AIG – From Bailout to Deregulation

On September 29, 2017, the Financial Stability Oversight Council (FSOC) voted to rescind its prior designation of AIG as a systemically important financial institution (SIFI). A majority of FSOC members now consider that material financial distress at AIG would not pose a threat to the stability of the financial system as whole. The decision was strange given that AIG has not changed fundamentally since it was originally designated as critical to the financial system in 2013. A number of concerns with the decision were voiced from within the Council itself and by outside observers questioning the validity of the process.

The public will remember that AIG received a $182 billion bailout during the 2008 financial crisis, the largest bailout of a private company in U.S. history. Soon after exiting from the bailout, in early 2013, AIG became the first non-bank to be designated as a systemically significant financial institution under new regulatory authority granted by the Dodd-Frank Act.

FSOC members voting to de-designate defended their position by pointing out that the firm had become somewhat smaller since being designated. However, AIG remains a large, complex, interconnected company operating across many different markets and in more than 80 countries. Figure 1 shows AIG’s asset size, debt outstanding, selected financial instruments, and equity at the time it was designated as a SIFI alongside all of those measures today. They are strikingly similar.

Figure 1. AIG at the Time of SIFI Designation vs. Today ($ Billions)

As shown in the figure above, AIG’s size, as measured by total assets, has barely shrunk since it was deemed a “too big to fail” institution. The company also remains exposed to over $400 billion in liabilities but now has a thinner equity cushion to absorb losses and protect the firm’s creditors than it did in 2013. In addition, AIG’s $30.9 billion in long-term debt is considerably larger than that of MetLife and Prudential (which are, respectively, the largest U.S. insurance company and a similar insurer still considered a SIFI).

The degree of AIG’s leverage was an important element considered by the FSOC in its original designation. As measured by total assets (excluding separate account assets) over total equity, AIG’s leverage ratio has risen from 5.0x then to 5.4x today. This reflects a move towards a larger dependence on debt finance and means that a negative shock to the firm’s balance sheet will have a greater destabilizing effect, potentially requiring selling assets to meet debt obligations.

In the context of this leverage, AIG’s $30.9 billion debt becomes a significant exposure to counterparties and a threat to the financial system. If material financial distress requires AIG to engage in fire sales to meet its obligations, the liquidation of such a large asset portfolio would put downward pressure on asset prices, inflicting significant damage – not only on the financial health of firms connected to AIG’s balance sheet, but also to the stability of the financial system as a whole. According to calculations by the Federal Reserve, among financial institutions, the impact on the financial system of an AIG fire-sale ranks 11th for an equity shock and 19th for an asset shock. Those positions have changed only a little from 10th and 16th in 2012. All these concerns were included in the original determination and, as the Chairman of the Federal Deposit Insurance Corporation noted, “nothing about the liquidity characteristics of AIG’s assets and liabilities has changed to diminish the concerns originally raised by the FSOC.”

Other Arguments

Some FSOC members voting in favor of the de-designation also raised an argument, not about AIG per se, but opposing FSOC’s authority to designate nonbank financial institutions for enhanced regulatory supervision generally. Their justification echoes one of the financial industry’s same old songs: that labeling specific nonbank firms as SIFIs puts them at a competitive disadvantage vis-à-vis other firms in their industry. In the view of the Acting Comptroller of the Currency, the costs of these regulations outweigh their potential benefits because designating nonbank financial firms for increased oversight in a competitive industry “has several fatal limitations.” This argument ignores the fact that nonbank financial firms’ reckless business models—and particularly AIG’s—led to the 2008 financial wreckage and caused an economic recession that cost almost 9 million jobs and over $10 trillion in economic losses.

AIG became a poster child for Wall Street recklessness during the last financial crisis when it received the largest public bailout in U.S. history. As the result of its own catastrophic
mismanagement and of the crisis it helped precipitate, the company is smaller today than it was before the bailout. However, AIG still is a complex international institution worth close to $500 billion and one of the largest insurers in the U.S. Now that it has been removed from special government oversight, AIG is set to immediately pursue additional growth and expand its balance sheet to take on new risks. Getting bigger through mergers and acquisitions has been a strategic goal of the company’s CEO for some time, and now he can pursue it.

The de-designation of AIG follows a dangerous deregulatory pattern laid out by the Trump administration and its Wall Street insiders. For the past four years while AIG was a SIFI, the Federal Reserve Board of Governors had, and exercised, regulatory oversight of the company. Now that AIG has been de-designated, it will once again primarily be overseen by state insurance regulators. State regulation alone is insufficient to capture the full picture of a large, complex financial institution operating across state lines, like AIG. State regulators are not focused on detecting and dealing with systemic issues, their focus is on the solvency of insurers to make good on their policies, not on the adverse consequences that these firms might have on our national financial system. Without effective oversight from a nation-wide and systemic risk perspective, we are at risk of AIG once again threatening the stability of the economy.