Insight

FSOC De-Designated AIG as a SIFI – What Does It Mean?

MEGHAN MILLOY | OCTOBER 11, 2017

Last month the Financial Stability Oversight Council (FSOC) voted to de-designate American International Group (AIG), allowing it to shed its systemically important financial institution (SIFI) label, thereby removing it from a barrage of extra regulations and oversight by the Federal Reserve. Recall that FSOC was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2010 and is tasked with, among other things, determining whether financial distress at a financial institution would pose a threat to the stability of the greater U.S. financial system. If they find that it would, then they designate an institution with the SIFI label. FSOC is also required to annually reevaluate its designation determinations. After designating AIG in July 2013, it has since reevaluated its decision multiple times, but only recently decided to remove its SIFI label. So what changed this time around?

In its "Notice and Explanation of the Basis for the Financial Stability Oversight Council's Rescission of Its Determination Regarding American International Group, Inc. (AIG)," FSOC goes into detail on why it decided to de-designate AIG. Specifically, FSOC states that it "has identified changes since the Council's final determination regarding AIG that materially affect the Council's conclusions with respect to the extent to which AIG's material financial distress could pose a threat to the U.S. financial stability. Some of these changes are the direct result of steps AIG has taken that have reduced the potential effects of the company's distress on other firms and market. For example, AIG has reduced the amounts of its total debt outstanding, short-term debt, derivatives, securities lending, repurchase agreements, and total assets. Further, additional analyses conducted for purposes of this reevaluation, including additional consideration of the effects of incentives and disincentives for policyholders to surrender their life insurance policies and annuities…indicates that there is not a significant risk that a forced asset liquidation by AIG would disrupt market functioning and thereby pose a threat to U.S. financial stability."

In short, FSOC is telling us that because AIG shrunk its balance sheet to some extent, it no longer deems it to be a big enough risk to the U.S. financial system if it were to fail and thereby believes that its SIFI status should be removed. As AAF has written previously, this is the right decision, but for the wrong reason. The only part of AIG that was involved in the crisis was its financial products division and, specifically, its credit-default swaps activities. Since AIG closed this division it is now more of an insurer than it was before the crisis. So the reason for de-designation cannot have anything to do with AIG being large – because it still is – or being an insurer – because it still is. Rather, it has everything to do with the mix of activities in which it is currently engaged.

Perhaps FSOC won't say it explicitly, but this decision does make it look like they're moving toward a more activities-based approach to thinking about systemic risk, especially for insurers. Under an activities-based approach, FSOC would identify specific risky activities or products and delegate the task of addressing those risks to the appropriate primary regulator. This is how it currently oversees asset managers, which has resulted in no designations. And, as AAF research has shown, if an activities-based approach had been in effect during the mid-2000s, it's possible that the financial crisis would have been substantially mitigated or even prevented.

AAF research has also found that FSOC's SIFI designation process, in its current form, "imposes direct costs and risk on the designated institutions. The magnitude of the costs is uncertain, especially given that the specific rules and capital requirements have largely yet to be determined, but it cannot be presumed negligible." More worrisome is the fact that FSOC's "two-tiered system will alter competitive dynamics in the insurance sector…Other things being equal, the increased costs of enhanced supervision will reduce their ability to compete effectively, plausible shifting some amount of business and risk to entities not subject to the additional level of regulation, and destabilizing rather than stabilizing the market." Where large banks that compete with each other are all under the same regulatory umbrellas, such is not the case with FSOC-designated non-bank SIFIs.

Now that AIG has been under FSOC's increased supervision and is now free, it estimates that it will save as much as $150 million in annual compliance costs alone as a result of the de-designation. In an administration aiming to boost job and economic growth, that savings is huge, and it should serve as good reason why the remaining SIFIs should be de-designated as well.

One of the two remaining SIFIs, MetLife, is in a unique situation. It was de-designated by a District Court ruling early last year. Officials in the Obama administration appealed that decision, and the case is currently stayed until Treasury comes out with its report on FSOC and its designation process (which could be out as soon as this week). This administration has an opportunity to step in and make sure that the good precedent set by that district court decision – that FSOC can no longer make "arbitrary and capricious" designations and must, instead, perform a proper cost benefit analysis each time it levies additional regulatory burden on a company – stands.

The current administration can and should drop the appeal filed by the past administration and help move the ball further down the field of improving upon bad designation policies of the past from FSOC. Once that's done, the only remaining SIFI would be Prudential, which never should have been designated in the first place. When FSOC returns to Prudential's annual review, it should de-designate just as they did with AIG. After all, having only one entity designated as a SIFI is counter-intuitive to the whole concept of systemic risk and its prevention.