AIG ruling highlights 'too big to fail' opaqueness

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On Sep. 29, the Financial Stability Oversight Council announced it was taking the insurance giant AIG off the list of companies it deems systemically important. Although reducing the number of companies deemed systemically important is good, it fails to fix the underlying problem: the fact that the government has a list at all.

The process for making and revising this list remains unclear, leaving companies, the markets and the public with little insight into what is driving the FSOC's decisions.

The FSOC is a super-regulator, chaired by the secretary of the Treasury and made up of the heads of the other federal financial regulators. Its members include the chair of the Federal Reserve Board, the director of the Consumer Financial Protection Bureau, the chair of the Securities and Exchange Commission and other heads of agencies.

Given the number of financial regulators we have, it makes sense to have a forum for them to share information about their particular areas of oversight. But FSOC is more than just a coffee klatch for regulators.

Before the 2008 financial crisis, many financial companies believed that if they were to take on too much risk and get in trouble, the federal government would bail them out. This belief wasn't unreasonable. In fact, the federal government had done just that many times before. And when the 2008 crisis hit, the government did it again.

Although these companies believed they'd get a bail-out, and although most of them were right, the promise of help from the government was never explicit, until Dodd-Frank and the FSOC came along.

Dodd-Frank gave this council the authority to designate certain financial institutions as "systemically important." Any company designated will then be subject to heightened oversight by the Federal Reserve.

The idea is that by giving the Fed the power to impose stricter requirements on these companies, they would be less likely to fail and therefore less likely to impose any ripple effects on the rest of the economy.

The problem is that it would be politically very difficult for the government to refuse a bail-out to a company it has already explicitly named "systemically important." What was purely an implicit guarantee has become, through the designation process, explicit.

Not only does this mean that the government is putting taxpayers on the hook for future bailouts, it also means that the government is in the business of managing these companies' risk.

If the government were uniquely good at this, if it had special insight into the right levels of risk and into what were good bets and what bets would go bad, it might make sense for it to take on this role.

But there is no reason to believe that the government is any better at making these assessments than the people managing the financial institutions themselves. The government, after all, has not predicted any of the last eight financial crises.

The de-designation of AIG tells the market that the government no longer thinks the company is systemically important. But so far, there has been limited explanation of why. It seems size has something to do with it, but FSOC has also insisted that size alone is not the sole criterion.

Fed Chair Janet Yellen did provide some insight into why she changed her vote (mostly AIG's reduced size), but the process overall remains opaque.

This highlights another problem with FSOC designations (and de-designation), which is that the process has been a black box. Another insurer, MetLife, has had its designation put on hold following a ruling by a federal court that the FSOC failed to follow its own rules in labeling MetLife systemically important.

Overall, FSOC has been explicitly tight-lipped about what makes a company eligible for the "systemically important" label, or its removal. It is true that there may be some proprietary company information that shouldn't be shared publicly, but that does not mean that FSOC itself cannot more fully share its own analysis and conclusions.

To the extent that there is such a thing as a systemically-important designation, it seems the goal should be to give companies as much information as possible to assist them in determining whether they want to take steps to avoid designation.

Not only does the secrecy make it difficult for a company to avoid designation, but it also risks public anxiety when a company like AIG, whose difficulties were central to many debates over the 2008 crisis and subsequent bailouts, is de-designated.

Worse, it could fuel speculation that the decision to designate or de-designate a company is fueled only by political winds.

It's bad enough that the government now sets itself up for future bailouts by handing out "too big to fail" labels. It at least owes the country an explanation for how it decides who gets those labels and how it decides when to take them back.

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