SECURITIES LENDING AND THE UNTOLD STORY IN THE COLLAPSE OF AIG

American International Group Inc. (AIG), a worldwide insurance powerhouse, avoided bankruptcy in 2008 thanks to generous bailouts from the federal government. Understanding what happened to AIG is critical in evaluating the regulatory reforms enacted since the crisis, and ascertaining whether earlier implementation of those reforms would have prevented the AIG bailout and whether the reforms will make future bailouts less, rather than more, likely. Our ability to craft appropriate regulation and avert future crises is limited as long as our understanding remains incomplete.

In a new study for the Mercatus Center at George Mason University, senior research fellow Hester Peirce shows that the causes of AIG’s collapse were more complicated than the conventional accounts—used to justify the regulatory responses embodied in Dodd-Frank—suggest. Dodd-Frank’s derivatives regulatory framework would not have solved AIG’s problems, and Dodd-Frank’s systemic oversight regime would have aggravated them. Unhindered by regulatory curtailment, market processes would resolve AIG-like problems by transferring salvageable assets to private-sector hands more capable of managing them. Bailouts and regulatory control are poor substitutes for market discipline.

For the full study, see “Securities Lending and the Untold Story in the Collapse of AIG.”

BACKGROUND: Why the Standard Explanation for AIG’s Downfall Is Wrong

The popular and oft-repeated explanation for AIG’s problems and subsequent bailout focuses almost exclusively on the derivatives products sold by AIG’s Financial Products unit (AIGFP). This explanation highlights only one source of AIG’s problems.

AIG’s securities lending program is just as critical to the story of its downfall. Through the securities lending program, AIG and its life insurance subsidiaries had massive exposure to residential mortgage-backed securities. At the height of the 2008 crisis, the program experienced a run, and AIG could not meet the massive repayment demands. The losses in the securities lending program were severe enough to imperil a number of AIG’s regulated life insurance subsidiaries. Before the bailout, AIG itself may have been insolvent.
FINDINGS: Misunderstanding of AIG’s Downfall Has Made Future Bailouts More Likely

The Dodd-Frank Act was the end product of a single-minded focus on AIGFP in debates over regulatory reform. AIGFP was decried for being unregulated, and this put AIG at the center of the push toward derivatives reform as well as systemic risk oversight for similar nonbank companies—both key components of Dodd-Frank. However,

- The derivatives AIGFP sold were not the type that can be standardized, traded on exchanges, and cleared through clearinghouses. Thus, Dodd-Frank’s derivatives rules are not an effective response to AIGFP’s problems.

- Lack of regulation was not the problem at AIG. AIG had many regulators—including a systemic regulator, the Office of Thrift Supervision—and AIG’s securities-lending issues arose in its heavily regulated life insurance companies. Thus, the changes that Dodd-Frank made to ensure that companies like AIG have yet another regulator will not prevent AIG-like problems in the future.

- AIG’s crisis is not fundamentally about securities lending or derivatives. It is about company-wide risk management failures. Those are failures regulators cannot solve, despite attempts in Dodd-Frank to do so—but market discipline can.

RECOMMENDATIONS AND CONCLUSIONS

Even five and half years after AIG’s bailout, it is not too late to learn from the regulatory failures associated with AIG’s collapse and to consider their policy implications.

- The markets themselves are the most effective regulators, if the government allows them to be. Sparing AIG prevented the markets from meting out discipline on the company. Regulatory reform efforts should aim to make companies more accountable to the markets.

- Relying on regulators to spot problems and solve them is not an effective alternative to corporate risk management. There is no reason to expect that a regulator like the Federal Reserve would have been more effective as a systemic regulator than the Office of Thrift Supervision.

- The additional layer of systemic regulation to which companies like AIG are now subject could increase risk to the financial system. The new regulatory framework effectively outsources risk management to regulators. Companies worried primarily about pleasing their regulators will not think strategically about their own risks.