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Multinational Banking and Regulatory Challenges: Lessons from the US Experience with AIG

Robert A. Eisenbeis*

Introduction

The financial crisis of 2007–09 quickly spread from financial markets and institutions in the US to those in many parts of the rest of the world, and in particular to institutions in the UK and continental Europe. Many of the largest institutions in the US, UK and the rest of the European Union have required substantial injections of public funds, in part because of the lack of easily invoked resolution methods to recapitalize or reorganize institutions without evoking costly general bankruptcy procedures that would entail long delays and possibly lead to severe negative externalities that would endanger the function of the financial system as a whole or individual markets.

The problems the US has experienced in dealing with the resolution of the financial difficulties of American International Group (AIG) serve as a case study of the issues that arise in attempting to deal with financial distress in a large international financial institution, be it a bank or other form of financial conglomerate. Already, the U.S. government has committed more than $180 billion in financial support to AIG, which exceeds the estimated cost of the Savings and Loan crisis of the 1980s. The lessons learned from this experience should play an important role in shaping future financial reforms applicable to the US as well as many other countries. This paper reviews the issues and points to possible needed reforms to deal with the failures and financial distress of large multi-national financial institutions.

Background on AIG

AIG was a large, complex insurance conglomerate with three main lines of insurance activities. These included property and casualty insurance; life and health insurance and retirement products; and asset management and financial services.[1] The company had about $1 trillion in consolidated assets and most relevant for the issues under consideration here, it operated in about 140 countries. It had more than 71 insurance companies based in the US and over 175 other insurance and financial services companies chartered in the US and in other countries. Much attention has been given to one segment of its operations – the activities of AIG Financial Products that created most of AIG's credit default swaps and ran its securities lending program. While as a US chartered entity its headquarters were located in the US, most of its activities were based in London and were conducted through the London branch of AIGFP's French chartered bank subsidiary, Banque AIG (Eisenbeis 2009a). This structure clearly was a complicating factor for US authorities in assessing consequences of AIG's possible demise, not to mention the impacts on its insurance activities.

There was no one insurance regulator or a consolidated federal insurance regulator responsible for AIG's insurance activities. US law (the McCarran-Ferguson Act) provides that insurance activities, like those of AIG, are regulated by the individual states in which insurance companies are licensed to operate.[2] Many of AIG's other activities were in affiliates or subsidiaries that were either technically unregulated or were subject to oversight by non-US authorities.

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[1] It also had an airplane leasing business.

[2] For example, the NY State Insurance Department representative's testimony specifically indicated that he was responsible only for AIG's insurance activities, which accounted for only about 10 of AIG's 71 US insurance companies, and that he was not responsible for AIG's other activities, especially AIG Financial Products (AIGFP).

However, AIG became a Savings and Loan Holding Company in 1999 and owned three federal savings banks. As such, AIG was subject to consolidated federal supervision by the Office of Thrift Supervision (OTS), and this oversight extended to AIG's Financial Products Group (AIGFP), the activities of which many believe were responsible for AIG's financial difficulties. Hence, while some of AIG's activities and/or subsidiaries and affiliates technically may have been *unregulated*, this did not mean that they were *unsupervised* nor subject to federal oversight.[3]

On the heels of the failure of Lehman Brothers on 16 September 2008 and the merger of Merrill-Lynch with the Bank of America, the immediate catalyst for the extreme actions taken by the Federal Reserve and US Treasury to bail out AIG was the recognition that AIG's need for capital might force it to declare immediate bankruptcy. The continued decline in AIG's stock price was indicative of questions in the market about its ability to continue to access short term capital markets and its need for an estimated USD 80 billion or so in additional capital because of the deterioration of its real estate securities.

Why did the government step in and rescue AIG?

In justifying their intervention with AIG, policy makers argued that they were concerned about systemic risk and the negative effects that a disorderly wind down of the institution would have on financial markets, both domestic and international. But the exact nature of the risks, how they would materialize or how they might affect the financial markets have yet to be clearly spelled out. In fact, the reasons given vary depending upon who is opining on the AIG case. For example, the following quotation from Chairman Bernanke (2009b) illustrates the broad view taken by the Fed and Treasury about the nature of the systemic risk posed by AIG without specifically making any attempt to define or flesh out the factors that might identify a systemically important institution: "In the case of AIG, the Federal Reserve and the Treasury judged that a disorderly failure would have severely threatened global financial stability and the performance of the US economy."

These comments do not mention the nature of AIG's business nor concerns about the interconnected aspects of its relationships. Rather they focus on the unspecified and amorphous likely costs of its demise. Chairman Bernanke (2009a) put a bit more flesh on his view of the concept: "In a crisis, the authorities have strong incentives to prevent the failure of a large, highly interconnected financial firm, because of the risks such a failure would pose to the financial system and the broader economy."

The implication is that the size of a firm and the nature of its business are important in identifying a systemically important institution. However, Vice Chairman Kohn (2009) quickly offered quite a different view in his testimony before the Senate Committee on Banking, Housing and Urban Affairs, in a verbal response to a question about systemic risk, how the Fed viewed AIG and why it intervened: "Let me be clear… Our actions were not aimed at AIG or its counterparties. Our actions were aimed at the US financial system and the knock-on effects of imposing losses on counterparties. Would those counterparties be willing to do business with other systemically important US institutions that might someday end up in the government's hands?"

This view states that the Fed acted because of the possible reactions of the counterparties of other unidentified US institutions that might be taken over by the government at some unspecified time in the future. This contradicts the rationale offered by Chairman Bernanke (2009b) in a subsequent speech on 14 April 2009:

> Many other serious consequences would have followed from a default by AIG: Insurance policyholders would have faced considerable uncertainty about the status of their policies; state and local governments, which had lent more than $10 billion to AIG, would have suffered losses; workers whose 401(k) plans had purchased $40 billion of insurance from AIG against the risk of loss would have seen that insurance disappear; and holders of AIG's substantial quantities of commercial paper would have also borne serious losses.
>
> Conceivably, its failure could have triggered a 1930s-style global financial and economic meltdown, with catastrophic implications for production, incomes, and jobs.

Finally in testimony before the House Financial Services in March, Treasury Secretary Geithner

[3] Federal Reserve and Treasury officials have repeatedly said that AIGFP was unregulated. See Kohn (2009) and Bernanke (2009c).

(2009) offered a somewhat different reason why the agencies made the decision to rescue AIG:

> Treasury, the Federal Reserve, and the Federal Reserve Bank of New York, acted to prevent the collapse of AIG. That action was based on a judgment, a collective judgment, that AIG's failure would have caused catastrophic damage, damage in the form of sharply lower equity prices and pension values, higher interest rates, and a broader loss of confidence in the world's major financial institutions. This would have intensified an already deepening global recession and we did not have the ability to contain that damage by other means. We did not have the authority to unwind AIG.

These descriptions of the rationale for AIG's rescue by the key parties involved expand significantly upon both the traditional concepts of systemic risk and the reasons for special treatment of banking organizations. The original reason for government regulation of banks and the provision of deposit insurance was to shortcut the adverse effects that information asymmetries and negative externalities might have on the payments system, which could also cause problems for the real economy. A massive conversion of deposit funds from banks into currency could spill over to healthy banks, become contagious and lead to a cumulative collapse of credit and the money supply.[4] The abrupt withdrawal of funds from healthy banks without sufficient access to short term liquidity to meet that demand could result in their collapse.

The concern about short term liquidity has also played an important role in the theoretical literature when a sudden shock to asset prices, like that experienced by US real estate, can cause a system wide liquidity crisis. This theoretical view helps in part to explain the initial interpretation of the US financial crisis as a problem of liquidity, because large banks were unable to continue to fund themselves in the short term asset backed commercial paper market as credit spreads widened and the decline in asset values triggered collateral calls. Essentially the same problem happened to AIG, which faced collateral calls on its credit default swaps and experienced difficulties in its securities lending program.

But viewing the current problems of financial institutions as a liquidity problem is looking at the short-term consequences of a much deeper problem. When counterparties begin to be concerned about repayment of even short-term borrowings, then this is, at root, a concern about solvency. This is a far cry from the short-term liquidity problems caused by traditional runs on banks. This happens when depositors suddenly show up at a bank's teller window demanding repayment of their par deposits. The institution may be solvent but simply has insufficient cash on hand to meet those withdrawal requests and lacks sufficient time to liquidate marketable assets to meet those demands. The justifications offered for intervention in AIG go beyond the traditional concerns about runs on banks.

Consider what typically happens when a bank fails and how that failure is resolved and its negative externalities averted. When a bank cannot meet its obligations or pay out its deposits in full, it goes into default, it is closed; insured depositors are paid the par value of their claims and losses are allocated among creditors and equity holders according to their priority in bankruptcy. The whole process, engineered by the FDIC, usually takes place over a weekend. In most instances the institution is re-opened on the following Monday, either having been acquired by another bank or as a temporary government-owned, newly chartered bridge bank. Insured depositors have access to the par value of the deposits, other uninsured creditors may have partial access to their funds and lending continues under near normal conditions.

When other US firms and European banks or European non-bank firms fail, the resolution process can typically can take months (Eisenbeis 2006). In the meanwhile creditors are denied access to their funds and services may be curtailed. Because of the importance of bank deposits as a medium of exchange, such delays were regarded as unacceptable and special bankruptcy provisions were enacted in the US enabling the institution to be closed by the primary chartering authority and the FDIC can begin the resolution process with the aim of opening the banks the next business day.[5]

The concerns about AIG, as expressed in these different policies, seems to include three main considerations: 1) the possible spillover effects related to the

[4] Diamond and Dybvig (1983) have built a model that describes when participating in a run and suspension of convertibility of deposits represent optimal depositor and bank behavior. See also Chari and Jagannanthan(1988), Chari(1989), Jacklin(1987), Jacklin and Bhattacharya(1988) and Wallace(1988).

[5] See Bliss and Kaufman (2006) for a comparison of bank and non-bank bankruptcy procedures.

unwinding of its derivative and credit default swap contracts, 2) the possible problems caused to AIG's insurance contract holders, and 3) a general and amorphous fear that its demise might cause a generalized, worldwide financial panic. None of these issues, except for perhaps the third, conform to the traditional concerns that specialized bankruptcy procedures were designed to remedy for banks.

What prevented US authorities from closing AIG?

Throughout the current crisis US officials have repeatedly complained that they lacked the necessary authority to windup institutions like Bear Stearns, Lehman Brothers and AIG in a prompt and efficient manner. To simply say that regulators needed to have the authority to put AIG into a bank-type insolvency and to resolve it the way banks are resolved is too simplistic when it comes to large multinational organizations like AIG or even large US or European multinational banks. The authority of a home-country authority to close the parent organization, such as AIG, really has limited reach because of the large number of foreign chartered affiliates and subsidiaries that a large, multinational firm may own.

In AIG's case, a good part of its problems emanated from the transactions that were originated in one way or another through a London office of a French-charted bank subsidiary of AIG's Finanical Products Group. Even if the Fed or Treasury, for example, could have closed AIG's parent holding company, this would not have permitted them to resolve many of the transactions that were at the root of AIG's problems. A sovereign authority cannot grant one of its agencies legal authority to close and resolve an entity chartered by another sovereign state. In the case of multination entities the resolution of such a failure can entail both agency problems and conflicts with other sovereigns and their regulators, each legitimately seeking to protect their citizens and claims. To suggest that US authorities could successfully deal with this issue, should one of its major banking institutions become insolvent, is not credible.

Failure and problems of institutional resolution

Many practical issues arise, should a large multinational financial institution experience financial difficulties and need to be resolved. The sheer size and complexity of modern multinational financial institutions clearly impacts the feasibility as well as efficiency of resolving insolvencies, where efficiency here means minimizing the costs to home and host country governments and customers. With different insolvency regimes applicable to affiliates and subsidiaries, even sorting out who would be responsible for what claims would be a daunting task, even if there was close co-operation and co-ordination among the responsible agencies. In general, however, cross border co-ordination and decision making would be extremely difficult, especially in the absence of explicit ex ante plans. Such firms are subject to multiple regulatory jurisdictions and regulators, as well as many different legal systems, which may even be in conflict with each other. In addition, the quality of host country monitoring and supervision may complicated, as it was in the case of AIG for the Office of Thrift Supervision (OTS) because of the need to co-ordinate with AIG's multiple regulatory authorities and because of the far-flung nature of its insurance and financial services activities. Furthermore, because the same claims might be treated differently by each responsible country, there might be incentives for individuals as well as the company experiencing financial distress to engage in intra company funds transfers that might delay the settlement and disposition of claims.

With the computerization of records and the centralization of operations, it is technically feasible to separate the operational and legal structures of an organization, so that the legal structure bears no relationship nor adequately captures the interdependence among subsidiaries and affiliates. Often both data and processing are located in home or multiple host countries to ensure 24/7 operations as markets open and close around the world. The fragmented nature of both an institution's organization and its information and operational structure will only increase the costs to regulators of gaining meaningful information on the cross-subsidiary linkages and the true nature and extent of its counterparty exposures.

Lack of information may also adversely affect the quality of both home and host country monitoring and supervision because regulators are generally less able to obtain useful financial information from domestically chartered, foreign-owned institutions than from domestically-owned institutions. In some instances, key management, records and processing capabilities may not even be located in any countries where financial affiliates or subsidiaries may be chartered. Thus, barriers posed by information costs, con-

straints on the ability of supervisors to assess the health of an institution and difficulties in identifying an institution's counter parties can pose considerable problems, especially when an institution's access to liquidity and funds may vanish quickly. For these reasons, timely resolution of a troubled entity may involve the co-operation and co-ordination of multiple regulators and chartering agencies across wide geographic areas and time zones, even when some of the legal-entities may appear to be sound according to their financial records. With such organizational structures the failure of an organization may make it impossible to rescue or keep open independently chartered subsidiaries and affiliates in the home countries where they are chartered in an effort to maintain key business relationships and provide customer access to services.

At the same time financial institution regulators naturally have a home-country bias and will likely respond to a problem in what they consider is the best interest of their country and its citizens (Bollard 2005). For these reasons, it is generally infeasible, as well as inefficient and costly to physically dispose of or liquidate large complex financial institutions when they are declared insolvent and closed legally.

In the case of AIG, its insurance activities were fragmented across many states and many different foreign countries, each with separate authorities, rules and regulations. This greatly complicated the OTS's consolidated supervisor responsibilities. Furthermore, these insurance subsidiaries were participating in a securities lending program, with the proceeds being invested in mortgage related securities through a non-banking subsidiary (AIGFP) using a subsidiary bank as a conduit.[6] The true risks to the insurance business lines could have only been assessed only by an entity with access to AIG's internal records on a consolidated basis.

A similar information problem existed, for example, for the bank supervisors of AIGs bank counterparties. Given that European banking supervision is left to the individual countries and is dependent upon co-ordination and co-operation, it is little wonder that we have not heard much about European banks broad exposure to AIG.

[6] In many instances, the individual state insurance regulators were empowered to restrict or reverse certain intra company transfers of funds and activities. For example, the state regulators were the ones that forced AIGFP to unwind AIG's securities lending program in an attempt to protect the reserves backing the insurance contracts in the state in which that insurance subsidiary was chartered.

Conclusions: actions to deal with financial difficulties in large financial institutions

A number of policy makers have made suggestions and recommendations to expedite the resolution of possible failures of large, systemically important institutions. Simply granting closure responsibility to a responsible agency, without either defining ex ante which institutions should be subject to a regime that does not address the complexity of the resolution process or that does not confront the legal difficulties in dealing with a multinational institution with perhaps hundreds of independently chartered affiliates and subsidiaries, fails to solve the problem. Moreover, it is not clear that appointing a systemic risk authority would be effective, especially given the potential conflicts that might arise when it comes to the independent conduct of monetary policy (Eisenbeis and Wall 1999). Consider, for example, the 2002–04 period. Would a systemic risk authority, if lodged with an agency outside the Fed, have forced the Fed to begin raising interest rates as housing was leading the US out of the recession? If the Fed had had the responsibility at that time would it have conducted policy differently? Formalizing systemic risk responsibility seems at best to simply be a substitute for avoiding the pursuit of destabilizing monetary and fiscal policies and lax financial institution supervision.

The following is a list of objectives and policies that should be the focus of regulatory reform efforts.

Regulatory initiatives not requiring legislation

1. Limit excessive leverage on the part of financial institutions by imposing a maximum leverage constraint – excessive leverage by financial institutions made them vulnerable to a decline in credit quality.
   a) Focus on capital that would be at risk and available to avoid losses – there are really only two types of liabilities in banks, for example, guaranteed liabilities and liabilities capable of absorbing losses.
   b) Abandon risk-based capital concepts. Regulators should not be involved in internal capital allocation decisions.

2. Focus supervisory efforts on the consolidated entity and look through legal affiliates and subsidiaries when assessing a firm's financial condition. If legal structure represents a potential res-

olution problem, then this should both be identified and be a focus of regulatory and supervisory co-ordination and co-operation.

3. Address the issue of organizational complexity: Charge complex institutions for the cost of supervision and examination to introduce a cost to complexity.

4. Seek to ensure that failures of financial firms are isolated events: Make an unwinding scenario part of the supervision of each large, complex financial institution.

Initiatives requiring legislative action

1. Consider restricting derivatives above the first degree.
   a) Complex instruments whose cash flows are dependent upon fund flows from other complex instruments serve little useful economic purpose relative to the risks.
   b) Consider restricting naked swaps.
   c) Put derivatives on exchanges structured like current futures exchanges.

2. For large, complex financial institutions focus international co-ordination and harmonization of supervision, regulation, deposit insurance coverage, and bankruptcy procedures.

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