Date: June 4, 2025

To: Board of Governors

From: Staff[1]

Subject: Proposal to Revise the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations

ACTIONS REQUESTED:

Staff requests approval to publish in the *Federal Register* the attached draft notice of proposed rulemaking (proposal), which would invite public comment on revisions to the Large Financial Institution rating system (LFI Framework) and the ratings system for supervised insurance organizations (Insurance Supervisory Framework, collectively with the LFI Framework, the Frameworks). Staff also requests authority to make technical, non-substantive changes to the attached materials to prepare them for publication in the *Federal Register*.

EXECUTIVE SUMMARY:

- The vast majority of large financial institutions are well capitalized, have sound liquidity positions, and good asset quality. Yet approximately 64% of large financial institutions are not "well managed" under the current LFI Framework.
- The current Frameworks evaluate firms based on three components: (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls. Each component is rated based on a four-point non-numeric scale: Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2. A firm that receives a rating of Deficient-1 or Deficient-2 in any component rating is not "well managed."

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- The proposal would revise the Frameworks such that a firm with at least two Broadly Meets Expectations or Conditionally Meets Expectations component ratings and no more than one Deficient-1 component rating would be "well managed."
    - A firm would not be "well managed" if it receives a Deficient-2 for any of the component ratings, consistent with the current Frameworks.
- The proposal would also remove the presumption in the Frameworks that the Board will bring an informal or formal enforcement action on firms with one or more Deficient-1 ratings. Instead, decisions to issue enforcement actions to those firms would be made based on the particular facts and circumstances of the firm. The Frameworks would continue to contain a presumption of an enforcement action for a firm that receives a Deficient-2 rating for any component.
- The proposed revisions would better reflect the current strength of the banking system and would more closely align the Frameworks with the supervisory rating systems used for other banking organizations.

BACKGROUND:

Current LFI Framework

In 2018, the Board issued the LFI Framework, which applies to (i) bank holding companies and non-insurance, non-commercial savings and loan holding companies with total consolidated assets of $100 billion or more, and (ii) U.S. intermediate holding companies of foreign banking organizations with total consolidated assets of $50 billion or more.[2] The LFI Framework evaluates whether a firm possesses sufficient financial and operational strength and resilience to maintain safe and sound operations and comply with laws and regulations through a range of conditions. It includes three components: (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls.[3] Each component is rated based on a four-point non-numeric scale (in descending order): Broadly Meets

[2] 83 Fed. Reg. 58724 (Nov. 21, 2018).

[3] See SR Letter 19-3 / CA Letter 19-2, Large Financial Institution (LFI) Rating System (Feb. 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm.

Expectations,[4] Conditionally Meets Expectations,[5] Deficient-1,[6] and Deficient-2.[7] A firm that receives a rating of Deficient-1 or Deficient-2 in any component rating is not "well managed" under the current LFI Framework, and therefore for purposes of the Bank Holding Company Act (BHC Act) and for certain other purposes.[8] A firm that is not "well managed" faces limitations on certain acquisitions and new activities. Moreover, the LFI Framework establishes a presumption that the Board will impose an informal or formal enforcement action on any firm that is not "well managed."

Current Insurance Supervisory Framework

In 2022, the Board adopted the Insurance Supervisory Framework, which applies to depository institution holding companies significantly engaged in insurance activities.[9] In addition to other tailoring of the supervision of insurance organizations,[10] the Insurance Supervisory Framework establishes a supervisory rating system for these firms modeled after the LFI Framework. Like the LFI Framework, the Insurance Supervisory Framework includes three components (Capital Management, Liquidity Management, and Governance and Controls), with each component rated based on a four-point non-numeric scale (Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2).

Like firms subject to the LFI Framework, certain insurance organizations that are not "well managed" may be restricted from engaging in certain acquisitions or new activities.[11]

[4] Indicates that a firm's practices and capabilities broadly meet supervisory expectations, and the firm possesses sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions.

[5] Indicates that there are certain material financial or operational weaknesses in a firm's practices or capabilities that may place the firm's prospects for remaining safe and sound through a range of conditions at risk if not resolved in a timely manner during the normal course of business.

[6] Indicates that there are financial or operational deficiencies in a firm's practices or capabilities, which put the firm's prospects for remaining safe and sound through a range of conditions at significant risk.

[7] Indicates that there are financial or operational deficiencies in a firm's practices or capabilities that present a threat to the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition.

[8] 12 U.S.C. § 1841(o)(9).

[9] 87 Fed. Reg. 60160 (Oct. 4, 2022); SR Letter 22-8, Framework for the Supervision of Insurance Organizations (Sept. 28, 2022), https://www.federalreserve.gov/supervisionreg/srletters/SR2208.htm.

[10] For example, the Insurance Supervisory Framework classifies supervised insurance organizations as either complex or noncomplex based on their risk profile. Supervisory activities vary based on this determination and also based on each firm's individual risk profile.

[11] See 12 CFR 225.83 and 238.66(b).

Under the Insurance Supervisory Framework, a supervised insurance organization must receive a rating of Conditionally Meets Expectations or better in each of the three rating components in order to be considered "well managed." Additionally, the Insurance Supervisory Framework establishes a presumption that the Board will impose an enforcement action on any firm that is not "well managed."

DISCUSSION:

The proposal would revise the Frameworks such that a firm with at least two Broadly Meets Expectations or Conditionally Meets Expectations component ratings and no more than one Deficient-1 component rating would be "well managed." A firm would not be "well managed" if it receives a Deficient-1 for two or more component ratings. Further, a firm would not be "well managed" if it receives a Deficient-2 for any of the component ratings, consistent with the current Frameworks. The proposal also would remove the presumption in the Frameworks that the Board will bring an informal or formal enforcement action on firms with one or more Deficient-1 ratings. Instead, firms with one or more Deficient-1 ratings may be subject to a formal or informal enforcement action by the Board, depending on the particular facts and circumstances of the firm. The Frameworks would continue to include a presumption that the Board will impose a formal enforcement action for firms with one or more Deficient-2 component ratings. The proposed revisions would reflect the strength of the banking system. Further the proposal would reflect that a firm with an idiosyncratic deficiency that results in a single component rating of Deficient-1 would generally have sufficient financial and operational strength and resilience to operate in a safe and sound manner through a range of conditions, if the other two components have a rating of Broadly Meets Expectations or Conditionally Meets Expectations. The proposal would also better align the Frameworks with the supervisory rating systems used for other banking organizations.

The current approach to determining whether a firm is "well managed" under the LFI Framework has resulted in outcomes that are not aligned with the strength of the banking system. As discussed in the Board's November 2024 Supervision and Regulation Report, the banking system remains sound and resilient overall.[12] However, under the LFI Framework,

[12] Specifically, this report states that most banks are well capitalized; liquidity and funding conditions are stable compared to 2023; and asset quality generally remains sound. Board of Governors of the Federal Reserve System, Supervision and Regulation Report (November 2024), available at https://www.federalreserve.gov/publications/files/202411-supervision-and-regulation-report.pdf.

approximately 64% of large financial institutions are not "well managed." In addition, experience based on implementation of the LFI Framework since 2018 indicates that a firm that receives two component ratings of Conditionally Meets Expectations or better and a single Deficient-1 component rating can maintain safe-and-sound operations through a range of conditions. The LFI Framework states that a "well managed" firm has sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones. A firm with an idiosyncratic deficiency that results in a single component rating of Deficient-1 would generally meet this "well managed" standard when viewed holistically, if the other two components have a rating of Broadly Meets Expectations or Conditionally Meets Expectations.

While the Insurance Supervisory Framework differs from the LFI Framework in that its structure and application support use for supervised insurance organizations of all sizes and risk profiles, the Insurance Supervisory Framework is ultimately modeled after the LFI Framework. Accordingly, the proposal would make parallel changes to the Insurance Supervisory Framework to align with the LFI Framework. These proposed changes would also reflect that a firm that has an idiosyncratic deficiency that results in a rating of Deficient-1 in an individual component while maintaining a rating of Broadly Meets Expectations or Conditionally Meets Expectations in its other two components would generally be able to operate in a safe and sound manner. Such firms also have sufficient financial and operational strength to serve as a source of strength for their depository institutions through a range of stressful yet plausible conditions. Further, following the adoption of the Insurance Supervisory Framework, the Board took steps to help ensure the financial strength of supervised insurance organizations by adopting risk-based capital requirements for these firms.[13] Currently, firms subject to these capital requirements have capital levels in excess of minimum requirements.

Additionally, no other supervisory ratings system applicable to Board-supervised institutions determines a firm's composite rating, which is relevant to its "well managed" status, based solely on any one of its component ratings.[14] By taking a more comprehensive approach,

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[13] 88 Fed. Reg. 82950 (Nov. 27, 2023).

[14] See, e.g., SR Letter 19-4 / CA Letter 19-3, Supervisory Rating System for Holding Companies with Total Consolidated Assets Less than $100 Billion (Feb. 26, 2019), https://www.federalreserve.gov/supervisionreg/srletters/sr1904.htm; SR Letter 96-38, Uniform Financial Institutions

the proposed revisions to the Frameworks would better align the Frameworks with the supervisory rating systems used for other banking organizations.[15]

In addition to this proposal, staff plans to develop and present for Board consideration at a later date more comprehensive changes to supervisory ratings systems, including the Frameworks, that apply to Federal Reserve-supervised institutions.

ECONOMIC ANALYSIS:

As of the fourth quarter of 2024, 36 holding companies were subject to the LFI Framework, of which 23 were not "well managed" under the LFI Framework. Staff estimates that the proposal would decrease the number of holding companies that are not "well managed" under the LFI Framework by eight. In addition to being "well managed" under the LFI Framework, a firm must be "well managed" at each of its depository institution subsidiaries to elect to be treated as a financial holding company, which, for example, permits the firm to engage in certain activities and invest in certain nonbank financial companies without obtaining prior Board approval. As a result, the proposed change to the LFI Framework would likely have a more limited initial impact: Only three of the eight firms whose holding companies would become "well managed" under the proposed revisions to the LFI Framework would also become "well managed" under the BHC Act, as of the fourth quarter of 2024.

As of the fourth quarter of 2024, there were five firms subject to the Insurance Supervisory Framework. Under the proposed changes, no supervised insurance organization would see a change in their "well managed" status. This indicates that the proposed changes would not have a meaningful short-term impact on the supervised insurance organizations.

Firms that have sufficient financial and operational strength and resilience to operate in a safe and sound manner through a range of conditions, and become "well managed" under the Frameworks and the BHC Act as a result of this proposal, may face reduced compliance costs and would be able to more easily pursue certain activities such as investments in new businesses. Such investments could enable large financial institutions to support financial innovation.

Rating System (Dec. 27, 1996), https://www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm; SR Letter 00-14, Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations (revised Oct. 23, 2020), https://www.federalreserve.gov/boarddocs/srletters/2000/sr0014.htm.

[15] See, e.g., 61 Fed. Reg. 67021 (Dec. 12, 1996); 70 Fed. Reg. 44256 (Aug 2, 2005); and SR Letter 96-36, Guidance on Evaluating Activities Under the Responsibility of U.S. Branches, Agencies and Nonbank Subsidiaries of Foreign Banking Organizations (Dec. 19, 1996),https://www.federalreserve.gov/boarddocs/srletters/1996/sr9636.htm.

Moreover, the proposal is likely to enhance supervisory efficiency and efficacy by ensuring that the definition of "well managed" reflects a firm's overall condition.

Potential costs might include a slight increase in risk-taking as firms may be marginally less incentivized to remediate single Deficient-1 component ratings. Notwithstanding, the possibility of losing "well managed" status due to a further rating decline to Deficient-2 might provide an incentive to address potential deficiencies promptly. Moreover, supervisors would continue to monitor the remediation of supervisory issues, ensuring that these issues are resolved in an appropriate timeframe. That said, the Board would continue to evaluate all banking applications for their effects on competition and financial stability, consistent with applicable law.

RECOMMENDATIONS:

Based on the foregoing, staff recommends that the Board approve the attached proposal for publication in the *Federal Register*. Staff also recommends that the Board delegate to staff authority to make technical, non-substantive changes to the attached materials to prepare them for publication in the *Federal Register*.

Attachment