

Client Update

Federal Reserve Publishes Advance Notice of Proposed Rulemaking on Capital Requirements for Insurers

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On June 3, 2016, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) issued an advance notice of proposed rulemaking soliciting comments on two approaches to capital requirements for Federal Reserve supervised institutions significantly engaged in insurance activities (the “ANPR”).¹ The ANPR follows remarks that Federal Reserve Governor Daniel Tarullo delivered at the National Association of Insurance Commissioners’ (the “NAIC”) International Insurance Forum on May 20, 2016 that outlined the two approaches.² Comments on the ANPR are due by August 2, 2016.

The ANPR contemplates capital requirements for the two categories of Federal Reserve-supervised-insurance groups : those that control a savings association, and are thus savings and loan holding companies (“SLHCs”) and those designated as non-bank systemically important financial institutions (“NB-SIFIs”) by the Financial Stability Oversight Council pursuant to section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). There are currently twelve SLHCs³ and two NB-SIFIs⁴ that would

¹ See Federal Reserve, Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities (June 3, 2016), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a1.pdf>.

² Concurrently with the ANPR, the Federal Reserve also issued a notice of proposed rulemaking that would establish enhanced prudential standards for certain systemically important insurers under its supervision. See Federal Reserve, Enhanced Prudential Standards for Systemically Important Insurance Companies (June 3, 2016), available at <https://www.federalreserve.gov/newsevents/press/bcreg/bcreg20160603a2.pdf>. Our client memo on the other update is available at <http://www.debevoise.com/insights/publications/2016/06/Federal-Reserve-Proposes-Enhanced-Prudential>.

³ Some of the largest such SLHCs include: Teachers Insurance & Annuity Association of America, State Farm Mutual Automobile Insurance Company, United Services Automobile Association, Mutual of Omaha Insurance Company and Nationwide Mutual Insurance Company.

be subject to the capital rules. Collectively, these firms have approximately \$2 trillion in assets and represent approximately one-quarter of the assets of the U.S. insurance industry.

Although the Federal Reserve has broad authority to establish regulatory capital requirements for both SLHCs and NB-SIFIs, the Federal Reserve has yet to establish any such requirements and, until recently, has not even indicated its approach to proposing such capital requirements. The ANPR thus is an important milestone in the development of enhanced regulatory standards for NB-SIFIs and other insurance companies the Federal Reserve regulates. It also will likely have a significant impact on the design of group capital standards, both in the United States and internationally, and may represent an important counterweight to the approaches followed in the international capital standards being developed by the International Association of Insurance Supervisors (the “IAIS”) as those are finalized by the end of 2019.

Section I of this client memo outlines the ANPR’s approach to capital requirements for SLHCs engaged significantly in insurance activities (“Insurance SLHCs”). Section II of this client memo outlines the ANPR’s approach for NB-SIFIs that engage significantly in insurance activities (“Insurance SIFIs”). Section III of this memo highlights some of the alternatives that the Federal Reserve considered, but ultimately rejected. Finally, Section IV of this memo highlights some of the potential impacts of the ANPR.

I. THE BUILDING BLOCK APPROACH: CAPITAL REQUIREMENTS FOR SLHCS

In addition to its broad authority to establish capital requirements for SLHCs under the Home Owners’ Loan Act, Section 171 of the Dodd-Frank Act (commonly referred to as the “Collins Amendment”) requires the Federal Reserve to establish minimum leverage and risk-based capital requirements that apply to SLHCs on a consolidated basis.⁵ In December 2014, Congress enacted the Insurance Capital Standards Clarification Act, which amends the Collins

⁴ American International Group, Inc. and Prudential Financial, Inc. would be subject to the contemplated capital requirements. GE Capital would not be subject, since it is not significantly engaged in insurance activities.

⁵ See 12 U.S.C. § 5371.

Amendment to permit the Federal Reserve to tailor these capital requirements to take into account the insurance activities of these firms.⁶

In accordance with this statutory mandate, the Federal Reserve suggest limiting the scope of these capital requirements to Insurance SLHCs, which would be defined to include SLHCs that hold 25 percent or more of their total consolidated assets in insurance underwriting subsidiaries (other than assets associated with insurance underwriting for credit risk)⁷.

Although the Federal Reserve's current capital requirements apply to banking organizations on a consolidated basis, in recognition of the fact that Insurance SLHCs may not prepare consolidated financial statements using Generally Accepted Accounting Principles ("GAAP"),⁸ the ANPR contemplates a so-called Building Block Approach for Insurance SLHCs (the "BBA"), in which capital resources and capital requirements would be aggregated across different legal entities within an Insurance SLHC group to calculate combined qualifying and required capital. The Federal Reserve states in the preamble to the ANPR that the BBA is appropriate for Insurance SLHCs, which are "generally less complex, less international, and not systemically important" as compared to Insurance SIFIs.

A. Description of the BBA

Under the BBA, qualifying capital and capital requirements for an Insurance SLHC would first be calculated at the legal entity level. For example, qualifying capital and capital requirements for regulated insurance underwriting subsidiaries of an Insurance SLHC would be determined by reference to the rules of the appropriate state or foreign insurance supervisor, while qualifying capital and capital requirements for each insured depository institution and regulated non-insurance or unregulated legal entity in the SLHC group (including an intermediate holding company) would be determined under the Federal

⁶ See Pub. L. No. 113-279, Insurance Capital Standards Clarification Act of 2014, *codified at* 12 U.S.C. § 5371 (2014).

⁷ This standard coincides with an exemption from the Federal Reserve's current capital requirements for banking organizations. See 12 C.F.R. 217.2 (definition of "Covered savings and loan holding company"). Under Regulation Q, capital requirements currently also do not apply if the top-tier holding company of an SLHC is itself an insurance underwriting company.

⁸ The Collins Amendment, as amended by the Insurance Capital Standards Clarification Act, prohibits the Federal Reserve from requiring supervised institutions that only prepare financial statements in accordance with U.S. SAP to prepare financial statements in accordance with GAAP. 12 U.S.C. § 5371(c)(3)(A)-(B).

Reserve’s current capital rules (or, in the case of an insured depository institution subsidiary, any other capital rules that might apply).

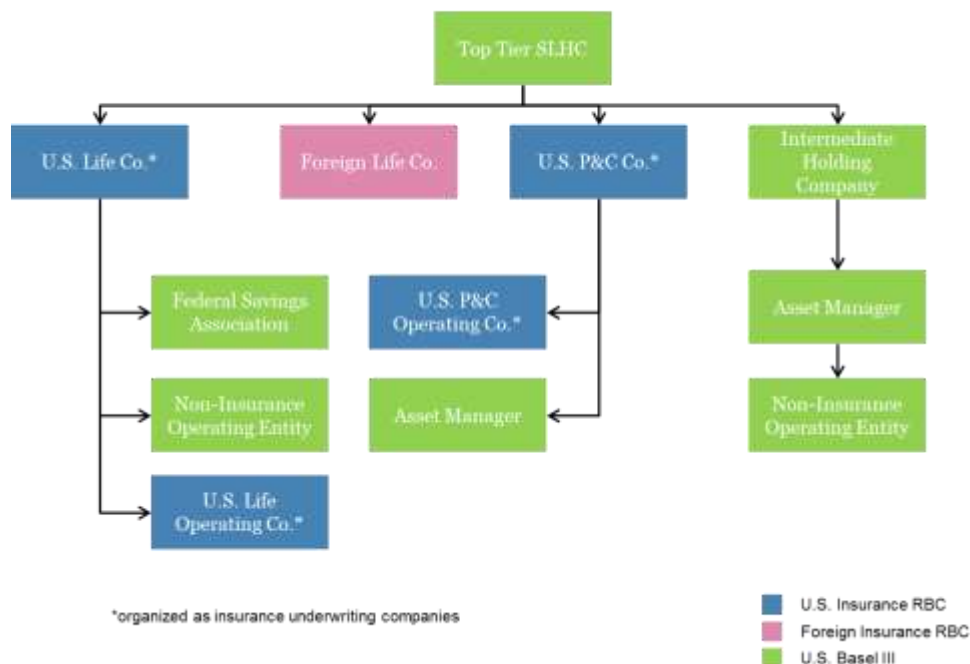
Once qualifying capital and capital requirements are identified and aggregated for each legal entity within an Insurance SLHC group, the resulting amount would be subject to various adjustments to conform or standardize accounting practices under Statutory Accounting Principles (“SAP”) among U.S. jurisdictions, and between SAP and non-U.S. jurisdictions. In addition, the ANPR contemplates adjustments to account for intercompany transactions, as well as the use of scalar multipliers to account for cross-jurisdictional differences in insurance capital requirements.

Finally, once the appropriate adjustments have been made, both qualifying capital and the scaled, adjusted required capital amounts would be aggregated across the Insurance SLHC to obtain a capital ratio.

Mathematically, the BBA can be expressed as:

$$Capital\ Ratio\ (BBA) = \frac{\sum_i Qualifying\ Capital_i}{\sum_i Adjusted\ Required\ Capital_i \cdot Scalar_i}$$

Figure 1: Stylized Representation of the BBA



B. Questions and Open Issues

In the preamble to the ANPR, the Federal Reserve noted a number of advantages of the BBA, including that it: (i) leverages existing legal entity-level regulatory capital frameworks; (ii) can be implemented expeditiously with relatively low regulatory costs and burdens; and (iii) would produce regulatory capital requirements tailored to the risks of each jurisdiction and each business line. The Federal Reserve also highlighted a number of potential disadvantages, including that the BBA (i) is not a true consolidated capital framework; (ii) would not discourage jurisdictional arbitrage; (iii) would necessitate adjustments for intercompany transactions that could be burdensome to implement; (iv) would require significant regulatory resources to calibrate the scalar multipliers; and (v) would require legal entity-level stress-testing.

The Federal Reserve solicited comment on certain key issues regarding the design and implementation of the BBA.

Baseline Capital Requirements

As mentioned above, the BBA would leverage the existing capital requirements applicable to each legal entity within an Insurance SLHC group. The Federal Reserve, however, has solicited comment on exactly how baseline capital requirements should be determined for these purposes. In particular, the Federal Reserve has requested comment on the appropriate baseline levels for determining the capital requirements, for example, with respect to regulated insurance companies, the Company Action Level and/or Authorized Control Level under state risk-based capital frameworks. Similarly, for insured depository institutions, the Federal Reserve suggests using the minimum capital ratios applicable under bank capital rules. For foreign insurance entities, the Federal Reserve would need to determine whether the local minimum capital requirement, prescribed capital requirement or some other requirement is the appropriate baseline. Determining the appropriate baseline level will be a critical decision that will directly affect how onerous the new capital requirement will be.

Reconciliation of Accounting Practices

In recognition of the fact that SAP accounting practices for insurance companies can vary from state to state and across jurisdictions, the BBA contemplates adjustments to the BBA based on state by state and international variance in accounting or capital standards. The Federal Reserve has solicited comment on how best to reconcile accounting practices across jurisdictions, including differences in permitted and prescribed practices.

Intercompany Transactions

As noted above, the BBA would not be a true consolidated capital requirement for Insurance SLHCs, but rather an aggregated capital requirement based on the individual capital requirements of its subsidiaries. In contrast to a consolidated framework (such as the Federal Reserve's existing capital requirements for banking organizations), an aggregated framework such as the BBA would need to be adjusted to take into account the effect of intercompany transactions. The Federal Reserve has solicited comment on the treatment of intercompany transactions, including which transactions should be eliminated.

Calibration of Jurisdictional Scalars

As discussed above, the BBA would require banking organizations to scale capital requirements (as adjusted) based on jurisdiction to account for differences in the stringency of local capital requirements. The Federal Reserve has solicited comment on how these scalar multipliers should be calibrated. The use of scalars could raise significant complexities in the design of the capital requirement, including whether the scalar would need to be regularly revised to account for changes in the relative stringency of the capital regimes, particularly for those that follow market valuation approaches, such as under Solvency II in Europe.

Aggregation of Qualifying Capital

Under the BBA framework described above, an Insurance SLHC would determine its aggregate qualifying capital by summing the qualifying capital at each of its legal entities. The Federal Reserve is considering a version of the BBA that would determine an institution's aggregate qualifying capital by reference to a single definition of qualifying capital for an Insurance SLHC, which would be applied to the institution on a fully consolidated basis. The Federal Reserve solicited comments on this approach, including with respect to the definition of "qualifying capital" for these purposes.⁹ The Federal Reserve has also solicited comments on rules to address minority interests (*i.e.*, capital instruments of a subsidiary that are held by third-parties).¹⁰

⁹ One open issue is the treatment of surplus notes. Surplus notes are not considered qualifying capital under the Federal Reserve's current regulatory capital framework, but are considered qualifying capital for insurance companies in many jurisdictions.

¹⁰ The Federal Reserve's capital framework for banking organizations contains a detailed methodology for accounting for minority interests. See 12 C.F.R. 217.21.

II. CAPITAL REQUIREMENTS FOR NB-SIFIS: THE CONSOLIDATED APPROACH

As in the case of SLHCs, the Collins Amendment requires the Federal Reserve to establish minimum leverage and risk-based capital requirements that apply to NB-SIFIs on a consolidated basis. Again, as in the case of SLHCs, the Insurance Capital Standards Clarification Act amended the Collins Amendment to permit the Federal Reserve to tailor these capital requirements for Insurance SIFIs.

The ANPR outlines the contours of the so-called “Consolidated Approach” (the “CA”) for Insurance SIFIs, defined in the ANPR to include NB-SIFIs with at least 40 percent of total consolidated assets related to insurance activities (or as otherwise ordered by the Federal Reserve). The Federal Reserve notes that this threshold “could reflect a level of insurance activity that is significant rather than incidental to the institution’s activities.”¹¹

The CA would categorize insurance liabilities, assets and certain other exposures into “risk segments,” determine consolidated required capital by applying “risk factors” to the amounts in each risk segment, define qualifying capital for the consolidated firm, and then compare consolidated qualifying capital to consolidated required capital. Unlike the BBA, which is based on aggregation of qualifying capital and required capital at the legal-entity level, the CA would be a fully consolidated framework consistent with existing capital requirements for banking organizations, but with factor weights appropriately calibrated for the longer-term nature of insurance liabilities. In this regard, the CA appears to be similar to the somewhat similar to “GAAP plus adjustments” approach contemplated by the International Capital Standard (the “ICS”) being designed by the IAIS (including the Basic Capital Requirement (the “BCR”) that the IAIS has developed for internationally to global systemically important insurers (“G-SIIs”). The IAIS’s current preferred approach for the ICS follows a market valuation approach to valuing assets and liabilities, which many criticize as being subject to excessive volatility in the capital models.

A. Description of the CA

The first step of calculating the CA capital requirement would be to assign each of an Insurance SIFI’s assets, liabilities and certain other exposures (determined

¹¹ ANPR at 8. In particular, the Federal Reserve notes that the CA “may be an appropriate regulatory capital framework for systemically important insurance companies,” particularly because “as a consolidated capital framework, [it] would reduce the opportunity for regulatory arbitrage and the potential for double leverage,” as well as “more easily enable supervisory stress-testing and other macroprudential features.” *Id.* at 22.

on a consolidated basis, based on GAAP) to defined “risk-segments.” Each of the risk segments would correspond to a different segment of an Insurance SIFI’s business (or a group of businesses that shared similar risk characteristics). For example, one segment could be “protection life,” while another could include “variable annuities.”

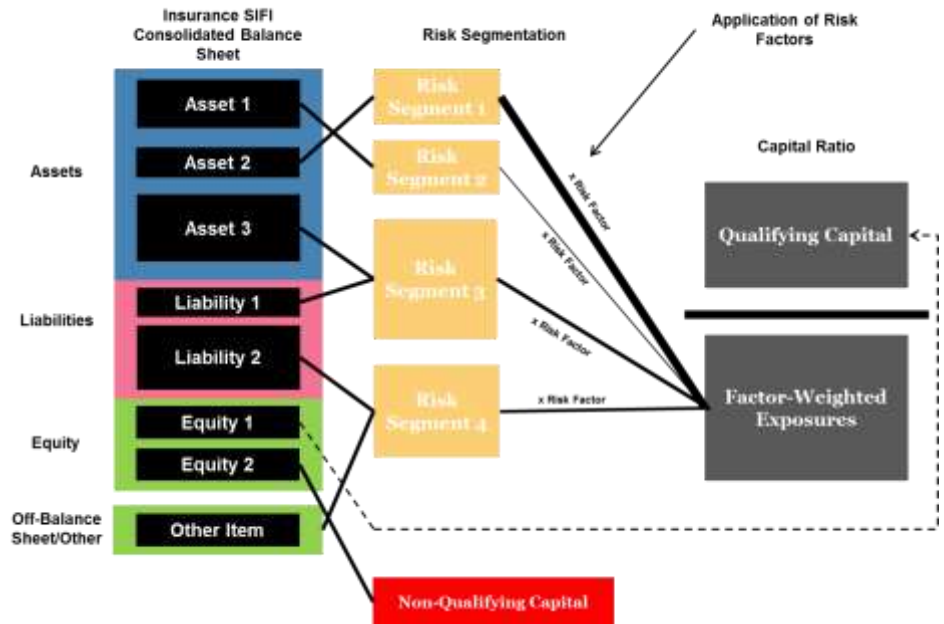
Next, an Insurance SIFI would be required to determine consolidated required capital by applying “risk factors” to the amounts in each risk segment and adding the “factor-weighted exposure” amounts obtained. These risk factors would be calibrated based on the perceived riskiness of the risk segment. This process appears to be substantially equivalent to the process for establishing risk-weighted asset charges under the Federal Reserve’s risk-based capital framework for banking organizations.

Finally, the Insurance SIFI would be required to calculate its consolidated qualifying capital and compare its qualifying capital to its consolidated required capital to make sure that it met any applicable minimum capital ratios.

Mathematically, the CA can be expressed as follows:

$$Capital\ Ratio\ (CA) = \frac{Qualifying\ Capital}{\sum_i Exposure\ Amount_i \cdot Risk\ Factor_i}$$

Figure 2: Stylized Representation of the CA



B. Questions and Open Issues

The Federal Reserve notes a number of advantages to the CA, including that: (i) it would be simple and transparent; (ii) it would cover all material risks of an Insurance SIFI; (iii) it would be a fully consolidated framework, rather than an aggregated framework like the BBA; (iv) it would be relatively expeditious for the Federal Reserve to develop; and (v) it would provide a solid basis upon which to build consolidated supervisory capital adequacy stress-testing for Insurance SIFIs. In addition, the Federal Reserve highlighted potential disadvantages of the CA approach, including that: (i) the factor-based approach could result in crude risk segments and limited risk sensitivity; and (ii) substantial analysis would be needed to design risk factors for all of the major segments of assets and insurance liabilities of an Insurance SIFI.

The Federal Reserve has solicited comment on certain key issues regarding the design and implementation of the CA.

Definition of Qualifying Capital

In contrast to the BBA, the CA is a consolidated approach to calculating regulatory capital requirements for Insurance SIFIs, and therefore will require a uniform definition of “qualifying capital.” The Federal Reserve has explicitly requested comment on how a uniform, consolidated definition of qualifying capital should be formulated.

Segmentation of Exposures

A fundamental element of the CA methodology is dividing an Insurance SIFI’s assets, liabilities and off-balance sheet exposures into risk segments, a process that seeks to account for differences among insurance risks as well as between insurance risks, banking risks and other non-insurance, financial risks. The Federal Reserve is considering the segmentation framework set forth in the Federal Reserve’s recently proposed Consolidated Financial Statements for Insurance Systemically Important Financial Institutions, but has generally solicited comment on how exposures should be segmented (the “FR 2085 Report”).¹² The FR 2085 Report would collect financial data on a consolidated basis from Insurance SIFIs, similar to the Federal Reserve’s FR Y-9C report, but is tailored to reduce the burden on, and reflect the business and risks of, Insurance SIFIs. In particular, the FR 2085 Report would include data items and schedules that are specific or unique to insurance, e.g., schedules that collect

¹² 81 Fed. Reg. 24,097 (April 25, 2016).

business-line level information in insurance-related underwriting activities (including reinsurance).¹³

Measurement of Exposure Amounts

In order to transform balance sheet and off-balance sheet items into required capital amounts, the CA would assign exposure amounts to each of an Insurance SIFI's assets, liabilities and off-balance sheet exposures. Although these exposure amounts can be determined in reference to GAAP, the Federal Reserve has solicited comment on how exposures should be measured to accurately reflect the risk exposure in determining required capital, particularly for off-balance sheet exposures such as derivatives.

Calibration of Factors

The final step in obtaining a required capital amount under the CA is to apply a supervisory risk factor to the exposure amounts of assets, liabilities and off-balance sheet items in each risk segment. As each risk factor should reflect the riskiness of the segment, the Federal Reserve has solicited comment on what it should consider in determining the various factors. Just how the capital requirements are calibrated will be a critical factor in determining how onerous overall the capital standard will be; for instance, the BCR was initially calibrated to fall between expected minimum and prescribed capital requirement levels applicable to the G-SIIs, but was later increased by one-third (through the use of an uplift) to bring it closer to general prescribed capital requirement levels.

Selection of Minimum Ratio

The CA would require the establishment of a minimum ratio of consolidated qualifying capital to consolidated factor-weighted exposures. The Federal Reserve has solicited comment on the criteria it should consider in developing a minimum capital ratio, including on how capital adequacy should be assessed for early remediation and other supervisory purposes (e.g., how "well capitalized" or "adequately capitalized" should be defined).

¹³ Federal Reserve, Instructions for Preparation of Consolidated Financial Statements for Insurance Nonbank Financial Companies, Reporting Form FR 2085, available at http://www.federalreserve.gov/reportforms/formsreview/FR2085_20160421_i_draft.pdf.

III. REJECTED APPROACHES

In formulating capital requirements for Insurance SLHCs and Insurance SIFIs, the Federal Reserve considered a number of frameworks in addition to the BBA and the CA. The ANPR highlights a number of these alternatives that the Federal Reserve considered, and provides justification, where applicable, as to why the Federal Reserve rejected these approaches.

Apply Bank Capital Rules

The Federal Reserve considered applying a risk-based capital rule based solely on the Federal Reserve's existing requirements for banking organizations. The Federal Reserve rejected this, noting that such an approach would not recognize the "unique risks, regulation, and balance sheet composition of insurance firms."

Exclude Insurance Subsidiaries

The Federal Reserve considered an approach that entirely excludes insurance subsidiaries and would only apply capital requirements to the non-insurance portion of an Insurance SLHC or Insurance SIFI. The Federal Reserve rejected this approach on the basis that it would not capture all the material risks of the organization.

Solvency II

The Federal Reserve considered an approach based on the European Solvency II framework, but rejected any such approach on the basis that it was not appropriately tailored to U.S.-based insurance companies. In particular, the Federal Reserve noted that using a Solvency II-based standard would not adequately account for U.S. GAAP, may introduce excessive volatility due to discount rate assumptions and would involve excessive reliance on internal models (which Solvency II allows and which many large insurance companies have adopted).

Internal Stress-Testing

Finally, the Federal Reserve also considered applying an approach based on internal stress-testing. The Federal Reserve noted that such an approach "would rely on internal models, be highly novel and complex, would entail a large and lengthy construction project, and would require a substantial dedication of supervisory resources to superintend." Although the Federal Reserve highlighted a number of difficulties with such an approach, it did not explicitly reject it, but

rather suggested that it will continue to explore the potential benefits of such an approach.

IV. POTENTIAL IMPACTS

The publication of the ANPR likely will impact the NAIC's ongoing efforts 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 Act era. However, by following approaches favored by U.S. insurers, the Federal Reserve's suggested approaches may alleviate concerns of some insurers that they will be subject to new and inconsistent capital requirements once the group standards are developed.

The Federal Reserve's dismissal of Solvency II as well as, it appears, the market valuation approach favored by the IAIS in the development of the ICS and the BCR as a workable basis for capital requirements for Insurance SLHCs and Insurance SIFIs 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 currently are expected to be finalized by 2019. With this ANPR, the Federal Reserve may 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. If the Federal Reserve's concerns are recognized in the final design of the international standards, international standards may follow a more localized approach and lose consistency in application across jurisdictions. On the other hand, if the international standards proceed along their current path, insurance groups subject to both the international standards and the Federal Reserve's rules may face additional layers of potentially inconsistent capital requirements.

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Please do not hesitate to contact us with any questions.