Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Kieran J. Fallon[1] Former Associate General Counsel, Board of Governors, US Federal Reserve System, 2005-2011
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Introduction:

The Yale Program on Financial Stability (YPFS) contacted Kieran Fallon to request an interview regarding Fallon's experience as Associate General Counsel for legislation and special projects at the U.S. Federal Reserve Board of Governors.[2] Currently Senior Deputy General Counsel for regulation and government affairs at The PNC Financial Services Group, Fallon joined the legal division of the Federal Reserve in 1995, where he earned several promotions and served until 2011. Prior to the Fed, Fallon served as associate in the financial practices group of the Washington office of Morrison and Foerster.

Among numerous initiatives Fallon worked on during his 16-year tenure at the Fed were the Community Reinvestment Act "sunshine" rule of 2001, the formulation of Regulation R in 2007 creating the SEC-Fed framework for implementing the Gramm-Leach-Bliley Act, the Commercial Paper Funding Facility of 2008, the restructuring of the American International Group following the Federal Government's bailout and the implementation of the Dodd-Frank Act. Fallon also served as General Counsel for the Financial Stability Oversight Board, one of the TARP oversight bodies, from 2008 to 2011. Fallon earned his J.D. from New York University Law School with high honors and his bachelor's degree from the Georgetown University School of Foreign Service with highest honors.

This transcript of a telephone interview has been edited for accuracy and clarity.

Transcript:

YPFS: **Thinking back now to the Global Financial Crisis period of 2007-08 and maybe 2009, how did you and your colleagues in the Fed Counsel's office first become aware of the crisis - that there was a crisis?**

[1] The opinions expressed during this interview are those of Mr. Fallon, and not those any of the institutions for which the interview subject is affiliated.
[2] A stylized summary of the key observations and insights gleamed from this interview with Mr. Fallon is available in the Yale Program on Financial Stability's *Journal of Financial Crises*.

Fallon: It was a slow-building thing, that began in 2007. But it's important to give some perspective here. I worked in the Legal Division. One of the things that I really loved and appreciated was the ability to work with a wide variety of colleagues, from regulators, economists, regional bank officials to market surveillance and traders on the market desk, who brought a wide range of different professional perspectives and skillsets that collectively made for a sort of broad vision.

In 2007 signs of stress emerged, in the spring. New Century Financial, a mortgage originator, was one prominent case that collapsed and filed for bankruptcy in April. There were signs of mounting problems in the sub-prime and Alt-A mortgages. In mid-June 2007, certain private funds of Bear Stearns ran into trouble, a key event we were aware of even though investment banks such as Bear were not regulated by the Federal Reserve. In March 2008, the situation intensified with Bear Stearns.

YPFS: With Bear Stearns, Lehman and AIG so widely documented, can you discuss the prior set of failures in 2007, the large institutions closer to the retail, consumer side. Wasn't WaMu one of these?

Fallon: Yes, Washington Mutual, known as WaMu, as well as Countrywide and IndyMac were all such cases. They were under the regulatory scope of OTS, the Office of Thrift Supervision. The OTS did not have a robust regulatory framework. There were no consolidated capital requirements or liquidity requirements for savings and loans holding companies. In a sense, the OTS was more of a promoter of the industry than a capable independent supervisory authority. In fact, the OTS was so weak and poorly structured that it was the one agency that was consolidated out of existence in the post-crisis reforms.

YPFS: The Commercial Paper Funding Facility (CPFF) of the Fed, which you helped implement, when commercial paper (CP) markets froze up, was that a signal moment of a different magnitude, was that in March of 2008?

Fallon: No, the design of the CPFF came later, not in March, but in September. In March spreads were getting higher. The point you refer to came in September.

YPFS: Right, thank you for clarifying. According to Yale researchers, the CPFF "was regarded by many Fed staffers as the program that most pushed the envelope of the Federal Reserve Act ... this was intensely debated." Who in the Fed was concerned and why?

Fallon: I think you're right about that. There are a couple of points. First, it's crucial at the Fed that all of our programs have to be self-standing. The Federal Reserve Act, if I can recall the exact language says, that "the Federal Reserve Banks can only lend to nonbanks if such loans are adequately secured" – no, it's "can only lend provided such loans are secured to the satisfaction of the Reserve Bank." While that may sound open, it's serious because the Fed has not lost a penny on its lending. And we did not want to be the first.

Second, from these concerns, the CPFF was structured with a number of features aimed at ensuring adequate security. Four features, specifically, were: One, it set up a Special Purpose Vehicle (SPV), so that the Fed lending was made from the New York Federal Reserve Bank (FRB) to the SPV, which took on the security risk of the underlying CP collateral.

YPFS: OK, but the risk still existed, right? The SPV still was holding the risk of the underlying CP asset, right?

Fallon: Correct, in the event that any one of the issuers would prove unable to repay, the SPV took on that risk. To account for that risk, additional features of the CPFF included that: Two, issuers had to pay a guarantee fee to participate, enabling the SPV to build up a cash fund to cover potential losses; Three, participation was limited to highly rated issuers, to corporations with relatively high credit quality; also lastly, interest earned on the CP was an additional source of funding for the cash reserve.

YPFS: In the current COVID-19 response, the Fed has again initiated a CPFF, based on your 2008 program but, if I understand correctly, in the current case backed by billions in capital provided by the US Treasury.

Fallon: That is correct. The current CP funding facility has a Treasury backstop that allows it a greater scale and impact, to a wider set of counterparties. As an example, the Fed's Main Street Lending has five lines and can offer longer term loans to a wider set of entities. The greater flexibility and range of the current Fed programs is possible because of the Treasury backstop; billions of support for the Fed's programs have been provided via the Treasury's Exchange Stabilization Fund (ESF) and the CARES Act. In case of losses in the current case, the Fed has this additional line.

In the circumstances in September 2008, however, we had to act to fashion a program *without* fiscal backing. The TARP (Troubled Asset Relief Program) had not been passed. The TARP, in the Emergency Economic Stabilization Act of 2008 (EESA), passed on October 3rd. The CPFF launched on October 7th. At the time the Exchange Stabilization Fund had been dedicated to supporting the money market industry.

YPFS: **Should we see the 2008 CPFF as a one-off that was useful for the moment then or as a policy model distinct from a US Treasury-backed fund?**

Fallon: The 2008 CPFF model could be relevant in other cases of significant stress. These aren't programs to be run out lightly. In cases of serious disruption and crisis, the Fed could do it with or without Treasury backing. It's easier with Treasury backing.

YPFS: **Looking back at the crisis response, with your extensive experience at the Federal Reserve and in private practice now nearly a decade later, what if any decisions or actions are you, Kieran J. Fallon, most proud of?**

Fallon: It's hard to say really what I would be most proud of personally because there are so many decisions and so many interactions.

I think what I am most proud of is the willingness of our principals - Bernanke, Paulson, and Geithner - to make tough decisions. We were blessed to have Ben Bernanke as Chair of the Federal Reserve Board at the time - someone with the greatest knowledge of financial crises and central bank intervention. Having Hank Paulson willing to advocate with Congress and the Administration for unpopular decisions - for actions that would not normally have been acceptable - made a major difference.

Also, the staff at the Federal Reserve and the Treasury were remarkable – the brightest, most dedicated people I've ever worked with. It was day in and day out for weeks and months. We had a saying then, "Thank God it's Friday - only two more working days until Monday."

YPFS: **Looking back in terms of your institution, are there any decisions or actions that you wished the Fed had handled differently?**

Fallon: No. We were working with imperfect information. Some of our interventions worked better than others. We weren't sure which would work, so we tried a variety of actions.

Public communication is an area in retrospect that could have been handled better. Central banks act behind the scenes. They are a bank to banks, without any direct business with members of the public, working in a technical, esoteric sort of area. So public communication has not been a natural sort of function or one the Fed had focused on as much as it might have. This is a concern in retrospect because of the public anger about Wall Street.

YPFS: **About Lehman Brothers, recognizing the counterfactual angle as well as the problem of the government's capabilities at the time, still, should the Fed and/or other US entities have found a way to rescue Lehman?**

Fallon: It's a tough question.

What is clear, I think, is that we underestimated the market reaction to Lehman Brothers' failure. Lehman had been on our problem list since 2008, with liquidity drying out, counterparties drawing away. There was M&A activity but takeovers of Lehman did not pan out. This was all in the public market view. We thought that markets had seen enough to sense the likelihood of Lehman going down. We knew it would be a shock but the severity of the shock surprised us.

But, on the other hand, Lehman failed before TARP passed. Therefore the legal and policy judgement calls we had to make in launching the CPFF were greatly magnified with the Lehman case.

It was unclear that a loan would have been sufficient to stabilize Lehman and that there were sufficient assets to secure a loan consistent with FRA section 13(3) standards. Some say that 13(3) authority is infinitely malleable, but in fact there are limits.

On the contrary, Lehman really was a solvency problem, a problem of equity, not a liquidity problem.

YPFS: **From your experience coordinating crisis response, can you describe the interactions between the Fed, White House and Congress? In what ways were the interactions similar to or different from noncrisis mode business?**

Fallon: In crisis mode we went into hyperdrive. There were regular ongoing contacts between the principals. Whereas in normal times the Chairman of the Board of Governors will hold regular monthly meetings with the Treasury Secretary, they were having daily conversations during the crisis.

On our side, Don Kohn and Kevin Warsh were immensely valuable in ensuring strong working relationships throughout the crisis with Secretary Paulson and Geithner at the New York Fed. They and Bernanke were at the center of regular frequent contacts with Congressional leaders.

YPFS: **In sum, regarding crisis response, what do you consider the main lessons learned from 2007-2008?**

Fallon: There are a couple of points. First, coordination is key. There are a lot of regulatory agencies. The US has one of the most fragmented regulatory systems -- the Fed, the FDIC, the Office of Thrift Supervision (OTS), the Consumer Financial Protection Bureau (CFPB), the Commodity Futures Trading Commission (CFTC), then the Securities and Exchange Commission (SEC). Coordination becomes especially key at times of stress.

Today's COVID-19 situation shows the importance of coordination. I would distinguish the public health crisis from the policy response to the economic shock. On the economic policy, coordination between the Fed and the Treasury and Congress have enabled a robust fiscal and monetary policy response, at least initially, while the public health agencies response to the pandemic has been disjointed and not as effective.

YPFS: Regarding public communication, is there a lesson from 2007-08 for the Fed about having a more proactive and effective public-facing posture?

Fallon: Yes. And the Fed has taken a number of steps in managing its communication. For example, the Chairman now has regular press briefings following FOMC meetings and the Fed has released a wide variety of information regarding its new lending programs.

Also, another lesson, don't be afraid to take big actions. Paulson said he needed TARP because he needed a bazooka. He actually said it regarding Fannie or Freddie conservatorship. It was the same idea … half measures are worse than not taking an action … if markets see central bank actions as not big enough, they can easily backfire and cause more damage. On the other hand, some programs had less take-up than we had anticipated. But the mere fact that the program was announced had a calming effect.

YPFS: So it's really the psychological effect of the intervention that counts. Can you give an example of this dynamic?

Fallon: One program that was effective in this way was the Asset-Backed Commercial Paper Liquidity Facility (AMLF) …. Also, with the Term Asset Backed Liquidity Facility (TALF) and money market liquidity facility (MMIFF) we were prepared to make more loans than we made. But there was an announcement effect instead that stabilized the markets.

YPFS: Having worked on financial market reform before and after the crisis,what is the relationship between crisis management and financial reform?

Fallon: There is a natural effect, with one following the other. But it's most important to focus on real causes that created the crisis. I think back on Dodd-Frank. A couple of causes were essential:

1. Capital and liquidity levels were far too low. The quality and quantity of capital needed to be improved. Liquidity needed to be made more robust within the banking system…. Key reforms that are out include the heightened capital and liquidity requirements required by Dodd-Frank for the largest banking organizations.

2. Also, there was a need for better information. When we at the Fed were trying to understand what was going on, we did not have supervisory authority over investment banks - Merrill Lynch, Morgan Stanley, Bear Stearns, Lehman Brothers - so the type and quality of information we were able to get was quite limited.

   After the crisis, investment banks became bank holding companies, for two reasons really: firstly, to make the markets more comfortable with them; and secondly, because of the M&A activity, the weaker players got purchased.

   Having real-time actionable information is important.

   When policymakers consider financial reform after a crisis, it's important to seek to avoid simply assuming the last crisis will be exactly like the next crisis. If you try to solve the last crisis with your reforms, you can create other problems or leave gaps. No two crises are ever exactly the same.

YPFS: How did the crisis experience affect the politics of financial market reform?

Fallon: There was a broad consensus after the crisis, at first.

Ultimately, however, before Dodd-Frank became law, the Republicans decided that they would oppose the overall law. It became clear the bill would need to be passed *without* Republican support.

This meant that we needed to rely exclusively on Democratic votes. The practical consequence was that it gave enormous leverage to individual Democratic Members of Congress, particularly in the Senate, to negotiate on behalf of planks motivated to aid their electoral campaigns or other pet issues that degraded the reform.

YPFS: **What were examples of such detrimental amendments to Dodd-Frank?**

Fallon: Blanche Lincoln, Senator from Arkansas who was in a tough reelection campaign, pushed the Lincoln amendment, also known as the "swap push-out rule." This would have required swaps to be pushed out of of banks. It was popularly argued that this would "Get banks out of casino derivatives trading." Swaps, however, are a key bank activity.

The Lincoln amendment's provision would have been enormously disruptive and a step backwards away from a sounder system. Note, one of the goals of financial reform was to make the system less complex. The Lincoln amendment threatened to make regulators and markets unable to ID where risks were residing and how they were being managed. It would have made the system even *more* complex.

Ultimately after a few years, the agencies used their authority in the law to delay implementation of the Lincoln amendment, and Congress decided that the rule didn't make sense. But the Democrats needed Lincoln's vote to pass Dodd-Frank.

Same thing in my mind with the Volcker Rule. The Volcker Rule was a solution in search of a problem. I dare you to find a single Great Recession post-mortem containing any account of bank proprietary trading as a problem precipitating the crisis. Instead, the Volcker Rule resulted in an entire regulatory monster, best known for its million exceptions.

But the Volcker Rule came in late, a pet cause of a Senator Merkley from Oregon, so Dodd was forced to take it to get his vote.

YPFS: **But wasn't the idea of the Volcker Rule that Wall Street banks' trading fueled the demand for junk Collateralized Loan Obligations (CLOs) and Collateralized Mortgage Obligations (CMOs) that blew the system up?**

Fallon: The Volcker Rule was designed to prohibit short-term proprietary trading. But proprietary trading is a normal activity of a market maker. The CLO and subprime positions that these institutions were taking weren't in their proprietary trading, they were in their investment book.

YPFS: **Overall, how do you evaluate the effectiveness of the post-crisis financial reforms, including but not limited to Dodd-Frank and the Volcker Rule?**

Fallon: Overall the changes made by Dodd Frank have had a number of salutary effects on the financial system:

1. Capital levels (before the crisis) were too low. Capital levels today are multiples of what they were before the crisis. For example, going into the financial crisis, Tier 1 capital was 4% including one half or 2.1% in common equity, whereas today common equity Tier 1 ranges from 9% to 13% at the largest banking organizations.
2. Establishment of Title II, the orderly liquidation authority, gives regulators a fighting chance to wind down a systemically important institution.
3. It has brought improvements in the regulation of the derivatives market, as institutions have moved to centralized clearing of swaps.
4. It has brought improvements on the consumer side. Having a single agency dealing with consumer financial issues makes sense, while I might not applaud every regulation that the CPFB has come forward with.

YPFS: **Derivatives were such a concern but today see far less coverage. Did the law achieve the central clearinghouse by fiat or by promoting financial sector coordination more indirectly?**

Fallon: Title VII of Dodd-Frank, which principally affects derivatives, requires market participants to standardize derivatives for central clearing; it established rules governing initial margins. Title VIII enhanced the regulatory framework for large clearing agencies such as the CBOE; it requires risk management practices at levels that would permit them to deal with the failure of a significant institution.

YPFS: **What current areas of the financial activity do you see as presenting potential vulnerabilities for the system?**

Fallon: Dodd-Frank has moved activities from the regulated sector to the nonbank area. Nonbank financial companies holding CLOs are a potential concern. Private equity funds are a significant player in leveraged loans. Their activity has fed an increase in the riskiest loans by nonbank players. Hedge funds are major players in certain financial markets, such as Treasuries, in risky ways.

Recently the Fed had to step into the Treasury market in part due to the activity by hedge funds. Even though Treasuries are risk-free assets, hedge funds are large players in Treasury basis trades. When the market got disrupted in early 2020 due to the pandemic, many hedge funds sought to exit these trades. The Fed had to intervene in the market.

The nonbank activity of the hedge funds and the recent Fed intervention create a certain moral hazard. Normally, we think of moral hazard in the regulated space, but here the Fed had to intervene in the nonregulated space, perceiving it necessary to effectively bail out this risky activity by the hedge funds.

YPFS: **Do regulators know how large the scale and scope of the nonbank market is or is there a significant kind opacity here?**

Fallon: The opacity is real. Regulators can see the flows, not in full view but enough to see that the scale of activity is significant. Look in the mortgage space, nonbank firms now have a majority share in the origination of residential mortgages?

One effect of the regulations has been that during the pandemic, regarding forbearance allowances, there has been concern that nonbank originators would not be able to survive. When a mortgage is pulled into a securitization and the borrower goes into forbearance, the servicer is obliged to continue to make payments even if the borrower stops payment.

YPFS: **What agency made the forbearance regulations?**

Fallon. The FHFA, the Federal Housing Finance Agency, for federally backed mortgages. Ultimately in this case, the servicers in question have been able to pay, but there's a vulnerability here, particularly with the COVID-19 stress continuing.
Throughout this period of the pandemic, by contrast, very few have been raising questions about the strength of the regulated banking sector.

YPFS: **So we had a shadow banking problem before the crisis, lots of reform, and now shadow banking all over again. Please explain - how does this happen?**

Fallon: Look at New Century Financial. They failed early on. When Dodd Frank came along, the banks were still standing, so they got the focus of regulation.

The CFPB has been a benefit for all consumers and provided a kind of check, but only in certain areas. Their rules apply to all sorts of financial entities. It has the ability to examine large mortgage companies, but only for compliance with specific consumer safety standards, not for capital requirements.

No one goes in with supervisory authority to find out the amount of their capital and the quality of their loans.

YPFS: **With no systematic way to read the scale and scope of the nonbank activity - just inside accounts and anecdotes - how do regulators and market participants know if this is a serious vulnerability or not?**

Fallon: That's a big question.

YPFS: **Considering the COVID-19 crisis, and the US economic policy response, are there lessons from the Global Financial Crisis that you would apply?**

Fallon: I will distinguish the public health response from the economic response. I have been surprised and pleased by the US response on the economic policies.

The coordination among the Fed, the executive and legislative branch leaders that were willing to move together is notable. They had the templates from the last crisis, in the CPFF, the Primary Dealer Credit Facility, etc. The US government writ large acted as one, with the CARES Act, to provide flexibility for the Treasury to aid in lending, to provide a loss backstop.

The coordination was strong initially. The second round is now hung up because of the partisan divide. To some extent, it is a replay of 2009. There was at first broad support across party lines to act in a certain way. Then by the time we got to a second stage, the divisions reemerged.

YPFS: **Is this another lesson, then, that financial crises lead to a first response of effective coordination, then a second phase marked by political division?**

Fallon: Perhaps.

YPFS: **You said "this is a different crisis (from 2008), but we're using the same policy intervention template." Is this a concern - what do you make of this?**

Fallon: I do worry about this - that there's a sense that everything can be solved by the Federal Reserve. For example, there is a state and local emergency facility (Municipal Liquidity Facility); you have the Main Street Lending Program, etc.

The risk is this: The Fed is a central bank; its job is to provide liquidity, but there is a big difference between liquidity and fiscal support. The difference can get fuzzy at the margin, but at some point, there are entities, troubled enterprises with a lack of revenue.

It doesn't aid troubled entities to take on more debt because they will never get on top of it. Even when business resumes, they may limp along, but many will not be able to properly recover and be able to service their debt.

At some point these troubled firms need fiscal support. The Fed will do its best, but at some point there is going to be losses.

YPFS: **When you said Fed lending won't suffice, I thought of the "zombie firms" argument for tapering monetary relief. But *fiscal support* is a step we haven't heard called for nearly as much. What does fiscal support mean?**

Fallon: To some extent it's like the PPP. Give people money. This will make recovery more sustained and widespread.

YPFS: **Considering PPP, the COVID-19 pandemic response has revealed major gaps in US capacities to support businesses and individuals. In your view, how should policymakers act to deal with these gaps?**

Fallon: There will be cases of fraud but at the end of the day, the PPP helped thousands and millions of people stay afloat during the sudden crunch. I can tell you firsthand from our business. Despite zero lead-time and planning for the rollout, the SBA processed more small business loans in one month than it had over a decade.

YPFS: **Looking ahead to recovery scenarios, do you think the various lending and grant programs the US has put in place thus far will prove sufficient to avoid a depression - or will it take more?**

Fallon: I'm convinced it will take more - fiscal stimulus. You can see that GDP is being impacted pretty massively. It's already down 10%. That's a drop on par with the Great Recession. The initial fiscal stimulus has helped limit that drop, but now it's running out.

Forbearance has solved the problem (of mortgage payments and defaults) up to today, but it cannot run on forever. The risk is that in coming months / later in 2020, you'll see a spike in delinquencies. And it's hitting low-income, minority communities much more heavily. Those with lower skill jobs can't work from home; they have less wealth, they depend on the paycheck for essential needs.

YPFS: **What was the program of the forbearances - was that a US policy or a financial sector initiative?**

Fallon: It was both public and private. Under the CARES Act, forbearances were expanded in a couple of ways. First, bank-issued mortgages backed by federal agency, or a government sponsored enterprise provided a forbearance option up to six months. Second, any federally-backed commercial mortgage automatically qualified for 3 months of forbearance.

This was crucial, but it's still just a temporary solution. At some point, people need to start paying. If not, there will be waves of defaults.

YPFS: **Kevin Warsh, your former Fed colleague, recently distinguished fiscal stimulus from income support. Stimulus aims to regenerate activity and jobs, whereas US grants that substitute for work people are not doing is really *income support.* What do you make of that distinction?**

Fallon: Well, that is interesting. It is telling that Kevin, a very conservative Republican, is even considering the policy option of income support at this stage. Because there is the concern that Republicans tend to have, that such measures generate pressure to perpetuate them and should therefore be clearly curtailed.

Kevin Warsh was remarkable. He was one of the Fed's key liaisons with markets and other key people in the Administration. He was a core part of the team that worked together across government agencies and branches to come up with a coordinated US response to the crisis.

YPFS: **Thank you for sharing your time and insights so generously. Is there any further comment you'd like to add?**

Fallon: Yes, one point, thank you. Perhaps it will sound like an apologist's view, recognizing my role at PNC, still it is important to point out that banks came out of the financial crisis with a really bad reputation. But banks turned out to be stronger than the other financial segments.

The banks were the ones standing when others weren't strong enough. You had every other piece of the system collapse: nonbanks in 2007; the investment banks in 2008; Fannie Mae and Freddie Mac in September; AIG in September.

So, it's not surprising that banks were weakened. That's one aspect. There were bad decisions on all sides. Does that statement mean there was recklessness in equal measure in each segment of the financial system? All large banks made it through. But not thrifts - their portfolios were filled with subprime mortgages. The investment banking sector was mixed, with the major failures as well as some that were stronger. But the commercial banking sector was the last piece standing.

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