Journal of Financial Crises

Volume 4 | Issue 2

2022

Lessons Learned: Scott G. Alvarez, Esq., Part 2

Steven Kelly
Yale Program on Financial Stability

Recommended Citation

Kelly, Steven (2022) "Lessons Learned: Scott G. Alvarez, Esq., Part 2," *Journal of Financial Crises*: Vol. 4 : Iss. 2, 2022-2026.
Available at: https://elischolar.library.yale.edu/journal-of-financial-crises/vol4/iss2/90

Yale Program on Financial Stability Lessons Learned

Scott G. Alvarez, Esq., Part 2

By Steven Kelly

Scott G. Alvarez was general counsel of the Federal Reserve Board during the Global Financial Crisis (GFC). He met with the Yale Program on Financial Stability (YPFS) to discuss a litany of legal aspects related to the Fed's interventions under its emergency liquidity provision authority under Section 13(3) of the Federal Reserve Act. We summarize some highlights from our April 2022 interview with Mr. Alvarez below; the full transcript of this interview is available here. The transcript of an earlier Lessons Learned interview with Mr. Alvarez, conducted in 2018, can be accessed here.

The genesis and design of each Section 13(3) facility tends to be a very cooperative process between the Federal Reserve Banks and the Board. The individual Reserve Banks are essential for operationalizing emergency lending facilities.

Alvarez emphasized how organic and cooperative the process for developing an emergency lending facility was across the Federal Reserve System during the GFC. While Section 13(3) implementation involves the regional Reserve Bank(s) running the program(s), being satisfactorily secured, recommending the interest rates, and more, the Board played a very direct role in the analysis and design of such facilities before ultimately authorizing them. It began with monitoring market and economic developments, a collaborative and ongoing effort between Reserve Banks and Board staff.

> What would usually happen was . . . for the broad-based facilities, we were watching the markets, watching what was going on; economists at the Board and economists at the Reserve Banks were paying attention to that on a moment-by-moment basis.

As unusual developments were identified, Alvarez recalled, the Board focused on the issue and assigned a team composed of Board staff and Reserve Bank staff to assess the need for an emergency facility and possibly design the terms:

> And so, when it looked like there was a market that was becoming illiquid, jamming up, freezing for one reason or another, the interest rates were getting out of whack or the transactions were becoming just too few, generally what would happen was somebody at the Board would raise a concern—[former Fed Vice Chair] Don Kohn was in charge of a lot of the coordination. And Don would have these regular meetings with staff. And we would brainstorm about various things. And then a person or a group of people would be sent off to develop a facility. And they would be in touch with the Reserve Bank people, and there'd be Reserve [Bank] people and Board staff on the same group. And we would be talking by phone and emails to try to figure out what would be a sensible approach and what we could actually operationally do.

A facility ultimately gets operationalized by a Reserve Bank—typically the Federal Reserve Bank of New York. However, Alvarez said that in 2008 the Federal Reserve Bank of Boston had volunteered to run any facility they could. With the New York Fed getting particularly busy, and many money market funds located in the Boston district, the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) was assigned to be run out of Boston.

Alvarez also discussed how any possible changes to the facilities after their initial authorizations were also subject to ongoing communication across the Fed system. While some facility changes received official Board votes, others were implemented at the regional Fed level. A facility would be presented to the Board informally, with appropriate details, but also broadly—to get the Board's view generally. That would help indicate when a change might need to go to a vote at the Board, or when it could be implemented under the existing authorization granted to the Reserve Bank. Moreover, Alvarez noted:

> There was a lot of walking around the halls to get a sense of what the governors thought and keeping them up to speed, just briefing them on things. And you'd get a sense of, "Well, do they care enough about this?" If somebody objects, let's get everybody together and talk it through. If everybody says, "this is fine," then you just move forward. Because time was of the essence on a lot of these things. You know, it was very dynamic in that respect.

Section 13(3)'s requirement that the provision of liquidity be "indorsed or otherwise secured to the satisfaction of the Federal Reserve Bank" has a large discretionary component—but cannot be less than reasonably expecting repayment. The Dodd-Frank Act of 2010, by explicitly adding that the Fed must be secured sufficient to "protect taxpayers from losses," effectively codified the Fed's existing interpretation of 13(3).

During the GFC, Fed policy makers and legal staff were of the view that, for the Fed to be secured to its satisfaction, it had to be reasonably confident it would be fully repaid. While the central bank may experience some losses in its operations, the ex-ante *expectation* of loss was seen as a fiscal decision. The Dodd-Frank Act, among other amendments, added language to 13(3) to require that all discounting be secured sufficiently enough "to protect taxpayers from losses."

Alvarez did not view this addition as meaningfully changing the Fed's implementation of the statute. Alvarez said of their pre-Dodd-Frank interventions during the GFC:

> The Fed was very aware that we were trying to mitigate the financial crisis using taxpayer money—any losses the Fed experienced on its emergency lending would have been borne by the taxpayer through [the] reduced Fed earnings needed to cover those losses.

Indeed, he viewed the new language as standing behind the Fed's practice to not provide assistance in cases where the risk of bearing losses was more appreciable.

Alvarez also noted that while the expectation of repayment served as a "kind of floor" on being satisfactorily secured, that determination was the second step in any emergency intervention. He said the Fed viewed the first consideration under Section 13(3) to be whether to provide liquidity at all and that the Fed centered this determination on the systemic importance of the target of the intervention. *Then*, the Fed would think about being able to get sufficiently secured. He said of the GFC:

> Even if there is a lot of security, the Fed has no obligation to lend under 13(3). It's totally discretionary. And the Fed could decide it's just not going to lend to someone. Indeed, during 2007-2009, we were inundated with requests from people to borrow from the Fed, and they were pledging everything you can imagine. And the Fed said all but a few handfuls of times, "no, we're not gonna do it." And it was largely because the Fed thought that a lot of the borrowers were not systemically important. They could be allowed to fail.

Regulation A is but one outline of an authorization to the Reserve Banks to lend under Section 13(3). It does not define the outside limits of the Fed's statutory authority under 13(3).

Regulation A (Reg A) does not strictly define the limits of the Fed's statutory authority under Section 13(3), as is sometimes presumed, but instead outlines "one specific authorization" under the authority. Alvarez noted that Reg A is not written like other bank regulation, which is narrowly prescriptive; rather, Reg A outlines an ongoing authorization to the Reserve Banks *if the terms of Reg A are met*.

However, it may not always be fitting for the contours of a given crisis, and it was regularly deviated from during the GFC. As Alverez noted, during the GFC the Board approved many broader additional tools under Section 13(3): "All the broad-based lending facilities are outside of what Reg A authorized." Alvarez stressed that the rule represented "the way the Fed was feeling about discount window and other kinds of loans at the time it wrote Reg A." It does not exhaustively outline the authorities provided by the 13(3) statute—and may not be able to. He noted that, for instance, Reg A had not contemplated broad-based 13(3) facilities in advance of the GFC.

> But what we were confronting during the financial crisis was a need for lending far beyond what Reg A had authorized, what Reg A contemplated. When Reg A was written, they didn't know that they would need broad-based facilities or other kinds of stuff. And so, the question was, can the Fed do that without amending Reg A?
>
> And it seemed pretty clear and simple to me that it could, as long as the Board did the authorization in accordance with Section 13(3). And so, the Reserve Banks were free to ask the Board for authority to lend under different conditions than Reg A had authorized. And the Board obviously did that.

While a Reserve Bank is free to submit a 13(3) program proposal to the Board that does not strictly hew to Reg A, following the regulation more closely may increase the likelihood of the Board approving the structure—particularly if Reg A is still representative of the Board's views on emergency liquidity assistance.

Utilizing an SPV structure brings several operational benefits. Contrary to a common misconception, the structure is not used to satisfy a legal requirement.

While many have attributed the Fed's frequent use of special purpose vehicles (SPVs) to implement its 13(3) interventions as having to do with a legal requirement, this has not been the view of the Fed.

Many have postulated that the Fed sets up an SPV when it wishes to execute purchases under 13(3) owing to a restriction that the statute provides only for lending: the idea being that the SPV executes the purchases, and the Fed lends to the SPV to fund them—thus circumventing this legal restriction. It's possible that the misconception is attributable to the term "discount," a dated banking word. However, the Fed has long interpreted "discount" as being inclusive of both direct advances and purchases of third-party notes—as is consistent with its historical usage.[1]

Indeed, internal legal memos from the GFC era show the Fed evaluating legality of the discounting done via SPVs on a look-through basis—as if the SPV did not exist between the Fed and the SPV's counterparties.[2] Alvarez noted that this evaluation was very important, as the Fed did not want to open itself to accusations that it was simply lending to itself.

Alvarez noted that the Fed viewed use of the SPV structure—including for broad-based facilities—as providing management, accounting, and legal advantages to an intervention, especially when the Fed operates multiple 13(3) programs in parallel.

> The idea of doing multiple [SPVs] rather than one is really: it is not easier to have just one SPV for all the facilities and have it be monstrous.

Each intervention has its own specific terms, timeline, capital structure, and management team. The management teams may also be in geographically separate Reserve Banks, depending on which one(s) is administering a given intervention.

The SPV structure simplifies the reporting of income and the management of any sales of assets discounted by the facility. Moreover, the degree of corporate separation from both the Fed and other 13(3) interventions provided by an SPV structure may give those other entities some protection in the event a 13(3) program is sued.

The "notes, drafts, and bills of exchange" language in Section 13(3) limits the Federal Reserve's discounting authority to instruments of credit.

---

[1] See also: *Federal Reserve Bulletin* (March 1958) and *June Oversight Report: The AIG Rescue, Its Impact on Markets, and the Government's Exit Strategy* (June 10, 2010).

[2] See: *Legal Memorandum to Board of Governors Re: The Authority of the Federal Reserve* (April 2, 2008) and *Memo to File Re: The Authority of the Federal Reserve to Provide Extensions of Credit in Connection with a Commercial Paper Funding Facility (CPFF)* (March 9, 2009).

Under Section 13(3), the Fed may discount “notes, drafts, and bills of exchange,” which limits the Fed to credit transactions. As Alvarez said:

> To be a note, it has to be an obligation of somebody to repay a set amount at a timing that the parties agree to: Money is given to them, and they have to repay that money. So, there's a lot of ways to document a note, and “bills of exchange” and “drafts” are actually two ways of documenting notes. An advance is another way to document a note. But it’s all credit transactions.

While the Fed can accept a much broader range of assets as *collateral*, there has to be an underlying credit transaction. According to Alvarez, this would limit the Fed from directly purchasing assets like equities or real assets.

For future crisis-fighters, Alvarez says: The statutory authorities really matter! These authorities meaningfully shape crisis-fighters’ response, or lack thereof.

> And so, I hope that when folks read through the material, they understand not so much, “oh those lawyers were too stodgy, and they didn’t give their decision makers enough flexibility.” I hope they come away with the idea that, look, it does matter what you write down in the statute! Make it a useful statute that’s going to allow the government to respond in a way that is helpful. Otherwise, you do have calamities that occur and there is nothing that you can do about them, and, as a decision maker, you're just sort of left to watch, and that’s painful. Painful for consumers, painful for the economy, not just painful for the decision maker, but painful for the people we’re trying to protect by having this authority.

Dated: July 2022

YPFS Lessons Learned No. 2022-09