

**Report of the National Association of Insurance Commissioners (NAIC) and
the Federal Reserve System
Joint Troubled Company Subgroup**

**A Comparison of the
Insurance and Banking Regulatory Frameworks
for Identifying and Supervising Companies in
Weakened Financial Condition**

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For Information Only

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This document is a working paper composed by staff of the state insurance departments, the NAIC and the Federal Reserve System participating on the NAIC and Federal Reserve System's joint Troubled Company Subgroup and does not necessarily express any official views of the state insurance departments, the NAIC or the Federal Reserve System.

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INTRODUCTION

The National Association of Insurance Commissioners (NAIC) and the Federal Reserve System (FRS) joint Troubled Company Subgroup (Subgroup) was formed in 2000.¹ The Subgroup's objective was to compare insurance and banking regulatory frameworks for identifying and supervising companies in weakened financial condition, and was one of four joint subgroups established by the NAIC and the FRS to address implementation of the Gramm-Leach-Bliley Act (GLB Act) enacted in November 1999.² The GLB Act facilitated the already growing integration of the insurance, banking and securities sectors by permitting wider latitude for insurance companies, banks and securities firms to operate within a single financial holding company (FHC), and mandated the coordinated supervision of entities within an FHC by the financial sector regulators. The joint efforts of the insurance and banking supervisors over the past several years have provided a foundation for effective communication and coordination between the state insurance departments and the FRS consistent with the GLB Act.

Topics presented and discussed by Subgroup members and guest speakers included: 1) regulatory financial reporting frameworks; 2) off-site surveillance and monitoring including "early warning systems" for identifying supervised companies having weak or deteriorating financial conditions; 3) on-site examinations; 4) corrective action plans; 5) enforcement powers; 6) risk-based capital (RBC) frameworks; 7) resolution processes for failing and failed insurance companies and banks; and 8) the FRS's role as umbrella supervisor for FHCs. Separately, in connection with this initiative, staff of the Federal Deposit Insurance Corporation (FDIC) presented a summary of that agency's resolution procedures to the NAIC task force members. In comparing the two frameworks of law, regulation, policy and procedures, the Subgroup members and other discussants stressed that the specific supervisory approaches taken for any given financially weakened insurance or banking company are dependent upon the specific facts and circumstances as well as upon the respective supervisory frameworks.

The Subgroup found that the frameworks for identifying and supervising financially weakened companies used by state insurance regulators and the FRS have many similarities. For example, both the state insurance departments and the FRS:

¹ The Subgroup's initiative was conducted by staff from several state insurance departments, the NAIC, the Board of Governors of the Federal Reserve System (Federal Reserve Board) and the Federal Reserve Bank of Boston under the auspices of the NAIC's Financial Condition (E) Committee. The Subgroup, which was originally established under the NAIC Coordinating with Federal Regulators Working Group now reports up through the NAIC Financial Analysis Working Group (FAWG) of the NAIC Financial Condition (E) Committee.

² Unless otherwise noted, the banking supervisory framework presented in this paper is the approach used by the FRS as it pertains to state member banks and bank holding companies (BHCs). The FRS also has supervisory responsibility for certain U.S. bank branches and certain other U.S. banking offices of foreign banking organizations (FBOs); however, the scope of this summary does not include FBO supervision. Additionally, the scope of this summary was generally limited to financial soundness monitoring and the supervision of financially weakened institutions. Comparisons of frameworks for identifying and correcting issues pertaining to compliance with consumer protection regulations were also beyond the scope of this summary.

- generally require supervised institutions to file detailed quarterly financial condition and income reports, related supplementary information, and information identifying affiliated entities of an insurer or a bank;
- conduct routine off-site monitoring of supervised companies other than small, noncomplex BHCs, in part based upon information contained in regulatory reports, and also using market information, to assist in early identification of financially weakened companies and in allocating on-site examination resources;
- have minimum capital standards, including an RBC framework that requires regulatory intervention when capital of a supervised insurance company or insured bank falls below a designated level;³
- impose limitations on and reporting requirements related to certain transactions within holding company systems, including certain acquisitions of or by a supervised entity;
- may require a financially weakened, supervised company to develop written corrective action plans and submit progress reports on compliance with plans; and
- may take various other supervisory actions against a financially weakened company, including imposing restrictions on activities.

The Subgroup also identified three broad phases of supervisory activities as follows:

- 1) conducting both off-site monitoring of financial condition using financial statement and market information analysis, and on-site examinations;
- 2) implementing corrective action plans for financially weakened companies; and
- 3) undertaking insolvency proceedings (generally the responsibility of the FDIC for bank insolvencies).

The attached Appendices A and B contain summary information regarding the insurance and banking regulatory processes for identifying and supervising financially weakened insurance and banking organizations.

³ State insurance departments and certain bank regulators are responsible for handling insurance company and bank insolvencies, respectively; insolvencies of insurance holding companies and BHCs are handled under federal bankruptcy laws.

BACKGROUND ON THE GLB ACT

The GLB Act amendments to the Bank Holding Company Act of 1956 (BHC Act) authorized a qualifying bank holding company (BHC) to operate as an FHC and to engage in a diversified range of financial activities, including insurance sales, insurance underwriting, securities underwriting and dealing, acting as a futures commission merchant, and engaging in merchant banking. To qualify as an FHC, each of the BHC's depository institution subsidiaries must be well capitalized and well managed and each of the BHC's insured depository subsidiaries must have received at least a "Satisfactory" Community Reinvestment Act (CRA) rating in its most recent CRA examination.⁴

Those insurance activities that are permitted to be conducted by an FHC include insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death; providing and issuing annuities; and acting as principal, agent, or broker for the foregoing activities. Permissible activities also include those that the Federal Reserve Board and the Secretary of Treasury jointly determine to be financial in nature or incidental to financial activities, or that the Federal Reserve Board determines are complementary to a financial activity and do not pose a substantial risk to the safety and soundness of depository institutions or the financially system generally.

Under the GLB Act, state regulation of insurance is preserved. A state law applicable to insurance may be preempted, however, if it prevents or restricts a depository institution or a depository institution affiliate from engaging in any activity authorized under the GLB Act. For instance, state laws relating to insurance sales, solicitation and cross-marketing activities may not prevent or significantly interfere with the ability of a bank or bank affiliate to engage in insurance sales activities.

With limited exceptions that existed prior to the passage of the GLB Act, insurance underwriting activities of an FHC may only be conducted by the FHC parent company or by a nonbank subsidiary of the FHC. A bank and its subsidiaries are generally precluded from insurance underwriting, other than the underwriting of credit life and credit health products. As set forth in the GLB Act, general insurance sales may be conducted by an FHC parent company or a nonbank subsidiary of the FHC, or by a financial subsidiary of a bank. The GLB Act did not change the authority for national or state-chartered banks to sell or underwrite insurance directly. Federal banking laws, however, generally continue to limit insurance underwriting activities of banks to credit-related underwriting activities. Most state banking laws now permit state-chartered banks to sell general insurance.

The Federal Reserve Board is the umbrella supervisor of BHCs, including FHCs. In accordance with the GLB Act, the Federal Reserve Board is to rely to the fullest extent possible on reports of examination made by the applicable functional securities and

⁴ A CRA rating is an indicator of how well the depository institution has met its legal requirement to serve its community, in accordance with applicable laws and regulations. CRA examinations are conducted by a depository institution's primary federal banking regulator.

insurance regulators, including for any licensed insurance company and any other subsidiary that the Federal Reserve Board finds to be comprehensively supervised by a federal or state authority. If information that is needed to assess the risk of a functionally regulated subsidiary of a banking organization is not available from the functional regulator, the Federal Reserve Board may examine a functionally regulated subsidiary of a BHC only if: the Federal Reserve Board has reasonable cause to believe that such subsidiary is engaged in activities that pose a material risk to an affiliated depository institution; the Federal Reserve Board reasonably determines, after reviewing relevant reports, that examination of the subsidiary is necessary to adequately inform the Board of the systems for monitoring and controlling operational risks that may pose a threat to the safety and soundness of a depository institution subsidiary of the BHC; or, based on reports and other available information, the Federal Reserve Board has reasonable cause to believe that the subsidiary is not in compliance with the GLB Act or any other federal law that the Federal Reserve Board has jurisdiction to enforce against such subsidiary, and the Federal Reserve Board cannot make such a determination through examination of the affiliated depository institution or the bank holding company.

OVERVIEW OF FRAMEWORKS FOR SUPERVISING INSURANCE AND BANKING ORGANIZATIONS

Insurance

The primary objective of insurance regulation is to correct market failures that would otherwise cause insurers to incur an excessive risk of insolvency or engage in market abuses that hurt consumers. Significant state insurance department regulatory resources are employed to monitor market behaviors, compliance, and solvency.

Each state, the District of Columbia, and the U.S. territories⁵ are responsible for regulating the insurance business within their own jurisdictions. Each state maintains its own insurance department, which operates under the supervision of a commissioner, director, or superintendent who is either appointed or elected. Some states have combined the regulation of insurance, banking, and securities, activities under one department or office.

The NAIC, formed in 1871, is a private, non-profit, voluntary association of the chief insurance regulatory officials of the 50 states, the District of Columbia, and the four U.S. territories (American Samoa, Guam, Puerto Rico, and the Virgin Islands). The NAIC provides its members with a forum for discussing common interests and for working cooperatively on regulatory matters that transcend the boundaries of their own jurisdictions. The NAIC is not a regulatory body or a trade association, but is instead an organization whose members consist solely of insurance regulators for the purpose of facilitating communication and interaction among insurance regulators to enhance insurance regulation and establish national standards, where appropriate.

The objective of the NAIC is to serve the public interest by assisting state insurance supervisory officials, individually and collectively, in achieving the following fundamental insurance regulatory objectives: 1) protect the public interest, promote competitive markets and facilitate the fair and equitable treatment of insurance consumers; 2) promote the reliability, solvency and financial solidity of insurance institutions; and 3) support and improve state regulation of insurance. The primary means for NAIC members to be actively involved in the association is through the NAIC committee system. Each commissioner serves, or delegates to state insurance department staff, the responsibility to serve on various NAIC committees, task forces and working groups. The NAIC is committed to conducting its business openly, subject to the discretion of the chairpersons of committees, subcommittees, tasks forces, working groups and subgroups, who may determine those situations in which public discussions would not be appropriate.

The NAIC coordinates and assists state solvency efforts in a number of ways, including: 1) maintaining extensive insurance databases and a computer network that are assessable

⁵ The fifty states, the District of Columbia, and the U.S. territories are collectively referred to as “states” in this document.

to all state insurance departments; 2) analyzing and informing regulators as to the financial condition of insurance companies; 3) coordinating examinations and regulatory actions with respect to financially weakened companies; 4) establishing and certifying states' compliance with minimum financial regulation standards through the NAIC's Financial Regulations Standards and Accreditation Program (Accreditation Program); 5) providing financial, reinsurance, actuarial, legal, computer and economic expertise to state insurance departments; 6) valuing securities held by insurers; 7) analyzing and listing nonadmitted alien insurers;⁶ 8) developing uniform statutory financial statements and accounting rules for insurers; 9) conducting education and training programs for insurance department staff; 10) developing model laws and coordinating regulatory policy on significant insurance issues; and 11) conducting research and providing information on insurance and its regulation to regulators, state legislators, Congress, U.S. government agencies, insurance regulators in other countries, and the general public.

In June 1989, the NAIC adopted the Financial Regulation Standards (the Standards), that established baseline sound practices for an effective regulatory system in each insurance department. The Standards are applied through a formal, voluntary certification program administered by the NAIC. The objective of the Accreditation Program is to provide a process whereby solvency regulation of multi-state insurance companies can be enhanced and adequately monitored by the states. The Standards are grouped into three areas: 1) laws and regulations; 2) regulatory practices and procedures; and 3) organizational and personnel practices. Under this Accreditation Program, an independent team of experienced consultants reviews each insurance department's compliance with the Standards at least every five years. All states have enacted legislation designed to achieve compliance with the Standards, and as a result, insurance department budgets and staffing have increased significantly. As of March 1, 2005, 49 states and the District of Columbia were accredited under the Accreditation Program.

Insurance companies are chartered by individual jurisdictions and receive a certificate of authority (that is, a license) to conduct business from each jurisdiction in which the company desires to underwrite insurance. This has been the case since 1792, when chartered insurance companies were first required by the states to limit company activities and investments, and to file financial statements. The power of a state to regulate insurance was established in 1869 in *Paul v. Virginia*, where insurance was

⁶ A nonadmitted insurer is a company not licensed by a state to sell insurance policies within the state. Alien insurers are those formed according to the legal requirements of a foreign country. In order for an alien insurer to conduct operations and sell its products in a particular state, the insurer must conform to the state's rules and regulations governing insurance companies. A nonadmitted alien insurer may be allowed to write on a surplus lines basis if it complies with the state's eligibility requirements. To assist states in their review of nonadmitted alien insurers, the NAIC produces a Quarterly *Listing of Nonadmitted Alien Insurers* (the Listing). If an insurer appears in the Listing, it has filed specified documents with the NAIC International Insurers Department (IID) and, based upon these documents and other information, appears to fulfill the criteria for eligibility set forth by the NAIC. Several states utilize the Listing to some capacity within their respective state statutes or regulations in relation to their eligibility requirements.

declared a local matter rather than commerce between the states. By 1870, many of the states had appointed a state official to oversee insurance.

In 1944, the U.S. Supreme Court in *United States v. South-Eastern Underwriters Association* ruled that insurance was “commerce” and subject in its interstate activity to regulation by the Congress and the statutory restriction of the Sherman Act prohibition against restraint of trade. In 1945, however, Congress enacted the McCarran-Ferguson Act, which included a limited exception from certain antitrust laws for certain insurance-related activities. The McCarran-Ferguson Act generally made insurance subject to state control and withheld the application of federal statutes to the extent that state law regulated such business, except in instances where the federal law specifically relates to insurance.

The states issue a number of different insurance company license types, including life and health, and property and casualty licenses. The states also issue insurance producer license types, including broker, independent agents, managing general agents, and general agent licenses.⁷ Reinsurers may either be authorized or licensed to write reinsurance business depending on the states laws and regulations. Under state insurance law, provided the owner meets certain criteria through the regulatory approval process, there are very few outright restrictions on a licensed insurer’s ownership by, or affiliation with, other financial or non-financial companies. An exception is the general prohibition on foreign government ownership of an insurer.

State insurance law does not provide for consolidated supervision of the insurance holding company or the parent holding company. However, an insurance company is subject to state restrictions and disclosures regarding inter-affiliate relationships, and change in ownership is subject to state insurance department approval. Under state law, a licensed insurance company is generally authorized to own subsidiaries that conduct insurance or insurance-related business activities, including real estate management and real estate development. Investments in higher risk activities are limited by state statutes and indirectly through statutory RBC minimum standards.

State insurance regulators have recognized a growing need to more fully coordinate their regulatory efforts with other state insurance regulators, including efforts for sharing confidential supervisory information. Historically, there has been significant coordination with respect to supervising financially weakened companies; similar efforts are also underway to focus on holding company systems or insurance groups that are financially strong. In 2000, the NAIC formed the Insurance Holding Company (E) Working Group (IHCWG) in an effort to document a framework for information sharing and coordination of regulatory processes for analyzing insurance holding companies and their insurance subsidiaries. The NAIC *Framework for Insurance Holding Company*

⁷ An independent agent is a contractor who represents more than one insurance company when placing a client’s business. A general agent is a person appointed by one insurer who is responsible for insurance agency operations in a particular geographical area, including the sale of life and health insurance, recruiting and training agents, and providing administrative support.

Regulation (Framework) is the result of the IHCWG’s work. The Framework provides guidance for state insurance regulators to understand the holding company structure of insurers operating in their state, as well as to coordinate their supervisory approaches for reviewing holding company transactions that may impact insurance subsidiaries domiciled in multiple jurisdictions. Currently, this Framework is in the implementation stage.

Banking

The FRS is the primary federal banking regulator for state member banks. It also has supervisory authority for all U.S. bank holding companies. In the U.S., commercial banks are either federally chartered by the Comptroller of the Currency (OCC) as national banks, or are chartered by a state. National banks are supervised by the OCC and are members of the FRS. State-chartered banks that are members of the FRS are referred to as state member banks, and are supervised by both the applicable state banking department(s) and the FRS. A state bank that does not choose to become a member of the FRS is referred to as a state nonmember bank and is supervised by both the applicable state banking department(s) and the FDIC. The OCC, FRS and FDIC are the primary federal bank supervisors for national banks, state member banks and state nonmember banks, respectively. A “dual banking system” exists in the U.S. whereby state-chartered banks have both a federal bank and a state bank regulator(s).⁸ Therefore, the FRS actively coordinates its supervision of state member banks with the applicable state banking department(s).

Prior Federal Reserve Board approval is required for a company to initially become a BHC or for an existing BHC to acquire control of, or more than five percent of a class of voting securities of, additional BHCs or banks. Relevant federal statutes state that control of a BHC or bank exists when a company has (i) ownership, control, or power to vote 25 percent or more of the outstanding shares of any class of voting securities of the BHC or bank, directly or indirectly or acting through one or more other persons; (ii) control in any manner over the election of a majority of the directors, trustees, or general partners (or individuals exercising similar functions) of the BHC or bank; or (iii) the power to exercise, directly or indirectly, a controlling influence over the management or policies of the BHC or bank. A company includes corporations, partnerships, associations, certain trusts, and similar organizations. Also, non-financial firms generally are prohibited from controlling banks and thus are prohibited from owning 25 percent or more of the voting stock of a bank.

The FRS has supervisory authority over BHCs, including those that are FHCs, and supervises these entities on a consolidated basis. The FRS supervisory approach reflects the “source of strength” doctrine, which asserts that a BHC should serve as a source of financial and managerial strength to its subsidiary banks, within certain constraints. This doctrine was reconfirmed in the GLB Act, except that the Act indicates that the FRS cannot require a BHC that is an insurance company, or an insurance company that is an

⁸ A state-chartered bank may be subject to supervision in all states in which it operates.

affiliate of a depository institution, to provide funds or other assets to the affiliated depository institution if the state insurance authority makes a determination, in writing, that such action would have a material adverse effect on the financial condition of the insurance company.

The FRS is comprised of 12 regional Federal Reserve Banks under the general oversight of the Federal Reserve Board, which is located in Washington, D.C. The Federal Reserve Board and its staff develop FRS regulations and policies. The Federal Reserve Board is an independent government agency overseen by 7 board members, including the Federal Reserve Board Chairman and Vice Chairman, all of whom are appointed by the president and confirmed by the Senate. Each Federal Reserve Board member is appointed to serve a 14-year term, or if replacing a board member whose term has not yet expired, to serve the remainder of the previous board member's 14-year term. The Federal Reserve Board Chairman has a 4-year term, and may be reappointed.

In carrying out responsibilities for the comprehensive supervision of BHCs, including FHCs, the FRS coordinates and cooperates, as appropriate, with the other bank and thrift regulators, including the OCC, the FDIC, the Office of Thrift Supervision (OTS), and state banking departments. The Federal Financial Institutions Examination Council (FFIEC), whose members consist of the FRS, OCC, OTS, FDIC and National Credit Union Administration (NCUA), is an organization that fosters uniform depository institution regulatory reporting and consistent supervisory policy among those federal agencies. Moreover, federal and state bank and thrift supervisors share certain databases and other supervision tools and resources in order to develop coordinated and consistent regulation of supervised entities.

Additionally, in carrying out its role as the consolidated supervisor for BHCs, including FHCs, the FRS also relies on and coordinates its supervisory activities with, as appropriate, the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission, and state insurance and securities regulators.

TOOLS FOR IDENTIFYING FINANCIALLY WEAKENED INSTITUTIONS

Insurance

Financial Reporting

The NAIC reporting requirements have evolved considerably since its annual statement introduction in 1879. All states require an insurer to use the NAIC annual and quarterly statement reporting forms to satisfy their statutory financial statement filing requirements, except that states may exempt an insurer from this requirement, as appropriate. The complete annual statement filing currently includes a balance sheet, income statement, statement of cash flow, notes to financial statements, general interrogatories,⁹ and a significant number of supporting details in various exhibits, schedules and supplemental filings. Some of the more important exhibits and schedules provide information about: investment income and realized gains and losses; nonadmitted assets; Asset Valuation Reserve and Interest Maintenance Reserve; premiums and losses; expenses; long-term investments in bonds, preferred stock, common stock, real estate, mortgage loans, and other investments; derivatives; short-term investments; cash and cash equivalents; reinsurance; and transactions with affiliates. Supplemental filings are also required of most insurers, such as the actuarial opinion, the management's discussion and analysis, the annual audited financial report, and the RBC report. Other supplemental filings include specialty information such as the Medicare supplement report, the credit insurance report, and the long-term care report. Since December 31, 2003, insurers are also required to report affiliations with a BHC, bank, thrift or securities firm; to provide the names of each such affiliate; and to identify the relevant federal regulators of each insurer's financial institution affiliate. In addition to the annual statements, most insurers also are required to file the NAIC quarterly statement reporting form that contains key information on assets and liabilities; income and surplus; changes in investments; reinsurance; premiums written; losses and reserves.

Insurance company statutory financial reports are based on statutory accounting principles (SAP), which are designed to address the concerns of regulators. SAP stresses measurement of the ability to pay claims of insurers in the future, while generally accepted accounting principles (GAAP) stresses measurement of earnings of a business from period to period, and the matching of revenues and expenses for the measurement period.¹⁰ Conservatism serves as a major principle in SAP. For example, some assets are not allowed to be included in an insurer's surplus; these are referred to as nonadmitted assets. Another example of conservatism is the prohibition against discounting reserves, and the fact that specific tables approved by regulators are required to establish reserves for various life insurance products. Under GAAP, the experience expected by each insurance company, with provision for the risk of adverse deviation, is used to determine the reserves it will establish for its policies.

⁹ General interrogatories are limited-scope questions regarding an insurer and its financial position and operations.

¹⁰ Source: Preamble of the NAIC Accounting Practices and Procedures Manual.

Solvency Screening and Financial Analysis Systems

The fundamental objective of insurance company solvency monitoring is to ensure that companies meet regulatory standards and to alert regulators if actions need to be taken to protect policyholders. To accomplish this task, the state insurance regulators conduct financial analysis using regulatory financial reports, financial tools and other sources of information to detect problems that may jeopardize a company's long-term viability. These sources include SEC filings, corporate reports, external, independent certified public accountant (CPA) attestation reports, financial examination and market conduct reports, rate and policy form filings, consumer complaints, independent rating agency reports, correspondence from agents and insurers, and business media.

State insurance departments generally prioritize the review of their domiciliary companies based on a system of financial ratios and other screening tools, including those maintained by the NAIC. The NAIC has created a network of financial information systems and tools, such as the Financial Analysis Solvency Tools (FAST) System that includes the Insurance Regulatory Information System (IRIS), the Scoring System, and the Insurer Profiles System that are discussed below. The NAIC makes the information systems and tools available to state insurance regulators over the NAIC's Internet-State Interface Technology Enhancement (I-SITE). I-SITE provides a common user interface for more than 50 applications that are used to produce a wide variety of standard and custom reports.

To be accredited, a state is required to conduct quarterly financial analysis on their domiciliary multi-state insurers. Most states conduct quarterly financial analysis on their single-state insurers as well. Typically, insurers with anomalous results, or those that have been previously identified for attention are subject to additional analysis.

The domiciliary state is relied upon as the primary solvency regulator. When there are concerns about the financial condition of an insurer, communications between the domiciliary state and the other states in which the company is licensed are increased. However, any state in which a company is licensed to conduct insurance business may perform its own monitoring, financial examinations, and may take regulatory action, as appropriate.

FAST System

The FAST System is a collection of analytical tools designed to provide state insurance regulators with an integrated approach to screening and analyzing the financial condition of insurance companies. The following are three key tools within the FAST System:

1) Insurance Regulatory Information System (IRIS)

IRIS has served as a baseline solvency screening system for the NAIC and state regulators since the mid-1970s. IRIS is designed to help regulators prioritize insurers for detailed financial analysis. The "statistical phase" of IRIS involves

calculating a series of financial ratios for each insurer based on its annual statement data. The IRIS ratio results are available to the public. Because the ratios by themselves are not indicative of adverse financial condition, an experienced team of state insurance examiners and analysts (Analyst Team) reviews the IRIS ratio results and various other financial information in the “analytical phase” of IRIS, called the Analyst Team System (ATS).

For the ATS, the Analyst Team meets annually at the NAIC Executive Headquarters to identify insurers that appear to require immediate regulatory attention in order to assist state insurance regulators in prioritizing their annual financial analysis reviews of insurers. The Analyst Team reviews a computer-selected priority listing of insurers that may be experiencing weak or declining financial results. It then validates the listing based on further analysis of those companies, and provides a brief synopsis of its findings in a document that can be accessed only by state insurance regulators and authorized NAIC staff.

2) Scoring System

The Scoring System is based on several financial ratios and is similar in concept to IRIS ratios. The Scoring System, however, includes a broader range of financial ratios and assigns a score to each ratio based on the level of solvency concern each result generates. The ratio results and scores are available only to state insurance regulators and authorized NAIC staff. The Scoring System is evaluated and updated, as appropriate, by the Financial Analysis Research and Development Working Group on an annual basis.

3) Insurer Profiles System

The Insurer Profiles System produces quarterly and annual profiles reports on property and casualty, life and health insurers. These profiles provide either a quarterly or annual five-year summary of a company’s financial position. The Insurer Profile reports provide not only a snapshot of the company's financial statement, but also include analytical tools such as financial ratios and industry aggregate information that can be used in an analyst's review of the company. Insurer Profile reports can assist state insurance department analysts in identifying unusual fluctuations, trends or changes in the mix of an insurer's assets, liabilities, capital and surplus and operations.

Peer Review Process

As a check and balance on the solvency screening efforts conducted by the states, a peer review process was created. The objective of the NAIC’s peer review process conducted by the FAWG is to monitor whether domiciliary regulators are taking appropriate and effective supervisory action with respect to nationally significant insurers that are in financial difficulty. The FAWG is made up of commissioner appointed members from sixteen states.

On a quarterly basis, the NAIC's Financial Regulatory Services Division staff identifies nationally significant insurers for review using analytical criteria. Division financial analysts perform preliminary reviews of identified insurers and then select insurers that warrant more in-depth reviews. For those insurers, the FAWG will review the analysts' reports and then query the domiciliary state on various aspects of each insurer's financial condition and any regulatory actions being taken. If the FAWG determines that the domiciliary regulator is taking appropriate actions, then the FAWG may close the file or continue to monitor the company. If the FAWG determines that further measures are desirable, it will recommend the appropriate corrective action to the domiciliary state. If the domiciliary regulators fail to follow the FAWG's recommendation, the FAWG will alert other affected states accordingly and coordinate their supervisory response.

State Insurance Department Financial Examination Process

The purpose of a financial condition examination is to: 1) detect insurers with potential weaknesses; 2) determine compliance with state statutes and regulations; and 3) compile information needed for timely, appropriate regulatory action. On-site financial condition examinations of insurers are either full-scope or limited-scope examinations. The full-scope examination is considered a comprehensive examination with an overall objective to report on the company's financial position and affairs. A limited-scope examination, often referred to as a target examination, is conducted to review specific financial accounts and or specific areas of the company's operations.

State laws and regulations, as guided by the Accreditation Program, require the states to conduct a full-scope examination for each multi-state domestic company at least once every five years. Individual state statutes may require financial condition examinations more often, and several states impose a three-year requirement. Limited-scope examinations do not satisfy the NAIC Accreditation Standards to conduct financial condition examinations at least once every five years. However, failing to conduct limited-scope examinations for financial weakened companies may impact the results of the accreditation review.

Frequently, full-scope examinations will be conducted as so called "zone examinations." A zone examination is a process to reduce the number of financial condition examinations of multi-state licensed insurers. The concept of zone examinations developed in response to the fact that states are entitled to conduct financial condition examinations on insurers that are licensed in their state regardless if they are domiciled elsewhere. As this ability could result in multiple examinations of the same company, the process of inviting representatives from other zones to participate evolved in order to reduce regulatory burden and increase efficiency.

On-site financial condition examinations investigate a company's accounting methods and procedures, financial statement presentation, and validate what is presented in the annual financial statement assets, liabilities, capital and surplus line items, to ascertain whether the company is in good financial standing. The main thrust of the examination is

to verify the company's solvency and determine whether the company has complied with state laws and regulations. In general, financial condition examinations shall at least encompass a review of all of the following matters: 1) company history; 2) management and control; 3) corporate records; 4) fidelity bonds and other insurance; 5) officers', employees', and agents' welfare and pension plans; 6) territory and plan of operation; 7) growth of company; 8) business in force by states; 9) mortality and loss experience; 10) reinsurance; 11) accounts and records; and 12) financial statements. Examinations are conducted using a risk-based approach, whereby those areas identified as more likely to be prone to material financial reporting error are accorded greater attention during both the examination planning phase and the on-site examination.

The state financial condition examination process also places emphasis on the quality of the company's internal control structure. This requires the state examiners to assess the internal control environment based on interviews with company management and personnel and other control testing procedures. On occasion, state insurance departments will engage outside experts to evaluate and test the effectiveness of internal controls (e.g., information system controls). The financial condition examination process also considers the work performed by external, independent CPAs as well as the work of internal auditors.

Regulatory Capital Framework for Insurance Companies

An insurer's capital and surplus provides a cushion against unexpected increases in liabilities and decreases in the value of assets, and are intended to absorb the costs of a rehabilitation or liquidation with minimal losses to policyholders and claimants. States require insurers to have a certain amount of capital and surplus to establish and continue operations. A state insurance department is authorized to take over, or "seize" an insurance company if the state can show to the applicable state court that the insurer will be unable to meet its obligations to policyholders.

Fixed minimum capital and surplus standards for licensing and operating an insurance company typically range in the area of \$2 million to \$5 million for a multi-line life and health or property and casualty insurer. Because of the limitations of fixed minimum capital standards, the NAIC adopted the Risk-based Capital (RBC) for Insurers Model Act. To be accredited, a state is required to adopt a substantially similar version of the Model Act, which contains separate formulas for life and health insurers and property and casualty insurers, and prescribes regulatory action to be taken if an insurer's Total Adjusted Capital declines below certain thresholds. The stated objectives of the NAIC RBC requirements are to provide a standard of capital adequacy that: 1) is related to risk; 2) raises the safety net for insurers; 3) is uniform among states; and 4) provides authority for regulatory action when actual capital falls below the standard. The model act specifies four levels of company and regulatory action, with more severe action required at lower levels.

The NAIC's life and health RBC formula encompasses six major categories of risk: 1) asset risk — affiliates; 2) asset risk — common stock; 3) asset risk — other; 4) insurance

or pricing risk; 5) interest-rate risk and health credit risk and 6) business risk. The risks addressed by the NAIC's property and casualty formula include: 1) asset risk — subsidiary insurance companies; 2) asset risk — fixed income; 3) asset risk — equity; 4) asset risk — credit; 5) underwriting risk — reserves; and 6) underwriting risk — net written premium.

Databases and Information Systems

The NAIC maintains a number of databases that state insurance regulators and NAIC staff use for financial analysis and other regulatory functions, including: 1) the Financial Data Repository (FDR); 2) the State Producer Licensing Database (SPLD); 3) Valuation of Securities (VOS); 4) Regulatory Information Retrieval System (RIRS); and 5) Special Activities Database (SAD). The NAIC financial databases serve as the core resource of the solvency surveillance and other analysis activities of state insurance regulators and the NAIC.

The FDR database contains the most recent 10 years of annual and quarterly financial statement information for the approximately 5,200 U.S. insurance companies. This database provides source data for reports on individual companies and for analytical tools, such as the FAST System.

The VOS database contains credit quality designations and fair values for insurers' securities that are not rated and monitored by a Nationally Recognized Statistical Rating Organization (NRSRO). This database, combined with NRSRO ratings data, allows regulators to assess the relative credit risk of the securities owned and reported by insurers.

The SPLD database contains information on insurance companies, such as consumer complaints, and on nearly 3.5 million individual producers, including producer licensing and appointment information.

RIRS database contains formally adjudicated regulatory actions taken by participating state insurance departments against insurance producers, companies and other entities engaged in the business of insurance. The SAD is a confidential database that contains information related to suspicious market activities and legal actions involving entities engaged in the business of insurance. The RIRS and SAD databases enhance state insurance regulators' ability to share information among state insurance departments on individuals or companies suspected of illegal or questionable activities and are tools to assist in the prevention of movement of these activities into new areas.

State insurance regulators and NAIC staff also use an electronic mail system on the NAIC's computer network to communicate and coordinate supervisory developments with respect to examinations, regulatory actions, financially weakened companies, and a variety of other matters.

Banking (State Member Banks and BHCs)

Financial Reporting

All banks, including state member banks, are required to file quarterly regulatory reports known as FFIEC Call Reports consisting of consolidated balance sheets, income statements, RBC data and selected supplementary financial information. All BHCs are also required to file periodic regulatory reports. Those BHCs with consolidated assets over \$150 million, and BHCs below that threshold that are categorized by the FRS as “complex,” are required to file consolidated balance sheets, income statements and RBC data, as well as parent company financial statements, on a quarterly basis. BHCs under \$150 million that are non-complex BHCs are required to file parent company only financial statements semi-annually, but are not required to file fully consolidated financial reports. Additionally, all BHC are required to file periodic regulatory reports detailing certain intercompany transactions and balances between a bank and its nonbank affiliates; balance sheet and income statement data for certain of its domestic, non-functionally regulated nonbank subsidiaries and certain foreign domiciled bank and non-bank subsidiaries; and reports of new activities commenced. There are a number of other regulatory reports that must be filed by state member banks and BHCS.¹¹

Surveillance and Monitoring

The FRS off-site surveillance program is designed to monitor the financial condition and performance of individual state member banks and BHCs on a quarterly basis to facilitate identifying deterioration in the condition of companies between on-site examinations and inspections. Monitoring is accomplished, in part, through the use of automated screening systems and econometric models. These tools rely significantly on data reported on standardized regulatory reports and from the findings of on-site examinations. The surveillance program takes into consideration a number of aspects of banking performance, including capital adequacy, asset growth, loan quality and loan concentrations, liquidity, and capital markets activities. These surveillance results, produced by Federal Reserve Board staff, are distributed to the Federal Reserve Banks for further review, analysis, and follow-up.

FRS Surveillance screens incorporate the results of two econometric models, together known as the System for Estimating Examination Ratings (SEER).¹² The SEER risk rank model estimates the probability that a bank will become critically undercapitalized within the next two years. The SEER rating model estimates a bank’s composite CAMELS

¹¹ A complete listing of bank and BHC report forms and instructions may be found on the Federal Reserve Board and the FFIEC websites (<http://www.federalreserve.gov/> and <http://www.ffiec.gov/>, respectively).

¹² The SEER system developed by a FRS Surveillance Task Force was formerly known as the Financial Institutions Monitoring System (FIMS). The SEER models have been updated since they were first implemented, but a detailed description of the econometric frameworks used is contained in an article by Rebel Cole, Barbara Cornyn and Jeff Gunther in the Federal Reserve Bulletin, volume 81, number 1, January, 1995, pps. 1-15.

rating based upon Call Report data and examination rating information. The surveillance screening results are strictly confidential.

To support off-site monitoring of bank performance and condition and on-site examinations, the FFIEC produces a quarterly Uniform Bank Performance Report (UBPR) for each commercial bank and FDIC-insured savings bank. These reports display current and historic balance sheet and income statement items, along with key performance ratios and peer group statistics. The FRS produces a similar report, the Bank Holding Company Performance Report (BHCPR), for BHCs over \$150 million in consolidated assets. These UBPR and BHCPR reports are publicly available.

Bank Examinations and BHC Inspections

The FRS's safety and soundness examinations of state member banks and inspections of BHCs are focused on determining the financial condition and performance of an institution, and on evaluating management, internal controls and the risk management structure. The Federal Reserve is required to conduct a full-scope, on-site examination of every insured state member bank at least once during each 12-month period, with the exception that certain small institutions may be examined once during each 18-month period. The frequency of BHC inspections is determined by the size, condition, and complexity of the BHC.

Examiners assign a composite rating to a banking institution reflecting an assessment of the overall condition of the institution, including an assessment of relevant processes and risk management techniques. As noted earlier, the rating system used for banks is known as CAMELS, an acronym for the components it evaluates: capital, asset quality, management, earnings, liquidity and sensitivity to market risk. Until January 1, 2005, BHCs were assigned a supervisory rating using a rating system known as BOPEC, which included evaluations of: bank subsidiaries ("B"); "other" (nonbank subsidiaries) ("O"); the parent company ("P"); consolidated BHC earnings ("E"); and consolidated BHC capital adequacy ("C"). A new BHC rating system has been adopted effective January 1, 2005.¹³ Under this system, a BHC is assigned an RFI/C(D) rating rather than a BOPEC rating. RFI/C(D) is an acronym for the components of: risk management ("R"); financial condition ("F"); potential adverse impact ("I") of nonbank affiliates on the affiliated depository institution(s); a composite BHC rating ("C") based on an evaluation and rating of the BHC's managerial and financial condition and an assessment of future potential risk to its subsidiary depository institution(s); and a rating for the depository institution(s) ("D") that will generally mirror the primary regulator's assessment of the subsidiary depository institution(s). Bank and BHC supervisory ratings and the reports of bank examinations and BHC inspections are strictly confidential.

FHCs are generally supervised similarly to any other BHC with a focus on understanding and assessing the quality of centralized risk management and control processes for key

¹³ SR letter 04-18, *Bank Holding Company Rating System*, may be accessed on the Federal Reserve Board's public website.

business lines, as well as understanding the intra-group exposures and risk concentrations across all business lines. To supervise a diversified BHC, the FRS relies to the extent possible on, and coordinates with, the appropriate functional regulators.

Financial safety and soundness examinations and inspections generally include a review of compliance with a wide range of laws and regulations. In addition, the FRS also conducts consumer compliance examinations of state member banks to determine adherence with applicable consumer protection laws and regulations and assigns a compliance examination rating. Depository institutions, including state member banks supervised by the FRS, are also evaluated for their compliance with the CRA and assigned a separate CRA rating. An institution's CRA rating is publicly available.

Regulatory Capital Frameworks

Basel Capital Accord

The Basel Capital Accord (Basel I), the current international framework for bank capital adequacy, was adopted in 1988 by the G-10 group of central banks and other national supervisory authorities, working through the Basel Committee on Banking Supervision.¹⁴ The FRS and the other federal banking agencies implemented an RBC approach for U.S. banking organizations in 1989. The fundamental objectives of Basel I are to promote the soundness and stability of the international banking system and to provide an equitable basis for international competition among banks. More specifically, Basel I sets forth RBC standards intended to assist in the assessment of capital adequacy of depository institutions. Other key objectives of the standards were to: 1) make regulatory capital requirements more sensitive to differences in risk profiles among banks; 2) factor off-balance sheet exposures into the assessment of capital adequacy; 3) minimize disincentives to holding liquid, low-risk assets; and 4) achieve greater consistency in the evaluation of the capital of the major banks throughout the world.¹⁵

Under the Basel I framework, capital adequacy is assessed primarily in relation to credit risk with the other risks addressed implicitly. In 1996, Basel I was amended to take explicit account of market risk in trading accounts (i.e., the risk of loss due to a change in market prices, such as equity prices or interest or exchange rates).

Under the Basel I framework, a bank (and, in the U.S., generally a BHC with consolidated assets greater than \$150 million) is required to have regulatory capital, as measured by combinations of equity, allowance for loan and lease losses (ALLL), qualified subordinated debt, and certain other instruments, at least equal to 8 percent of

¹⁴ The Basel Committee on Banking Supervision was established in 1974 comprising members from the central banks or other supervisory authorities of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the U.S.

¹⁵ Additional detail and background on the FRS's and the NAIC's RBC approaches can be found in the *Report of the NAIC and the Federal Reserve System Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage*, dated May 24, 2002.

the amount of its risk-weighted assets. For the calculation, assets are weighted according to the level of perceived risk, and each off-balance sheet exposure is converted to an on-balance sheet equivalent, and then risk-weighted. Assets and off-balance sheet equivalents are generally risk-weighted at 100, 50, 20, or 0 percent. This measure is referred to as the total RBC ratio.

Another measure of capital adequacy used in the banking organization RBC framework is the Tier 1 RBC ratio. The Tier 1 RBC ratio is a more conservative measure that generally excludes debt instruments and the ALLL from the capital numerator. To be adequately capitalized, a U.S. banking organization must have a minimum Tier 1 RBC ratio of 4 percent. In addition, banking organizations are subject to a leverage ratio measure to evaluate capital adequacy. The leverage ratio, which is calculated as equity capital as a percentage of average balance sheet assets, is also used to evaluate capital adequacy.

Currently, a revised RBC framework referred to as the Basel II Capital Accord is in the process of being implemented by U.S. and many foreign bank regulators. The objectives for reform include improving risk measurement and management; linking, more precisely, the amount of minimum regulatory capital to the amount of risk taken; further focusing the dialogue between supervisors and a banking organization on the measurement and management of risk and the connection between risk and capital; and increasing market discipline through enhanced transparency.¹⁶

Prompt Corrective Action (PCA)

As a result of the bank failures in the late 1980s and the rapid depletion of the federal deposit insurance fund, Congress mandated a PCA framework in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This act requires federal bank regulators to administer timely corrective action to a bank when its capital position is deemed to have declined below certain threshold levels. The PCA framework specifies mandatory actions that regulators must take if capital ratios fall below certain thresholds, as well as discretionary actions that may be taken.¹⁷

Under the PCA statute and accompanying regulations, a bank is assigned to one of five capital categories based primarily on the capital ratios reported in the quarterly FFIEC Call Reports. Four of the five PCA capital categories – “well capitalized,” “adequately capitalized,” “undercapitalized,” and “significantly undercapitalized,” are based on three capital adequacy ratios: the total RBC ratio, the Tier 1 RBC ratio, and the leverage ratio. The most severe capital category, “critically undercapitalized,” is determined by a bank’s

¹⁶ Additional information pertaining to the Basel II Capital Accord may be found on the FRS public website (<http://www.federalreserve.gov/>) and the Bank for International Settlements public website (<http://www.bis.org/index.htm>).

¹⁷ The PCA regulations applicable to state member banks are found at the Federal Reserve Board’s Regulation H, Subpart D (12 C.F.R. 208.40 *et seq.*).

tangible equity ratio, which measures the equity capital to assets ratios excluding intangible assets from the numerator and the denominator.

If a bank is deemed to be “undercapitalized,” “significantly undercapitalized,” or “critically undercapitalized” as defined in FDICIA based on its capital ratios, the bank must submit a capital restoration plan that is acceptable to its primary federal regulator, may not make any capital distribution, and may not pay a management fee to anyone that controls the bank. In addition, the bank may not increase its asset size, except under limited conditions, and may not make acquisitions or establish new branches or new lines of business, unless it meets certain conditions. Significantly undercapitalized and critically undercapitalized banks are subject to additional mandatory restrictions. The bank’s primary federal regulator may also impose one or more of the discretionary restrictions enumerated in the statute and regulations through the issuance of a Prompt Corrective Action Directive to any undercapitalized, significantly undercapitalized, or critically undercapitalized bank. A bank may contest the issuance of such a directive through an agency appeal process. Under the PCA statute, a critically undercapitalized bank generally must be placed in conservatorship or receivership within 90 days of becoming critically undercapitalized.

In accordance with FDICIA, a BHC must guarantee its subsidiary bank’s capital restoration plan and provide appropriate assurances of performance. Additionally, the cross-guarantee provision of FDICIA requires that, generally, any insured depository institution is liable for losses to the FDIC arising from the default of a commonly controlled insured depository institution. This provision was implemented, in part, to avoid the potential adverse effect of a bank shifting bad assets into a failing affiliate bank and thereby increasing the cost to the FDIC insurance fund.

Databases and Information Systems

The Federal Reserve Board maintains the National Information Center (NIC), a repository for both bank structure, financial, and confidential supervisory data for all commercial banks and BHCs. Additionally, the Central Document Text Repository (CDTR) is the repository for the electronic versions of commercial bank examination and BHC inspection reports, as well as other confidential supervisory documents. Front-end systems are available to authorized FRS staff for accessing these databases containing both publicly available and confidential supervisory information.

APPROACHES FOR SUPERVISING A FINANCIALLY WEAKENED COMPANY

The state insurance regulators and the FRS each have enforcement powers to support their ability to carry out their supervisory responsibilities, and both are subject to laws that require the regulator to take specified corrective action based on RBC thresholds for supervised insurers and supervised state member banks, respectively.

State Insurance Departments

Regulatory actions of an insurance department include activities that go beyond the monitoring and surveillance activities described above include:

Hearings/Conferences – These are sessions in which witnesses are requested to discuss, testify, or otherwise provide information to a state’s insurance department with respect to a specific insurance company or group of companies. Hearings or conferences may be conducted either informally, involving only the department and insurance company personnel, or formally, involving the presence of an appointed hearing officer to conduct the session.

Implementation of a Corrective Plan – This involves the execution of a plan of action, reviewed and monitored by a state insurance department, for an insurer to correct a troubled or potentially troubled situation. This may include corrective plans required under RBC requirements.

Restrictions on Activities – Such activities may include prohibitions, conditions, or limitations placed by a state insurance department on certain activities or transactions of an insurance company. Examples include requiring pre-approval by the department of specific activities or transactions. The ability to place restrictions on an insurance company depends, in part, on the laws or regulations of the particular jurisdiction.

Notice of Impairment – This is a formal regulatory communication from a state insurance department to an insurance company informing the insurance company that the company does not meet stated minimum statutory capital and/or surplus requirements and requiring the company to correct the deficiency by a certain date.

Cease and Desist/Suspension Order – This is a formal regulatory communication from a state insurance department ordering an insurance company to stop certain activities, such as the issuance of new insurance policies.

Supervision – This is an action taken by a state insurance department under its administrative or legal provisions, under which a supervisor is appointed by an insurance department or by a court to “supervise” the operations of an insurance company. The supervision may be “confidential” (i.e., unannounced or “drawer”), “announced” by the insurance department, or “voluntary” (i.e., assistance was requested or acknowledged by the insurance company).

The Federal Reserve System

The FRS employs a range of tools to identify and address a supervised bank or BHC exhibiting emerging problems or weakened financial condition in order to maintain a sound banking system, minimize potential losses to the FDIC insurance fund, and facilitate the institution's return to financial health, if possible. Routinely, a summary of examiner findings and expected actions is conveyed to the banking organization following each targeted review of a particular business line or business activity, as well as in an examination report that summarizes the key findings of the reviews conducted during the 12- to 18- month examination cycle. For those institutions whose problems warrant additional supervisory action, a range of informal and formal supervisory actions is available, in addition to the PCA measures for banks described above.

Informal corrective actions include resolutions adopted by an institution's board of directors and Memoranda of Understanding between the appropriate Federal Reserve Bank and an institution, whereby the institution's board agrees to implement the actions that the institution will take to correct deficiencies. Informal actions are not made publicly available by the FRS.¹⁸

Formal corrective actions, including Written Agreements and Cease and Desist Orders, are authorized by the Federal Deposit Insurance Act (FDI Act) to correct violations of law and unsafe or unsound practices. These agreements and orders may require a depository institution, a BHC, certain other entities, and any institution-affiliated party, including any director, officer, employee or controlling shareholder to take affirmative action to correct deficiencies or to cease engaging in the violations or other unsafe or unsound practices. Written Agreements and Cease and Desist Orders are made publicly available. They may include measures designed to improve a bank's capital and asset quality by placing restrictions on dividends, requiring the employment of more qualified management and improved oversight by the bank's board of directors. Written Agreements and Cease and Desist Orders against BHCs may also include requirements for capital infusions to an undercapitalized FDIC-insured subsidiary bank; restrictions on additional debt, dividends, and inter-corporate transactions; and the termination of certain nonbank activities that constitute violations of law or unsafe or unsound banking practices.

In cases where specific violations or practices are likely to cause insolvency, cause dissipation of assets or earnings, weaken the condition of the institution, or prejudice the depositors' interests, the FRS may issue a Temporary Cease and Desist Order to address these violations or practices. A Temporary Cease and Desist Order requires the banking organization to take or cease specific actions and remains in effect pending the outcome of an administrative hearing on the issues. Temporary Cease and Desist Orders are

¹⁸ The SEC requires publicly traded companies to make public disclosure of certain material information that may affect the securities markets. A publicly traded financial institution, therefore, may be required to disclose the existence of certain informal actions taken by the FRS if the actions are deemed to be material.

generally not made public by the FRS. In the event that an institution does not consent to supervisory action, the FRS may issue a Notice of Charges to initiate litigation.

The FRS is authorized by the FDI Act to suspend or remove institution-affiliated parties who have engaged in a violation of law, an unsafe or unsound practice, or a breach of fiduciary duty, which has caused a bank to suffer a financial loss or other damages or has resulted in a gain to the individual, and that involves personal dishonesty or demonstrates continuing or willful disregard for the safety and soundness of the institution.

Notwithstanding these enforcement powers, the GLB Act prohibits the Federal Reserve Board from requiring an insurance company that is a BHC or an insurance company that is a subsidiary of a BHC to provide capital to a depository institution subsidiary of the BHC if the state insurance authority determines, in writing, that such a funds transfer would have a material adverse effect on the financial condition of the insurance company. Additionally, the GLB Act generally prohibits the Federal Reserve Board from taking enforcement action against an insurance company, unless the action is necessary to prevent or redress a practice that poses a material risk to an affiliated depository institution or to the domestic or international payments system, and it is not reasonably possible to protect against the material risk through action directed at the depository institution.¹⁹

¹⁹ These provisions are codified at 12 U.S.C. 1844(g) and 12 U.S.C. 1848a, respectively.

RECEIVERSHIP AND LIQUIDATION

Both state insurance regulators and banking regulators have statutory requirements for receiverships and liquidations of supervised entities. State receivership and liquidation laws vary to some degree. For a state insurance department to be accredited by the NAIC, a state must have laws that substantially conform to the NAIC Model Receivership Act.

State Insurance Supervisors

Delinquency proceedings are instituted against an insurance company by a state insurance department for the purpose of conserving, rehabilitating, reorganizing, or liquidating the insurance company. Among the various types of delinquency that may be permissible under state law are the following:

Conservation — This term has different meanings in different jurisdictions. The scope of conservation efforts can vary from a seizure of certain assets to rehabilitation.

Seizure of Assets — A state's legal or administrative provisions provide for an insurance department to take control of an insurer's assets, books, records, and business premises if the insurer is domiciled in the state, in order to conserve the company's assets for the benefit of its policyholders and creditors.

Rehabilitation — An insurance company may be placed in a rehabilitation status by an insurance department through a jurisdiction's legal or administrative proceeding. The rehabilitation process generally involves, sometimes under a court order, the transfer of operational authority from insurance company management to a rehabilitator with the objective of returning the company to a sound financial and operational condition. The court order could, among other matters, direct the rehabilitator to take possession of the assets and administer the assets and the operations of the insurance company under the supervision of the court or under a formal plan approved by the court with notice to the company's affected creditors.

Liquidation — In the event that rehabilitation of an insurer is unsuccessful, the insurance department may, through legal proceedings, place the insurer in liquidation. The liquidation process ordinarily would include the seizure and marshalling of the company's assets, a determination of the company's liabilities, and the distribution of the assets of the insurance company under the supervision of the court to address or redeem those liabilities.

Dissolution — An insurance department may petition a court for an order to dissolve or terminate the corporate existence of a domestic insurance company following its complete liquidation.

The nature, timing, and extent of regulatory action in any given troubled company situation depends, in part, on the applicable jurisdiction's laws and regulations to which

the insurance company is subject, as well as the circumstances of the particular situation. State insurance law may use different terms to refer to essentially similar actions, and the actions that are available to an insurance department differ among the states.

When an insurer is found to be insolvent and is ordered liquidated, the guaranty funds are the source of last resort to provide protection for the insurer's policyholders and claimants. Not all policy obligations, however, are covered. For those that are covered, statutory limits apply. Additionally, not all policyholders and claimants are covered.

Bank Supervisors

In the event that a commercial bank is formally declared insolvent by its chartering agency (a state banking department or the OCC), the chartering agency and the applicable federal regulator — the FRS, OCC, or the FDIC, in its supervision capacity — generally no longer have any responsibility for supervising the bank. Federal statutes name the FDIC as receiver and outline the process of a bank receivership and liquidation as well as the prioritization of claims. The amount of FDIC insurance coverage of \$100,000 per depositor is uniform nationwide in the event of a bank insolvency. Deposits of larger amounts have priority over all other non-depositor creditors.

In the event that all of a BHC's insured depository institutions are placed into receivership, the company is no longer a BHC, and, therefore, is no longer supervised by the FRS. The FRS generally has no role in the liquidation of a BHC or a company that was formerly a BHC. Such liquidations are administered in accordance with federal bankruptcy laws.

CONCLUSION

This joint initiative has advanced the insurance and banking regulators' understanding of each other's approaches for identifying and supervising financially weakened institutions and enhances coordination between the state insurance departments and the FRS, consistent with the GLB Act mandates for supervision of FHCs. In addition, many other efforts between the FRS and the state insurance supervisors, including the implementation of Memoranda of Understanding now in place between most state insurance departments and the Federal Reserve Board for sharing appropriate confidential, supervisory information and consumer complaints, as envisioned in the GLB Act,²⁰ have fostered effective coordination of supervisory activities. These accomplishments represent significant milestones in the achievement of effective cooperation between banking and insurance regulators.

²⁰ Other initiatives include the completion of a report mapping risks arising from insurance company activities into the standard FRS bank supervisory risk categories. See the report by the NAIC and the Federal Reserve System Joint Subgroup on Financial Issues, *Identification and Mapping of Insurance Risks into the Federal Reserve System's Defined Banking Risks*, dated June 10, 2003.

Appendix A

Summary of State Regulation for Identifying and Supervising Financially Weakened Insurers

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
1	Periodic (annual and quarterly) financial analysis of statutory financial statements	Annual Statements are filed by March 1 of each year. Quarterly Statements are filed within 45 days following each quarter-end. The annual statement review process tends to be the more comprehensive of the two periodic reviews, because of the amount and depth of information provided by the statement. The analytical tools described in the cells below are utilized throughout the reviews. In addition, the state insurance department analyst also consider other factors/conditions such as a prolonged devaluation in the stock or real estate markets; reinsurance recoveries; deterioration of parent company's public debt rating; and class action lawsuits.	Used in annual reviews, quarterly reviews and financial condition examination planning. Analysis results may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.	NA	The NAIC Accreditation Program provides timelines by which analysis of domestic insurers should be completed by state insurance departments.

¹ The term, "phase" in this table is used to refer to possible levels of progression relating to supervisory action as outlined in the NAIC Troubled Company Handbook.

² Powers confirmed by discretionary authority of a commissioner or department of insurance.

³ Powers permissible by state statute or regulation.

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
1	Scoring System	The NAIC Scoring System ratios and scores provide an integrated approach to screening and analyzing the financial condition of insurers.	Used in annual reviews, quarterly reviews and examination planning. Analysis results may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.		Ratios and scores are confidential. Ratios address critical areas of an insurer's operations, such as leverage of capital, growth, underwriting and investment profitability, investment holdings and liquidity. Companies receiving highest scores receive immediate attention, which often leads to a more in-depth analysis.
1	Analyst Team System (ATS) Review	The NAIC ATS is a multi-tiered process through which insurers are assigned levels of priority by a team of state analysts/examiners. The system is based on a series of tests applied to an insurer's financial results, which then assigns a "level" ranking. If an insurer receives a ranking in the top two levels, the company is reviewed by a team member who then validates or changes the assigned level.	Used in annual reviews and examination planning. Analysis results may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.		Like the Scoring System, the review process and results of the ATS are confidential. They are used by some states to gauge the financial soundness of non-domestic (foreign) insurers operating within the state.

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
1	Financial Condition Examination	An on-site examination may detect existing or potential financial problems or may be used to investigate problems arising from routine financial analysis.		Required by state law; state insurance commissioner has absolute power to conduct examinations as appropriate; insurer must respond to examination report comments and recommendations.	Examinations are conducted on either a full or limited-scope basis. Full-scope examinations are conducted every 3 - 5 years. Limited-scope examinations may be conducted more frequently, depending on circumstances.
1	Model Regulation Regarding Hazardous Financial Condition	This model is a Standard in the NAIC Accreditation Program. The purpose of this regulation is to set forth standards, which the state insurance department may use for identifying insurers found to be in an unsound financial condition and for authority to initiate action.	Standards considered and measured during analysis process; analysis results may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.	These standards provide the basis for a court petition to rehabilitate or liquidate.	All accredited states have passed laws substantially similar to the NAIC model. A state's rehabilitation and liquidation act may incorporate by reference its hazardous financial condition law.
1	Reinsurance Company Failure	An insurer's reinsurance program is closely monitored by a state insurance department's staff and measured by various financial ratios. A significant rating downgrade or failure of any reinsurer triggers a reaction from department staff to identify affected insurers and to assess potential impact on the insurer's solvency.	Analysis results may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.	May result in limited-scope examination.	Credit for reinsurance is heavily regulated through statutes, regulations, statutory accounting and reporting rules. These rules are part of the NAIC Accreditation Program.

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
1	Holding Company Filing	All insurers are required to register certain information with their domiciliary regulator, if part of a holding company system. Information must be disclosed regarding transactions, relationships and agreements with parent, subsidiary and affiliate (PSA) entities, among other information.	Analysis results may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meetings with management.	May result in limited-scope examination.	Filings are required pursuant to NAIC Insurance Holding Company System Model Act. All accredited states have passed laws substantially similar to the NAIC model.
1	Market Conduct Finding	All insurers periodically undergo some form of "market conduct" examination. As with financial condition examinations, these may be used to detect or investigate problems that impact existing as well as prospective policyholders. These examinations may also affect the insurer's financial stability.		State insurance commissioner has absolute power to conduct examinations as appropriate; insurer must respond to examination report comments and recommendations.	The NAIC continues to work toward developing standards of practice for conducting market conduct examinations.
1	Actuarial Opinion	All insurers are required to appoint "qualified actuary," as defined by the NAIC <i>Annual Statement Instructions Property and Casualty (P&C)</i> , to provide an opinion on the adequacy of loss and loss adjustment expense reserves, if a P&C insurer; or policy reserves and other actuarially-determined reserves, if a life or health insurer.	Opinion statements or a change in actuary may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.		To the extent possible and appropriate, examiners may utilize the work of the appointed actuary, to validate reserve adequacy.

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
1	Independent Audit Report (Report on Significant Deficiencies in Internal Controls)	All insurers are required to obtain an opinion from an independent auditor on their annual financial statements. In addition, each insurer must submit a report prepared by the auditor describing significant deficiencies in the insurer's internal control structure identify during the annual audit. An insurer is also required to report a change in auditor to the insurance department of the state of domicile within five business days of the event.	Report findings or a change in auditor may lead to: 1) phone or e-mail inquiry; 2) letter requesting additional information; or 3) face-to-face meeting with management.	Associated with this filing are reporting requirements the independent, external auditor must fulfill if the insurer has materially misstated its financial condition. If internal control deficiencies are reported, the insurer must submit a remediation plan.	To the extent possible and appropriate, examiners may utilize the work of the independent auditor, following some re-testing.
2	Business or Corrective Plan	Closer monitoring requires obtaining the insurer's business plan or corrective plan (including financial projections), depending on the severity of the situation. Two to three year plans are often requested. Financial analyst/examiners utilize these plans to monitor management's execution of the plan and to stimulate dialogue.	A business plan or corrective action plan may be required under general supervisory authority.	In some instances, state law explicitly requires the insurer to file a business or corrective action plan. For example, if an insurer triggers a certain RBC action level, a Corrective Action Plan is required.	Some state insurance departments are moving to routinely request business plans and financial projections from domestic insurers, particularly life insurers.

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
	Risk-Based Capital (RBC)	There are five action levels, which are determined by comparing a company's Total Adjusted Capital (TAC) to its Authorized Control Level (ACL) RBC as computed by the RBC formula. TAC is compared to ACL RBC because the ACL RBC is the level at which a state insurance commissioner may first take control of an insurer – that is, control of the insurer may be seized.		RBC standards and actions are statutory requirements.	The NAIC Risk-Based Capital for Insurers Model Act, or an act substantially similar, is required to attain state insurance department accreditation under the NAIC's Accreditation Program.
2	RBC Company Action Level	TAC of 150% to 200% of minimum RBC constitutes a company action level under which an insurer must prepare a report to the state regulator outlining the corrective actions the company intends to take. At this level, an insurer must submit a comprehensive financial plan to the regulator that identifies the conditions contributing to the company's financial condition. This plan must contain proposals to correct the company's financial problems and provide projections of the company's financial condition, both with and without the proposed		RBC standards and actions are statutory requirements.	

<u>Phase</u> ¹	<u>Trigger Points</u>	<u>Explanation</u>	<u>Regulatory Response</u>		<u>Comments</u>
			<u>Informal</u> ²	<u>Formal</u> ³	
		<p>corrections. The plan also must list the key assumptions underlying the projections and identify the quality of, and the problems associated with, the insurer's business. If a company fails to file this comprehensive financial plan, this failure to respond triggers the next action level.</p>			
2	RBC Regulatory Action Level	<p>TAC of 100% to 150% of minimum RBC triggers a Regulatory Action Level initiative. At this level, an insurer is also required to file an action plan, and the state insurance commissioner is required to perform any examinations or analyses of the insurer's business and operations deemed necessary. The state insurance commissioner also issues appropriate corrective orders to address the company's financial problems.</p>		RBC standards and actions are statutory requirements.	

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
3	RBC Authorized Control Level	TAC of 70 to 100% of the minimum RBC triggers an Authorized Control Level. This is the first point that the law authorizes the regulator to take control of an insurer. This authorization is in addition to the remedies available at the company and regulatory action levels. It is important to note that the law grants the state insurance commissioner this power. This action level occurs at a point where the insurer may still be technically solvent according to traditional standards – that is, the company’s assets may still be greater than its liabilities.		RBC standards and actions are statutory requirements.	
3	RBC Mandatory Control Level	TAC of less than 70% triggers a Mandatory Control Level that requires the regulator to take steps to place an insurer under control. This situation can occur while the insurer still has a positive level of capital and surplus, although a number of the companies that trigger this action level are technically insolvent (liabilities exceed assets).		RBC standards and actions are statutory requirements.	

Phase ¹	Trigger Points	Explanation	Regulatory Response		Comments
			Informal ²	Formal ³	
3	Administrative Supervision	<p>State insurance commissioner exercises varying levels of control over operations of an insurer, dependent upon the circumstances of the specific case. Ownership of company is not disturbed and directors remain in place. This phase usually involves submission of a corrective plan by the insurer.</p> <p>The state insurance commissioner may appoint an on-site supervisor to monitor performance.</p>		Statutory requirements relating to administrative supervision vary by state.	
4	Receivership	<p>State insurance commissioner obtains a court order authorizing</p> <p>1) seizure of a company; 2) appointment of the state insurance commissioner as receiver; and 3) vesting legal title to all assets of the company in the state insurance commissioner's name.</p> <p>Management and directors are removed. As receiver, the state insurance commissioner's actions are subject to supervision by the state court that issued the receivership order. State insurance commissioner typically appoints a special deputy receiver to manage the receivership.</p>		Statutory requirements relating to receivership vary by state.	Initial seizure order may be obtained <u>ex parte</u> in some situations. State insurance commissioner has broad discretion in administering the receivership.

<u>Phase</u> ¹	<u>Trigger Points</u>	<u>Explanation</u>	<u>Regulatory Response</u>		<u>Comments</u>
			<u>Informal</u> ²	<u>Formal</u> ³	
		Receiver may attempt to rehabilitate the insurer or, if rehabilitation is not practical, the receiver will liquidate the company.			

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Appendix B

Summary of Federal Reserve System Framework for Identifying and Supervising Financially Weakened State Member Banks and Bank Holding Companies

This table highlights key elements of the FRS’s supervisory framework pertaining to bank holding companies (BHCs) and state member banks. It does not purport to include all events that may trigger a supervisory response or the full range of applicable supervisory actions.

Event That May Trigger Supervisory Response	Applicable Regulation/ Policy or Guidance¹	Supervisory Action and Time Frames for Action if Applicable
1) Quarterly surveillance results for state member banks	SR letter 00-7: <i>System Bank Watch List Program</i>	Reserve Bank staff investigates potential financial weaknesses and prepares or updates analyses for watch list banks identified through the FRS’s quarterly surveillance process. The analyses address the sources of potential weakness and their potential effect on safety and soundness; assess the appropriateness of current supervisory ratings and on-site examination schedules; and detail future supervisory plans.
2) Quarterly surveillance results for BHCs	SR letter 95-43: <i>Revised Bank Holding Company Surveillance Procedures</i> SR letter 02-01: <i>Revisions to BHC Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less</i> (Contains separate guidance for both BHCs \$1 - \$5 billion, and BHCs less than \$1 billion in assets.)	Reserve Bank staff prepares or updates analyses for BHCs with assets of \$1 billion or more identified by quarterly exception screens. The Reserve Bank analyses detail the sources of potential weakness, their effect on safety and soundness, and supervisory actions in response to surveillance screen results. For BHCs under \$1 billion, (except small, non-complex BHCs), quarterly surveillance screens are also used to identify potentially significant changes in the conditions of these companies between on-site supervisory reviews.

¹ SR letters, the *Commercial Bank Examination Manual*, and the *Bank Holding Company Inspection Manual* provide guidance to Federal Reserve Banks for implementing their Federal Reserve Board-delegated responsibility for the supervision of banking organizations. SR letters are issued by Federal Reserve Board staff to the officers in charge of supervision at each Reserve Bank. These documents are accessible on the Federal Reserve Board’s website at www.federalreserve.gov.

Event That May Trigger Supervisory Response	Applicable Regulation/ Policy or Guidance¹	Supervisory Action and Time Frames for Action if Applicable
<p>3) Risk assessments of BHCs, including FHCs, and banks are prepared by Federal Reserve Bank staff. Risk assessments include an analysis of the level of risk, the direction of risk, and management controls. The following risks are assessed for the consolidated organization, as well as for the major business lines: operational risk, credit risk, market risk, liquidity risk, legal risk, reputational risk, and overall risk. For FHCs, particular focus is on understanding intra-group exposures and risk concentrations across all business lines.</p>	<p>SR letter 97-24: <i>Risk-Focused Framework for the Supervision of Large Complex Institutions</i></p> <p>SR letter 97-25: <i>Risk-Focused Framework for the Supervision of Community Banks</i></p> <p>SR letter 99-15: <i>Risk-Focused Supervision of Large Complex Banking Organizations</i></p> <p>SR letter 02-01: <i>Revisions to BHC Supervision Procedures for Organizations with Total Consolidated Assets of \$5 Billion or Less</i></p> <p>SR letter 00-15: <i>Risk-Focused Supervision Policy for Small Shell BHCs</i></p> <p>SR letter 00-13: <i>Framework for Financial Holding Company Supervision</i></p>	<p>Based on the risk assessment, supervisory staff determines the scope, objectives and dates for targeted on-site reviews of selected risk areas.</p> <p>Supervisory staff coordinates with functional and primary regulators when appropriate.</p>
<p>4) Significant market, economic or other external event affecting banking industry condition</p>	<p>FRS's role to maintain stability of the banking system as well as role of prudential regulator for banking institutions.</p>	<p>Conduct monitoring and targeted reviews of banking organizations, as appropriate, and develop action plans.</p>
<p>5) Bank examinations and BHC inspections</p>	<p>Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires full-scope on-site examinations of state member banks are required at least once during each 12-month period with the exception that certain small institutions can be examined once during each 18-month period.</p> <p>The frequency of BHC inspections is dependent on the size, condition, and complexity of the institution.</p>	<p>Institutions are required to respond to issues identified. A range of informal and formal supervisory actions that may be appropriate to address weaknesses identified include but are not limited to:</p> <ul style="list-style-type: none"> • Written Agreement, • Cease and Desist Order, • Temporary Cease and Desist Order, and • Prompt Corrective Action (PCA) (see below portion of this chart regarding PCA).

Event That May Trigger Supervisory Response	Applicable Regulation/ Policy or Guidance¹	Supervisory Action and Time Frames for Action if Applicable
6) FHCs whose depository institution subsidiaries become less than well capitalized or are not well managed	Formal corrective action is required under section 4(m) of the BHC Act	<ul style="list-style-type: none"> • Requires an agreement between the FHC and the FRS within 45 days of notification of deficiency. • Institution must submit a plan for corrective action. • Institution must correct deficiency within 180 days; FRS may extend the deadline based on reasonable cause.
7) Capital deterioration - Bank capital deterioration:	FDICIA PCA provisions apply to bank capital levels. These provisions do not apply to BHC capital levels.	
Well capitalized		No action required
Adequately capitalized		No action required
Undercapitalized	FDICIA PCA provisions apply to bank capital levels. These provisions do not apply to BHC capital levels.	Increase monitoring. The following conditions apply: <ul style="list-style-type: none"> • Capital restoration plan is required; • Parent BHC must guaranty bank’s capital plan; • Cessation of dividends; and • Limitation on management fees paid to controlling persons.
Significantly undercapitalized	FDICIA PCA provisions apply to bank capital levels. These provisions do not apply to BHC capital levels.	Conditions (see above) for “Undercapitalized” banks apply. Mandatory and discretionary restrictions include: <ul style="list-style-type: none"> • Sale of shares to increase capital; • Sale or merger of bank; • Restrictions on transactions with affiliates; • Restrictions on interest rates; and • Restrictions on senior officer compensation.
Critically undercapitalized	FDICIA PCA provisions apply to bank capital levels. These provisions do not apply to BHC capital levels.	Conditions (see above) for “Undercapitalized” and “Significantly Undercapitalized” banks apply. The Federal Deposit Insurance Corporation (FDIC) may be appointed receiver within 90 days.

Event That May Trigger Supervisory Response	Applicable Regulation/ Policy or Guidance¹	Supervisory Action and Time Frames for Action if Applicable
BHC capital deterioration	BHC Act	BHC capital deterioration may trigger informal or formal action such a Memorandum of Understanding, Written Agreement, or Cease and Desist Order.
8) Bank & BHC insolvency		
<ul style="list-style-type: none"> • Bank insolvency or other factors identified by the chartering agency (state banking department or OCC) that are likely to result in losses to the federal deposit insurance fund • BHC insolvencies 	<p>Federal Deposit Insurance Act</p> <p>N/A: BHC insolvencies fall under federal bankruptcy laws.</p>	<p>FDIC is generally appointed receiver.</p> <p>N/A</p>