Federal Reserve previews forthcoming insurance capital rules

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In prepared remarks before the American Council of Life Insurer's Executive Roundtable (Naples, Florida, 9 January 2019), Federal Reserve Board (FRB) Vice Chairman for Supervision Randal Quarles provided the insurance industry with a high-level overview of the FRB's forthcoming proposal on consolidated capital requirements for insurers supervised by the FRB.

Background

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) gave the FRB regulatory responsibilities both for insurance holding companies that own a federally insured bank or thrift and for insurance companies designated as systemically important by the U.S. Financial Stability Oversight Council (so-called SIFIs), the former of which represent approximately 10 percent of the U.S. insurance industry. With Prudential's de-designation in October 2018, no insurer currently has the SIFI label.

In June 2016, the FRB published an advance notice of proposed rulemaking (ANPR) describing two potential regulatory capital frameworks for FRB-supervised insurers: a capital framework, styled as a "building block approach," to be applied to savings and loan holding companies or bank holding companies with significant insurance activities and a "consolidated approach" applicable to insurer SIFIs.

The FRB's building block approach (BBA)

Before turning to its key attributes, Vice Chairman Quarles prefaced his 9 January remarks by describing what the BBA was not intended to be. He noted that the FRB, now in its eighth year of supervising insurers

- decided against applying FRB bank holding company capital rules to supervised insurers at the enterprise level, in light of the very different business models of insurance and banking;

- determined that a capital approach akin to the European Solvency II framework would not adequately incorporate U.S. accounting frameworks and could unintentionally crimp the ability of insurers to provide long-term life insurance and retirement planning products; and

- concluded that the insurance capital standard (ICS) being developed by the International Association of Insurance Supervisors (IAIS) for internationally active insurance groups was not an optimal framework for the U.S. insurance market.

Key attributes of the BBA

Quarles noted that, as the name implies, the soon to be published BBA constructs "building blocks" — or groupings of entities in the supervised firm — that are covered under the same capital regime, which are then used to calculate combined, enterprise-level capital resources and requirements.

- For example, subsidiaries within a life insurance building block would be treated under the BBA the way they would be treated under life insurance capital requirements, while subsidiaries in a depository institution building block would be subject to bank regulatory capital requirements.
- To address regulatory gaps and arbitrage risks, the BBA generally would apply bank regulatory capital requirements to nonbank/noninsurance building blocks.
- Once the enterprise's entities are grouped into building blocks, and capital resources and requirements are computed for each building block, the enterprise's capital position is, subject to certain adjustments and scaling (described below), produced by generally adding up the capital positions of each building block.
- Finally, the BBA would impose a minimum capital requirement against the holding company's aggregate capital position calibrated to "ensure that the risks of the enterprise do not present undue risk to the safety and soundness of the depository institution."

Adjustments to the building blocks

Vice Chairman Quarles described a number of adjustments that the BBA would need to make to the building blocks in order for the aggregation to function appropriately, including measures designed to avoid double-counting that could arise from intercompany transactions and provisions to comply with the Collins Amendment under Dodd-Frank.

Significantly, one adjustment to the building blocks would apply insurance capital rules consistently, without regard to permitted accounting practices granted by an individual state, thus uniformly applying statutory accounting principles as set forth by the National Association of Insurance Commissioners (NAIC).

Quarles also commented on the need of the BBA to "scale" capital positions in different regimes through analyzing historical defaults because, as he noted, "two building blocks under two different capital regimes cannot simply be added together if, as is frequently the case, each regime has a different scale for its ratios and thresholds."

FRB's engagement with NAIC and IAIS

Quarles concluded his remarks by describing how the BBA was developed in collaboration with, and mindful of, the NAIC's ongoing developments of its group capital calculation (GCC), though he noted that some differences between these two frameworks may arise, given their different mandates — namely, "the states" focus is on policyholder protection, while the [FRB] serves as the overall firm's consolidated safety-and-soundness supervisor."

Lastly, Quarles highlighted the work the FRB has been doing (as part of Team USA) with the IAIS and other international stakeholders since 2013 to ensure the United States has a voice in any international insurance standards being developed. Ultimately, he observed, "[i]t is our intent that the Federal Reserve's development of the BBA, together with the NAIC's development of the GCC, will assist with Team USA's advocacy of an aggregation method that can be deemed comparable to the ICS."

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