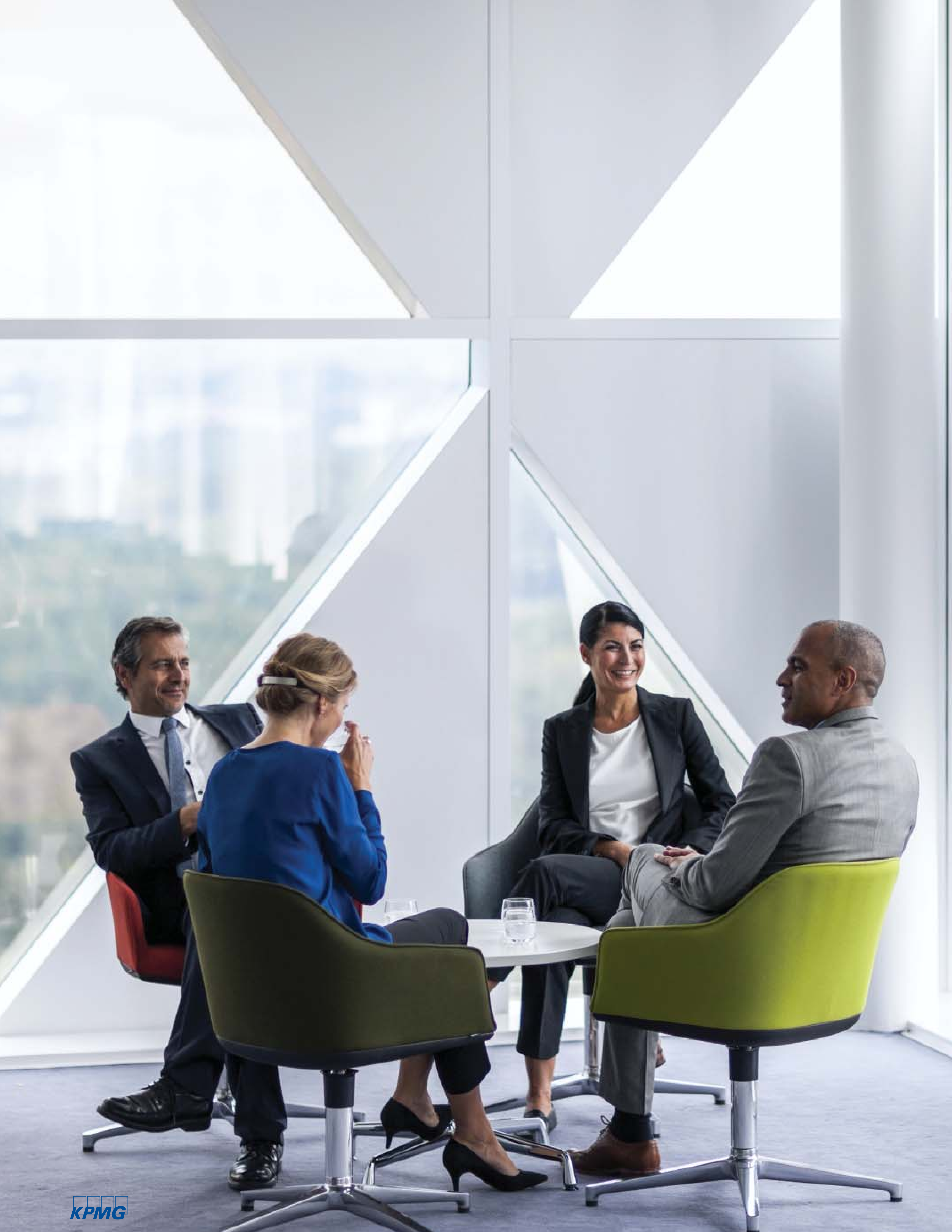
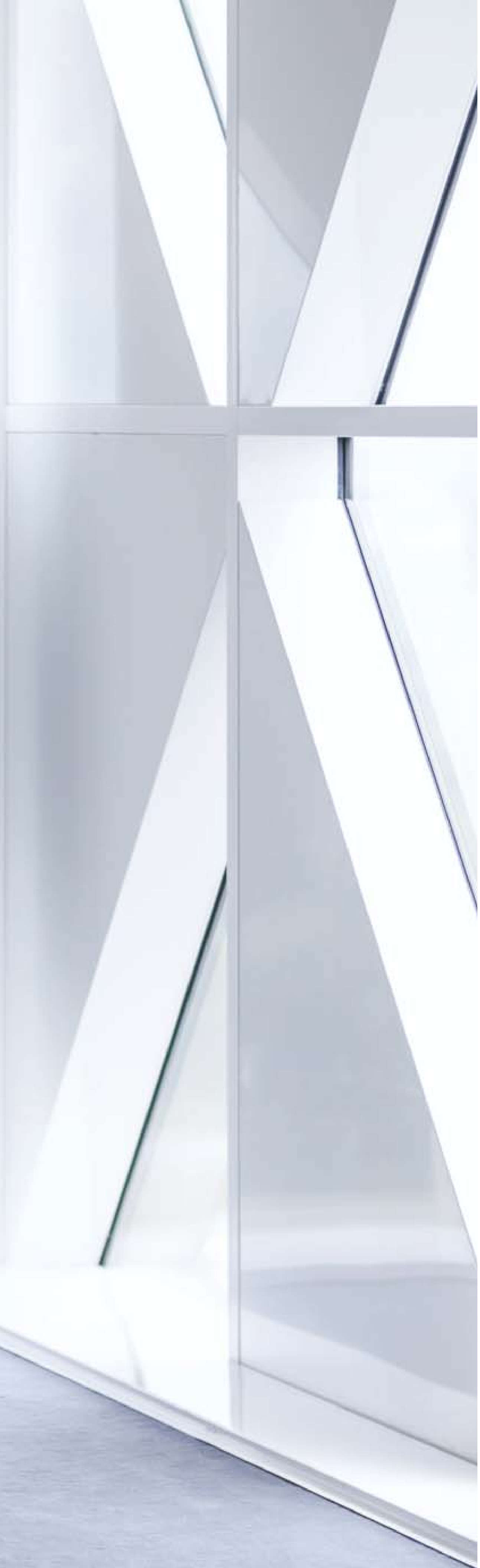
Client alert

Federal Reserve's two-track approach to regulatory capital for insurers

kpmg.com





Executive summary

Towards the end of May, the Board of Governors of the Federal Reserve System (FRB or Federal Reserve) indicated its intent to implement new regulatory capital standards for insurance companies subject to FRB jurisdiction. The Federal Reserve also signaled its intention to reject international standards and, instead, proceed on a policy trajectory unique to the United States.

These signals were sent in a speech[1] by FRB Governor Daniel Tarullo to the National Association of Insurance Commissioners' (NAIC) 10th annual International Insurance Forum on May 20, 2016. This Client Alert assesses the clearly defined policy shifts articulated by Governor Tarullo in that speech and its implications for insurance companies subject to FRB jurisdiction.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("DFA") expanded FRB supervisory authority into the insurance sector for two classes of insurance companies: (i) insurance holding companies that own a federally insured bank or thrift and (ii) insurance companies designated as "systemically significant" by the U.S. Financial Stability Oversight Council (FSOC). As of May 2016, the FSOC had designated four non-banks as systemically significant. Three out of those four institutions are insurance companies: American International Group, Inc., Prudential Financial, Inc., and MetLife, Inc.[2] One of those insurance companies challenged the FSOC's jurisdiction in federal court.[3] The U.S. District Court in D.C. rescinded the FSOC's designation on March 30 and unsealed its decision on April 7. Within days, U.S. Treasury Secretary Jack Lew (the FSOC Chair) announced the FSOC would appeal, asserting that "This decision leaves one of the largest and most highly interconnected financial companies in the world subject to even less oversight than before the financial crisis."

Governor Tarullo indicated that the FRB jurisdiction now accounts for approximately 25 percent of U.S. insurance industry assets. He stressed the important partnership between the Federal Reserve and state regulators who remain the primary functional regulators for U.S. insurance companies.

---

1 *Insurance Companies and the Role of the Federal Reserve*, Speech by Gov. Daniel K. Tarullo at the National Association of Insurance Commissioners' International Insurance Forum (May 20, 2016).

2 DFA Section 113 authorizes the FSOC to designate as systemically significant nonbank financial institutions determined to pose a threat to The FSOC non-bank designations list, including the dates on which the designations were made and PDFs of the original designation documents, can be found on the FSOC's website: https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx

3 MetLife, Inc., v. Financial Stability Oversight Council, United States District Court for the District of Columbia Civil Action No. 15-0045 (RMC) Unsealed Opinion filed March 30, 2016. Available at: https://www.metlife.com/assets/cao/sifiupdate/MetLife_v_FSOC--Unsealed_Opinion.pdf

Three key policy shifts

Regulatory Capital Proposals Previewed: Governor Tarullo announced that an Advanced Notice of Proposed Rulemaking (ANPR) will be released "in the coming weeks" in order to implement DFA Section 113 regarding group capital standards. He also previewed the two different methodologies that will be proposed in the ANPR. Firms designated as systemically significant by the FSOC will be subject to a capital framework determined by a standardized consolidated capital process. Other insurance firms supervised by the FRB will be subject to a "building block" approach process to set capital requirements.

— **FSOC-designated insurance companies and the "Consolidated Approach"**: The Consolidated Approach would borrow from bank holding company capital requirements by categorizing all insurance group assets and liabilities into risk segments. Each segment would receive a standardized risk factor charge, using risk weights and risk factors appropriate to the long-term nature of insurer balance sheet exposures. Governor Tarullo indicated the initial risk weights and factors would be quite broad but, with experience, the FRB could make them more granular. He also indicated that the FRB expects compliance costs for this approach will be lower than those that would apply to bank holding companies while being higher than the alternative proposed framework for non-systemic insurance companies.

— **Non-Systemic Insurance Companies (the "Building Block" Approach):** Insurance companies owning a bank or thrift would be required to aggregate capital requirements across subsidiaries. Regulated financial subsidiaries (e.g., depository institutions, insurance companies) would be permitted to use existing regulatory capital requirements set by their Home state regulator, regardless of whether that regulator is located in the United States at the state level or in a foreign country. Other subsidiaries would be required to generate regulatory capital requirements by applying "standardized risk-based capital rules applicable to affiliates of bank holding companies." Governor Tarullo in his speech expressed the opinion that this approach would generate a relatively low regulatory burden compared with the bank-specific rules and the Consolidated Approach.

Internal Models, International Capital, and Accounting Standards Rejected: Governor Tarullo's speech made clear that the FRB does not seek to approve the use of internal models for regulatory capital purposes. In addition, he made clear that the FRB seeks to use the U.S. domestic accounting framework (adjusted Generally Accepted Accounting Principles GAAP) for the Consolidated Approach and domestic Statutory Accounting Principles for the Building Block Approach) when setting regulatory capital for insurance companies subject to FRB jurisdiction.

Governor Tarullo indicated the FRB will likely rely on stress tests and scenario tests in order to achieve international consistency and measurement. He also indicated that the FRB will provide mutual recognition to regulatory capital decisions set by foreign regulators as well as U.S. state-based regulators on an equivalent basis for a relatively small number of insurance companies: those that are part of a group with a federally insured depository institution.

Limited Reliance on Mutual Recognition by the FRB: As noted above, the FRB is poised to propose in the ANPR that official Federal Reserve policy will apply mutual recognition to regulatory capital processes implemented abroad and at the state level in the United States, at least for insurance institutions that are not designated as systemically significant by the FSOC. This is a significant shift in Federal Reserve policy. It is particularly significant because in the banking sector the FRB recently implemented a policy that effectively denies mutual recognition to foreign banks operating in the United States.[4]

[4] Section 165 of the Dodd-Frank Act, implemented by the FRB, requires in part that foreign banks establish an "intermediate bank holding company" over their businesses in the United States. The intermediate holding company must hold regulatory capital in the United States on a consolidated basis, calculated using U.S. regulatory capital rules.

Implications

Governor Tarullo's speech signals a sharp expansion in the Federal Reserve's engagement regarding insurance regulation. His speech made clear that regulatory capital approaches developed abroad are progressing too slowly and are not aligned to U.S. domestic needs at present.

The policy trajectory shifts announced by the FRB may not, however, represent a sharp break from international engagement. The speech suggests strongly that the FRB's exercise of its statutory responsibility domestically will be paired by an effort to exert leadership internationally in order to generate insurance regulatory capital standards. Governor Tarullo enumerated specific concerns about International Association of Insurance Supervisors (IAIS) and European Union (EU) standards, but he also expressed support for some of the processes incorporated in those standards. In the process, the FRB may have effectively initiated a negotiation with its counterparts at the cross-border level regarding insurance regulatory capital.

For example, Governor Tarullo's speech creates a small but significant possibility that the FRB might permit certain EU insurers to receive mutual recognition for regulatory capital standards set by their lead regulators in Europe under Solvency II. Governor Tarullo clearly stated that the Building Block Approach applied to non-systemic insurance companies owning a thrift or bank would generate regulatory capital rules "for each regulated insurance or depository institution subsidiary…based on the regulatory capital rules of that subsidiary's lead regulator – whether a state or foreign insurance regulator or a federal banking regulator for depository institutions."

If the ANPR details are consistent with this speech, it seems that any EU insurance company subject to FRB jurisdiction could calculate its regulatory capital using internal models and international accounting standards. Depending on how the Federal Reserve proposes to verify the capital calculations, it is possible that such insurance companies could at least see their regulatory reporting requirements increase. Insurers subject to Federal Reserve jurisdiction pursuant to an FSOC designation seem likely to experience the largest increase in regulatory burden associated with the FRB's approach outlined in Governor Tarullo's speech. The full extent of the regulatory transformation underway in the insurance industry will become clearer when the ANPR releases the full details of the proposed regulatory capital framework.

The most profound regulatory changes, however, seem likely to arise among insurance companies subject to Federal Reserve jurisdiction that are not designated as systemically important by the FSOC. These non-systemic insurance companies will be required to apply banking sector regulatory capital requirements to a small number of their affiliates. They will also become subject to new Federal Reserve reporting and capital aggregation requirements.

Governor Tarullo indicates that the effort to rely on the existing regulatory capital framework at the state and foreign level is minimal due to the small number of institutions subject to the new rule. However, the conceptual leap to rely on external capital calculations at the state and foreign levels is significant given the multi-year efforts by both states and foreign governments to receive federal recognition in Washington for their regulatory capital frameworks in the insurance sector.

Discussion and debate regarding the Federal Reserve ideas has already begun, before the ANPR has been issued. Initial analysis of the speech by Standard & Poors indicates that the Federal Reserve's efforts to assess regulatory capital for insurance groups on a consolidated basis is similar to some components of the initial basic capital requirements under discussion at the IAIS. They have also raised concerns that the Federal Reserve's preference for simplicity in the regulatory capital calculation "may run the risk of not fully accounting for insurers' heterogeneous risk profiles that could account for historical loss activity and observed volatility.[5]"

---

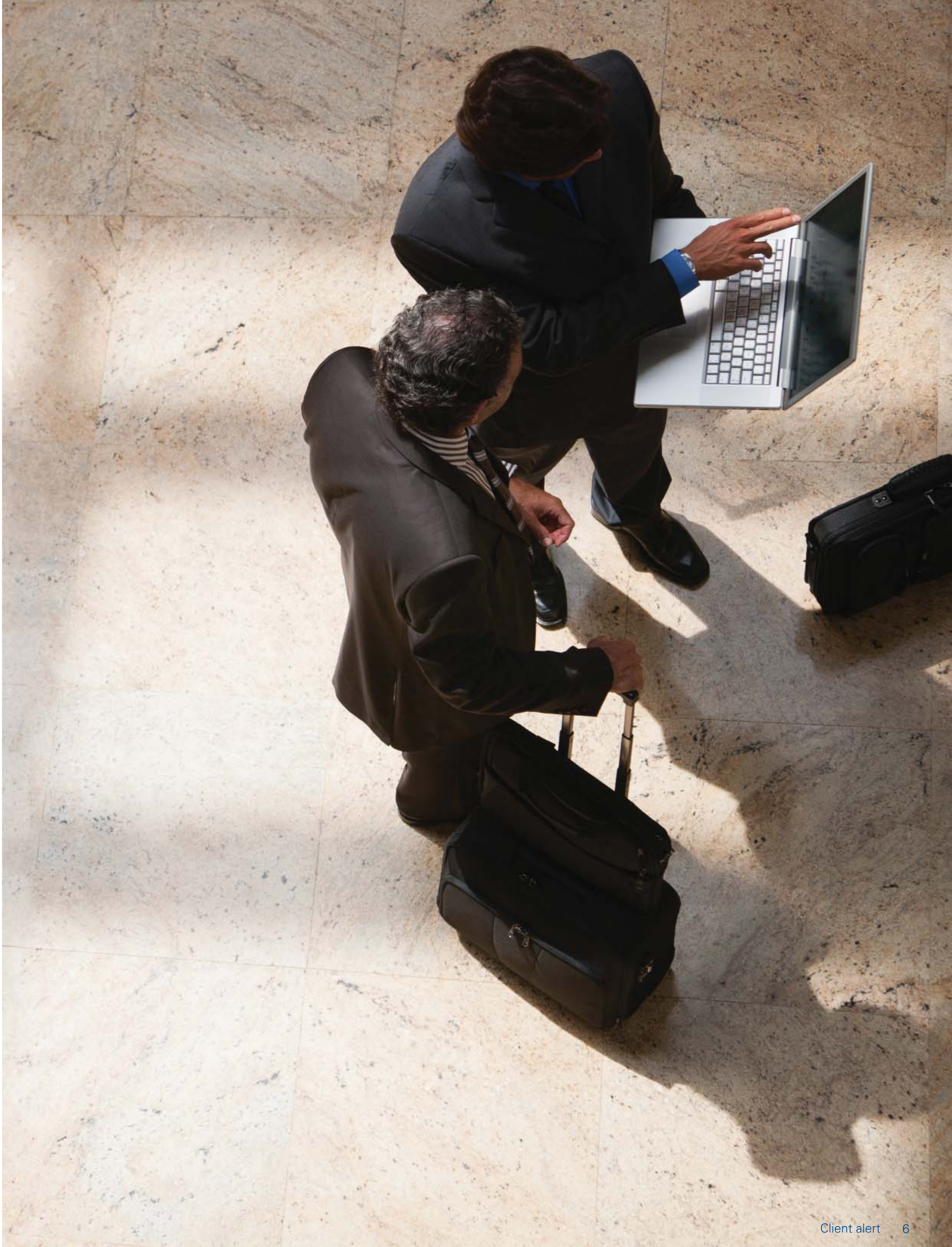
[5] Sarah Veysey, "U.S. poised to go its own way on insurer SIFI regulation," *Business Insurance*, May 24, 2016, http://www.businessinsurance.com/article/20160524/NEWS06/160529934

On a closely related matter, U.S. and EU representatives met in Washington, D.C. on May 25-26, 2016 to continue discussions that began in November 2015 on a covered agreement relating to prudential insurance and reinsurance measures. The covered agreement being discussed includes group supervision, exchange of confidential information and reinsurance supervision, including collateral requirements. The US Department of Treasury together with the US Trade Representative seek recognition in these areas of US insurance regulation to create equivalence for insurers and reinsurers doing business in Europe. In addition the negotiations will seek national uniform treatment of EU reinsurers operating in the US, especially concerning collateral. As these negotiations are viewed along with the recent Fed capital proposals discussed here, a move towards a system of mutual recognition and equivalence is developing on several fronts, all initiated by a growing influence of Federal involvement in US insurance regulation. Both Federal related tracks bear watching as the Fed develops its approach to capital for insurers under their jurisdiction and the covered agreement dialogue moves forward. The door is opening wider to a greater Fed influence on US insurance regulation.

Conclusion

Governor Tarullo's speech initiates a period of heightened uncertainty and change for large insurance companies subject to Federal Reserve jurisdiction. The full impact of regulatory change regarding insurance companies will become clearer when the Federal Reserve releases the ANPR.

Insurance companies subject to Federal Reserve oversight can start preparing now for a shift in their regulatory requirements. In particular, chief executives and boards should begin considering whether their current corporate structure represents the optimal allocation of resources in light of the different regulatory capital standards that would apply to their different business units. They can also initiate or update existing regulatory mapping assessments to determine their potential exposure to various regulatory capital requirements.

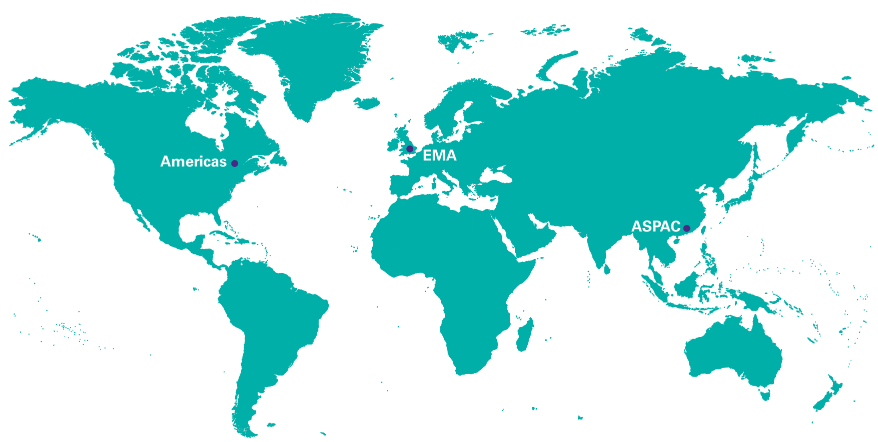


For additional information, please contact:

Barbara Matthews
Managing Director
Advisory
T: 202-533-3443
E: bcmatthews@kpmg.com

Robert Kasinow
Director, Regulatory Risk
Advisory Services
T: 908-433-9409
E: rkasinow@kpmg.com

The Americas Financial Services Regulatory CoE is based in Washington, DC and comprised of key industry practitioners and regulatory advisers from across KPMG's global network.



kpmg.com/socialmedia

Some or all of the services described herein may not be permissible for KPMG audit clients and their affiliates.