



# Deregulating AIG Was a Mistake

By Gregg Gelzinis    October 11, 2017

The Financial Stability Oversight Council (FSOC), under the direction of Secretary of the Treasury and FSOC Chairman Steven Mnuchin, recently voted to deregulate American International Group (AIG) by removing its designation as a systemically important financial institution (SIFI)—basically declaring that the mega-insurer no longer warrants heightened scrutiny from regulators.<sup>1</sup>

The \$500 billion international insurance giant received a \$182 billion federal bailout during the global financial crisis of 2007 through 2008. While significantly smaller and less complex than it was at the height of the crisis, it is not fundamentally different than it was in 2013 when the FSOC determined that it was systemically important.<sup>2</sup> That is why removing AIG's SIFI designation—which comes with enhanced oversight and regulation by the Federal Reserve Board—is a serious mistake.

The 6-3 vote to deregulate AIG pitted the Obama-era regulators on the FSOC representing the Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Corporation (FDIC), and the Federal Housing Finance Agency (FHFA)—all of whom opposed this decision—against four President Donald Trump-appointed FSOC members who were joined by Federal Reserve Board Chair Janet Yellen and an independent FSOC member with insurance expertise. The vote to deregulate AIG was even more disturbing, given remarks made by AIG's new CEO, Brian Duperreault, who said in May, "I didn't come here to break the company up. I came here to grow it."<sup>3</sup>

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## The FSOC's designation authority

One of the many wake-up calls coming out of the global financial crisis was that systemic risks in the financial sector can build up outside of traditional banks. The failure or potential failure of massive, interconnected financial institutions such as Lehman Brothers and AIG demonstrated the need for enhanced regulations and oversight for systemically important, nonbank financial institutions. The Dodd-Frank Wall Street Reform and Consumer Protection Act addressed this regulatory gap by creating the

FSOC in 2010, which brings together financial regulators responsible for various parts of the financial sector to analyze systemic risks and to take action to mitigate threats to financial stability.<sup>4</sup>

The FSOC has the authority to designate nonbank financial institutions as systemically important if material financial distress at the institution could threaten the United States' financial stability or if the institution's nature, scope, size, scale, concentration, interconnectedness, or mix of activities could threaten the stability of the U.S. financial system.<sup>5</sup> The Dodd-Frank Act requires the FSOC to consider several factors—including leverage, off-balance sheet exposures, assets, liabilities, and supervisory regime without SIFI designation—when determining whether to designate an institution as systemically important. Once designated, an institution is subject to enhanced regulations and oversight from the Federal Reserve Board. A designation is not meant to be a permanent status, however. For example, the FSOC de-designated GE Capital—the financial services arm of General Electric—after the firm broke itself up and fundamentally restructured its business model.<sup>6</sup>

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### Financial stress at AIG could still threaten financial stability

In 2013, AIG was designated by the FSOC as systemically important.<sup>7</sup> At the time, the company had \$549 billion in assets, served 98 percent of Fortune 500 companies, and operated in more than 130 countries.<sup>8</sup> Today, AIG has \$500 billion in assets, serves 87 percent of Fortune 500 companies, and operates in slightly more than 80 countries.<sup>9</sup> Proponents of de-designating AIG point to how much the firm has shrunk and simplified since the financial crisis, when it received the largest bailout in U.S. history. The U.S. government has since sold off its equity stake in AIG, and the company has repaid its federal loans. Comparing the company today to its crisis-era footprint is the wrong benchmark. Certainly, AIG is not as large or complex as it was in 2007, but the FSOC analyzed the company in 2013—five years after the crisis—and determined that material financial distress at the company could pose a threat to financial stability. The FSOC outlined its rationale for designating AIG in 2013 in an official determination letter. Based on AIG's most recent annual report and the Securities and Exchange Commission's quarterly filing, it is clear that many of the FSOC's financial stability-related concerns, as outlined in the 2013 determination letter, still exist today.<sup>10</sup>

When analyzing potential threats to financial stability, the FSOC looks at how stress at one company can be transmitted throughout the U.S. financial system. The three main transmission channels identified by the FSOC are counterparty exposure, asset liquidation, and critical service or function.<sup>11</sup> In 2013, AIG had \$215 billion of total derivatives exposure, compared to \$165 billion in exposure today.<sup>12</sup> The company also had \$49 billion in long-term debt in 2013, compared with \$32 billion in long-term debt currently.<sup>13</sup> The modest decrease in derivatives exposure and debt on one side is countered by a decrease

in equity capital, resulting in a modest increase in the firm's leverage. Stress at AIG would negatively affect these considerable derivatives counterparties and bondholders, transmitting stress both directly and indirectly through the capital markets.

In 2013, the FSOC was also concerned that AIG's clients—98 percent of Fortune 500 companies at the time—could face losses if AIG failed, especially given the fact that state-based guarantee funds might not have the capacity to deal with such a significant collapse.<sup>14</sup> And while AIG has shed clients, it still insures 87 percent of Fortune 500 companies today.

In terms of the asset liquidation transmission channel, if a firm does not have enough liquid assets to meet their obligations in a time of severe stress, it may have to sell off illiquid assets at steep losses—pushing prices down across asset classes. Today, AIG's \$12 billion in liquidity resources at the holding company is less than the \$16 billion it had in 2013, even when controlling for the slightly smaller size of the firm.<sup>15</sup> AIG is a major participant in both the corporate debt and state and municipal bond markets, so a liquidity strain that leads to an asset sell-off could push down prices in these assets across the financial sector—affecting banks, insurance companies, and funds that hold these assets.

In 2013, AIG held \$152 billion in corporate bonds and \$36 billion in state and municipal bonds, while today those numbers are \$134 billion and \$20 billion, respectively.<sup>16</sup> In its 2013 determination letter, the FSOC was particularly concerned about the possibility that AIG's life insurance and retirement clients could pull their funds during a crisis, despite early redemption and surrender fees, causing a liquidity strain on the company.<sup>17</sup> The liquid assets at AIG are a small fraction of the liabilities that could come due during a crisis, were policyholders to pull their funds. It is worth noting that the life insurance and retirement business lines constituted about one-quarter of AIG's overall business in 2013, roughly the same portion that it constitutes today. FDIC Chairman Martin Gruenberg casting his dissenting vote argued, “Nothing about the liquidity characteristics of AIG's liabilities and assets has changed to diminish the concerns originally raised by the FSOC.”<sup>18</sup>

In 2013, the FSOC also determined that AIG provides a critical function to the U.S. economy that would not necessarily be easily replaced by insurance industry competitors.<sup>19</sup> AIG is one of the leading providers of commercial insurance, and during a crisis, it is unlikely that its competitors would have the capacity to quickly provide AIG's clients with coverage—potentially leaving certain U.S. businesses partially exposed to formerly covered risks for a period of time.

The FSOC also outlined concerns regarding AIG's supervision, resolvability—the government's ability to shut AIG down in an orderly manner—and the potential broader impact on the confidence of the insurance sector if it faced material stress.

In 2013, the FSOC pointed out that AIG owned a federal savings bank and was therefore registered with the Federal Reserve Board as a savings and loan holding company (SLHC). Under that classification, the Federal Reserve Board would have supervised AIG's holding company, even if it was not a SIFI. The FSOC was concerned, however, that absent SIFI status, AIG may drop the bank and deregister as a SLHC—removing it from any consolidated federal supervision.<sup>20</sup> In 2014, AIG did deregister as a SLHC. Therefore, with de-designation, it will not be supervised on a consolidated basis by any federal regulator.

Moreover, the FSOC thought that resolving a massive, cross-border insurance company that operated in 130 countries would aggravate that company's disruption to financial stability if it was wound down.<sup>21</sup> While progress has been made on living wills—resolution plans outlining how a company would be wound down to avoid bailouts—and cross-border resolution, it is still the case that resolving AIG, which now operates in 80 countries, would aggravate financial stability during a crisis. To make matters worse, AIG will no longer have to file living wills with regulators. FHFA Director Mel Watt highlighted this concern in his dissent, rightfully noting that there still is no global framework for resolving a massive, interconnected insurance company that operates internationally.<sup>22</sup>

Back in 2013, due to AIG's size, interconnectedness, and role as a leading insurance company in the United States, the FSOC was also worried that material distress at the company would reduce confidence in the insurance industry, potentially causing creditors and policyholders to reduce their exposure and remove funds from otherwise healthy insurance companies. That concern remains today.<sup>23</sup>

TABLE 1

## The American International Group Inc. is not a fundamentally different company today than it was when labeled a systemically important financial institution

Select business and financial data from AIG, in millions except for nonmonetary data

	SIFI designation, 2013	SIFI de-designation, 2017
Assets	\$548,633	\$499,762
Gross notional derivatives exposure	\$215,552	\$164,983
Global Fortune 500 clients	98%	87%
Countries of operation	130+	80+
Parent liquidity	\$16,123	\$12,297
Long-term debt	\$48,500	\$31,812
Corporate bond holdings	\$152,432	\$133,898
State and municipal bond holdings	\$35,705	\$19,722
Revenue from life and retirement business	29%	25%
Financial leverage	5.0x	5.6x
Consolidated federal regulator absent SIFI status	Federal Reserve Board	None
Global insurance resolution regime	No	No

Sources: American International Group Inc., *Annual Report on Form 10-K for the fiscal year ended December 31, 2016*, (U.S. Securities and Exchange Commission, 2016), available at <http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/december-31-2016-10k.pdf>; American International Group Inc., *Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2017*, (U.S. Securities and Exchange Commission, 2017) available at <http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/2017/june-30-2017-10q.pdf>; American International Group Inc., *Annual Report on Form 10-K for the fiscal year ended December 31, 2012*, (U.S. Securities and Exchange Commission, 2012), available at <http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/4q-2012-form-10k.pdf>; Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, (U.S. Department of the Treasury, 2013), available at [https://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis of Final Determination Regarding American International Group, Inc.pdf](https://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf).

In de-designating AIG, the FSOC released a letter outlining its reasoning, but as Watt noted in his dissent, the justification contradicts itself at several junctures.<sup>24</sup> At times, the letter paints a clear picture of a systemically important financial institution, leaving the reader wondering why the FSOC decided to de-designate the firm. It is also apparent that the FSOC started with a certain outcome in mind and worked backward to justify that outcome. The assumptions in the analysis used to justify the de-designation of AIG, as highlighted by FDIC Chairman Gruenberg in his dissent, are different than the assumptions used when designating AIG in 2013 or when re-evaluating the designation in 2014 and 2015.<sup>25</sup> The FSOC's analysis for the de-designation relied on data from the "experience of much smaller insurance company failures in moderate stress environment."<sup>26</sup> On its face, this is clearly inappropriate for assessing the impact on financial stability of the failure of a massive, interconnected insurance company—potentially during a severe stress environment.

Part of the disconnect highlighted in the letter was on display in Treasury Secretary Mnuchin's statement following the vote. Mnuchin explained that the FSOC reviewed whether AIG poses a risk to financial stability and reaffirmed his commitment to de-designate companies "if a company does not pose a threat to financial stability."<sup>27</sup>

This is not the standard outlined in the Dodd-Frank Act, however, which clearly states that a company should be designated as a SIFI if material distress at the company could pose a threat to financial stability. Designation has nothing to do with whether the company is currently posing a threat to financial stability or whether it is likely to experience material distress in the near term.

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## Conclusion

AIG has not changed drastically since it was designated as a systemically important financial institution (SIFI) in 2013. Yes, it is smaller and less complex than it was during the financial crisis, and it should be commended for its progress, but as Consumer Financial Protection Bureau Director Richard Cordray stated, material stress at AIG could pose the same fundamental risks as outlined by the FSOC in 2013.<sup>28</sup>

If AIG were on the brink of failure tomorrow, it could threaten U.S. financial stability. Moreover, its CEO has stated that he plans to grow AIG, not shrink it further—making its release from enhanced federal oversight even more concerning. Even policymakers who think AIG is no longer systemically important should be given pause by that statement.

With the SIFI designation, AIG had to submit a living will annually to plan for its orderly failure, was subject to stress tests, faced consolidated capital requirements, and was required to implement enhanced risk management standards. Removing these sensible safeguards from AIG—an institution that received a \$182 billion bailout from taxpayers—was a serious mistake.

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## Endnotes

- 1 U.S. Department of the Treasury Office of Public Affairs, "Financial Stability Oversight Council Announces Rescission of Nonbank Financial Company Designation," Press release, September 29, 2017, available at [https://www.treasury.gov/initiatives/fsoc/news/Documents/Financial\\_Stability\\_Oversight\\_Council\\_Announces\\_Rescission\\_of\\_Nonbank\\_Financial\\_Company\\_Designation.pdf](https://www.treasury.gov/initiatives/fsoc/news/Documents/Financial_Stability_Oversight_Council_Announces_Rescission_of_Nonbank_Financial_Company_Designation.pdf).
- 2 For more information on government assistance to AIG during the financial crisis and AIG's repayment, see U.S. Department of the Treasury, "Investment in American International Group (AIG)," available at <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/aig/Pages/default.aspx> (last accessed October 2017).
- 3 Chad Bray, "I Am Here to Grow A.I.G., Its New C.E.O., Brian Duperreault, Pledges," *The New York Times*, May 15, 2017, available at [https://www.nytimes.com/2017/05/15/business/dealbook/aig-brian-duperreault-ceo.html?\\_r=0](https://www.nytimes.com/2017/05/15/business/dealbook/aig-brian-duperreault-ceo.html?_r=0).
- 4 U.S. Department of the Treasury, "Financial Stability Oversight Council: About FSOC," available at <https://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx> (last accessed October 2017).
- 5 U.S. Department of the Treasury, "Financial Stability Oversight Council: Designations," available at <https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx> (last accessed October 2017).
- 6 Financial Stability Oversight Council, *Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding GE Capital Global Holdings, LLC* (Washington: U.S. Department of the Treasury, 2016), available at [https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE\\_Capital\\_Public\\_Rescission\\_Basis.pdf](https://www.treasury.gov/initiatives/fsoc/designations/Documents/GE_Capital_Public_Rescission_Basis.pdf).
- 7 Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.* (Washington: U.S. Department of the Treasury, 2013), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf>.
- 8 American International Group, Inc., "AIG Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2012" (2012), p. 204, p.2, available at <http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/4q-2012-form-10k.pdf>; Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, p.8.
- 9 American International Group, Inc., "AIG Quarterly Report on Form 10-Q for the Quarterly Period Ended June 30, 2017" (2017), p.2, available at <http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/2017/june-30-2017-10q.pdf>; American International Group, Inc., "AIG Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2016" (2016), p.3, p.4 available at <http://www.aig.com/content/dam/aig/america-canada/us/documents/investor-relations/december-31-2016-10k.pdf>.
- 10 Ibid.
- 11 Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, p.5.
- 12 Total derivatives exposure figures refer to gross notional exposure. See American International Group, Inc., "AIG Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2012," p. 277; American International Group, Inc., "AIG Quarterly Report on Form 10-Q for the Quarterly Period Ended June 30, 2017," p.45.
- 13 Ibid., p. 204, p. 2
- 14 Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, p. 6.
- 15 American International Group, Inc., "AIG Quarterly Report on Form 10-Q for the Quarterly Period Ended June 30, 2017," p. 150; American International Group, Inc., "AIG Annual Report on Form 10-K for the Fiscal Year Ended December 31, 2012," p. 124.
- 16 Ibid., p. 240, p. 15
- 17 Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, p. 7.
- 18 Financial Stability Oversight Council, *Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG)* (Washington: U.S. Department of the Treasury, 2017), p.5, available at [https://www.treasury.gov/initiatives/fsoc/news/Documents/Member\\_Views.pdf](https://www.treasury.gov/initiatives/fsoc/news/Documents/Member_Views.pdf).
- 19 Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, p. 8.
- 20 Ibid., p. 9.
- 21 Ibid., p. 10.
- 22 Financial Stability Oversight Council, *Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG)*, p. 10–11.
- 23 Financial Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.*, p. 8.
- 24 Financial Stability Oversight Council, *Notice and Explanation of the Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding American International Group, Inc. (AIG)* (Washington: U.S. Department of the Treasury, 2017), available at [https://www.treasury.gov/initiatives/fsoc/designations/Documents/American\\_International\\_Group,\\_Inc.\\_\(Rescission\).pdf](https://www.treasury.gov/initiatives/fsoc/designations/Documents/American_International_Group,_Inc._(Rescission).pdf); Financial Stability Oversight Council, *Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG)*, p. 10–11.
- 25 Financial Stability Oversight Council, *Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG)*, p. 5.
- 26 Ibid.
- 27 U.S. Department of the Treasury Office of Public Affairs, "Financial Stability Oversight Council Announces Rescission of Nonbank Financial Company Designation."
- 28 Financial Stability Oversight Council, *Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG)*, p. 4.