Rule, the Federal

1 Federal Reserve, Enhanced Prudential Standards for Systemically Important Insurance Companies (June 3, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a2.pdf.

2 Federal Reserve, Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (June 3, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a1.pdf.

3 Federal Reserve Publishes Advance Notice of Proposed Rulemaking on Capital Requirements for Insurers (June 6, 2016), *available at* http://www.debevoise.com/insights/publications/2016/06/Federal-Reserve-Publishes-Advance-Notice.

4 *See, e.g.*, 12 CFR 225.8 (capital plan rule), 12 CFR Part 252 (stress-testing rules) and 79 Fed. Reg. 17,420 (Mar. 27, 2014) (establishing the Federal Reserve's EPS rule under Regulation YY).

Reserve has stated that it modified the terms of the EPS applicable to BHCs to take into account the particular business models, capital structures and risk profiles of the covered Insurance NB-SIFIs.

While the requirements discussed below will be new for Insurance NB-SIFIs, the Federal Reserve has noted in the preamble to the Proposed Rule that it expects that compliance with the proposed EPS will not impose any significant new costs on existing Insurance NB-SIFIs. Nevertheless, we expect that Insurance NB-SIFIs will need to engage in a thorough review of their policies and procedures in order to ensure compliance with the EPS set forth in the Proposed Rule.

Context for the Proposed Rule. While the capital standards contemplated by the ANPR ultimately may have the most immediate, obvious impact on affected institutions' organic and M&A growth and product strategies, as BHCs are aware, the Federal Reserve is increasingly coming to the conclusion that an operational issue at an institution is the result of a management deficiency, rather than just the result of the complexity of financial institutions. In our experience, management-based downgrades are coming much more quickly and with much greater severity and duration than previously, and any such downgrade can materially impair the ability of an institution to pursue expansion objectives, and can instead force the institution to spend substantial sums on infrastructure and consultants to remediate perceived issues. Therefore, compliance with the letter and spirit of these proposed EPS is in many respects as critical as compliance with the coming capital rules. Moreover, while the Proposed Rule by its terms applied to Insurance NB-SIFIs, in our experience, the rules applicable to large BHCs have become viewed by regulators as "best practices" for smaller institutions, and thus also may be relevant, in whole or in part, to Insurance SLHCs as well.

This Client Update describes the proposed EPS applicable to Insurance NB-SIFIs, while also highlighting a number of comparison points between the EPS for BHCs and the proposed EPS for Insurance NB-SIFIs. We also draw certain key distinctions from the corresponding framework that we have assisted many large banks to establish to comply with their version of the EPS rules.

More specifically, Section I of this Client Update provides a summary of the scope and application of the Proposed Rule. Section II focuses on corporate governance requirements, and Section III discusses the risk management framework which Insurance NB-SIFIs would be required to implement. Finally, Section IV discuses liquidity risk management, including requirements relating to internal controls, cash flow projections, contingency funding, risk limits, risk monitoring, stress testing and liquidity buffers.

I. SCOPE AND APPLICATION

The Proposed Rule applies to Insurance NB-SIFIs with 40% or more of their total consolidated assets related to insurance activities as of the end of either of the two most recently completed fiscal years. Currently, American International Group, Inc. and Prudential Financial, Inc. would be subject to the Proposed Rule.

A company that is an Insurance NB-SIFI on the final rule's effective date would be required to comply with the requirements of the Proposed Rule beginning on the first day of the fifth quarter following the effective date. Any insurance group meeting the above 40% test and designated as an Insurance NB-SIFI *after* the effective date of the Proposed Rule would have to comply with its EPS requirements on the first day of the fifth quarter following its designation.

II. CORPORATE GOVERNANCE

As a general matter, the Proposed Rule establishes a number of corporate governance requirements at different levels of an Insurance NB-SIFI. In many respects, the corporate governance requirements set forth in the Proposed Rule are built upon the core corporate governance requirements which the Federal Reserve has already imposed on BHCs and other large financial institutions. In our experience, while many BHCs and other large financial institutions already had robust corporate governance frameworks, thoughtful review and resulting adjustments were essential to bring such frameworks into full compliance with the Federal Reserve's requirements. We expect the same to be true of Insurance NB-SIFIs and the Proposed Rule.

A. Risk Committee

The Proposed Rule would require an Insurance NB-SIFI to establish and maintain a risk committee to approve and periodically review the company's risk management policies and, more generally, oversee the company's enterprise-wide risk management framework. The Proposed Rule's requirements for the framework itself are set forth in Section III below. The risk committee also must oversee liquidity risk management, as described in Section IV below. Further demonstrating its significance, the risk committee would be required to have a formal charter, be an independent committee of the ultimate parent company's board of directors and report directly to the board of directors.

The risk committee would be required to have at least one member with experience in identifying, assessing and managing risk exposures of large, complex financial firms. Such prior experience may be with insurance companies, securities broker-dealers or banks. The chair of the risk committee would also be required to have "sufficient independence" from the company, meaning that the chair (1) may not have been an officer or employee of the company during the previous three years; (2) may not be a member of the immediate family of a person who is, or has been within the last three years, an executive officer of the company; and (3) must meet the requirements for an independent director under Item 407 of the Securities and Exchange Commission's Regulation S-K, or must otherwise qualify as an independent director under the listing standards of a national securities exchange, if the company does not have an outstanding class of securities traded on a national securities exchange.

B. Chief Risk Officer

The Proposed Rule would require Insurance NB-SIFIs to appoint a chief risk officer (the "CRO"), who would report directly to both the board's risk committee and the chief executive officer of the company. The CRO's compensation would be required to be structured to enable the CRO to be able to provide an "objective assessment" of the company's risks. Like the risk management-experience requirement for one member of the risk committee, the Proposed Rule would require the CRO to have experience in identifying, assessing and managing risk exposures of large, complex financial firms.

The CRO would oversee all risks facing the company, including risks from both insurance and non-insurance activities. In particular, the CRO would be responsible for overseeing (1) the establishment of risk limits on an enterprise-wide basis and for monitoring compliance with such limits; (2) the implementation of and ongoing compliance with the policies and procedures for risk management governance; (3) the development and implementation of the processes and systems related to global risk management; and (4) management of the risks and risk controls within the parameters of the company's risk control framework, and the monitoring and testing of such risk controls. The CRO would also be responsible for reporting any deficiencies relating to risk management to the risk committee.

C. Chief Actuary

Unlike with BHCs, Insurance NB-SIFIs also would be required to have a chief actuary, who would report directly to the board's audit committee (and may also have additional reporting lines). Similar to the CRO, the compensation of the chief actuary would be required to be structured to enable the chief actuary to be able to provide an “objective assessment” of the company's reserves. In addition, the Proposed Rule would not permit the roles of CRO and chief actuary to be performed by the same person.

The chief actuary would be responsible for ensuring an enterprise-wide view of reserve adequacy across legal entities, lines of business and geographic boundaries. The chief actuary would be responsible for advising the chief executive officer, other members of senior management and the audit committee on the level of reserves, and for overseeing (1) implementation of measures to assess the sufficiency of reserves; (2) review of the appropriateness of actuarial models, data and assumptions used in reserving; and (3) implementation of and compliance with appropriate policies and procedures relating to actuarial work in reserving.

If an Insurance NB-SIFI has significant amounts of life insurance and property and casualty insurance business, the Proposed Rule would permit—but not require—the company to have co-chief actuaries, one responsible for the life insurance business and one responsible for the property and casualty insurance business. Indicating the Federal Reserve’s preferred approach, the preamble to the Proposed Rule notes that a single position with an enterprise-wide view of reserve adequacy “is desirable.”

BHC EPS Comparison*: Understandably, the EPS applicable to BHCs do not require BHCs to have a chief actuary. Here, the Federal Reserve has tailored the EPS for Insurance NB-SIFIs with their business model and risk profile in mind.*

III. RISK MANAGEMENT FRAMEWORK

The Proposed Rule would require an Insurance NB-SIFI to have a risk management framework commensurate with the company’s structure, risk profile, complexity, activities and size, and which includes policies and procedures establishing risk management governance, risk management procedures and risk control infrastructure for the company’s global operations. The risk management framework would also be required to include processes and systems for implementing and monitoring compliance with such policies and procedures. Such processes and systems must include mechanisms to (1) identify and address risks and risk management deficiencies; (2) promote managerial and employee responsibility for risk management; (3) ensure the independence of the risk management function; and (4) integrate risk management with management goals and its compensation structure.

IV. LIQUIDITY RISK MANAGEMENT

The Proposed Rule would require an Insurance NB-SIFI to implement a number of provisions to manage its liquidity risk. Liquidity risk is a primary risk to insurers that Federal Reserve Governor Daniel Tarullo cited in his May 20th speech previewing the releases of the Proposed Rule and the ANPR.[5] In the preamble to the Proposed Rule, the Federal Reserve has indicated that "liquidity" refers to an Insurance NB-SIFI's "capacity to meet efficiently its expected and unexpected cash flows and collateral needs at a reasonable cost without adversely affecting the daily operations or the financial condition" of the company, and "liquidity risk" refers to the risk that the company's "financial condition or safety and soundness will be adversely affected by its actual or perceived inability to meet its cash and collateral obligations."

A. Internal Control Requirements

The Proposed Rule would require an Insurance NB-SIFI's board of directors, risk committee and senior management to fulfill key corporate governance and internal control functions with respect to liquidity risk management. In addition, the company would be required to establish and maintain an independent review function to review and evaluate the liquidity risk management framework and the adequacy and effectiveness of the company's liquidity risk management processes.

Board of Directors. The board of directors must approve, at least annually, the company's liquidity risk tolerance, which should set forth the acceptable level of liquidity risk that the Insurance NB-SIFI may assume in connection with its operating strategies. Similarly, the board of directors must receive from senior management and review, at least semi-annually, the company's liquidity risk practices and performance to determine whether the company is operating in accordance with its established liquidity risk tolerance. The board must also approve and periodically review the liquidity risk management strategies, policies and procedures established by senior management.

Risk Committee. The risk committee (or a designated subcommittee consisting of board members) must review and approve the company's contingency funding plan (described in Section IV(C) below) at least annually and approve any material revisions to that plan.

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

Senior Management. The Proposed Rule would require senior management to establish and implement the liquidity risk strategies, policies and procedures, as well as the liquidity risk measurement and reporting systems, it mandates. In addition, before an Insurance NB-SIFI offers a new product or engages in a new activity that could potentially materially adversely affect liquidity, senior management must approve the product or activity after evaluating the liquidity costs, benefits and risks, and whether the liquidity risk (under current and stressed conditions) is within the company's liquidity risk tolerance. Moreover, senior management must review at least annually significant business activities and products to determine whether any creates any unanticipated liquidity risk, and whether such risks are within the liquidity risk tolerance. Senior management also must (1) review the cash flow projections (described in Section IV(B) below) at least quarterly; (2) set liquidity risk limits (described in Section IV(D) below) at least quarterly; and (3) approve and review the company's liquidity stress testing practices (described in Section IV(F) below), including reviewing the results of the stress tests at least quarterly, reviewing the independent review of the practices periodically, and approving the size and components of the liquidity buffer at least quarterly. The Proposed Rule would also require senior management to review cash flow projections at least quarterly and to review and approve liquidity stress testing practices, methodologies, assumptions and results.

Independent Review Function. Under the Proposed Rule, an Insurance NB-SIFI must also establish an independent review function tasked with evaluating the company's liquidity risk management. The independent review function must specifically (1) review and evaluate the adequacy and effectiveness of the company's liquidity risk management process (including the company's liquidity stress testing (described in Section IV(F) below)) at least annually; (2) assess whether the company's liquidity risk management function complies with all applicable laws, regulations, supervisory guidance and sound business practices; and (3) report material liquidity risk management issues to the board of directors or the risk management committee. The independent review function must be independent from those management functions which execute funding.

BHC EPS Comparison*: The Proposed Rule specifically identifies insurance liabilities as potential sources of liquidity risk.*

B. Cash Flow Projections

An Insurance NB-SIFI would be required to produce comprehensive enterprise-wide cash flow projections that take into account cash flows from assets, liabilities and off-balance sheet exposures over short- and long-term time horizons, including horizons longer than a year. The Insurance NB-SIFI must update short-term cash flow projections daily and longer-term cash flow projections at least monthly. The Proposed Rule sets out detailed requirements for the methodology, which would be required to include reasonable assumptions regarding future behavior of assets and liabilities and recognition of mismatches. The projections would be required to include, for example, cash flows from (1) anticipated claim and annuity payments; (2) policyholder options, including surrenders, withdrawals and policy loans; and (3) premiums on new and renewal business.

***BHC EPS Comparison**: The Proposed Rule emphasizes the importance of longer time horizons for insurance companies, because insurance companies generally have liabilities that extend far into the future. Tracking cash-flow mismatches can help facilitate asset liability management, particularly with regard to reinvestment risk from interest rate changes.*

C. Contingency Funding Plan

Under the Proposed Rule, an Insurance NB-SIFI would be required to establish a contingency funding plan that can be implemented to address liquidity needs during periods of stress. The Insurance NB-SIFI must update the plan at least annually, and as conditions otherwise warrant. The plan would be required to include (1) a quantitative assessment to identify liquidity stress events that could significantly impact the company's liquidity and assess the available funding sources during liquidity stress; (2) a liquidity event management process that details how the company would manage liquidity during a stress event; and (3) monitoring requirements, including identifying early warning indicators of emerging liquidity stress events.

The company would be required to periodically test the components and operational elements of its contingency funding plan as well as the methods the company would use to access alternative funding sources during liquidity stress events. While not contained in the text of the Proposed Rule itself, the preamble to the Proposed Rule suggests that, in some cases, such testing would also require the actual liquidation of assets in the company's liquidity buffer. The Federal Reserve has indicated that it believes a company can, with proper planning, take such action without sending a distress signal to the marketplace.

D. Liquidity Risk Limits

Under the Proposed Rule, an Insurance NB-SIFI would be required to monitor sources of liquidity and establish limits on sources of liquidity risk, including (1) concentrations of funding by instrument type, single counterparty,

counterparty type, secured and unsecured funding and other liquidity risk identifiers; (2) potential sources of liquidity risk arising from insurance liabilities; (3) the amount of non-insurance liabilities that mature within various time horizons; and (4) off-balance sheet exposures and other exposures that could create funding needs during liquidity stress events.

E. Collateral, Legal Entity and Intraday Liquidity Risk Monitoring

Collateral Positions. Under the Proposed Rule, Insurance NB-SIFIs must establish and maintain policies and procedures to monitor those assets that have been (or are available to be) pledged as collateral in connection with transactions to which it or its affiliates are counterparties. Specifically, an Insurance NB-SIFI must (1) calculate all of its collateral positions on a weekly basis (or more frequently, as determined by the Federal Reserve); (2) monitor the levels of unencumbered assets which are available to be pledged as collateral; (3) monitor shifts in the company's funding patterns; and (4) track operational and timing requirements associated with accessing collateral at its physical location.

Legal Entities, Currencies and Business Lines. An Insurance NB-SIFI would also be required to establish and maintain policies and procedures for monitoring and controlling liquid risk exposures and funding needs within and across significant legal entities, currencies and business lines. In establishing such policies and procedures, the Proposed Rule would require the company to consider legal and regulatory restrictions on the transfer of liquidity between legal entities.

Intraday Exposures. The Proposed Rule would also require Insurance NB-SIFIs to monitor intraday liquidity risk exposures to the extent such exposures are necessary for an Insurance NB-SIFI's business. If applicable, an Insurance NB-SIFI must (1) monitor and measure daily gross liquidity inflows and outflows; (2) identify and prioritize time-specific obligations so that the company may meet these obligations and settle less critical obligations as soon as possible; (3) coordinate the purchase and sale of derivatives in order to maximize the effectiveness of the company's hedging program; (4) take into account the amount of collateral and liquidity needed to meet obligations when assessing the company's overall liquidity needs; and (5) manage and transfer collateral to obtain intraday credit as needed.

F. Liquidity Stress Testing and Buffer Requirements

Liquidity Stress Testing. An Insurance NB-SIFI would be required to conduct monthly liquidity stress tests of its projected cash flows, liquidity position, profitability and solvency. The test must address both the direct adverse impact of the market disruption on the Insurance NB-SIFI, as well as the indirect effects resulting from the actions of other market participants. The company would be required to establish a liquidity buffer based on the results of the tests.

The Proposed Rule would require the stress tests to include, at a minimum, scenarios reflecting macroeconomic, sector-wide and idiosyncratic events. The Proposed Rule would require that the assumptions used to formulate such scenarios be conservative and approved by the company's CRO. The scenarios would be required to include 7-day, 30-day, 90-day and one-year time horizons, as well as any other planning horizon relevant to the company's liquidity risk profile. As noted below, the company would be required to use the 90-day horizon test to establish its liquidity buffer.

BHC EPS Comparison*: The BHC EPS requires stress scenarios use an overnight time horizon (among others), whereas the Proposed Rule instead requires a 7-day time horizon.*

The Proposed Rule would require Insurance NB-SIFIs to appropriately address assets in restricted accounts, like those in legally-insulated separate accounts and in any closed block. These assets would be able to be included as cash flow sources only in proportion to the cash flow needs in the same accounts. As a result, the Federal Reserve notes in the preamble to the Proposed Rule that separate account assets would not be available to meet general account liquidity needs.

Furthermore, the Proposed Rule would not permit an Insurance NB-SIFI to assume for the purposes of its stress tests that the company would delay payments under insurance contracts. The Federal Reserve notes that such crediting of stays—which are measures of last resort—would not be consistent with preventing the failure or material financial stress of an Insurance NB-SIFI.

The Proposed Rule also requires Insurance NB-SIFIs to maintain adequate management information systems and data processing capabilities to enable the company to effectively and reliably collect, sort and aggregate data relating to stress testing. Insurance NB-SIFIs are also required to ensure that the results of such stress tests are used to enhance the company's stress testing practices.

BHC EPS Comparison*: Restricted accounts and stays are items that are unique to or at least more relevant for insurance companies. The BHC EPS do not discuss similar items.*

Liquidity Buffer. Finally, an Insurance NB-SIFI would be required to maintain a liquidity buffer sufficient to meet projected net stressed cash-flow needs, which the Proposed Rule defines as the difference between the amount of its cash-flow needs and its cash-flow sources over the 90-day planning horizon. The buffer must consist of assets (1) that are "highly liquid"; (2) that are unencumbered; and (3) that, for purposes of the buffer calculation, are discounted to reflect fair market value, credit risk and market price volatility.

The Proposed Rule notes that "highly liquid" assets would include (1) securities issued or guaranteed by the U.S. Department of Treasury; (2) liquid and readily marketable securities issued or guaranteed by any other U.S. government agency whose obligations are fully and explicitly guaranteed by the full faith and credit of the U.S. government; (3) certain liquid and readily marketable securities issued or guaranteed by other sovereign entities, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Community or a multilateral development bank; and (4) liquid and readily marketable securities issued or guaranteed by a U.S. government-sponsored enterprise which are investment-grade and senior to preferred stock. In addition, liquid and readily marketable investment-grade corporate debt securities would qualify as "highly liquid" assets if they are issued or guaranteed by an entity which is not a financial sector entity or a consolidated subsidiary of a financial sector entity, and "whose obligations have a proven track record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions[.]" Similarly, liquid and readily marketable publicly traded public equity shares which are included in the Russell 1000 index would also qualify as "highly liquid" assets if they are issued by an entity which is not a financial sector entity or a consolidated subsidiary of a financial sector entity, and "whose publicly traded common equity shares have a proven track record as a reliable source of liquidity in repurchase or sales markets during stressed market conditions[.]"

BHC EPS Comparison*: The BHC EPS requires large BHCs to use a 30-day, as opposed to a 90-day, planning horizon. In the preamble to the Proposed Rule, the Federal Reserve indicated that the 90-day period is consistent with the generally longer-term nature of insurance liabilities. In addition, there are different categories of assets which qualify as "highly liquid" in the Proposed Rule than there are in the BHC EPS. Finally, because of insurance law restrictions on the transfer of funds out of a regulated insurance company, the Proposed Rule would limit where an Insurance NB-SIFI may hold assets in the liquidity buffer. For example, a top-tier holding company would be required to hold an amount of highly liquid assets sufficient to cover the sum of all stand-alone material entity net liquidity deficits, which is calculated as that entity's amount of net stressed outflows over a 90-day planning horizon less the highly liquid assets held at the material entity. No such limitations exist for where BHCs may hold their highly liquid assets.*

V. CONCLUSION

The proposed EPS for Insurance NB-SIFIs are important not only because of the changes Insurance NB-SIFIs may have to undertake to comply with them, but also because they represent the continuation of the expansion of banking principles into other areas of financial services, although with the recognition that insurance is different. For next steps, we recommend Insurance NB-SIFIs (1) perform a close evaluation of their own corporate governance structures, as compared to those in the Proposed Rule, (2) coordinate with trade groups to determine common areas of focus and (3) evaluate whether a separate comment letter may be appropriate to highlight the Insurance NB-SIFI's own concerns.

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Please do not hesitate to contact us with any questions.