The New Federal-Policy Paradigm:
Competitors, Opportunities, and Risks

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- Federal regulators are deeply worried by life-insurance liquidity, foreign-exchange, valuation, and resolvability risk.
- The policy response will be to expand barriers between banking and life-insurance companies, limiting the extent to which life insurers can obtain financing or risk transfers from the largest banks. Systemic designation of the sector or major companies is unlikely.
- Changing U.S. policy nonetheless may give life insurers a new chance to own limited-purposed insured depositories without coming under the Fed.

As I do not need to tell you, the Trump Administration blew into Washington after Inauguration Day and radically realigned once-unquestioned tenets of federal financial policy. Just for starters, the federal banking agencies – including even the Federal Reserve – are no longer considered to be independent agencies when it comes to regulatory decisions and supervisory actions.[1] Treasury Secretary Bessent has also announced sweeping plans to redesign the manner in which the Financial Stability Oversight Council (FSOC) functions.[2] This is of course the federal body chartered by Congress in part to keep an eye on the life-insurance sector through its Federal Insurance Office (FIO). There was some talk of eliminating FIO when agency charters were flying out the door early in the new Administration, but that never happened, nor did Congress curtail it in the recent reconciliation package. So, FIO is still here, and insurance will still figure in federal decision-making affecting sectors such as the future of private credit even as the Federal Reserve and global regulators ramp up their worries about nonbank financial intermediaries (NBFIs) – life insurers very much included.

To be sure, life insurance so far is a second-order financial stability concern. However, federal and global regulators have significant qualms about life-insurance solvency and liquidity risk. I'll detail these today and then lay out how federal policy may directly and indirectly define life insurance not so much because these agencies can do much about life insurers, but because they can and likely soon will curtail interconnections between these companies and the nation's largest banks. As you'll hear, things may seem quiet, but a lot is afoot of consequential import.

What Scares the Regulators

As you well know, federal agencies have no direct authority over state-licensed insurers and nothing short of a crisis is likely to change that. Still, federal regulators and especially the banking agencies have longstanding concerns about the construct of life-insurance prudential standards. Recent NAIC actions have addressed some of the banking agencies' fears since 2008, But NAIC standards are voluntary and state implementation, if any, varies widely. Further, the sector's capital construct remains dependent on external ratings and internal models, a world apart from the bank construct requiring percentages of external equity capital backing assets and exposures as a whole (leverage) and risk, whichever standard is higher and, even then, how it performs under supervisory stress tests.[3]

The disdain – and I don't think that's too strong a word – for insurers is evident in the risk-based rules first when it comes to the weighting assigned to financial institutions – life insurers are treated the same as gas stations – and the extensive collateral and other restrictions applicable to any exposure guaranteed or otherwise backed by an insurer.[4] There is no capital recognition at all for large-bank exposures backed by monoline credit insurers,[5] which also covers certain reinsurers despite all the dramatic changes mortgage insurers undertook after the 2008 crisis.

Worries about life-insurance resilience have recently gone beyond the old liquidity fears, although it's still prominently mentioned in the Fed's most recent financial-stability report.[6] One brand-new worry is cited in the most recent financial-stability assessment from the Bank for International Settlements (BIS),[7] the central bank for the world's central bankers. Although the BIS continues to worry about liquidity mismatch, it now raises a very different concern: the extent to which life-insurance companies hold dollar or other foreign-currency assets, but pay claims in domestic currency. Currency mis-matches are hedged with forex derivatives, hedging forex risk but – the BIS fears – creating new ones. These include rollover risk because forex instruments are generally short-term hedges, but insurer dollar-denominated assets are typically long-dated. Recent disruptions in forex swaps markets under stress put insurers at considerable risk in a $111 trillion market with systemic consequence.

Notably, the Fed shares these fears even though domestic life-insurance companies pay claims in dollars, noting that U.S. life-insurance firms increasingly hold foreign-exchange denominated assets. The Fed does not say why this poses risk beyond noting the derivatives-market exposure,[8] but the Fed has also reiterated its deep concern about liquidity mis-matches and reliance on "non-traditional liabilities" such as Home Loan Bank advances. Fed staff studies also bemoan the sectors' concentrated risk in commercial real estate – and – a new,[9] but powerful concern – about reliance on private credit assets and complex risk-mitigation structures with affiliated asset managers.[10]

The latter concern echoes the most recent report from the Federal Insurance Office,[11] which points to greater interconnection with private-equity owners and a complex web of asset holdings and risk transfer activities, many of which are offshore. As you surely know, FIO also remains concerned about the web of state guaranty backstops that might face obstacles in a multistate resolution.

What Will Be Done About These Risks?

The insurance sector is a particularly problematic arena for bank regulators because it combines the long standing problems feared to have systemic risk such as liquidity and foreign-exchange hedges – with new worries about concentrated holdings of private-credit assets subject to significant valuation and concentration risk.[12] Growing capacity and conflicts due to private-equity ownership also frighten regulators – as one former Fed official recently put it,[13] private-equity investors aren't patient.

Will any federal regulator or the FSOC take any action to curtail banking-sector and insurance interconnections? Likely not in the near term because they all have their hands so, so busy with an array of regulatory rewrites, policy changes to comply with a raft of Presidential decrees, and the supervisory challenges created by a world in which other nations no longer trust the United States to stand by bank branches outside the U.S. or to cooperate in other ways in the next systemic scare.

This is not, though, to say that no pending decision has any material consequence on life insurers and those who worry about their resolvability. Several near-term actions do pose strategic challenges in this sector.

First, I see little to no chance that the banking agencies will liberalize the capital rules governing direct or indirect insurance exposures. Indeed, the banking agencies have just begun to gather more data about NBFI exposures. If those to insurance companies start to look worrisome, then strong pressure to curtail them, perhaps in Fed stress-testing, will follow.

There is also little likelihood that other supervisory barriers between banking and insurance will drop. One of the most important over the last year or so governs how banks are permitted to engage in synthetic credit risk transfers (SCRTs). Insurers are very eager for these transactions, but the Fed and other agencies do not have confidence that SCRT investors can actually absorb credit risk under acute stress. It is for this reason that they require full collateralization of the SCRT amount for an issuing bank to receive the capital credit that makes SCRTs worth the bother.[14]

I also see no chance that the banking agencies will allow their charges to give insurers any more room to extend and pretend when it comes to problematic commercial real estate exposures. The agencies don't want banks taking collateral and increasing their own problematic CRE books, but rollovers of low-cost loans are increasingly unlikely for any property without a credible valuation compared to outstanding debt.

Could a life insurer buy a bank or bank acquire an insurer? This is of course possible under the 1999 Gramm-Leach-Bliley Act (GLBA).[15] Indeed, part of the driving force behind this law was the belief that combining banking and life insurance was a viable value proposition. It didn't turn out that way and, for giant banking organizations, the rationale for owning a life insurer today seems no stronger than it's been over the past two decades.

Life insurers may, though, be both more interested in and able to own a bank. The Fed's final rules on insurance-owned depository-institution holding companies are tolerant.[16] This is a sharp contrast to the Fed's initial intention, but the result of strong Congressional demand. This demand might still be there, but the Fed doesn't have to authorize the formation of new DIHBs, just to continue to be kind to them under applicable capital rules.

It will take a very, very strong case for a life insurer to persuade the Fed otherwise, but an insurer doesn't necessarily have to do so. Federal policy is set to change on charters for state-chartered industrial loan companies (ILCs) that are banks in all but name. Insurers looking for low-cost funding – and there are many – may well consider this option once the federal framework becomes clearer over the next few months. The FDIC oversees granting ILCs the deposit insurance they need to secure low-cost funding and parent companies of ILCs need not be BHCs, thus exempting their parent companies from costly bank-capital requirements. Or so it will go if the FDIC now decides to authorize a charter dogged by controversy ever since it was first authorized in 1987.[17]

One last point: there is little, to no, chance of systemic designation for any life insurer akin to those for MetLife and Prudential after the 2008 crisis. The Biden Administration's FSOC issued standards designed to make it easier to designate activities or practices as systemic,[18] thus to designate them or major providers as systemically-important.[19] However, the Biden Administration did nothing with these standards since they were issued in 2023 and the Trump Administration is likely to do little more than roll them back, should they even find the time to bother.

Conclusion

If there's no crisis, the uneasy equilibrium between federal bank standards and state insurance regulation will be little changed. Key points of interconnection between banks and life insurers will continue to be constrained and perhaps even choked off if the banking agencies worry about growing exposure to a sector they continue to believe poses an array of systemic risks. However, none of these possible limitations is more than an important strategic consideration when it comes to pricing financial products, not a game-changer. New ILC charters might be more of a structural, franchise-redefining rewrite, but a lower-rate environment could make enough of a difference to prevent too much of a change unless or until yield-chasing returns and poses renewed strength and, thus, threat.

In short, the fate of life insurance in the United States remains largely in your hands. If you can ensure Treasury and the banking agencies that these companies are resolvable under even acute stress, life insurers might gain the benefit of new powers and even a deposit-insured affiliate. If not, banking agencies will continue to do their best to ensure that life insurance and banking are twain that, should it meet, is only a date from time to time, not a marriage.

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