BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date:	June 3, 2016
To:	Board of Governors
From:	Governor Tarullo DKT
Subject:	Advance notice of proposed rulemaking regarding capital requirements for supervised institutions significantly engaged in insurance activities

Attached are a memorandum to the Board and a draft Federal Register notice inviting public comment on an advance notice of proposed rulemaking (ANPR) regarding potential regulatory capital frameworks that would apply to nonbank financial companies significantly engaged in insurance activities that the Financial Stability Oversight Council has determined shall be supervised by the Board (systemically important insurance companies), and bank holding companies (BHCs) and savings and loan holding companies (SLHCs) significantly engaged in insurance activities. The draft ANPR discusses two, independent capital frameworks tailored to the business mix and risk profile of these supervised institutions.

The building block approach (BBA) would use, as a starting point, existing legal-entity capital requirements for insurance companies, including state and foreign insurance risk-based capital requirements, and the BHC or bank risk-based capital standards for banking, non-insurance and unregulated entities. A firm's aggregate capital requirements generally would be the sum of the capital requirements at each subsidiary, with adjustments to address items such as differences in accounting and to eliminate inter-company transactions, and scalars to reflect cross-jurisdictional differences such as differing supervisory objectives and valuation approaches. The building block approach may be appropriate for SLHCs and BHCs that are significantly engaged in insurance activities.

The consolidated approach (CA) would categorize all of a consolidated insurance firm's assets and insurance liabilities into risk segments tailored to account for the liability structure and other unique features of an insurance firm, apply risk factors to the amounts in each segment, and then set a minimum ratio of consolidated capital resources to consolidated capital requirements. The consolidated approach may be a suitable approach for systemically important insurance companies.

The proposal is being issued as an ANPR in order to give interested parties an opportunity to comment on the conceptual aspects of the two capital frameworks before their details are proposed.

The Committee on Bank Supervision has been briefed on the attached materials, and I believe they are ready for the Board's consideration.

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: June 3, 2016

To: Board of Governors

From: Staff[1]

Subject: Advance notice of proposed rulemaking regarding capital requirements for supervised institutions significantly engaged in insurance activities

ACTIONS REQUESTED: Approval to invite public comment on the attached draft advance notice of proposed rulemaking (ANPR) regarding potential regulatory capital frameworks that would apply to nonbank financial companies significantly engaged in insurance activities that the Financial Stability Oversight Council has determined shall be supervised by the Board (systemically important insurance companies), and bank holding companies (BHCs) and savings and loan holding companies (SLHCs) significantly engaged in insurance activities (all, supervised insurance institutions). Staff also requests authority to make technical and minor changes to the draft ANPR to prepare it for publication in the Federal Register.

EXECUTIVE SUMMARY:

- The draft ANPR invites public comment on two approaches to regulatory capital requirements for supervised insurance institutions that would fulfill the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Issuing an ANPR allows for comment on the approaches before their details are developed.
- The regulatory capital approaches in the draft ANPR would apply to systemically important insurance companies, as well as BHCs and SLHCs significantly engaged in insurance activities, such as those that have 25 percent or more of their total consolidated assets in insurance underwriting subsidiaries other than assets associated with insurance underwriting for credit risk (insurance depository institution holding companies).[2]

[1] Messrs. Gibson, Van Der Weide, Lindo, Sullivan, Ms. Duzick, and Mr. Paliwal (Division of Banking Supervision and Regulation), and Mr. Alvarez, Ms. Schaffer, Messrs. McDonough, Wilson, and Alexander, and Ms. Watkins (Legal Division).

[2] Presently, the population of Board-supervised insurance depository institution holding companies consists of 12 SLHCs; there are no BHCs that meet the criteria.

- The draft ANPR outlines two conceptual, tailored capital frameworks:
  - **Building block approach**. The building block approach (BBA) would use, as a starting point, existing legal-entity capital requirements for insurance companies, including state and foreign insurance risk-based capital requirements, and the BHC or bank risk-based capital standards for banking, non-insurance, and unregulated entities. A firm's aggregate capital requirements generally would be the sum of the capital requirements at each subsidiary, with adjustments to address items such as differences in accounting and to eliminate inter-company transactions, and scalars to reflect other cross-jurisdictional differences such as differing supervisory objectives and valuation approaches. Based on a preliminary analysis, this approach may be appropriate for the twelve insurance depository institution holding companies currently under Board supervision, as these firms are significantly engaged in insurance activities, but are not systemically important, engage in less complex and foreign activities, and generally prepare financial reporting only using U.S. statutory accounting principles (SAP) rather than U.S. Generally Accepted Accounting Principles (GAAP).
  - **Consolidated approach**. The consolidated approach (CA) would categorize all of a consolidated insurance firm's assets and insurance liabilities into risk segments tailored to account for the liability structure and other unique features of an insurance firm; apply risk factors to the amounts in each segment; and then set a minimum ratio of consolidated capital resources to consolidated capital requirements. Based on a preliminary analysis, the CA may be a suitable approach for institutions that are large, complex, international, and systemically important, which currently are the two systemically important insurance companies. A consolidated form of capital requirements would better ensure that the risks these firms pose to the financial system are taken into account.

DISCUSSION:

In developing capital standards for supervised insurance institutions, there are two primary objectives: first, to protect insured depository institutions and, second, to promote financial stability in a manner that takes account of both the unique form of financial intermediation reflected in the insurance business and the activities by a few firms that are much more closely connected to short-term financial markets and the rest of the financial system. These factors suggest different approaches to capital requirements for insurance depository institution holding companies and for the systemically important insurance companies.

Any minimum capital requirements for supervised insurance institutions must also satisfy the requirements of section 171 of the Dodd-Frank Act (the Collins Amendment).[3] With respect to both insurance depository institution holding companies and systemically important insurance companies, the Collins Amendment requires the Board to establish minimum leverage capital requirements and minimum risk-based capital requirements that, on a consolidated basis, are at least as stringent as the generally applicable leverage and risk-based capital requirements that apply to insured depository institutions.[4] As amended in 2014, the Collins Amendment provides the Board with flexibility to tailor these capital requirements to the risks presented by insurance companies.[5]

The approaches to consolidated capital standards described in the draft ANPR reflect input received and considered through engagement with insurance regulators, industry and accounting experts, and representatives from the insurance industry, among other interested parties. By seeking comment through the draft ANPR, the Board would have an opportunity to receive input on general approaches to capital regulation for supervised insurance institutions before issuing a specific regulatory proposal for public comment. (***See Attachment pp. 4-11***)

A. Building Block Approach (BBA)

The Board has traditionally set capital requirements for holding companies on a consolidated basis.[6] Among other things, a consolidated holding company capital standard deters holding companies (1) from placing assets in whichever legal entity has the lowest legal-entity-level capital requirements; and (2) from engaging in double leverage (that is, use by a holding company of debt that is down-streamed as capital to subsidiaries). However, many insurance depository institution holding companies do not produce consolidated financial statements.

[3] 12 U.S.C. § 5371.

[4] Id.

[5] Id.

[6] See 12 CFR part 217.

Moreover, the Collins Amendment prohibits the Board from requiring such firms to produce consolidated financial statements under U.S. GAAP.[7] Given that none of the insurance depository institution holding companies have been designated as systemically important and that the depository institutions they own tend to be relatively small parts of the total firm, the compliance costs of requiring a non-U.S. GAAP form of consolidated approach may outweigh the incremental safety and soundness benefits of doing so.

Under the BBA, legal-entity-level capital requirements would serve as building blocks to calculate capital requirements for an entire insurance depository institution holding company. The BBA would build upon and aggregate legal entity (insurance, non-insurance financial, non-financial, depository institution, and holding company) qualifying capital and required capital, subject to adjustments. A firm's aggregate qualifying capital generally would be the sum of the qualifying capital positions at each legal entity, subject to any relevant adjustments, and a firm's aggregate required capital would be the sum of the capital requirements for each legal entity, also subject to relevant adjustments.

There are several types of adjustments that may be necessary for calculation of an insurance depository institution holding company's enterprise-wide capital requirement, such as adjustments to standardize the accounting practices under SAP between U.S. jurisdictions and adjustments to eliminate inter-company transactions. Additionally, the BBA may require consideration of other cross-jurisdictional differences, through the use of scalars. Scalars would be used to account for differences in stringency among the capital rules applied by insurance supervisors, and to ensure adequate reflection of safety and soundness and financial stability goals as opposed to policyholder protection, as well as other relevant considerations. The regulatory capital requirement for each insured depository institution subsidiary, regulated non-insurance subsidiary, or unregulated subsidiary (for example, leasing subsidiaries, credit card affiliates, and mid-tier holding companies) generally could be determined under the Board's standardized risk-based capital rules for banks. The ratio of aggregate qualifying capital to

[7] See section 171(c)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), as amended, which prohibits the Board from requiring, pursuant to the Dodd Frank Act or the Home Owners' Loan Act, supervised institutions that only prepare financial statements in accordance with U.S. SAP to prepare financial statements in accordance with U.S. GAAP. 12 U.S.C. § 5371(c)(3)(A)-(B).

aggregate required capital could represent the firm's capital adequacy at a consolidated level. (***See Attachment pp. 11-14, 16-19***)

The BBA would use existing legal-entity-level regulatory capital frameworks that already apply to the various units of an insurance depository institution holding company. As such, it would involve relatively low regulatory burden for these entities, and would appear to produce regulatory capital requirements that are reasonably well tailored to the insurance-related risks for each jurisdiction and line of business of the institution. In addition, staff expects that the BBA could be developed and implemented expeditiously. However, the BBA would require adjustments to conform differences in accounting, and scalars for a large number of state and foreign insurance regulatory capital regimes to adjust for differences across these regulatory requirements. Moreover, if used as a basis for stress testing, the BBA would require legal-entity-level stress tests, which could present challenges due to diversification and inter-company risk transfer mechanisms, among other things. (***See Attachment pp. 14-15***)

Based on these considerations, staff believes that the BBA has the potential to be an appropriate regulatory capital framework for the twelve insurance depository institution holding companies currently under Board supervision: they are significantly engaged in insurance activities, they are not significantly engaged in unregulated or foreign activities, they have not been determined to pose significant risk to financial stability, and they generally prepare only SAP financial statements. In particular, the BBA is relatively low burden, standardized, executable, uses U.S.-based accounting principles, accounts for material insurance risks, strikes a balance between risk-sensitivity and simplicity, and is tailored to the business model and risks of insurance. However, the draft ANPR invites comments on whether larger or more complex insurance companies that might in the future acquire a depository institution should be subject to a regulatory capital framework other than the BBA. (***See Attachment pp. 15-16***)

B. Consolidated Approach (CA)

Systemically important insurance companies are large, complex, and interconnected with the financial system. Application of an aggregated approach such as the BBA to systemically important insurance companies could pose risks to the achievement of the Board's statutory mandate to impose enhanced risk-based capital requirements to mitigate the risk to U.S. financial stability from the failure or material financial distress of these firms. Moreover, to make it suitable for systemically important insurance companies, the BBA would require significant adjustments to reflect the non-insurance activities of these companies and varying U.S. and foreign accounting practices, among other things.

The CA would establish a consolidated capital requirement, with the purpose of addressing all of the institution's material risks. 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 segment; define qualifying capital for the consolidated firm; and require a minimum ratio of consolidated qualifying regulatory capital to consolidated risk-weighted assets and insurance liabilities. The CA would use risk weights and risk factors that are appropriate for the longer-term nature of most insurance liabilities.

The foundation of the CA would be consolidated financial information based on U.S. GAAP with adjustments for regulatory purposes. Implementing the CA would require a framework for assigning risk factors to segments of balance-sheet assets, balance-sheet insurance liabilities, and certain off-balance-sheet exposures. The segmentation process would take account of differences among insurance risks and between insurance and banking risks. Appropriate segmentation would be important to ensure that similar risks face broadly similar capital requirements and that the capital regime produces an appropriate degree of risk sensitivity while minimizing the opportunities for regulatory arbitrage. While the initial version of the CA likely would have broad risk segments, the CA could evolve over time to become more risk sensitive by including more granular risk segments. (***See Attachment pp. 19-21, 23-25***)

The CA would have the benefits of addressing all material risks and would be a fully consolidated framework that would address risks across the entire organization. The CA would help prevent intra-group regulatory arbitrage opportunities and the potential for double leverage. In addition, the CA would provide a good foundation on which to build a consolidated supervisory stress testing framework. However, to implement the CA, additional analysis would be needed to design a set of risk factors for all of the assets and insurance liabilities of systemically important insurance companies. (***See Attachment pp. 21-22***)

Based on these considerations, staff believes that the CA has the potential to be an appropriate regulatory capital framework for systemically important insurance companies. (***See Attachment p. 22***)

RECOMMENDATIONS:

For the reasons discussed above, staff recommends that the Board approve the attached draft ANPR for a public comment period of 60 days. Staff also seeks approval to publish the draft ANPR in the Federal Register and to make minor wording and technical changes to the draft ANPR (e.g., formatting) in order to prepare it for publication in the Federal Register.

Attachment