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28. February 2009

Online at http://mpra.ub.uni-muenchen.de/14122/
MPRA Paper No. 14122, posted 17. March 2009 05:12 UTC

AIG and the Fed: Prologue to Future Financial Regulation?

John A. Tatom

Financial sector regulatory reform has been a leading national issue since the U.S. Treasury issued its *Blueprint* for reform in spring (2008).[1] The mortgage foreclosure and financial crises reinforced popular interest in whether the U.S. regulatory framework was deficient, whether those deficiencies contributed to the crises, and how to fix the regulatory framework. Policymakers have focused on the recession, the foreclosure crisis and the bank confidence problem over the past year, with less attention to regulatory overhaul, but those priorities appear to be changing. The Obama administration called for renewed regulatory reform efforts on February 25, 2009, and congressional leaders are hard at work on reform.[2] The Committee on Capital Markets Regulation (2009) issued a call for federal regulatory consolidation, simplification and reform. A working group of the Group of 30 (2009) also released a key document calling for financial regulatory reform in January and regulators and policy leaders are looking forward to the release of a Group of 20 report on regulatory reform in April 2009. The broad agenda is moving to the table. Meanwhile, some key decisions in the United States, particularly concerning the failure and bailout of AIG and some investment banks in fall 2008, have established precedents for a new regulatory framework and policies. Where policymakers go from here is not certain, but the ideas on the table and the direction of policy suggest that the role of the Federal Reserve (Fed) in financial regulation will become central, at least in critical periods.

President Obama called for oversight of all financial institutions that pose systemic risks to financial markets and urged the public to be assured that the Federal Reserve "understands the institutions it insures and actively monitors them to keep their risk-taking in check."[3] He also said that an overhauled financial regulatory structure "must be strong enough to withstand both systemwide stress and the failure of one or more large institutions." The role of the Federal Reserve as a "financial stability" regulator, called for in the *Blueprint*, is widely expected to be central to the new regulatory system, especially because it has stepped up as such a regulator in the current financial crisis and perhaps because there is no other existing institution that is available to play such a role. A financial stability regulator, as proposed in the *Blueprint*, would have broad new sweeping powers of oversight and control over financial policies and actions of all firms operating in the United States.

I. The Fed as the New Financial Stability Regulator

The Fed has stepped in to the bailout of AIG because of concern of systemic risk. In the *Blueprint*, an overarching financial stability regulator was envisioned and the Fed was viewed as a prime candidate for this authority. More recently, this concern has narrowed from financial stability to systemic risk. The other popular stereotypical example of potential systemic risk today is the potential failure of Citigroup that has justified Treasury funding of some $45 billion so far.

[1] See U.S. Treasury (2008).
[2] See Hitt (2009). Not all analysts agree that the financial crisis arose from inadequate or reduced regulation, though some blame the federal government and some regulators specifically for not performing their authorized responsibilities. See Gramm (2009) for example. Moreover, calls for regulatory reform predate the financial crisis, especially the development of the Treasury's *Blueprint* (2008).
[3] See Hitt (2009).

The notion of systemic risk has become quite nebulous and is subject to considerable abuse in regulatory discussions. Largely it now refers to situations where there is a high correlation of asset prices so that a decline in one firm or group of firms has negative effects on the solvency of other firms. Of course the list of potential positive correlations in asset prices is endless so the list of potential systemic risk situations is equally endless. It is not limited to large firms, or to financial services firms. Both are examples of the "Too Big to Fail Doctrine," which was widely presumed to have been repealed in the early 1990s.[4] Instead, the doctrine, once applicable only to banks and their regulators, has been expanded to other financial institutions via the assertion of Fed responsibility for them. For both Citigroup and AIG, emphasis is put on the size of the institutions and their global reach, as if the international implications of a failure increase the potential systemic risk or contagion. The extension of Fed oversight to other financial institutions besides banks extends so far to AIG, investment banks, commercial paper issuers, brokers and dealers, issuers of money market mutual funds and to other issuers of securitized debt or to holders of securitized assets.

The original basis of a regulatory role in assisting an illiquid financial institution in avoiding insolvency, in the Fed's case as "lender of last resort" for banks, was the risk to the nation's payments system in the event of bank failure. This was based on the notion that depositors cannot distinguish good, or solvent ,banks from bad, or insolvent, banks, so a bank failure could create panic as depositors run on banks to salvage their deposits at both good and bad banks. As banks are forced into fire sales of assets to obtain cash to meet withdrawals, asset values decline and banks are forced into insolvency and failure. The potential for such a systemic failure because of runs was largely ended in the mid 1930s with the introduction of deposit insurance. At least up to generous limits today, depositors do not have to worry about access to their deposits because deposits are insured. Even if banks fail, the payments system cannot easily be forced into collapse because depositors do not run. However, for the largest banks and the largest depositors, there could be runs on deposits that exceed the insurance limits. These deposits are well managed, though, so that the likelihood of a bank failure because of a run is minimal. Moreover, the Fed has powers to lend that are sufficient to keep a solvent bank from becoming insolvent and failing in the event of a run on one or on many banks. These powers were redefined and reinforced following the U.S. savings and loan crisis.[5] Today the notion of systemic risk is more vague and seems to apply to any situation where risk sensitivity grows or revenue losses occur because of developments in another firm. There is a loose presumption that such potential losses are to be compensated or underwritten by government entities.

II. The Fed and AIG

The Federal Reserve took on oversight and intervention in the potential failure of AIG in September 2008, at the same time that investment banks Lehman Brothers and Merrill Lynch failed, with the latter forced to be acquired by Bank of America. Initially the Fed entered into an agreement to lend AIG $85 billion. In November 2008, the Fed reduced their direct line of credit to AIG to $60 billion, when the Treasury agreed to lend AIG $40 billion from the Troubled Asset Recovery Program (TARP). This original agreement has been changed three times in its first five months, the latest changes coming on March 2, 2009 when the Treasury agreed to lend a further $30 billion and the Fed modified some terms of

[4] The Federal Deposit Insurance Corporation Improvement Act of 1991 was intended to circumscribe the ability to have a financial institution that is too big to fail to a degree that many analysts thought that no institution would ever again meet the requirements. See Kaufman (12007) for an update on its coverage and its shortcomings.
[5] See Kaufman (2008) for a discussion of the powers of regulators to avoid systemic runs and bank failures and their policies to minimize the costs of bank failures.

the loans it had made. As of February 25, 2009, however, the Fed held $38 billion in direct loans to AIG, $27.7 billion in a structured investment vehicle (SIV) called Maiden Lane II, which houses collateralized debt obligations (CDOs) purchased from AIG, and $18.6 billion in Maiden Lane III, which houses residential mortgage backed securities purchased from AIG, a total of $84. 3 billion.[6] The Fed originally loaned the two SIVs $30 billion and $22.5 billion, respectively. Thus, within only a few months, the Fed's two AIG related SIVs have lost over $6 billion.

Fed losses on loans to non-bank financial institutions are well outside the normal mandate of the Fed and raise questions about its financial integrity and the soundness of its financial judgment and its ability to conduct a sound and responsible monetary policy. Not surprisingly, the Fed has reduced its willingness to lend to AIG and reportedly has insisted that the Treasury take on any new financial exposure to AIG, but they have not reduced their exposure to other non-bank financial institutions.

Critics of the proposal that the Fed take on the role as a financial stability regulator with super powers to examine and control any financial practice anywhere in the economy point to its narrow function as the central bank and monetary authority, and as a regulator of banks. They emphasize the Fed's lack of success as a regulator and the questionable presumption that a country requires a special regulator to promote financial stability. A well run monetary policy and regulators that properly maintain the solvency of the nations' banks have historically been regarded to be sufficient to avoid financial crises. Justification for regulation of bank solvency primarily arises because of government-sponsored deposit insurance; solvency regulation is a legitimate means to hold down the potential cost of insurance to taxpayers and has the side effect of improving financial stability. The evidence on the Fed's new lending programs for private financial firms, especially to take on toxic debt from Bear Stearns and AIG, suggests that there is an inherent conflict in its pursuit of its own independence, financial integrity and its role as monetary policymaker and its new private sector lending and oversight responsibilities.

No doubt the debate over whether countries need a financial stability regulator and whether the Fed should be diverted from its existing role as central bank to provide new regulatory services will be heated, especially since it will also create turf struggles with existing regulators of financial services firms and because it may also stir an ongoing debate over whether the federal government should charter and regulate large insurance companies, as the G30 has recommended, or perhaps any insurance company, as envisioned in the *Blueprint* and in congressional proposals to permit optional federal charters.

III. The AIG Problem

AIG was one of the first insurance companies to suffer large losses on mortgage backed or related securities in 2008. During the first three quarters of 2008, AIG had losses of $37.6 billion, but in the fourth quarter, losses for the year grew by $61.7 billion to a total of $99.3 billion for the year. Losses in 2007 were large but reached "only" $10 billion. The fourth quarter 2008 loss was the largest for any firm in U.S. history. Strikingly, only $25.9 billion of the fourth quarter loss was due to mortgage-backed securities or credit default swaps, the primary source of losses earlier at AIG and at other financial firms seriously affected by the financial crisis. Financial sector losses are spreading well beyond the residential mortgage-related debt, to commercial real estate-related debt and to other new securities including credit

[6] See Board of Governors (2009).

default swaps, other collateralized debt obligations, auction rate securities and other newer and untested securities.

Assets and income at AIG are shrinking rapidly. Premiums fell 22 percent from the fourth quarter of 2007 to the last quarter of 2008, and assets fell $140 billion in the just the last quarter of 2008 to $860 billion. Fed and Treasury holdings of AIG claims have risen to over $150 billion, or more than 16 percent of AIG total assets and more than 80 percent of equity in AIG. Continuing losses will fall disproportionately on the Fed and Treasury, raising the question of whether either institution has a threshold beyond which their losses on AIG become unsustainable. Bankruptcy is a more likely process if such large losses continue. The $6 billion loss on the Fed's AIG-related SIVs, is larger than losses on the toxic securities acquired by the Fed's first SIV, which houses securities acquired from the Bear Stearns failure. Together these losses have absorbed about 30 percent of the Fed's annual payments to the Treasury from its profits. This sum is growing and does not include losses on the extensive private credit facilities that have been created over the past two years. Should these losses continue to cumulate, financial sector pressures and congressional pressures will mount to limit or end such new ventures by the Fed. Fed credit can more safely and prudentially grow by purchases of U.S. government debt, with the marketplace determining where the new Fed credit extensions are ultimately allocated, instead of the Fed attempting to assess the solvency and liquidity of particular financial firms and sectors and directly lending to them.[7]

IV. Three new challenges to U.S. regulatory reform

One of the key differences in U.S. and European regulatory approaches has been the evolution of the Financial Services Authority (FSA), first in Great Britain, as the model for regulatory reform. The presumption has been that the competing U.S. regulatory bodies with overlapping responsibilities have been inefficient and have put the focus on specific regulatory silos for different types of financial institutions. The growing convergence of financial institutions who share particular types of risk of concern to regulators has led to an FSA-approach where all institutions are regulated and the focus of differentiation is the type of risk rather than institutional affiliation. This approach is advocated by the Committee on Capital Markets Regulation (2009), the Treasury 's *Blueprint* and, to a degree, in the G30 report. Interestingly, the Vice Chair of the European Central Bank has taken another view, suggesting that the FSA approach is too slow and inefficient and not focused sufficiently on the unique issues posed by banking system risk. In his view, bank regulation should be given over to the European Central Bank in its role of protector of the banking system and at least to that extent, protector of financial stability. This controversy in Europe opens a new front in the debate over why financial institutions are to be regulated, how, and by whom.

A second challenge reinforced by the AIG debacle is regulatory reform of the U.S. insurance industry. All calls for regulatory reform emphasize the importance of a federal role in regulating insurers, which are currently regulated by the states. Part of the AIG problem is that the losses arose at an unregulated subsidiary of the holding company, which technically was regulated by the Office of Thrift Supervision. A federal role in insurance regulation could have provided a regulator that had a broader view of AIG and that subjected the holding company components to closer regulatory scrutiny, as the Federal Reserve currently does with bank holding companies. All of the major proposals for reform call for an expanded

[7] See Tatom (2008a, b) and Kuttner (2009) for assessments of the financial market and political effects of the Fed's new policies.

federal role, ranging from the introduction of an optional federal charter, under which insurers could obtain federal charters and become subject to federal regulation instead of state regulation, to federal regulation of all systemically important or significant insurers as proposed by the Group of 30.[8]

Another problem with the Fed becoming the financial stability regulator is that the Fed could more easily lose its independence in the process. Independence is important because it allows the central bank to be focused on the longer term objective of maintaining the purchasing power of money or price level stability. This is the only sustainable long term objective of any central bank, but because of the power to print money, central banks suffer from strong competing pressures to pursue a variety of other objectives. During the recent crisis, the Fed has engaged in another new policy that involves a shell game with the Treasury.[9] Under this policy, the Fed borrows directly from the Treasury and then uses these new securities to raise funds in the securities market in order to lend to the private sector institutions. The Treasury cooperates with this scheme by promising, so far, to hold the funds it receives from the Fed as deposits in a special account at the Fed. This keeps the Fed purchases of securities or private sector lending from having direct effects on bank reserves or the monetary base, but it allows the Fed to expand its credit to the private sector.

This policy jeopardizes the independence of the Fed and, even more than the losses on private sector lending, threatens the credibility, transparency and independence of the Fed. As of February 25, 2009, the Fed has borrowed $200 billion from the Treasury in this special program that allows the Fed to sell the securities and then lend the proceeds to the private sector. The program began in the week of September 25, 2008 and the Fed lending under this program peaked at $558.9 billion for the week ending November 13, 2008. At any moment the Treasury could spend the proceeds from these security sales, increasing bank reserves and the monetary base by a huge amount, but so far, the Treasury has respected the independence of the Fed and refused to use the proceeds of these special loans for financing new government expenditures. If the Fed takes on a new role to protect the financial stability of the economy, it is likely that such new initiatives could expand, complicating the ability of the Fed to pursue monetary stability and price stability. Congress will have to finesse the competing goals of price stability and short-term objectives of financial stability if it is to ensure that the Fed maintains its traditional and well founded responsibilities while pursuing new short term financial market objectives.

The Fed's actions with regard to AIG provide strong evidence that broadening the too big to fail policy or broadening the Fed's lender of last resort policy to include non-bank firms pose strong conflicts for the achievement of the objectives of monetary policy or of financial stability. Moreover, the loss experience of AIG indicates the problems of fragmented or absent federal regulation of insurers for regulatory reform.

[8] The Committee on Capital Markets Regulation (2009) has not taken a position on a federal role in insurance regulation.

[9] See Tatom (2008b) for a fuller description of this arrangement.

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