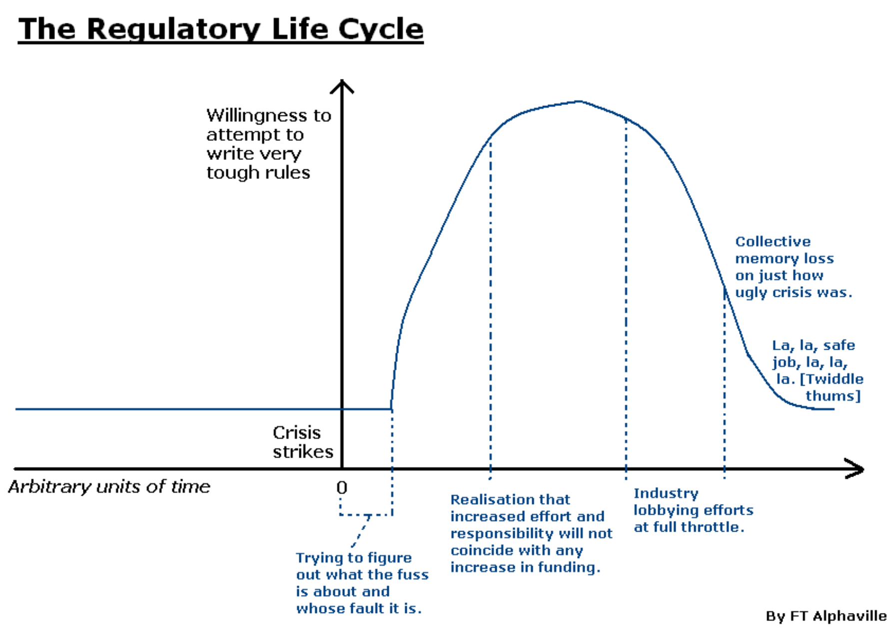
MetLife's Lawsuit Against the FSOC Could Lead to More Financial Crashes and More Massive Bailouts Like AIG's

The Financial Stability Oversight Council (FSOC) is the country's **only** early warning system for systemic threats posed to our financial system and economy from **nonbank** financial firms. It is also the **only** entity that stands between taxpayers and future bailouts of such nonbank firms. Before the 2008 crash, the insurance company AIG, the investment banks Bear Stearns, Lehman Brothers, Goldman Sachs, Morgan Stanley, and Merrill Lynch, the money market funds, and GE were all nonbank financial firms. They all played roles in causing the 2008 crash and, except for Lehman, all required massive government support and/or taxpayer backed bailouts. The FSOC was created to prevent nonbank financial firms like these from ever posing such risks to our financial system and to our taxpayers.

Yet just a few short years after the 2008 crash, the FSOC is under attack from the financial services industry. The financial services industry has launched this attack even though many industry participants called for the creation of just such an entity following the crash. How could this be? There are several answers to that question, but the writers of the *Financial Times* blog Alphaville showed one reason in just one chart: many in the financial industry hope that the more time passes and the farther away the 2008 financial crisis seems, the less important the need for financial reform will appear:



But the financial crisis cost the American people more than $20 trillion. For that reason, we cannot afford to let elected officials, policy makers and regulators forget the painful and costly lessons of 2008. The 2008 financial crisis was caused, in large part, by the mistaken belief that Wall Street's largest and most systemically significant firms — from global conglomerates like Citigroup to investment banks like Lehman Brothers to insurance companies like AIG — could regulate and police themselves.

It was AIG's surprise failure and its bailout seven years ago - which cost the government more than $182 billion - that demonstrated the need for and importance of the FSOC. The FSOC, established by the Dodd-Frank Wall Street reform law, is solely charged with identifying those systemically significant nonbank financial firms and activities that might otherwise escape oversight or regulation. In other words, the FSOC exists to help protect taxpayers from future AIGs and future bailouts.

Despite broad support for the creation of FSOC in the wake of the financial crisis — including from many in the financial services industry — systemically significant firms are now turning on this law, shown most notably through their opposition of the FSOC's recent designation of the gigantic global insurance company MetLife as a systemically significant nonbank.

To understand how we got here, the importance of the FSOC, and how a lawsuit by MetLife (discussed below) could put taxpayers back on the hook for more bailouts, we must first look back at a defining moment: AIG's failure and the government's taxpayer-supported rescue.

A Look Back at AIG's Failure

AIG was brought to the brink of bankruptcy by the activities of its London-based subsidiary AIG Financial Products, whose business model was based on selling credit-default swaps (really insurance policies against default) on subprime-mortgage-backed securities to financial institutions, many of which were buying this insurance to avoid holding greater capital against these assets. When times were good, AIG Financial Products generated enormous profits for its parent company: it collected premiums for insuring mortgage-backed securities and never had to pay out. It also never reserved a dime to cover any future potential losses on the CDS/insurance it had sold. But when times turned bad, AIG was called upon to post collateral against the credit-default swaps that its subsidiary had written.

The collateral calls became so great that the credit rating agencies downgraded AIG's triple-A credit rating, which triggered even more collateral calls, which pushed AIG into insolvency. Although it was one of the world's largest insurance companies, AIG was not subject to effective regulation or supervision. AIG's insurance business was subject to supervision by state insurance commissioners, none of which oversaw the London subsidiary. And while AIG's ownership of a thrift nominally subjected AIG to the supervision of the now-defunct Office of Thrift Supervision (OTS), in reality the OTS had no experience or expertise in regulating the complicated credit derivatives that AIG FP was selling.

The result was that AIG's riskiest business — a business that not only brought down one of the world's largest insurance companies but also nearly brought down the entire global financial system — was effectively unsupervised and unregulated. In former Fed Chairman Ben Bernanke's words, "There was no oversight of the Financial Products division. This was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets—took huge losses."

Because no regulator was charged with monitoring the risk that AIG posed to the global economy, AIG's failure crashed into the country's consciousness as a total surprise. No one saw the disaster coming because no one was charged with watching.

On September 16, 2008 – a day after the government let Lehman Brothers fail - the Federal Reserve exercised its authority under Section 13(3) of the Federal Reserve Act to extend an $85 billion loan to the insurance conglomerate, an amount that was vastly insufficient. However, no one knew that at the time. In fact, no one at AIG knew how much it might owe on the insurance it had sold. Although the bailout eventually reached $182 billion, during the early days of the crisis AIG liabilities were a bottomless pit. Chairman Bernanke justified the bailout of AIG, saying, “We had no choice but to try to stabilize the system because of the implications that the failure would have had for the broad economic system.”

Yet the bailout of AIG was not about saving AIG so much as it was bailing out the creditors and counterparties of its London subsidiary — large U.S. financial institutions, such as Goldman Sachs and Merrill Lynch, and foreign banks, like Deutsche Bank and BNP Paribas. The Federal Reserve’s bailout of AIG kept it from crashing into bankruptcy, and paid these counterparties off 100 cents on the dollar, all in the name of preserving financial stability.

Weak to non-existent regulatory oversight allowed AIG to effectively operate as a hedge fund in the dark, outside the view of anyone. As a result, AIG not only helped bring about the 2008 financial crisis, its failure and the threat it posed to the financial system proved to be a huge and total surprise.

Moreover, paying off AIG’s creditors in full sent a dangerous signal to financial markets, as Princeton University economist and former Federal Reserve Vice Chairman Alan Blinder pointed out:

> “[T]he most serious economic issue posed by the AIG bailout was probably the decision to pay off AIG’s creditors one hundred cents on the dollar, rather than impose any losses on them. . . . [W]hen creditors who lent to, and counterparties who dealt with, AIG without bothering to worry about its creditworthiness are bailed out 100 percent, the government is inviting creditors and counterparties of other companies to assume the same.”

Like Professor Blinder, the noted economist Willem Buiter pointed out that the key problem with the AIG bailout was the message it sent to market participants that the government would be willing to bail them out no matter how reckless their decisions:

> “I am deeply worried that other people may, as a result of this, be willing to do business with other U.S. financial institutions on the same ludicrous terms that brought us the current crisis. And, why wouldn’t they be happy and relaxed about once again taking wild and crazy bets? They now know that, should their bets fail, in a crisis like this, there is some sucker-institution in Washington DC that will make sure that they don’t have to take some losses.”

(Remarkably, those very real concerns are actually compounded because adding to the injury of the $182 billion bailout is the insult of the pending lawsuit by AIG’s former CEO against the government. That lawsuit claims that the government owes AIG’s shareholders $40 billion more in so-called “damages” allegedly because the $182 billion bailout was insufficient.)

The Creation of FSOC and its Designation of MetLife

Congress and President Obama helped take the government and taxpayers off the hook for bailing out future AIGs by enacting the Dodd-Frank Wall Street reform law, which charged one entity, the FSOC, with identifying systemically significant nonbank financial firms and activities that might otherwise escape oversight or regulation. Many in the industry supported the creation of an entity like the FSOC, including the Financial Services Forum, the American Bankers Association, the Securities Industry and Financial Markets Association, and the Investment Company Institute.

After it conducts an exhaustive analysis as required by the law, if the FSOC determines that a nonbank financial institution poses a possible systemic risk, the FSOC designates that nonbank for enhanced supervision and regulation by the Federal Reserve. To date, the FSOC has designated only four nonbanks since 2010, which highlights just how deliberate it has been in exercising this responsibility.

One of those designations was of MetLife, a global insurance company that operates in more than 60 countries. MetLife's designation came only after the FSOC had analyzed MetLife for more than 17 months, reviewed tens of thousands of documents provided by MetLife, repeatedly met with company leaders, and granted MetLife a full hearing to make its case.

In its 341-page explanation, the FSOC detailed that MetLife, "has higher total financial leverage and more total debt and operating debt than most of its peer life insurance organizations." The FSOC also noted that MetLife engages in a variety of complex, high-risk financial activities — including funding-agreement backed securities, commercial paper issuance and securities lending activities — and that MetLife's financial distress could create liquidity problems for the company, which could then be transmitted throughout the wider financial system.

Despite the FSOC's thorough and fair process, MetLife has sued to try to get a court to overrule the FSOC's decision and avoid systemic regulation. MetLife's allies have used this lawsuit as a means to relentlessly attack the FSOC, ignoring the compelling reasons that support the FSOC's designation and its deliberative process.

Why This Matters Today

MetLife and its industry allies are hoping that the public and leaders in Washington have forgotten about the huge surprise that AIG's failure was seven years ago. Without warning, AIG's sudden failure posed a lethal threat to the financial system, and it took hundreds of billions of dollars to prevent AIG's failure from precipitating a second Great Depression.

If MetLife's lawsuit succeeds in crippling the FSOC's mission or authority, then once again no one will be responsible for reviewing and analyzing the threats posed by systemically significant nonbank financial institutions. These serious threats to the U.S. financial system will go unregulated, just as they did in the years before the 2008 financial crisis. Limiting the FSOC's authority to identify these risks would put taxpayers back on the hook for future AIGs and other unexpected threats to our financial system, lead to more bailouts and increase the odds of another catastrophic financial crash. Rolling back the FSOC's authority and returning to the world as it was before the crisis would be a gross disservice to the American people, many of whom are still suffering from the economic wreckage caused by the last crash.