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Regulation: A Legal View

SETTING STANDARDS

Changing the Rules

With its proposed capital standards, the Fed takes a different approach for systemically important insurers and insurers that own a bank or thrift.

by Frank Monaco and Larry Hamilton

The Federal Reserve recently caught the attention of insurers when it announced proposed capital requirements and prudential standards for certain insurance companies subject to its supervision.

In a speech at the International Insurance Forum in Washington, D.C., in May, Fed Governor Daniel Tarullo previewed the Fed's intention to adopt capital standards for insurance companies designated as systemically important insurers, as well as for insurers subject to the Fed's supervision because they own a federally insured bank or thrift. Tarullo also discussed the U.S. central bank's intention to adopt enhanced prudential standards for systemically important insurers. Two weeks later,

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the Fed sought public comment on a preliminary outline of its proposed capital standards and on the proposed prudential standards for systemically important insurers.

As proposed, these capital standards would directly affect a comparatively small number of insurance groups, because currently there are only two systemically important insurers and 12 insurers supervised because they own a bank or thrift. It is possible, however, that the final version will affect a broader array of insurers. In any case, these standards are part of the broader ongoing dialogue about insurers' appropriate capital standards taking place at the state, federal and international levels.

Key Points

The Proposal: The Fed suggests adopting different approaches to changes in capital standards for systemically important insurers and insurers supervised by the Fed because they own a bank or thrift.

The Question: How will the proposed capital requirements interact with the existing state insurance regulatory regime?

What's Next: The industry is waiting to see how public comments on the proposed rules will affect the Fed's proposals and impact their businesses going forward.

Capital Standards

In developing capital standards for the insurers that own banks or thrifts, the Fed is seeking to protect insured depository institutions. The Fed's proposal to develop capital standards for systemically important insurers seeks to promote financial stability in a manner that recognizes both the unique form of financial intermediation in the insurance business and the way in which the activities of systemically important insurers are much more closely connected to short-term financial markets and the rest of the financial system. The Fed believes those two objectives suggest adopting different approaches for each group.

According to the proposed framework for capital standards, any minimum capital requirements must satisfy the Dodd-Frank law's Collins Amendment, which requires the Fed to establish minimum leverage capital and risk-based capital requirements that, on a consolidated basis, are at least as stringent as those in effect for insured depository institutions on July 21, 2010, and at the present time. As amended in 2014, the Collins Amendment provides the central bank with flexibility to tailor these capital requirements to the risks presented by insurance companies. The proposed capital standards are intended to complement the state insurance regulators' primary mission, which focuses on policyholder protection.

The Fed appears to acknowledge that the liability structures, asset classes and asset-liability matching of insurers differ from those of bank holding companies. However, the Fed also takes the view that capital standards must consider both insurance and noninsurance risks and, to the extent possible, risks across the entire holding company system. The Fed also notes that financial distress has the potential to spread from unregulated subsidiaries to regulated ones, and it has expressed a preference for standardized and consistent capital requirements—rather than allowing a group to rely predominantly on internal models.

Non-Systemically Important Insurers

For insurers that own a bank or a thrift, the Fed proposes a building-block approach. With this method, capital requirements at each regulated subsidiary (e.g., insurer, bank or thrift) would generally be determined using the regulatory capital rules (including risk-based capital rules) already applied to that subsidiary by the relevant regulator, which in the case of an insurer could be a state or non-U.S. insurance regulator. Unregulated subsidiaries would be analyzed using the existing standardized risk-based capital rules applicable to nonbank subsidiaries of bank holding companies.

A holding company's aggregate capital requirements would generally be the sum of the capital requirements at each subsidiary, with adjustments to address items such as differences in accounting, to eliminate

intercompany transactions and to reflect "other cross-jurisdictional differences such as differing supervisory objectives and valuation approaches."

The Fed would develop a translation matrix—an array of adjustment factors called scalars—which it would use to put different regulatory regimes on an equivalent footing and to address intercompany transactions and other exposures (such as permitted accounting practices for insurers).

Scalars also would be used to account for differences in stringency applied by different insurance supervisors, and to ensure adequate reflection of safety and soundness and financial stability goals, rather than policyholder protection, as well as other relevant considerations. Notably, the Fed does not specify scalar values or categories and invites comment on the criteria it should use to develop them.

The goal would be to impose some type of enterprisewide capital requirement without forcing non-SIIs to incur the burdens and costs associated with moving to consolidated financial reporting on a generally accepted accounting principles (GAAP) basis.

The Fed notes that at present the building-block approach would apply to the 12 insurance depository institution holding companies that are currently under Fed supervision as savings and loan holding companies. There are currently no insurers under Fed supervision as bank holding companies. The Fed has invited comment on whether larger or more complex insurers that might in the future acquire a depository institution should be subject to a regulatory capital framework other than the building-block approach.

These standards are part of the broader ongoing dialogue about insurers' appropriate capital standards taking place at the state, federal and international levels.

Systemically Important Insurers

For systemically important insurers, the Fed is considering a modified consolidated capital framework because of risks it believes those entities pose to financial stability. Accordingly, this approach would use consolidated financial information based on GAAP, with adjustments for regulatory purposes. The Fed notes that applying the consolidated approach 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 statutory accounting principles.

Statutory accounting principles, which differ in a number of respects from GAAP, are the accounting principles used by U.S. insurance companies to prepare the statutory financial statements they are required to file with state insurance regulatory authorities.

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 consolidated group's qualifying capital 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 Fed gains experience with the consolidated approach. The regulatory capital framework for systemically important insurers, therefore, would be similar in scope and structure to the basic regulatory capital framework for bank holding companies, with perhaps some more favorable risk weightings and other potential adjustments tailored to the insurance business.

Prudential Standards for SIIs

Dodd-Frank directs the Fed to establish enhanced prudential standards for bank holding companies with at least $50 billion in total consolidated assets and nonbank financial companies designated by the Financial Stability Oversight Council as systemically important financial institutions (SIFIs, of which systemically important insurers are a subset) in order to prevent or mitigate risks to U.S. financial stability from the material financial distress or failure, or ongoing activities, of these companies.

In 2014 the Fed adopted enhanced prudential standards for larger bank holding companies, and in June issued a proposed rule to apply enhanced prudential standards to insurers designated by the council as systemically important. Once final rules are adopted, systemically important insurers would be expected to comply with the enhanced prudential standards on the first day of the fifth quarter following the effective date (about a year).

As outlined in the Fed's notice of proposed rulemaking, two types of enhanced prudential standards would apply to systemically important insurers: corporate governance and risk management, and liquidity risk management, including a contingency funding plan and stress testing. These standards would be tailored to the insurance industry. The corporate governance and risk management standard would require each systemically important insurer to have a chief actuary who would monitor reserve adequacy on an enterprisewide basis and would require the board of directors to establish a separate risk committee chaired by an independent director. Also, in light of the different nature of insurance liabilities, the liquidity risk management standards would apply a 90-day planning horizon for the liquidity stress testing requirement instead of the 30-day planning horizon applicable to large bank holding companies.

Request for Public Comment

The Fed solicited input on the proposed capital standards and enhanced prudential standards. An overarching question was how the proposed capital requirements should interact with the existing state insurance regulatory regime, including state-by-state variations in accounting and capital treatment and the effect of permitted—as distinguished from prescribed—accounting practices under statutory accounting principles. Some questions on which the Fed sought public comment include:

- Criteria to develop scalars for different jurisdictions.
- Whether the same capital framework should apply to all supervised insurance institutions.
- Criteria to determine whether a supervised insurance institution should be subject to regulatory capital rules tailored to the business of insurance.
- What activities, in addition to insurance underwriting, should determine whether a supervised institution is significantly engaged in the business of insurance and therefore should be subject to regulatory capital requirements tailored for insurance.
- What is the potential for the building-block approach and/or the consolidated approach to be subject to regulatory arbitrage.
- Whether the building-block approach would be appropriate for larger or more complex insurers that might in the future acquire a depository institution.
- How qualifying capital should be defined for purposes of meeting the capital requirements and whether qualifying capital should be categorized into multiple tiers.

The deadline for submitting comments was in August. Whether the public comments significantly affect the shape of the proposed rules will be of continuing interest to the insurance industry. BR

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