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The Fed's Proposed Capital Rules Could Be Overly Complex

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On Friday, May 20, 2016, Daniel Tarullo, a member of the board of governors of the U.S. Federal Reserve System, previewed a conceptual proposal for capital standards that will be applied to insurers subject to the board's supervision. In a speech at the International Insurance Forum in Washington, D.C., sponsored by the National Association of Insurance Commissioners (NAIC), Gov. Tarullo announced that the board would issue an advance notice of proposed rulemaking (ANPR) in the coming weeks to solicit feedback from regulators, the U.S. insurance industry and other interested parties on a two-pronged approach that would impose separate capital standards on systemically important insurers (SIIs) and on insurers subject to the board's supervision as a result of their ownership of a federally insured bank or thrift (non-SIIs).[1] He also indicated that the board would soon propose enhanced prudential standards for SIIs in the areas of corporate governance, risk management and liquidity management and planning.

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Background

Section 312 of the Dodd-Frank Wall Street Reform and Consumer Protection Act abolished the Office of Thrift Supervision (OTS) and distributed its responsibilities among several federal agencies, including the board. Supervisory oversight of savings and loan holding companies, a category that includes several dozen insurers with bank or thrift subsidiaries, was transferred from the OTS to the board. As a result of Dodd-Frank, the board is also vested with oversight of insurers designated by the Federal Stability Oversight Council (FSOC) as systemically important — currently Prudential Financial Inc. and AIG. According to Gov. Tarullo, this means that 25 percent of U.S. insurance industry assets are now within the jurisdiction of the board.

In his speech, Gov. Tarullo briefly surveyed a number of existing or developing frameworks for insurance capital regulation, including the Solvency II regime adopted by the European Union and the insurance capital standard being developed by the International Association of Insurance Supervisors for internationally active insurance groups and global systemically important insurers. Gov. Tarullo stated, however, that the board does not intend to follow any of those approaches. Among other criticisms, he indicated that several of the approaches rely too extensively on internal models, and others have conceptual appeal or promise but are "impractical for the foreseeable future" given the board's need to develop and implement its insurance capital standard in the relatively near term.

Capital Standards for Non-SIIs

Gov. Tarullo devoted a significant portion of his speech to addressing capital rules for non-SIIs. He suggested that the board is likely to propose what he called a "building block approach" (BBA) for non-SIIs. Under the BBA, capital requirements at each regulated subsidiary (e.g., insurer, bank or thrift) would "generally" be determined using the regulatory capital rules already applied to such subsidiary by the relevant regulator, which could be a state or non-U.S. insurance regulator in the case of an insurer. (Unregulated subsidiaries would be analyzed using the existing standardized risk-based capital rules applicable to affiliates of bank holding companies.) The group's aggregate capital requirement would in turn "generally" be the sum of these individual capital requirements. Gov. Tarullo expressed the view that most of the complexity in such a regime would involve developing a translation matrix to put different regulatory regimes on an equivalent footing and then applying that matrix to address intercompany transactions and other exposures (such as permitted accounting practices for insurers). The goal would be to impose some type of enterprisewide capital requirement without forcing insurers to incur the burdens and costs associated with moving to fully consolidated generally accepted accounting principals-type financial reporting.

Capital Standards for SIIs

Gov. Tarullo also commented on the board's likely approach to capital requirements for SIIs. In contrast to the BBA to be used for non-SIIs, Gov. Tarullo indicated that a modified consolidated capital framework would be appropriate for SIIs because of the risks they pose to financial stability. Accordingly, this "consolidated approach" would use consolidated financial information based on GAAP, with "appropriate adjustments for regulatory purposes." The consolidated insurance group's assets and liabilities would be segmented with each segment receiving a risk weighting that takes into account the longer-term nature of most insurance liabilities. The consolidated capital requirements would then be compared to the corresponding resources and measured against a minimum ratio of required capital. The number of risk categories could be increased over time to achieve greater risk sensitivity as the board gains experience with the consolidated approach. The regulatory capital framework for SIIs as outlined by Gov. Tarullo therefore would be similar in scope and structure to the basic regulatory capital framework for bank holding companies, though with perhaps some more favorable risk-weightings and other potential adjustments tailored to the insurance business.

Implications

Assuming the building-block and consolidated approaches to insurer capital regulation are ultimately implemented in a manner consistent with Gov. Tarullo's speech, multinational insurance groups subject to the board's jurisdiction will soon face additional challenges in navigating an even larger patchwork of capital standards (one of two board standards: the insurance capital standards of the International Association of Insurance Supervisors or the NAIC and other country-specific standards, including Solvency II). Gov. Tarullo acknowledged as much in his speech, though he expressed the view that the incremental regulatory burden under the board's forthcoming proposals would be less than under alternative proposals it has considered. In making this observation, he may have been mindful of the recent decision by the United States District Court for the District of Columbia in MetLife Inc. v. Financial Stability Oversight Council, No. 15-0045 (D.D.C. Mar. 30, 2016), which rested in part on the failure of the FSOC to consider the costs attendant to MetLife complying with its SII designation.

It is also not immediately apparent what additional insight the board will gain from the BBA, which

generally tracks existing regulations. Because most non-SIIs do not, and under the Collins Amendment to Section 171 of Dodd-Frank cannot be required to, produce consolidated financial statements on a GAAP basis, the board will have to rely heavily on the translation matrix in order for the BBA to produce meaningful results. It is therefore possible that the translation matrix, when proposed, will be quite intricate and complex, which could have the unintended consequence of placing a comparatively larger compliance burden on non-SIIs than on SIIs.

Next Steps

As noted above, Gov. Tarullo stated that the board intends to issue an ANPR in the coming weeks to solicit feedback from interested parties. In choosing to telegraph the scope and content of the ANPR with Gov. Tarullo's speech, the board has, in effect, acknowledged that its forthcoming proposals may create substantial controversy in the U.S. insurance industry. Based on the reception to Gov. Tarullo's speech at the International Insurance Forum, such controversy may not be limited to the domestic market.

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[1] The non-SIIs addressed by Gov. Tarullo consist of those insurers that own a bank or thrift and that are significantly engaged in commercial or insurance underwriting activities. Those insurers were specifically excluded from the board's U.S. Basel III capital rules adopted in 2013 pending the development of a tailored capital rule along the lines outlined by Gov. Tarullo. See 78 Fed. Reg. 62018 (Oct. 11, 2013). The board's U.S. Basel III capital rules (with some special insurance-specific provisions) apply to banks and savings and loan holding companies that are not themselves significantly engaged in commercial or insurance underwriting but that own insurers.

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