A low-angle photograph of a city street, likely in New York City, showing tall buildings and American flags. The image is used as a background for the document. A yellow banner is overlaid on the top left, containing the title text.

**The Federal Reserve's
proposed rule for
enhanced prudential
standards: what it means
to insurers and what they
should do now**

The EY logo, consisting of the letters 'EY' in a bold, white, sans-serif font. A yellow chevron shape is positioned above the 'Y'.

Building a better
working world

On June 3, 2016, the Federal Reserve Board of Governors (FRB) released a notice of proposed rulemaking (NPR) to apply enhanced prudential standards (EPS) to systemically important insurance companies (SIICs). Though only two insurers would be subject to the new standard, based on current designations of the Financial Stability Oversight Council (FSOC), the specific content of the new standards will be of interest to all insurers, given its likely influence on future regulatory initiatives across the industry and their grounding in sound risk management and governance principles.

Specifically, the FRB proposes corporate governance, risk management, and liquidity risk management standards tailored to the business models, capital structures, risk profiles, and systemic footprints of insurance companies. As expected, the EPS for insurers is largely based on the EPS for US bank holding companies and foreign banking organizations, with a few insurance-specific considerations (such as the proposal to have a chief actuary who reports to the audit committee). The proposed standards may also be indicative of the FRB's approach to regulate insurance savings and loan holding companies (ISLHCs). We suggest companies understand the expectations of the standards and consider responding to the FRB's questions to shape the final regulation.

This document provides a detailed overview of each section of the NPR, outlines the impacts, and highlights both immediate-term actions for insurers and longer-term considerations. It does not cover the FRB's Advance Notice of Proposed Rulemaking (ANPR) regarding capital requirements for supervised institutions significantly engaged in insurance activities, which was announced at the same FRB open meeting.

Next steps for all insurers: consider EPS sound principles to determine the impact on capabilities

The FRB proposed rule represents further movement toward broader, stricter and more standardized regulatory oversight. It may pave the way for increased FRB supervisory requirements for ISLHCs and for other regulatory bodies to raise their expectations. Thus, all insurers, whether regulated by the FRB or not, should review the NPR in detail and consider commenting on it. Further, they should assess the impact at a broad level, especially relative to data and systems. Lastly, they should consider the sound and useful principles for corporate governance, enterprise-wide risk management and liquidity risk management that the EPS describes.

The FRB NPR: what insurers need to know and can do

The FRB's latest NPR is not surprising because it largely applies the same risk management and governance principles applicable to the banking industry, with some nuances and modifications to fit the unique financial models and risk profiles of the insurance sector.

The immediate impact of the EPS may appear to be small because there are currently only two SIICs. However, given that the EPS will likely influence the FRB's expectations about ISLHCs and may influence other regulators and stakeholders (such as the National Association of Insurance Commissioners), all types and sizes of insurers may wish to familiarize themselves with the NPR's content. More importantly, the proposal describes a number of good business practices and sound risk management principles that may benefit the carriers that choose to adopt them, whether they are required to do so or not.

Many insurers stand to benefit from engaging in the comment process. The FRB posed 28 questions to gain insight into the impact and compliance requirements for SIICs. However, anyone may comment on the proposed rule by August 2, 2016. (Comments are made public.)

Though all industry stakeholders must decide if they want to participate in the dialogue, past experience suggests that regulators heed industry's concerns. For example, the FRB's NPR in 2012 generated hundreds of comments. The FRB appears to have incorporated this industry feedback, given the changes to the original NPR and the amount of time between the proposal and the final ruling.

More broadly, insurers will want to think about the various technical and business requirements raised by the proposed standards. For instance, all insurers, not just the two SIICs, can use the EPS as a benchmark to assess their current governance, enterprise-wide risk management, and liquidity risk management capabilities and processes. Again, the EPS is based on principles that are the foundation of a robust risk management and governance framework.

Technology and data management investments are also likely, especially relative to developing liquidity risk frameworks. Front-loading technology investments – in new analytical systems, scenario-modeling tools and the integration of disparate data sources, for example – may represent a “down payment” on future regulatory requirements, even for carriers that aren't immediately subject to the NPR.

Scope and timing

The FRB's new NPR for EPS:

- ▶ Applies to SIICs as designated by the FSOC
- ▶ Proposes a compliance date five quarters from the effective date of the proposal
- ▶ Requires comments by August 2, 2016

Key highlights and potential implications

The NPR's main section largely focuses on corporate governance, enterprise risk management frameworks and liquidity risk management.

Corporate governance and risk management

The standard builds on provisions from the FRB's Supervisory and Regulation Letter (SR 12-17) Consolidated Supervision Framework for Large Financial Institutions, stipulating that insurers must maintain an enterprise-wide risk management framework to appropriately identify, measure, monitor and control risk throughout the entire organization. The standard also details requirements and responsibilities for risk committees, chief risk officers (CROs) and chief actuaries.

Risk committees	Implications
<p>The risk committee must be an independent committee of the board, chaired by a director who is not currently, and has not been, an officer or employee of the company during the previous three years. Risk committees must meet at least quarterly, or more frequently as needed, and fully document proceedings, including risk-management decisions. At least one member of the risk committee must have experience identifying, assessing and managing risk exposures for large, complex financial firms.</p>	<p>Insurers must recognize that there is no “one-size-fits-all” answer to developing a risk committee and governance structure. However, committees should be designed for:</p> <ul style="list-style-type: none"> ▶ Clarity of roles, responsibilities and expectations, and management’s focus must be clear ▶ Complementarity of the risk committee with other board and management committees ▶ Coherence of purpose and structure to effectively support the CRO ▶ Coordination among subcommittees (e.g., enterprise risk committee, asset liability management committee, operational risk committee) ▶ Consistency of protocols to facilitate efficient and effective meetings
<p>Risk management frameworks</p> <p>The enterprise-wide risk management framework must be commensurate with the company's structure, risk profile, complexity, activities and size.</p> <p>Further, it must establish accountability for risks in different geographic areas and lines of business, including risk from intragroup transactions, unregulated entities or centralized operations not subject to review at the legal-entity level. The NPR also stipulates that the CROs report directly to the board risk committee and the chief executive officer of the company, while the chief actuary must report directly to the audit committee of the company. This directive clarifies that CROs and chief actuaries must not be the same person.</p>	

Beyond effective risk committee and risk management frameworks, insurers may consider additional components of effective risk governance, including risk appetite and accountability (including the three lines of defense), controls effectiveness and risk information systems.

Finding the right talent and cultivating a risk culture are also critical considerations. Insurers may need to redesign the roles and responsibilities of the CRO and chief actuary, conduct competency assessments, and define specific learning and development opportunities for them to succeed. Such efforts can further the post-crisis progress of risk governance, which has been mostly been tactical in nature. Indeed, many past programs have been narrowly focused in response to regulatory directives.

Looking forward, firms should build toward integrated frameworks that deliver on both regulatory and firm requirements. For instance, a systematic approach to evaluating financial and nonfinancial incentives may be needed to encourage or discourage behavior and processes. See Figure 1 for a conceptual model of risk governance.

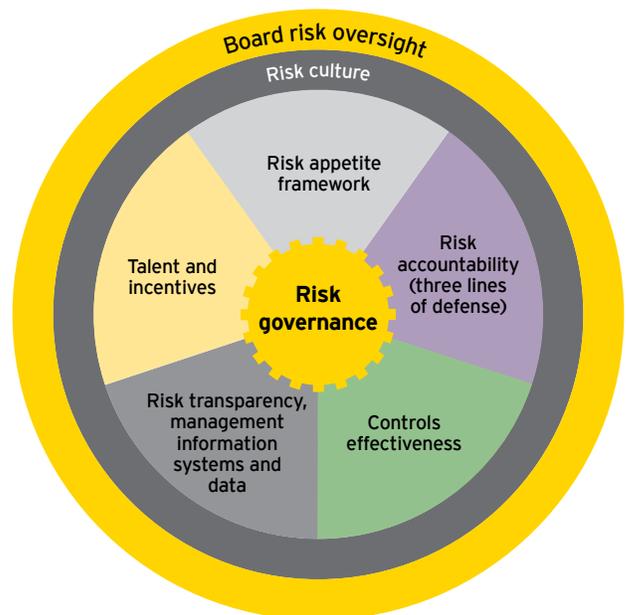


Figure 1. A holistic model for effective risk governance

Liquidity risk management

The EPS proposal is a principles-based framework that defines a framework across governance, cash flow projections, the contingency funding plan (CFP), liquidity risk limits, risk monitoring (collateral, legal entity and intraday), stress testing and liquidity buffer criteria. The FRB has not ruled out any quantitative metrics (e.g., liquidity coverage ratio or net stable funding ratio) in the future.

Governance

Key roles within the governance framework for liquidity risk include the board of directors, senior management and an independent review function. The proposed responsibilities for each role are in line with broader corporate governance expectations and need to be incorporated and documented in the insurer's strategies, policies and procedures.

Implications

Insurers will have to define clear roles and responsibilities to address liquidity governance components across the three lines of defense, as well as in the context of the corporate governance and risk management requirements of the EPS. Understanding how each function will behave in both business-as-usual and stress scenarios will have to be codified and demonstrable for regulators.

Cash flow projections

The proposed standards require comprehensive enterprise-wide cash flow projections arising from assets, liabilities and off-balance-sheet exposures over short- and long-term horizons. Daily updates are required for short-term cash flow projections, and monthly updates are needed for longer-term cash flow projections. The methodology must include all material liquidity exposures and sources, with adequate documentation of the methodology and assumptions used in generating the cash flow projections.

Implications

Most insurers will be challenged to generate cash flow types at the granularity and frequency outlined in the proposal. Mapping the cash flow data landscape, identifying authorized cash flow sources and making certain results align with other risk areas (e.g., asset liability management, financial forecasting) for consistent reporting will be required so cash flows are robust and complete.

CFPs

The proposal requires CFPs that include:

- ▶ A quantitative assessment
- ▶ An event management process
- ▶ A monitoring process

As with other elements of the EPS, CFPs should be commensurate with the company's capital structure, risk profile, complexity, activities, size and established liquidity risk tolerance. Insurers will be required to identify stress events (short term and long term) that will have an impact on the company's liquidity position.

Implications

Insurers will need to develop clear procedures, documentation and testing across the quantitative assessment, monitoring and event management to meet the NPR's requirement for CFPs.

Collateral, legal entity and intraday risk monitoring

Insurers are required to maintain procedures to monitor:

- ▶ Collateral with both affiliates and external counterparties on at least a weekly basis
- ▶ Liquidity risk across significant legal entities, currencies and business lines
- ▶ Intraday liquidity risk applicable to the insurer's exposures

Implications

The FRB is asking insurers to demonstrate a clear understanding of their activities and develop strong monitoring capabilities for each domain area with potential linkage to liquidity risk events.

Limits

If the EPS is adopted, insurers will be required to define and monitor liquidity risk limits based on their capital structure, risk profile, complexity and activities. The limits should include:

- ▶ Funding concentration limits
- ▶ Insurance liability limits
- ▶ Non-insurance liability-maturity timing limits
- ▶ Off-balance-sheet exposure limits

Implications

Insurers will need to develop limit-monitoring frameworks at the enterprise, significant legal entity, and line-of-business or product levels. Companies should make certain these frameworks leverage authorized data sources, have defined thresholds (e.g., red, yellow, green), have automated triggers, have escalation procedures and are run at the frequency appropriate for the potential liquidity risk impacts.

Stress testing

The FRB has defined guiding principles for insurers' liquidity stress-testing frameworks, with clear expectations for frequency, scenarios, planning horizons, cash flow sources and governance. These principles include:

- ▶ Frequency: performed at least monthly
- ▶ Scenarios: minimum three scenarios (adverse market, idiosyncratic and a combined scenario)
- ▶ Planning horizons: minimum 1 week, 30 days, 90 days and 1 year
- ▶ Cash flow sources: for 90-day planning horizon, insurers must exclude future borrowings (e.g., Federal Home Loan Bank advances) and liquidation of any non-liquidity buffer asset, but may include future premiums based on conservative assumptions
- ▶ Governance: policies and procedures to define stress-testing practices, methodologies and assumptions; controls and oversight approved by the CRO; management information systems (MIS) and data processes to support the stress-testing process

Implications

To meet this requirement, insurers will have to re-evaluate their current liquidity stress-testing frameworks across all key components, paying specific attention to:

- ▶ Scenario definitions and assumptions: while insurance liability risks have generally been defined, companies will likely have to work to define and enhance their capital market risks (e.g., risks associated with derivatives) within their scenarios.
- ▶ Governance: companies will need to evaluate the roles of the first, second and third lines of defense and make certain their roles and responsibilities are in line with the NPR's expectations.
- ▶ Architecture: companies will likely need to enhance their management information systems and processes so they can source granular data in an automated and controlled manner and have the ability to perform stress testing on a monthly (and potentially more frequent) basis for material legal entities.

Liquidity buffer

Insurers will be required to maintain a buffer of highly liquid diversified assets to satisfy net stressed cash outflows during a 90-day planning horizon. Non-highly liquid assets can be considered for liquidation only outside of the 90-day planning horizon. The definition of highly liquid assets leverages the banking sector definition of high-quality liquid assets. Key criteria stipulate that assets:

- ▶ Must be unencumbered
- ▶ Must be deemed "liquid and readily marketable"
- ▶ Cannot be an obligation of a financial sector entity
- ▶ Can include securities issued or guaranteed by the US Department of Treasury, a US government agency, US governance-sponsored entities, US public-sector entities, sovereign entity or multinational organizations (e.g., International Monetary Fund)
- ▶ Can include equities included in the Russell 1000® Index

A complete list of these criteria may be found in the NPR.

Implications

Insurers will have to re-evaluate their investment portfolios to understand what portion can be considered highly liquid assets and monetized within the 90-day planning horizon. The expectation is that a more granular analysis (i.e., beyond the level of asset types) will be required. Insurers may look to the banking industry for guidance about how to define highly liquid assets.

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EYG no. 02168-161Gb1
1607-1985843FSO
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