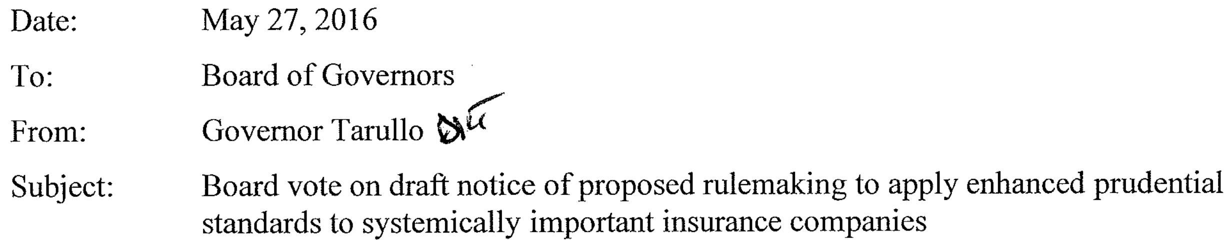
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM



Date: May 27, 2016

To: Board of Governors

From: Governor Tarullo

Subject: Board vote on draft notice of proposed rulemaking to apply enhanced prudential standards to systemically important insurance companies

Attached are a memorandum to the Board and a draft Federal Register notice of proposed rulemaking (proposed rule) that would require nonbank financial companies with significant insurance activities that the Financial Stability Oversight Council has determined shall be supervised by the Board (systemically important insurance companies) to comply with a corporate governance and risk-management standard and a liquidity risk-management standard. Currently, American International Group, Inc. and Prudential Financial, Inc. would be required to comply with the proposed enhanced prudential standards, if adopted as proposed.

The proposed enhanced prudential standards have been tailored from the standards that are applicable to bank holding companies. The corporate governance and risk-management standard would require a systemically important insurance company to implement an enterprise-wide risk management framework, maintain a risk committee, and appoint a chief risk officer and chief actuary.

The proposal also would require that a systemically important insurance company implement a number of prudential standards to manage its liquidity risk. The proposed rule would require a systemically important insurance company to meet key internal control requirements with respect to liquidity risk-management, generate comprehensive cash flow projections, establish and monitor its liquidity risk tolerance, and maintain a contingency funding plan to manage liquidity stress events when normal sources of funding may not be available. The proposed rule also would introduce liquidity stress testing requirements for these firms.

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

Attachments

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: May 27, 2016

To: Board of Governors

From: Staff[1]

Subject: Notice of proposed rulemaking to apply enhanced prudential standards to systemically important insurance companies

ACTIONS REQUESTED: Approval to invite public comment on the attached draft notice of proposed rulemaking (proposed rule) that would implement risk management, corporate governance, and liquidity risk management standards for nonbank financial companies significantly engaged in insurance activitivites that the Financial Stability Oversight Council (Council) has determined shall be supervised by the Board (systemically important insurance companies). Staff also requests authority to make technical and minor changes to the attached materials prior to publication in the Federal Register in order to respond to comments from the Federal Register.

EXECUTIVE SUMMARY: Section 165 of the Dodd-Frank Act directs the Board to establish prudential standards for systemically important insurance companies.[2]

- Scope of application. The proposed rule's prudential standards would apply to any systemically important insurance company. Currently, American International Group, Inc. (AIG), and Prudential Financial, Inc., would meet these two requirements and would be subject to the proposed rule, if adopted.
- Risk management. The proposed rule would require a systemically important insurance company to maintain an enterprise-wide risk-management framework, including related policies and procedures.
- Corporate governance. The proposed rule would require a systemically important insurance company to maintain a risk committee of its board of directors that is

[1] Messrs. Gibson, Van Der Weide, Lindo, and Sullivan, Ms. Duzick, and Messrs. Cuttler and Walker (Division of Banking Supervision and Regulation) and Mr. Alvarez, Ms. Schaffer, and Messrs. Wilson and Bowne (Legal Division).

[2] 12 U.S.C. § 5365.

responsible for the company's risk-management policies and framework and have a chief risk officer and a chief actuary.

- Liquidity risk-management. The proposed rule would set forth responsibilities for a systemically important insurance company's board of directors, risk committee, and senior management with respect to liquidity risk management. A systemically important insurance company would be required to (1) have short- and long-term cash-flow projections, a contingency funding plan, liquidity risk limits, and procedures for monitoring liquidity risk; and (2) conduct liquidity stress tests on a monthly basis and maintain a liquidity buffer sufficient to cover its net stressed cash flows over a 90-day period.

DISCUSSION: The proposed enhanced prudential standards are based on enhanced prudential standards that have been adopted by the Board under the Dodd-Frank Act for large and complex banking organizations. However, these proposed standards for systemically important insurance companies have been tailored from the standards that are applicable to bank holding companies in order to reflect the systemic footprints, business models, capital structures, and risk profiles of systemically important insurance companies.

Corporate Governance and Risk Management Standard

Effective enterprise-wide risk management promotes financial stability by reducing the likelihood that companies will suffer material distress or failure. An enterprise-wide approach to risk management would allow systemically important insurance companies to appropriately identify, measure, monitor, and control risk across their entire organizations, including risks that may arise from intragroup transactions, unregulated entities, or centralized material operations that would not be subject to review at the legal entity level. Accordingly, the proposal would apply an enhanced corporate governance and risk-management standard that would build on the core provisions of SR 12-17, the Board's consolidated supervision framework for large financial institutions. The corporate governance and risk-management standard is tailored to reflect the significant amount of insurance activities in which systemically important insurance companies engage.

The proposal would require a systemically important insurance company to establish and maintain an enterprise-wide risk-management framework that is commensurate with its structure, risk profile, complexity, activities, and size. An enterprise-wide risk-management framework

facilitates management of and creates accountability for risks that reside in different geographic areas and lines of business.

The risk-management framework would be required to include policies and procedures establishing risk-management governance, risk-management procedures, and risk-control infrastructure for the company's global operations and processes and systems for implementing and monitoring compliance with such policies and procedures. The processes and systems would be required to: (1) include mechanisms to identify and report risks and risk-management deficiencies, including emerging risks, and ensure effective and timely implementation of actions to address such risks and deficiencies; (2) promote managerial and employee responsibility for risk-management; (3) ensure the independence of the risk-management function; and (4) integrate risk-management and associated controls with management goals and its compensation structure for its global operations.

These insurance companies would not be expected to adopt the same risk-management practices applied to banking organizations. Instead, risk management practices would be expected to reflect the risks and structure of insurance operations as well as the regulatory framework applicable to insurance activities.

To ensure that risk management has an appropriate level of stature and independence within an organization's governance framework, the proposed rule would also require a systemically important insurance company to maintain a risk committee of the board of directors that is responsible for the company's risk-management policies and oversight of the company's global risk-management framework. The risk committee would be required to have a formal, written charter, be a stand-alone committee of the company's board of directors, report directly to the company's board of directors, meet at least quarterly, and fully document and maintain records of its proceedings. The risk committee would receive and review regular reports from the company's chief risk officer. The chair of the risk committee would be required to be independent of the company, and the committee would be required to include at least one director with experience in identifying, assessing, and managing risk exposures of large, complex financial firms.

The proposed rule would require a systemically important insurance company to appoint a chief risk officer to ensure that a systemically important insurance company has a dedicated executive officer responsible for implementing and maintaining the company's risk-management framework. The chief risk officer would be responsible for overseeing (1) the establishment of

and compliance with enterprise-wide risk limits; (2) the implementation of and compliance with policies and procedures establishing risk-management governance and the global risk-management framework; and (3) management of risks and risk controls within the company's risk control framework. The chief risk officer also would be responsible for reporting risk-management deficiencies and emerging risks to the risk committee. The chief risk officer would report directly to both the risk committee and the chief executive officer of the company.

The proposed rule would also require a systemically important insurance company to appoint a chief actuary to ensure an enterprise-wide view of reserve adequacy that crosses legal entities and lines of business. The chief actuary would be responsible for (1) implementation of measures that 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. The proposed rule would permit the chief actuary to have additional responsibilities, including over ratemaking for insurance products. The chief actuary would report directly to the audit committee of the company but could also have additional lines of reporting. For companies engaged in significant amounts of both life and property and casualty business, the proposal would allow for co-chief actuaries – one with enterprise-wide responsibility for the company's life insurance business and one with enterprise-wide responsibility for the company's property and casualty business. The two current systemically important insurance companies already have chief risk officers and chief actuaries with the duties outlined in the proposal.

Liquidity Risk-Management Standard

The proposal would require a systemically important insurance company to implement a number of provisions to manage its liquidity risk because a liquidity crisis at these companies could harm the broader economy by causing the liquidation of assets in a manner that would disrupt key financial markets or cause losses or funding problems at other firms with similar holdings. The proposal has been tailored to account for the particular risk profile and funding models of these companies.

Under the proposal, a systemically important insurance company's board would be required to (1) review liquidity risk practices and performance at least semi-annually to determine whether the company is operating in accordance with its established liquidity risk tolerance and (2) approve and periodically review the liquidity risk-management strategies, policies, and procedures. The risk committee would be required to review and approve the

company's contingency funding plan at least annually and whenever materially revised. Senior management would be responsible for (1) establishing and implementing strategies, policies, and procedures to manage the company's liquidity risk and overseeing the development of liquidity risk measurement and reporting systems; (2) reporting quarterly to the company's board of directors or risk committee on the company's liquidity risk profile and tolerance; (3) approving new products and activities that could materially impact the company's liquidity risk profile and reviewing significant business activities and products to determine whether their liquidity risk is within the company's established liquidity risk tolerance; (4) reviewing cash flow projections at least quarterly; (5) establishing liquidity risk limits and reviewing the compliance with those limits at least quarterly; and (6) approving liquidity stress testing practices, methodologies, and assumptions.

The proposal also would require a systemically important insurance company to maintain a review function that is independent of the management functions that execute funding and that meets frequently to review and evaluate the effectiveness of the company's liquidity risk-management processes, including its liquidity stress test processes and assumptions.

To ensure that a systemically important insurance company has a sound process for identifying and measuring its liquidity risk, the proposal would require the company to produce comprehensive enterprise-wide cash-flow projections.

Moreover, under the proposed rule, a systemically important insurance company would be required to have, maintain, and periodically test a contingency funding plan for responding to a liquidity crisis. The contingency funding plan must (1) include a quantitative assessment of available and needed funding sources during potential liquidity stress events; (2) outline the company's process for responding to liquidity stress events; and (3) include procedures for monitoring emerging events.

The proposed rule also would require a systemically important insurance company to establish and maintain procedures for monitoring collateral, legal entity liquidity risk, and intraday liquidity risk. The company would be required to establish and maintain procedures to monitor assets that have been, or are available to be, pledged as collateral and liquidity risk exposures and funding needs across significant legal entities, currencies, and business lines, taking into account legal and regulatory restrictions on the transfer of liquidity between legal entities. Reflecting that systemically important insurance companies may not have material amounts of obligations that must be settled at a specific time within the day, the proposed rule

would require monitoring of intraday liquidity risk only where the company has material exposures to intraday liquidity risks.

To reduce the risk of a systemically important insurance company's failure due to adverse liquidity conditions, the proposal would require the company to conduct regular stress testing and scenario analysis. The internal stress tests would be required to include macroeconomic, sector-wide, and idiosyncratic events. The proposed rule would require a minimum of four stress testing time horizons: 7 days, 30 days, 90 days, and one year. Within the stress tests, each company would be required to reflect potential deteriorations in asset valuations by imposing a discount to the fair market value of assets used as cash flow sources.

The proposal also would require these companies to maintain a liquidity buffer comprised of highly liquid, unencumbered assets sufficient to meet their cash flow needs over a 90-day period. This 90-day period, which is longer than the 30-day period applied to bank holding companies, reflects the long-term nature of certain insurance liabilities. The proposed rule would, however, allow a wider range of assets to satisfy the liquidity buffer than must be maintained by bank holding companies because the longer 90-day time horizon would allow more time to convert assets into cash. Highly liquid assets under this proposal would include, with some limitations, securities issued or guaranteed by the U.S. government or a U.S. government-sponsored enterprise, other sovereign debt, investment-grade corporate debt, some forms of publically-traded common equity, and some investment-grade municipal bonds. In addition, a systemically important insurance company could include other assets in its liquidity buffer if it demonstrates to the satisfaction of the Board that the asset (1) has low credit risk and low market risk; (2) is liquid and readily marketable; and (3) is of a type that investors historically have purchased in periods of financial market distress during which market liquidity has been impaired.

Transition Arrangements and Future Compliance

Systemically important insurance companies would be required to comply with the corporate governance and risk-management standard and the liquidity risk-management standard beginning on the first day of the fifth quarter following the final rule's effective date. Any systemically important insurance companies designated thereafter would be required to comply

with each of the standards on the first day of the fifth quarter following the date on which the Council determines the company should be subject to Board supervision.

CONCLUSION: Based on the foregoing, staff recommends that the Board approve the attached draft notice of proposed rulemaking with a public comment period of 60 days. Staff also requests the ability to make technical and minor changes to the proposed rule and Federal Register notice in order to respond to comments from the Federal Register.

Attachments