CLIENT MEMORANDUM

Federal Reserve Announces Outline of New Capital Regime for Insurers

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The NAIC held its tenth International Insurance Forum in Washington, D.C. on May 19 and May 20. The highlight of the forum was the keynote address entitled “Insurance Companies and the Role of the Federal Reserve” delivered by Mr. Daniel Tarullo, a governor of the Board of Governors of the Federal Reserve System (“FRB”). Governor Tarullo announced that in the coming weeks, the FRB will release an Advanced Notice of Proposed Rulemaking (“ANPR”) regarding group capital standards for (i) insurance groups designated as Systemically Important Financial Institutions (“SIFIs”) and (ii) insurance groups that include federally chartered thrifts or banks (“Depository Groups”).

Noting the FRB’s dual regulatory mandate of (i) protecting the safety and soundness of depository institutions and their holding companies and (ii) promoting the stability of the U.S. financial system as a whole, Governor Tarullo described separate group capital standards for Depository Groups and for SIFIs, as described below. Governor Tarullo said that the FRB considered other standard setting setters’ group capital systems during its deliberations. Solvency II’s approach to capital requirements in the European Union was “unpromising” for the groups under the FRB’s supervision, because the valuation frameworks for insurance liabilities in Solvency II differ starkly from U.S. GAAP and would be inconsistent with the FRB’s “strong preference” for building a standardized risk-based capital rule that allows for comparisons across firms without excessive reliance on internal models.

With respect to the work of the International Association of Insurance Supervisors (“IAIS”), Governor Tarullo noted the work being done on an insurance capital standard (“ICS”) for internationally active insurance groups (“IAIGs”) as well as the process for developing capital standards for global systemically important insurers. He identified several difficulties that have slowed the process of building these standards including the heterogeneity among the insurance products offered by IAIGs, jurisdictional differences in accounting and valuation standards, and significant disagreement on the extent to which capital standards for IAIGs should be built on internal models. Consequently, Governor Tarullo noted that the IAIS proposals are insufficiently developed to form a basis for the FRB's development of a group capital standard for the insurance companies it supervises.

Other significant considerations described by Governor Tarullo included paying close attention to how insurance company funding patterns differ from other forms of financial intermediaries. In this respect, he noted that the funding structures of traditional insurers are generally more stable than those of commercial banks and broker-dealers. It was noted that insurance company obligations generally cannot be accelerated, and therefore insurers are less vulnerable to runs and to short term pressures to sell assets into declining markets. On the other hand, insurers may offer product features that are very different from the traditional insurance model. In this respect he noted investment and retirement products in which account values can be withdrawn at the policyholder’s discretion. Other potential risks identified by Governor Tarullo involve capital market activities of insurers creating closer connections to the rest of the financial system such as securities lending, repo, over the counter derivatives and other transactions.

Based on these various considerations, Governor Tarullo described the following two group capital standards as likely to be put forward in the ANPR. Depository Groups would be subject to a capital aggregation or “building block approach” (known as “BBA”), where the enterprise’s capital requirements would be the sum of the capital requirements for each subsidiary. Each entity’s existing entity-level capital requirements would be used for this aggregation—*i.e.*, the regulatory capital rules of that subsidiary’s lead regulator, whether a state or foreign insurance regulatory or a federal banking regulator for depository institutions. The regulatory capital requirement for a non-insurance, non-banking subsidiary would probably be determined under the standardized risk-based capital rules applicable to affiliates of bank holding companies. Governor Tarullo expects the BBA approach to be a relatively low regulatory burden for Depository Groups.

SIFIs, on the other hand, would be subject to a consolidated approach (“CA”) which would categorize all of the enterprise’s assets and insurance liabilities into risk segments, apply risk factors to the amounts in each segment and then set a minimum ratio of required capital comparing the consolidated capital requirements to the group’s consolidated capital resources. The CA would use risk weights or risk factors appropriate for the longer term nature of most insurance liabilities. There will be a “relatively small” number of risk categories. Unlike the BBA, which aggregates the capital of group members based on the entity’s regulatory capital, the foundation of the CA would be consolidated information based on GAAP. Governor Tarullo said the CA would help prevent “intergroup regulatory arbitrage opportunities.” The compliance cost of CA will be higher than BBA, but Governor Tarullo said this is justified by the enhanced risk to the financial system that is posed by SIFIs.

Governor Tarullo said it is important that financial regulation be "tiered" so as to regulate for the kinds of risks actually posed by various groups of financial institutions, rather than take a "monolithic" approach. The CA approach would also be compatible with supervisory stress testing, according to Governor Tarullo, which is now a central component of the FRB's supervisory program for SIFIs.

At the outset of his remarks, Governor Tarullo spoke highly of the interactions the FRB has had with state insurance regulators and NAIC staff on policy matters. He also emphasized that the FRB will have no role in regulating "the types of insurance offered by affiliates of the holding companies we supervise or the manner in which the insurance is provided," as these matters are exclusively the realm of state regulators.

Governor Tarullo also expressed hope that the ANPR will help advance the development of international standards by the IAIS for IAIGs and encouraged all interested parties to provide comments on the forthcoming ANPR. Meanwhile, the FRB will continue to work on its other Dodd Frank-related mandates with respect to SIFIs—namely, reporting requirements and enhanced corporate governance, risk management and liquidity standards.

The full text of Governor's Tarullo's remarks may be found here. We will send out further Client Alert updates once the ANPR is released.

If you have any questions, please contact Leah Campbell (212-728-8217, lcampbell@willkie.com), Maureen Kellett Curtiss (212-728-8902, mcurtiss@willkie.com) or the Willkie attorney with whom you regularly work.

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