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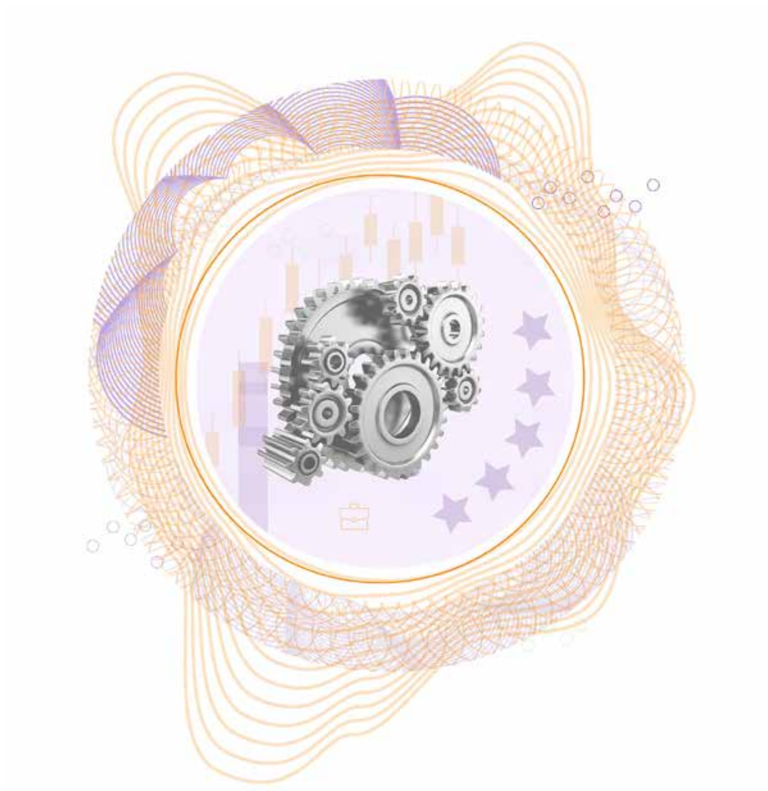

Federal Reserve Proposes Framework for Insurance Holding Company Supervision

On January 28, 2022, the Federal Reserve Board of Governors (FRB) issued draft guidance outlining a bespoke supervisory framework in its latest attempt to tailor the supervision of insurance holding companies and account for distinct business risks at these firms.[1] The proposed framework sets forth general adjustments applicable to all insurance holding companies coupled with specific requirements for firms deemed large and complex. Below, we highlight the FRB's changes to holding company supervision, potential areas of impact, and action steps.

Changes to the FRB's approach to supervision

Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act, the FRB has supervisory oversight responsibilities for those insurance holding companies with Federal Deposit Insurance Corporation (FDIC)-insured subsidiary depository institutions.[2] In an effort to better capture and assess risk specific to insurance firms, the FRB continues to advance policy development in this space.[3]

Recently, the FRB issued a draft framework for insurance holding companies, subjecting them to a revised risk-based supervisory approach.[4] The proposed approach is aimed at better aligning with the risk profiles and addressing the risks characteristic of these firms. The framework references leveraging the work of state insurance supervisors to stem regulatory burden resulting from duplicative supervisory requests and examination activities. Key changes outlined in the framework include the application of the Large Financial Institution (LFI) ratings system, adjustment of the LFI ratings components to better assess risk inherent in insurance holding companies, assignment of complexity designations, updated examination frequency criteria, and coordination with external insurance supervisory counterparts.[5]

Taken together, these changes represent a marked departure from the previously applied supervisory approach for insurance holding companies. In addition to understanding how the proposed framework would impact the supervision of these companies in their current state, firms should also be mindful of the magnitude of future expansionary and strategic plans as they may have unintended supervisory implications. The FRB is requesting feedback on the proposed framework, with the comment period ending April 5, 2022.

Details of the guidance

The proposed guidance covers supervised insurance organizations, which includes the following: 1) bank holding companies that are insurance underwriting companies and 2) bank holding companies where over 25 percent of consolidated assets are held by insurance underwriting subsidiaries. The proposed framework calls for the following key changes:

- **LFI Rating System:** Each insurance holding company would be rated using the LFI rating system as opposed to the risk management practices, financial condition, potential impact, composite, and depository institution (RFI/C (D)) ratings system previously used for insurance savings and loan holding companies.[6] The shift from the RFI/C (D) ratings system to the LFI rating system is reminiscent of the shift completed by certain of the large holding companies supervised by the FRB several years ago. Accordingly, under the LFI rating system, insurance holding companies would receive one of four ratings (Broadly Meets Expectations, Conditionally Meets Expectations, Deficient-1, and Deficient-2) for each of three components (Capital Management, Liquidity Management, and Governance and Controls).
- **Tailoring:** Certain aspects of the LFI components are tailored to the activities of insurance holding companies. Under the Governance and Controls component, insurance holding companies are not subject to enhanced prudential standards, as reflected in Regulation YY.[7] While internal audit expectations for complex firms are similar to those at large banks, noncomplex firms subject to the guidance would be expected to follow the National Association of Insurance Commissioners (NAIC) Model Audit Rule 205, or the corresponding state law, to determine the effectiveness of the internal audit function.[8] The guidance mentions reliance on the Own Risk and Solvency Assessment to inform key areas of the evaluation of capital and liquidity management.
- **Complexity designation:** With regards to balancing supervisory activities with firms' respective risk profiles, all insurance holding companies would be classified as complex or noncomplex. Preliminarily, the guidance draws a bright line between complex and noncomplex insurance holding companies at $100 billion. Complex insurance holding companies would generally have total consolidated assets of more than $100 billion and noncomplex firms would have assets of less than $100 billion.
  - Additional classification criteria include:
    - Capital and liquidity considerations
    - Asset size of subsidiary bank(s)
    - Organizational structure
    - Involvement in other activities (e.g., unregulated, or unsupervised)
    - International exposures
    - Product and portfolio risk
    - Other supervisors' perspectives and ratings
    - Systemic risk implications related to interconnectedness
  - In contrast, the guidance provides for firms with total consolidated assets exceeding $100 billion to be classified as noncomplex given four conditions: (1) most assets are tied to "traditional insurance activities"; (2) the depository institution is small in size; (3) the firm has historically maintained significant capital and liquidity reserves; and (4) the firm is considered well managed and poses a limited risk to its subsidiary bank.
- **Examinations:** Examination frequency parameters are based on a firm's complexity classification, where complex firms would receive greater regulatory scrutiny than noncomplex firms. Consistent with the regulatory approach for large bank holding companies, the FRB would assign complex insurance holding companies a dedicated supervisory team to conduct point-in-time examinations as well as ongoing monitoring activities. In contrast, insurance holding companies classified as noncomplex would generally adhere to an annual examination schedule.
- **Supervisory coordination:** Similar to prior interagency guidance applicable to insurance savings and loan holding companies on relying on the primary federal regulator, the proposal outlines the need for coordination and enhanced information sharing amongst supervisors, namely state insurance supervisors.[9] The draft guidance notes that FRB examination staff would place significant dependence on the supervisory documentation and views of other related supervisors. However, the guidance suggests that additional supervisory examination activities may be conducted, as needed.

Potential impact

All insurance holding companies would be subject to both the change in ratings system and the new complexity classifications, as mentioned above. Initial ratings would be assigned during the year that the guidance takes effect, although given variation is current examination timelines, it is possible that the initial LFI ratings will be assigned for different firms at different times during the year.

As of 2Q 2021, one insurance holding company would be classified as complex and would be subject to increased and constant supervisory coverage, as outlined above. Five insurance holding companies would be classified as noncomplex based on the size of banking assets, where the firm with the largest amount of banking assets is over $60 billion away from the $100 billion threshold.

Challenges, opportunities, and action steps

Insurance holding companies may experience challenges as they transition to the LFI ratings system as their last RFI/C (D) ratings will not map directly to the LFI ratings. It may take a few iterations of receiving LFI ratings to understand how the system works and how strengths and weaknesses in each component are accounted for. However, the guidance encourages enhanced coordination and information sharing between supervisors and could lead to streamlined information requests and abbreviated onsite examination activities. Affected firms should take into consideration the following when preparing for the new guidance to take effect:

- Familiarize themselves with the LFI ratings components and categories. Develop an understanding of the ratings criteria and refer to existing resources on the LFI ratings system to get a sense of how the ratings are applied and their implications.
- Express concerns and communicate unintended consequences associated with the guidance via the comment process.
- Prepare regulatory liaisons or compliance function leads for an enhanced supervisory presence and increased supervisory examination schedule, as needed, consistent with complexity classifications.
- Communicate with both FRB examination staff and state insurance supervisors to manage expectations concerning coordination and information sharing protocols.

Going forward

Insurance holding companies will need to formulate timelines for institutionalization of the changes reflected in the draft guidance. To the extent that existing functions, risk management practices, or operational controls exhibit weaknesses, firms will need to prioritize addressing existing issues in anticipation of the revised supervisory regime. Firms should be aware of their relative complexity classification and make any necessary adjustments to regulatory relations staff, policies, or procedures to accommodate any expected changes to supervisory oversight.

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Endnotes

1. Federal Reserve Board of Governors (FRB), "Federal Reserve Board invites public comment on proposed guidance to implement a framework for the supervision of certain insurance organizations overseen by the Board," accessed January 28, 2022.
2. 111th Congress (2009-2010), "H.R.4173 Dodd-Frank Wall Street Reform and Consumer Protection Act," accessed March 1, 2022.
3. FRB, "Federal Register: Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities" June 14, 2016.
4. FRB, "Federal Reserve Board - Federal Reserve Board invites public comment on proposed guidance to implement a framework for the supervision of certain insurance organizations overseen by the Board," January 28, 2022.
5. FRB, "SR 19-3 / CA 19-2: Large Financial Institution (LFI) Rating System," February 26, 2019; and, Deloitte, "New rating system for large financial institutions," November 8, 2008.
6. The "RFI/C (D)" rating system encompasses the evaluation of three core components (R – risk management practices, F – financial condition, and I – potential impact). The "C" in this ratings system reflects the composite rating for the holding company and the "D" generally indicates the composite rating for the subsidiary bank. FRB, "The Fed - SR 19-4 / CA 19-3: Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion (federalreserve.gov)," February 26, 2019.
7. Code of Federal Regulations, "eCFR :: 12 CFR Part 252 – Enhanced Prudential Standards (Regulation YY)," accessed February 28, 2022.
8. NAIC, " MO205 (naic.org)," accessed February 28, 2022.
9. FRB, "The Fed - SR 16-4: Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion (federalreserve.gov)," March 3, 2016. Revised February 17, 2021