GAME CHANGERS
Economic Policies for a Working America

POLICY BRIEF

End Financial Instability to Protect Household Income and Wealth

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The Problem: Unstable financial markets destroy household income and wealth, harming working class households the most

Increased financial fragility across banks and nonbank financial institutions is a threat to workers, businesses, and communities. The 2008 Great Financial Crisis demonstrated how large a threat it can become. That crisis precipitated prolonged recession, with high and persistent loss of income and wealth. Losses were higher for working class households.

Past Failures: Current financial regulation fails to eliminate instability

The Dodd Frank Act (DFA), enacted into law in the aftermath of the Great Financial Crisis (GFC), rests primarily on three pillars: making banks self-insure against runs, asset fire sales, and insolvency, by raising minimum levels of bank equity; restricting access to general purpose lender of last resort facilities to solvent banks experiencing bank runs; and resolving failed banks through either standard Federal Deposit Insurance Corporation procedures, or, when stability would otherwise be compromised, through the orderly liquidation authority. The aim of this structure is to force banks to take into account the costs created by high-risk behavior, to end rescue of the "too big to fail," and to make the banks that remain upright post-crisis pay the clean-up costs.

Unfortunately, the framework has been poorly implemented. Bank equity levels remain inadequate because of bad decisions by regulators and push-back by banks. This vulnerability was brought home in 2023 after the Federal Reserve (Fed) raised interest rates sharply, beginning in 2022. The effect on bank asset values left many banks insolvent. It took Fed intervention to stop a run on mid-sized banks, and probably to prevent a more widespread run on the financial system.

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Moreover, although the DFA created a Financial Stability Oversight Council, the FSOC cannot address threats to financial stability created by weakly-regulated nonbank financial intermediaries such as hedge funds and life insurers. FSOC's power is limited to designating individual institutions that can be shown to pose systemic risk, not activities or practices that can create it.

In 2020, hedge funds provided a clear example of the destabilizing shocks that can be created by collections of (relatively) small nonbank financials. When Covid-related disruptions forced them to liquidate their large and highly leveraged bets involving U.S. Treasury securities, the sales by hedge funds and others forced the Federal Reserve to intervene and buy $1 trillion in U.S. treasury securities to stabilize the market.

The ongoing transformation of the life insurance industry is making it more vulnerable to financial shocks, thereby creating new risks to the financial system. Beginning around 2014, asset managers, engaged in lightly regulated private credit lending, have taken over several insurance companies. These asset managers now use life insurer income and assets as funding for, and buyers of, opaque, high-risk private credit securities.

Moreover, life insurers are backing an increasing share of annuity liabilities with reinsurance provided by offshore companies, and by domestic "captive" companies, owned by the firms they reinsure. Collectively these reinsurers have lower disclosure and equity requirements, and fewer asset restrictions, than domestic public reinsurers.

At the same time, insurer equity-to-asset ratios have declined markedly, reducing their ability to absorb losses on the investments that back the annuities they sell.

Game Changer: Enact reasonable policy changes to reduce instability and protect workers

Policy should be changed to make banks self-insure against loss, prevent hedge funds from making system-destabilizing bets, and protect retirement savings that are managed by life insurers:

Banks

Require banks to put more of their own funds at risk when they operate their business. A greater level of self-funding will act as self-insurance against insolvency and make banks less likely to take bets that can threaten overall financial stability.

Hedge Funds

Limit the ability of hedge funds to use extraordinary amounts of runnable short-term debt by requiring all Treasury repurchase transactions be conducted on supervised central exchanges, with strict limits on the leverage of the counterparties.

Life Insurers

Authorize the Federal Insurance Office (FIO) to regulate life insurers, with a mandate to limit the risks to insurer stability caused by private credit takeovers and regulatory arbitrage.

*For more information on this topic, including the **Background Paper**, please visit our policy page.*

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