

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Date: August 31, 2023
To: Board of Governors
From: Staff¹
Subjects: Final rulemaking to establish a risk-based capital requirement for depository institution holding companies significantly engaged in insurance activities, with accompanying reporting requirements

ACTIONS REQUESTED: Approval of (1) the attached draft final rule, which would establish minimum risk-based capital requirements applicable to bank holding companies and savings and loan holding companies significantly engaged in insurance activities (Supervised Insurance Organizations or SIOs), (2) the implementation of a new reporting form (FR Q-1) to collect data relevant to the rule, and (3) the attached order delegating authority to staff to take certain actions under the draft final rule that do not raise significant legal or policy issues. Staff also requests authority to make technical, nonsubstantive changes to the draft final rule and associated reporting form to prepare them for publication.

EXECUTIVE SUMMARY:

- Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) requires the Board to establish, on a consolidated basis, minimum risk-based capital requirements for depository institution holding companies, including SIOs, that are not lower than the risk-based capital requirements for insured depository institutions (IDIs).² Currently, SIOs are excluded from the Board's risk-based capital rule for depository institution holding companies.³ Staff expects that the Board would supervise five SIOs at the time this draft rule would become effective.⁴

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² 12 U.S.C. § 5371.

³ 12 CFR part 217 (Regulation Q).

⁴ These SIOs are Ameriprise Financial, Inc.; The Auto Club Group; First American Financial Corporation; Ohio Farmers Insurance Company; and United Services Automobile Association. Another SIO, TIAA Board of Governors, sold its subsidiary savings association, now named EverBank, National Association, and is expected to deregister as a savings and loan holding company.

- In September 2019, the Board invited comment on a notice of proposed rulemaking (NPR or proposal) that would establish minimum risk-based capital requirements for SIOs.⁵ The NPR proposed an enterprise-wide approach, called the Building Block Approach (BBA), which aggregated the available capital and required capital of a top-tier company in an SIO with those of its subsidiaries, as determined according to each subsidiary's applicable capital framework. An additional calculation would have ensured compliance with section 171 of the Dodd-Frank Act (section 171 calculation).
- Commenters strongly supported using an aggregation approach to determining enterprise-wide capital requirements. However, most commenters argued that the section 171 calculation was unnecessary, that the overall calibration was too high, that the limits on certain types of capital instruments were too low, and that senior debt should qualify as capital.
- The draft final rule would be largely consistent with the proposal published in September 2019. However, in response to comments, the draft final rule would make certain changes to better align SIO capital requirements with the requirements for other depository institution holding companies, including by changing the size of the proposed capital conservation buffer and adding a tier of eligible capital instruments, additional tier 1 capital instruments. The draft final rule does not allow senior debt to be considered capital and does not change the proposed section 171 calculation.
- Although the proposed requirements are higher than current state capital requirements, most insurers operate at multiples of the current state capital requirements. None of the affected firms would need to raise capital to comply with the rule.

DISCUSSION:

A. Background

The Dodd-Frank Act requires that the Board establish minimum risk-based capital requirements on a consolidated basis for depository institution holding companies, IDIs, and nonbank financial companies supervised by the Board under Title I of the Dodd-Frank Act. The Act also provides that the Board may not require a supervised firm that is also a state-regulated insurer and files financial statements utilizing only Statutory Accounting Principles (SAP) to prepare such financial statements in accordance with U.S. generally accepted accounting principles (GAAP).⁶ The Board currently supervises six SIOs, all of which are savings and loan holding companies. Although all these firms are significantly engaged in insurance activities,

⁵ Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, 84 Fed. Reg. 57240 (October 24, 2019).

⁶ [12 U.S.C. § 5371\(c\)\(3\)\(A\)](#).

the portfolio exhibits significant variety in ways that are relevant to an enterprise-wide capital requirement. SIOs have been excluded from the Board's banking capital rule until an approach could be developed that would appropriately address the range of firm structures and insurance-related risks.

This draft final rule follows the issuance of two documents for comment by the Board. In 2016, the Board published an advance notice of proposed rulemaking (ANPR) on using an aggregation approach to setting capital requirements for SIOs. The ANPR described the concept of the BBA as a capital framework and sought input on all aspects of its development at an early stage.⁷ The Board considered this feedback and invited comment on a detailed BBA proposal in the NPR.⁸

B. Overview of Proposed BBA

The NPR proposed risk-based capital requirements for SIOs. In addition to the enterprise-wide capital requirement based on the BBA framework, the proposal would have applied a minimum risk-based capital requirement to the enterprise using the flexibility afforded under amendments enacted in 2014 to section 171 of the Dodd-Frank Act to exclude certain state- and foreign-regulated insurance operations.⁹

The proposal would have aggregated the capital requirements of companies under an insurance depository institution holding company, with adjustments to harmonize treatment of risks and loss absorbing resources and would have expressed the aggregate in terms of a common capital framework. To best reflect all material risks and streamline implementation burden, the BBA would have used state insurance regulators' risk-based capital (RBC) frameworks, as set forth by the National Association of Insurance Commissioners (NAIC) as the common capital framework for insurance entities.

The BBA would have applied to an organization through the following steps:

⁷ Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38631 (June 14, 2016).

⁸ Regulatory Capital Rules: Risk-Based Capital Requirements for Depository Institution Holding Companies Significantly Engaged in Insurance Activities, 84 Fed. Reg. 57240 (October 24, 2019).

⁹ Pub. L. No. 111-203, 124 Stat. 1376, 1435-38 (2010), as amended by Pub. L. No. 113-279, 128 Stat. 3017 (2014).

1. Compile an inventory of all the companies in the insurance depository institution holding company's enterprise;¹⁰
2. Group the companies in the inventory into sub-groups termed "building blocks," generally based on whether the companies directly or indirectly fall under a distinct capital framework;¹¹
3. Determine the available capital and capital requirements (the numerator and denominator, respectively, in a required capital ratio) for the parent company of each building block (the "building block parent") under its applicable capital framework;
4. Apply any adjustments to available capital and capital requirements within each building block, as required under the BBA, to harmonize the reflection of loss-absorbing resources and risks across the enterprise;
5. As needed, translate the adjusted available capital and capital requirement amounts from the applicable capital framework for each building block parent to their equivalents under the common capital framework;
6. Aggregate the translated, adjusted available capital and capital requirement amounts for each building block parent, making deductions to avoid double counting and double leverage; and
7. Determine whether the aggregate ratio meets the Board's minimum requirement and capital conservation buffer.

These steps have not been changed in the draft final rule.

C. Summary of Comments Received

The Board received substantive comments on the proposal from 18 commenters. The Board's Insurance Policy Advisory Committee (IPAC) also made recommendations on several aspects of the BBA. Most commenters supported the BBA's general framework and strongly preferred applying this framework, rather than other frameworks like the banking capital rule.

¹⁰ This inventory would generally be determined by taking the set of entities shown on the firm's insurance statutory financial statements together with those shown in its submission of the Board's Forms FR Y-6 and FR Y-10. All companies under the insurance depository institution holding company would be included in the BBA.

¹¹ For example, where an insurance depository institution holding company has U.S. banking, life insurance and non-life insurance operations, the BBA would group each of the firm's banking, life insurance, and non-life insurance operations into distinct building blocks.

Although commenters were supportive of the framework, some commenters expressed concerns regarding calibration, qualifying capital instruments, and one aspect of the reporting that they considered burdensome. The following are some of the main issues that were raised by commenters:

- *Section 171 Calculation* – Most commenters argued that the section 171 calculation was unnecessary because the BBA itself would comply with section 171 of the Dodd-Frank Act.
- *Calibration* – Under the proposal, the minimum ratio of enterprise-wide available capital to enterprise-wide required capital would have been 250 percent along with a capital conservation buffer of 235 percent above the minimum requirement. The proposed minimum ratio was derived by translating the 8 percent of risk-weighted assets requirement under the banking capital rule to an equivalent value for the BBA using a scaling methodology. In addition to this equivalent value, the proposed rule would have also included a margin of conservatism to provide a heightened degree of confidence that the BBA’s requirement would be compliant with section 171 of the Dodd-Frank Act. Like the proposed minimum requirement, the proposed capital buffer was determined based on the capital conservation buffer under the Board’s banking capital rule, translated to its equivalent under the BBA’s common capital framework. Most commenters supported setting the BBA’s requirement equal to other banking capital requirements based on the indicated results from the scaling white paper and not including the proposed additional margin of conservatism.
- *Qualifying Capital Instruments and Limits* – The proposed capital instrument criteria were aligned with the Board’s banking capital rule (instruments failing these criteria, including senior debt, would not qualify as regulatory capital under the BBA) except that additional tier 1 capital was not included due to the composition of the capital structures of SIOs. Additionally, in the proposal, the tier 2 capital limitation was 62.5 percent. Most commenters argued that the Board’s proposed capital instrument qualification criteria were too narrow, and that senior debt should qualify as capital, although several commenters disagreed. Some commenters argued for increasing the proposed limits on less loss-absorbing tiers of capital instruments. They expressed a concern that the conservative nature of statutory accounting distorts the ratio of tier 2 capital instruments to common equity tier 1 capital, which causes the 62.5 percent to be overly conservative. Some commenters

also argued that surplus notes, a form of subordinated debt issued by U.S. insurers, should qualify as tier 1 capital and, alternatively, if they are included as tier 2 capital, then no limits should apply. Commenters also requested the inclusion of additional tier 1 capital to allow SIOs flexibility in their capital structures.

- *Reporting Burden* – Under the proposed form FR Q-1, SIOs would have needed to report certain basic information (for example, total assets and total liabilities) for all inventory companies. Commenters expressed concern with the burden associated with reporting assets and liabilities of potentially thousands of inventory companies. The commenters asserted that SIOs could not easily calculate the total assets of subsidiaries multiple levels down their organization chart. To avoid this burden, these commenters argued for excluding immaterial, non-operating entities from the inventory.

D. Key aspects of the Draft Final Rule

Covered institutions – The draft final rule applies to a depository institution holding company where the top-tier depository institution holding company (1) is an insurance underwriting company or (2) held, as of June 30 of the previous year, 25 percent or more of its total consolidated assets¹² in insurance underwriting companies (other than assets associated with insurance underwriting for credit risk).¹³

Scaling – The draft final rule includes the concept of scaling, which is a mechanism by which a building block's available capital and capital requirement under one capital framework would be translated to their equivalents in another framework. Because of the importance of scaling when aggregating numbers in different regulatory capital frameworks, a white paper

¹² The SIO would calculate its total consolidated assets in accordance with GAAP, or, if the firm does not calculate its total consolidated assets under GAAP for any regulatory purpose (including compliance with applicable securities laws), the firm may estimate its total consolidated assets, subject to review and adjustment by the Board.

¹³ All current SIOs, including one predominantly engaged in title insurance, would be subject to the proposed BBA. At the legal entity level, U.S.-based title insurance companies are not subject to a risk-based capital standard promulgated by the NAIC. The proposed BBA would adopt the Board's banking capital rule for an insurance depository institution holding company that is predominantly engaged in title insurance. In applying this rule, the BBA proposes to add, in the denominator of this framework's ratio, the firm's claim reserves relating to title insurance business, risk weighted at 300 percent. This risk weight was based on review of data from historical title claim reserves that showed a risk comparable to assets that have been assigned a 300 percent risk weight in the Board's banking capital rule.

explaining the development of the scalars was published along with the NPR.¹⁴ This white paper introduced a methodology for determining scalars from an analysis of defaults—in particular, the relationship between pre-default solvency ratios and observed default rates. Because all current SIOs are U.S.-based insurers that own IDIs, the draft final rule would include a scaling mechanism to translate between federal banking capital rules and the states’ insurance RBC frameworks. The draft final rule does not include scalars between non-U.S. insurance capital frameworks and the states’ insurance RBC frameworks because of the limited international insurance operations of SIOs and limited international default data.

Minimum requirement – In the draft final rule, the minimum ratio of enterprise-wide available capital to enterprise-wide required capital is 250 percent.

Capital buffer – The draft final rule includes a 150 percent capital conservation buffer, rather than the 235 percent buffer proposed in the NPR. This smaller capital conservation buffer better aligns the BBA’s stringency with the Board’s banking capital rule. Thus, the minimum capital requirement, together with the buffer, under the BBA would be 400 percent (analogous to 10.5 percent of risk-weighted assets under the banking capital rule).

Companies not subject to capital rules – In the draft final rule, companies in an SIO that are not subject to company-level capital regulations are generally treated as they are under the indicated capital framework for the parent of the building block of which they are members.¹⁵ However, in certain cases, such a company that is a financial entity can have characteristics (such as risk exposure, activities, structure, complexity, affiliate guarantee, or size) that render it significant in the insurance depository institution holding company’s enterprise. In these cases, the draft final rule would place such a company, termed a “material financial entity” (MFE), into a distinct building block. When an MFE is not engaged in insurance or reinsurance underwriting, the draft final rule would use the Board’s banking capital rule to assess the available capital and capital requirements of the MFE and any of its subsidiaries in the same building block. When an MFE is engaged in insurance or reinsurance underwriting (for example, a captive reinsurance company), the draft final rule would use the RBC capital

¹⁴ *Comparing Capital Requirements in Different Regulatory Frameworks*, September 2019, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20190906a1.pdf>.

¹⁵ For example, if a SIO has life insurance operations grouped into one building block, and the building block parent had a nonfinancial subsidiary not subject to capital regulations, the nonfinancial subsidiary would be treated in the BBA the same way that it is treated under the life insurance risk-based capital framework.

framework to assess the available capital and capital requirements for this entity and any subsidiaries in its building block.

Adjustments to capital requirements and available capital – To determine available capital and capital requirements for each building block, an SIO would begin by computing available capital and capital requirements for the building block parent under its indicated capital framework. The draft final rule would then require the SIO to apply certain adjustments to ensure uniform treatment, appropriate reflection of risks and loss absorbing resources, and fulfillment of the Board’s supervisory objectives. For capital requirements (the denominator of the ratio), the draft final rule includes the following adjustments:

1. Elimination of (i) permitted and prescribed accounting practices¹⁶ and (ii) transitional measures in jurisdictions’ solvency frameworks;
2. Optional elimination of capital charges for credit risk of affiliates and allocation of an MFE’s risks to affiliates within the supervised organization;¹⁷
3. Addition of claim reserves relating to title insurance business, subject to a risk weight of 300 percent; and
4. Changes to required capital resulting from deduction of investments in own capital instruments, consistent with the Board’s banking capital rule.

For available capital (the numerator of the ratio), the draft final rule includes the following adjustments:¹⁸

1. Application of the criteria to qualify as tier 1 additional capital under the Board’s banking capital rule with a limitation of 100 percent of the building block capital requirement for the top-tier parent.
2. Application of the criteria to qualify as tier 2 capital under the Board’s banking capital rule (instruments failing these criteria, including senior debt, would not qualify as regulatory capital under the BBA). The draft final rule also includes a limitation on tier 2

¹⁶ Some U.S. states have local permitted and prescribed accounting practices that depart from the standard insurance SAP as promulgated by the NAIC. These practices result in inconsistent application of insurance RBC within the United States and can allow for regulatory arbitrage.

¹⁷ These adjustments may involve effort on the part of the insurance depository institution holding company such that the firm may not find the benefits to exceed implementation burden. The proposed BBA would thus have left this adjustment at the firm’s option to apply.

¹⁸ The proposal generally followed the banking capital rules, although it only included two tiers of capital because no SIO had issued additional tier 1 capital. In following the banking rules, surplus notes issued by mutual insurers would have been considered tier 2 capital instruments subject to the tier 2 limitation.

capital instruments to be no more than 150 percent of the building block capital requirement for the top-tier parent.

3. Elimination of the deduction of the regulatory capital requirement for insurance underwriting risks under the Board's banking capital rule;¹⁹

Aggregation – Under the draft final rule, following the applications of adjustments and scaling, data from the building blocks would be aggregated to calculate the enterprise-wide available capital and capital requirement. In so doing, intercompany transactions in which capital is downstreamed within the enterprise would be appropriately deducted to avoid double-counting.

Form FR Q-1 – Under the draft final form FR Q-1, SIOs would only be required to report the assets and liabilities of inventory companies whose parents represent more than one percent of the group's assets.

E. Section 171 Calculation

Under section 171(b) of the Dodd-Frank Act, the Board must establish minimum risk-based and leverage capital requirements, on a consolidated basis, for all depository institution holding companies. These capital requirements must be (i) not less than the capital requirements generally applicable to IDIs, and (ii) not quantitatively lower than the generally applicable capital requirements in place for IDIs on July 21, 2010. In order to establish a capital framework for SIOs that meets the requirements of section 171, the draft final rule includes a simple, supplemental minimum risk-based capital calculation that is separate from the BBA.

The draft final rule allows each SIO two alternative paths to demonstrate compliance with section 171. First, the company may choose to demonstrate that it meets, on a fully consolidated basis, the minimum risk-based capital requirements that apply to IDIs. Second, consistent with flexibility provided in section 171, the SIO may choose to demonstrate that it meets the minimum IDI risk-based capital requirements on a partially consolidated basis, excluding the assets and liabilities of certain subsidiary insurers. Under this second path, the draft final rule allows two possible treatments for unconsolidated insurance subsidiaries: (1) a deduction from qualifying capital of the aggregate amount of the outstanding equity investment

¹⁹ In lieu of this deduction, which applies when a bank or bank holding company has an insurance underwriting subsidiary, under the BBA, the insurance subsidiary would be in a distinct building block from its banking parent. The insurance subsidiary's risks, and resources, would be aggregated in the BBA rather than deducted.

in the subsidiary, including retained earnings; or (2) inclusion of the net investment in the subsidiary as an asset subject to a risk weight of 400 percent, consistent with the current treatment of certain equity exposures under the regulatory capital rules applicable to IDIs.

F. Impact Assessment of the Final Rule

Based on several different empirical exercises, staff does not presently anticipate that any current SIO would need to raise additional capital to meet the requirements of the BBA, including the proposed buffer, or the separate section 171 calculation. Moreover, staff has attempted to limit burden on SIOs by relying on existing capital frameworks and accounting standards, and by proposing reporting forms that would use information already reported to company-level regulators. Staff believes that the draft final rule would fulfill the statutory mandate for a capital requirement in an appropriate and efficient manner that places streamlined implementation burden upon SIOs.

G. Paperwork Reduction Act

Under the Paperwork Reduction Act (PRA), the Board must undertake a review prior to implementing a new collection of information. In connection with the attached draft final rule, staff recommends that the Board finalize the implementation of form FR Q-1 as a new collection of information. The Office of Management and Budget has delegated to the Board the authority to review and approve collection of information requests and requirements pursuant to the PRA.²⁰ The Federal Reserve's review of the collection of information should include: (1) an evaluation of the need for the collection of information, (2) a description of the information to be collected, (3) a plan for the collection of information, (4) a specific estimate of burden, (5) an evaluation of whether burden may be reduced by use of information technology, (6) a test of the collection through a pilot program, if appropriate, and (7) a plan for the efficient management and use of the information to be collected.²¹

The draft form FR Q-1 would comply with the PRA, and the information is not available from other sources. The information that would be collected by the form FR Q-1 would be necessary for the Board to administer the BBA, if it is adopted in final form. The estimated

²⁰ See 5 CFR 1320.16.

²¹ See 5 CFR 1320.8(a).

annual burden associated with the form FR Q-1 is 1,097 hours (878 for initial setup and 219 hours for ongoing compliance). The Board invited public comment on the need for the information in the proposed collection of information; the estimated burden; suggestions for improvements to the quality, utility, and clarity of the information; and suggestions to minimize the burden on the respondents, and the only comment received on burden was the amount of subsidiary entities where firms would have to report total asset and total liabilities. The draft final FR Q-1 would substantially decrease this burden by only require reporting with respect to material entities.

RECOMMENDATIONS: For the reasons discussed above, staff recommends that the Board approve the attached draft notice of final rulemaking, Form FR Q-1, and the attached draft delegation order. Staff also recommends that the Board authorize staff to make technical, non-substantive changes to the materials prior to publication.

Attachments