CLIENT MEMORANDUM

Federal Reserve Board Invites Public Comment on Group Capital and Prudential Standards for Certain Insurance Groups

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AUTHOR

Leah Campbell

During an open meeting on June 3, 2016, the Board of Governors of the Federal Reserve System (the "FRB") voted to invite public comment on: (i) an Advance Notice of Proposed Rulemaking ("ANPR") regarding group capital requirements for supervised institutions significantly engaged in insurance activities and (ii) a Notice of Proposed Rulemaking ("NPR") to apply enhanced prudential standards to systemically important insurance companies. FRB Governor Daniel Tarullo had previewed these actions in his May 20th speech (the "Preview") at the National Association of Insurance Commissioner's International Insurance Forum. The FRB's advance meeting materials propose a 60-day time frame for public comments, which will close on August 2nd.

Group Capital Standards

The FRB voted to invite public comment on an ANPR that sets forth insurance capital frameworks on a conceptual basis. The ANPR vehicle (as opposed to an NPR) invites interested parties to play a more significant role in developing the details of a proposed rule and affords the FRB the best opportunity to "get it right," according to the FRB. The ANPR approved at the meeting is consistent with the summary provided by Governor Tarullo in the Preview, which we described in detail in our Client Memorandum dated May 23, 2016.

Specifically, the ANPR outlines the two conceptual capital frameworks described by Governor Tarullo in the Preview: the Building Block Approach ("BBA") and the Consolidated Approach ("CA"). The former would apply to insurance groups that include a bank holding company or a savings and loan holding company; the latter would apply to systemically important financial institutions ("SIFIs") designated for supervision by the Financial Stability Oversight Council ("FSOC"). FRB Chair Janet Yellen stated that the FRB is developing two frameworks (i.e., the BBA and CA) rather than one because "these groups present different risks to the financial system." Governor Tarullo stated that the BBA approach would "literally build on the requirements placed on the insurance affiliates of the holding company by their insurance regulators," while the CA approach would be a "conventional consolidated approach" based on risk categories applied to assets and liabilities across the holding company system. However, such risk categories would be "designed with insurance activities in mind." FRB staff noted in the meeting materials that the approaches to the capital standards in the ANPR reflect input from and engagement with insurance regulators, industry and accounting experts, and insurance industry representatives.

Prudential Standards

Governor Tarullo's Preview identified the FRB's three major regulatory initiatives for SIFIs: (i) reporting requirements; (ii) capital standards; and (iii) enhanced prudential standards related to risk management, corporate governance and liquidity. A significant portion of the FRB's June 3rd public meeting focused on proposed prudential standards for systemically important insurance companies, and the FRB voted to invite public comment on the NPR.

In pursuit of the goal of ensuring financial stability, the NPR presents three main proposals: (i) increasing risk management measures; (ii) bolstering corporate governance; and (iii) increasing liquidity risk management measures, including increasing the responsibilities that systemically important insurance companies' senior management, risk committees, and boards of directors have with respect to liquidity risk management.

It is important to note that public comment is invited not only on the substance of the NPR, but also on the proposed definition of a "systemically important insurance company" subject to the NPR. Specifically, the NPR provides that enhanced prudential standards would apply to an enterprise that meets two requirements: (i) it has been designated by the FSOC as a nonbank SIFI; and (ii) "the company has 40% or more of its total consolidated assets related to insurance activities as of the end of either of the two most recently completed fiscal years . . . or otherwise has been made subject to" these requirements by the FRB.

Tom Sullivan, an Associate Director of the FRB Division of Banking Supervision and Regulation, noted that the proposed prudential standards "are based on best practices of large interconnected financial institutions, but with modifications to reflect insurance-centric risk." Governor Tarullo and the FRB staff explained that the NPR builds on the core provisions of the FRB's consolidated supervision framework for large financial institutions tailored to reflect the systemically important insurance company's significant amount of insurance activities. Mr. Sullivan also particularly noted that the proposals are qualitative, not quantitative, in nature, although FRB staff later mentioned that they are still considering whether to recommend that the liquidity risk provisions include a quantitative component.

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As proposed, systemically important insurance companies would be required to comply with the adopted standards by the first day of the fifth quarter following the final rule's effective date. Companies designated after the rule's effective date would have to comply with the standards as of the first day of the fifth quarter following the date on which FSOC determines the company should be subject to FRB supervision.

Corporate Governance and Enterprise Risk Management

The NPR requires a systemically important insurance company to establish a risk management framework to identify, measure, monitor, and control risks across the entire organization in a manner that is appropriate for its structure, risk profile, complexity, activities, and size. Risk management should apply across geographical areas and lines of business and should "reflect the risks and structure of insurance operations as well as the regulatory framework applicable to insurance activities."

The NPR states that such risk management framework should (i) have mechanisms to identify, report and ensure implementation of actions to address risks (including emerging risks) as well as risk management deficiencies; (ii) establish managerial and employee responsibility for risk management; (iii) ensure the independence of the risk management function; and (iv) integrate risk management with management's goals and its compensation structure for global operations.

More specifically, the NPR includes bolstered corporate governance standards that would require the establishment of a risk committee of the board of directors and appointment of both a chief risk officer ("CRO") who has experience in identifying, assessing, and managing risk exposures of large, complex financial firms, and a chief actuary.

The risk committee would be responsible for overseeing the company's risk management policies and global risk management framework. Its chair would be required to be independent of the company, and the committee would have to include at least one director with experience in identifying, assessing, and managing risk exposures of large, complex financial firms (i.e., an insurance company, a securities broker-dealer, or a bank). The risk committee would receive and review reports from the company's CRO at least quarterly, including information on emerging risks and risk management deficiencies. The CRO would report directly to both the risk committee and the chief executive officer of the company.

The NPR requires that the chief actuary ensure an enterprise-wide view of reserve adequacy that crosses legal entities, lines of business, and geographic boundaries, and enumerates its responsibilities. The NPR also permits the chief actuary to have additional responsibilities such as control over rate making for insurance products. The chief actuary would report directly to the audit committee of the board of directors.

Liquidity Risk

A significant portion of the NPR relates to liquidity risk management. It is noted that, although many liabilities of systemically important insurance companies are long-term or contingent upon the occurrence of a future event such as a

death, other products are subject to surrender or withdrawals on short notice. These products and certain other business practices can create sudden liquidity needs, according to the NPR. The NPR defines liquidity risk as “the risk that a [company’s] financial condition or safety and soundness will be adversely affected by its actual or perceived inability to meet its cash and collateral obligations.”

The NPR would require systemically important insurance companies to incorporate multiple provisions to manage liquidity risks, including the following:

- boards must approve at least annually a company’s liquidity risk tolerance and must review liquidity risk practices and performance at least semi-annually to determine whether the company is operating in accordance with its established liquidity risk tolerance;
- boards must approve, and periodically review, the liquidity risk management strategies, policies, and procedures;
- the risk committee must approve and review the company’s contingency funding plan at least annually and whenever materially revised;
- systemically important insurance companies must conduct regular stress testing and scenario analysis, using at least four stress testing horizons: seven days, 30 days, 90 days, and one year;
- systemically important insurance companies must produce comprehensive enterprise-wide cash-flow projections; and
- systemically important insurance companies must maintain a liquidity buffer comprised of highly liquid, unencumbered assets sufficient to meet their stressed cash flow needs over a 90-day period. This time period and the range of satisfactory assets differ from bank holding company requirements and are described in detail in the NPR.

<u>Looking Forward</u>

FRB Vice-Chairman Stanley Fischer stated that the FRB is also working on additional subjects mandated by the Dodd-Frank Act. He noted in particular that the FRB has been conceptually developing the stress testing requirement framework concurrently with developing the capital standards of the ANPR, although the establishment of the capital standards is “more or less a condition precedent” for establishing the stress testing framework. Other subjects of future FRB action include single counterparty credit limits, but such topics cannot be properly addressed until the FRB settles on the capital standards.

If you have any questions regarding this memorandum, please contact Leah Campbell (212-728-8217, lcampbell@willkie.com) or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is an international law firm with offices in New York, Washington, Houston, Paris, London, Frankfurt, Brussels, Milan and Rome. The firm is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our fax number is (212) 728-8111. Our website is located at www.willkie.com.

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