Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Alejandro Latorre[1] Assistant Vice President, Federal Reserve Bank of New York
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Introduction:

The Yale Program on Financial Stability (YPFS) interviewed Alejandro Latorre on Feb. 26, 2020, regarding his experience as an assistant vice president at the Federal Reserve Bank of New York during the financial crisis.[2] In that role, he was active in the bailout of American International Group (AIG) from its inception to the end when AIG fully repaid its outstanding obligations to both the Federal Reserve and U.S. Treasury. He provided analysis to inform the Federal Reserve's initial decision to lend to AIG, participated in the structuring of Maiden Lane III, a credit facility formed to buy the collateralized debt obligations (CDOs) on which AIG had written credit default swap (CDS) contracts, and oversaw the wind-down of AIG Financial Products (AIGFP or FP), the troubled AIG subsidiary.

In his 22 years on the staff of the Federal Reserve System, Mr. Latorre worked on monetary policy, capital markets, and financial supervision and regulation. In 2018, he joined EY as a principal in its Financial Services Risk Advisory practice.

Mr. Latorre emphasized that the views discussed in this interview are his own, not the views of anyone else currently or previously within the Federal Reserve System or the views of his current employer.

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

Transcript:

YPFS: **We're going to be talking mostly about AIG in 2008. I'd like us to keep in mind the major goal of this program is to distill the lessons you've**

[1] The opinions expressed during this interview are those of Mr. Latorre, 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. Latorre is available here in the Yale Program on Financial Stability's *Journal of Financial Crises*.

learned so that others might be able to learn from your experience in the future. So we may keep coming back to that theme.

In the book they wrote together, Tim Geithner, Ben Bernanke, and Henry Paulson said that before 2008, as regulators they had little to no visibility into AIG. Yet visibility became highly critical in 2008. As I understand, it was part of your job to assess the situation at AIG and to weigh the pros and cons of a loan to the company. What kind of information did you need to do that? How did you get that information, and not just about AIG, but about its counterparties and its role in the overall financial system?

Latorre: Let me take a step back and explain the phases of the AIG rescue, which I was involved in. As you point out, the first phase is really around the initial decision on whether to intervene in AIG. The second phase, as you point out, was with respect to the establishment of the Maiden Lane III facility to provide additional support for the company.

And the third stage was really monitoring and providing oversight for the continued wind-down of the remainder of AIGFP to ensure that the credit facility that was issued to the company would be repaid in a way that avoided further disruption to markets and the economy. The reason why I set up these three phases is because I think the kind of information you need varies across the phases.

My experience during the AIG period and subsequent to that is that the kind of information you need pre-crisis is a little bit different than the kind of information you need post-crisis. So, on the pre-crisis side—which as you point out we did not have access to—the key piece of information is really firm-specific information about the balance sheet, the income statements, in other words, the capital, as well as the liquidity risk profile of the organization.

And you need that information both at an aggregated or enterprise-wide level and, importantly, you need that information, particularly liquidity information, at the legal entity or subsidiary level. That would have been the ideal set of information to have, and also the confidence that the quality of that information was such that you could rely upon it.

So, because the Fed did not have any supervisory experience with AIG, it did not have that information readily available to us. I think it's important, pre-crisis, in making sure that you have that kind of information available to you, at least for the large firms that have the potential to create systemic risk, and perhaps for a sector of firms that in conjunction with one another, or in aggregate, could pose systemic risk to the financial system.

So not having what we needed was a key issue. The other piece of information that we didn't have pre-crisis was that we didn't know a lot about AIG's businesses with the necessary depth. Importantly we also didn't have a lot of detailed and consolidated, coherent information about the ecosystem in which AIG was operating. If you think about its key markets today, with 20/20 hindsight, obviously the mortgage market and understanding the mortgage dynamics associated with that were important and we did understand those at a high level, based on our routine monitoring of market conditions at the time. But not to the depth that you would need in order to effectuate a rescue. Similarly, commercial paper markets where they operated in, securities lending, insurance, etc. So you also need to understand the interconnectedness of a firm that is potentially at risk with the rest of the market, especially when you're in the midst of a crisis.

In the beginning we relied to a large extent on AIG's description and understanding of what their exposures were and how those exposures were performing. But, importantly, we validated that with the assistance and support of third parties working for us at the time. For example, with respect to liquidity, we challenged the accuracy and integrity of that information before making any decisions.

YPFS: **How could you approach such an assessment when you didn't have much time or complete information, as you've been talking? And how could you stay focused on that, knowing what the stakes might be?**

Latorre: I would say one, it's about knowing, and this is I think is a key lesson, knowing what you know, and knowing what you don't know, and knowing what you need. I think we were pretty effective at understanding the information we had, and the information we needed, and the challenge then was how to close those gaps.

And again, I think one of the strengths of the Federal Reserve System is, and continues to be, the diversity of talent and experience within the organization across different disciplines—regulation and supervision, financial markets, and monetary policy. So when you're faced with an information gap of the size and magnitude that we had, and the stakes are as high as they were, closing the information gap always comes down to the people.

I think one of the places that we were very effective is on being able to rally the organization and to leverage the diverse set of experiences that we had. We were able to cumulate in real time what we knew up until that point in the financial crisis so that we could make sure that our decisions, or in my case, the recommendations that we were making to our principals, were informed by the best minds and the best ideas that we had available at the time.

I think making sure that you have right people around a table with the right attitude and the right set of experiences was critical in being able to get to the outcome that we got to.

YPFS: **And when you're talking, the diversity of people, you're just focusing on the New York Fed? Or are you also looking at the entire system?**

Latorre: I would say the entire system. I think over the course of that very narrow time frame, the burden fell on the New York Fed, but the New York Fed is part of a system and I think, we were very well plugged in, not just with the Board of Governors, but also with the U.S. Treasury.

And I think that also provides benefits in terms of understanding what you can do and what you can't do in terms of supporting the company, and also what we think will be effective versus what won't be effective. I think all that is critical, and I think we were successful at being able to leverage both the guidance of the Board and Treasury, and the expertise of other parts of the System.

YPFS: **Let's talk a little about Maiden Lane III. How did it become obvious that AIG needed more help? What were the concerns you had at that point, and what information did you have that was relevant that you may not have had earlier?**

Latorre: As I mentioned before, your information needs—knowing what you have and what you don't have and what you need—it's very critical to maintain that awareness across these three phases. So now here in phase two, we kind of understand the company a little bit better, so I would say that while the information considerations are important, they weren't necessarily the binding constraint in this phase.

I think some combination of time and clear understanding of counterparty incentives, and also our objectives, and the communication of those objectives, become more important considerations in this phase. Let me get into some of the specifics.

What triggered the concerns were frankly the rating agencies. The rating agencies had seen the continued liquidity outflows due to the CDS positions. They looked at that in relation to the size of the facility that the Fed had provided with the support of Treasury, and they were concerned. They were concerned about whether or not the firm could avoid insolvency given the continued deterioration in markets, given the size of the outstanding facility.

So we had a pretty good understanding based on AIG's historical performance under the CDS contracts, which became the key focal point of our concern. We had the support of third parties who worked for us with the right analytics to be able to assess how these assets might perform over time. So there again, I don't think it's really information that's the constraint in this period

The constraint here is really finding a solution. One that's going to alleviate the liquidity pressures on the firm, arising from the continued deterioration of these positions, in a way that gives the rating agencies the confidence that these issues have been addressed, but also importantly, ensuring that the public interest is protected. Ensuring that whatever risks that we're taking in the solution are prudent and ensuring that the economic gains for those risks would accrue appropriately to the public.

And I would say lastly, continuing to ensure and promote financial stability. Because at this juncture, the markets were still very fragile, and the worst of all possible outcomes would have been for the company to have failed after the Fed and Treasury committed to supporting it. This would have called into question the credibility of the Federal Reserve and Treasury and created more instability for markets and the economy.

YPFS: **Then moving along, let's go to stage three, the unwinding of FP. What are your considerations, how do you move forward with that, what are the concerns?**

Latorre: I would say that again the information considerations were less pressing at this point because we knew the company reasonably well. I would say on the margin there still might have been some challenges in terms of aggregating at an enterprise level the firm's exposures. But I didn't consider those at the time to be significant concerns at that time.

The goal was to monitor AIGFP's approach and progress. We were not directing the company to eliminate certain exposures at the expense of others, we weren't guiding them in terms of what levels that they should exit at. Where we challenged them was, what's your framework for determining that? How are you confident that the level at which you're unwinding the portfolio is the best one in order to achieve the orderly wind-down objective as well as preserve values for the taxpayer?

That was the central focus of that phase.

YPFS: **Could this happen again? Do regulators have the visibility that they need into nonbank financial institutions?**

Latorre: Never say never. I think that the post-crisis reforms have really strengthened the resiliency of the financial system in meaningful ways, increasing both the quality and quantity of capital liquidity, certainly amongst the largest financial firms.

The challenge going forward could very well be smaller firms in isolation may not be materially significant, but in aggregate, because of concentration in a particular exposure or particular technology, could create near-term risks, and you combine that with the lesser degree of fiscal and monetary policy space. That could create risks.

Now whether or not the nonbank sector is sort of more exposed to that than the banking sector, that's hard to tell. I come back to my earlier comments: I think it's important for supervisors, whether at the macroprudential level or at the microprudential level, to have a keen understanding of what information they have, what information they don't have, and what information they need in a crisis so that they can be better prepared.

And I think those lessons have been understood, but the challenge of financial crisis is you're constantly having to relearn these age-old lessons because the economic and political environment changes, so that the application is slightly different and isn't always obvious.

I think that's sort of the challenge that we face, which is recognizing that it will somehow be different, and being able to extrapolate from the lessons of the AIG crisis and apply them in different political as well as economic settings where the application isn't always obvious. I think that's much harder to do in real time. And I think that what the AIG experience taught us was how to do that, and being cognizant of, as I mentioned before, information.

It’s also important to pay very close attention to financial innovation because that in my view decides how much time you have between the most recent crisis and the next one that will inevitably arrive, because financial innovation changes both the political and economic backdrop, making it difficult to apply these general lessons from a previous crisis into the specific crisis that you're trying to deal with today or at the time.

Financial innovation also drives the regulatory perimeter; it drives the ability of firms outside that perimeter to do banking-like activities outside the safety net, and that's where I think the focus on nonbanks should be. The focus really should be on where is financial innovation happening, where is change happening, and what are the firms that are affected, what are the markets that they operate in, and those are the entities that I think we should be watching closely.

YPFS: **I'm going to ask if you can go off on a little tangent here. The AIG rescue has been criticized a lot over the last decade, on Capitol Hill and**

elsewhere. Obviously a lot of the criticism has been leveled at the people who were the faces of this, but you and others—who at least, very seldom actually had to actually had to testify on the Hill—how do you deal with and internalize this sort of after-action criticism of the work you did?

Latorre: I think at the time it was arguably relatively easy, and I'll tell you why. One, we were very focused on the objective, and candidly we had very good leadership who had our backs. At the New York Fed, we had then-President Geithner, Tom Baxter, who was our general counsel, and others at the Board of Governors including certainly Chairman Bernanke, then-Vice Chairman [Donald] Kohn, and Scott Alvarez [general counsel] at the Board. I didn't worry about it because I knew they were focused on it.

That was important in giving us the space. I think the other point I would raise is that we were trying to do the right thing – we were trying to avoid an implosion of the financial system and the economy with all the attendant negative consequences on real people. The failure of AIG would have been a disaster for everyday people and that was a key driver of the Federal Reserve's decision to support the company. I was in the Federal Reserve System for 22 years. One of the things that kept me there for so long is not just the quality and caliber of the people, but the integrity of the people that I worked with. So I never doubted that what we were doing was right and appropriate. That said, I think that in retrospect I was a little naïve in thinking that our actions would speak for themselves given the complexity of what we were doing and the environment at the time.

I learned that central banks and regulators need to be proactive about the messaging around objectives, about articulating a pre-crisis framework *ex ante*, recognizing that that framework is going to have to adjust in response to new information and new developments. The changes need to happen quickly and be communicated in a crisis setting. It is also important to communicate information that gives insight into whether or not you're achieving those objectives and at what cost, and relative to what alternatives. I think those are critical aspects that need to be embedded in the next crisis when it happens.

I think a lot of the criticism that we received was particularly around how opaque we were, around how and why certain actions were taken. None of this was done to deceive anyone. It was really driven by being too focused on the moment.

As a result, it is important to be self-aware and accountable. The Federal Reserve is accountable to Congress.

YPFS: **What else should we be discussing in the way of lessons learned, things you wish somebody had told you in 2007, wisdom you might pass along?**

Latorre: I think we covered a lot of it. I would say that there are important lessons to be learned post-crisis that I think need additional attention across the financial system. I touched on them before but I'll raise them again, and be more explicit about them.

One is, how do we ensure that firms have the proper incentives to manage their risks prudently? I think there's been a lot of emphasis, certainly in the financial community as well as the regulatory community, around building up liquidity and capital buffers, and all of that's very important in terms of stress testing. But in my view, those are means to an end. The end is to ensure that you have better-run firms so that they don't find themselves in the predicament that many of them found themselves in.

How do you ensure that firms have the proper internal governance to create incentives so that they avoid races to the bottom like we saw in 2008? Importantly, how can both macroprudential and microprudential supervisors contribute to that?

I also think there's a role to play for market discipline; I think market discipline post-crisis has gotten a really bad reputation. But I feel like there's been a little bit of throwing the baby out with the bathwater. I think there's a question of how do we resurrect market discipline in a way so that it works in congruence with prudent risk management as well as macroprudential and microprudential objectives. I would say that is kind of critical. I know the agencies are focused on ensuring firms are better-run, but trying to really get at the incentives is kind of critical.

I would also add that, and I think the supervisors are certainly going down this path, more transparency about the state of firms, as relates to their risk management practices. Now that's delicate, obviously, because you don't want to reveal too much information, but is there an opportunity to reveal more information? And I think there's some constructive trends happening in sort of the regulatory community on that score.

And then I think it's more training for supervisors. I think there's a view that systemic risk really should focus on macroprudential regulation and certainly that's a piece of it. But I guess I would say in the fog of war, it's very difficult to differentiate a firm-specific event, or a microprudential event, from a macroprudential event. It's very difficult to distinguish between a liquidity event and a solvency event.

Walter Bagehot gets a lot of attention for his treatise on Lombard Street as it relates to the lender of last resort. There's been a lot of work in terms of trying to interpret and apply his lessons for future financial crises. But I think there are other lessons there that in my view are probably more lasting —because they center on human nature which is less mutable—than the lender of last resort. Because in the context of the lender of last resort, he was talking about a specific political and economic setting that isn't really relevant today. We don't have currencies fixed to gold or even for the most part other currencies. The Bank of England is not a private-sector entity anymore. And you didn't have the degree of democratic accountability that you have today where you could sacrifice domestic economic considerations in order to achieve international financial stability outcomes.

But there are lessons there around good governance and around financial innovation that relate directly to human nature, that if you read very carefully, I think are applicable to this day. So I think more training and more support from the academic community around what does effective supervision look like, how do you achieve not just effective macroprudential supervision but also microprudential supervision. . I'm not suggesting macroprudential is unimportant – only that it is incomplete.

There has been good progress on using data to inform macroprudential risks, and we need to see similar progress on the microprudential side. I think it's good to see the regulators becoming more transparent and the release of more information on firms' supervisory conditions. I think there's probably more to come there over time. I think incorporating that into central bank training is important.

It is important for central banks to have visibility on financial innovation and the implications for incentives, governance, and ultimately regulation, supervision, and financial stability.

One of the things I really enjoyed about my experience at the Fed was that I was fortunate enough to have worked with very good people and have a set of experiences that spanned monetary policy, capital markets, and regulation and supervision. . I had different perspectives I could draw upon in designing solutions and was able to leverage each of those pools of talent and expertise during the crisis. I think there needs to be focus on providing dedicated training that spans each of these disciplines for individuals going forward so that we can, not just sort of record the lessons learned but embed them in future generations.

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