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Yale Program on Financial Stability Lessons Learned: Scott Alvarez, Esq.

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Lessons Learned

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Alvarez, who was General Counsel of the Federal Reserve System, Board of Governors during 2007-2009, gives us his take on how best to prepare for future crises.[1]

Before a crisis hits, counsel and policymakers should thoroughly understand the details of their authorities that may come into play. During a crisis, there is little time to waste on figuring out what one's authorities are or how far they extend.
The longer an organization waits to act during a crisis, the more severe economic conditions may get and the more difficult it might be to implement any plan. If leaders understand the extent of their authorities ahead of time, they can spend less time determining the legalities in the heat of the crisis and approve programs more swiftly. I began talking about Section 13(3) lending with Chairman Bernanke, the Board, and the team at the FRBNY at the very beginning of fall 2007 and then kept talking about it. By the time fall 2008 rolled around, "the Board members understood what Section 13(3) was by heart, they knew what the limits were, they had been living with it for year, and it was integrated into their thought process."

When considering use of the Federal Reserve's emergency authority, the most important thing is ensuring that any extension of credit is "secured to the satisfaction" of the Reserve Bank.
The word "satisfaction" can have many different meanings, but the general guideline for the Board of Governors and any Reserve Bank considering recourse lending under Section 13(3) of the Federal Reserve Act is to secure the credit to satisfactorily ensure full repayment by the borrower. The value of the pledged assets does not have to equal the value of the credit line, but the assets should make up any amount that the borrower might not be able to pay from future cash flows, or that are backed in some way by another firm.

For example, if a Reserve Bank is looking to provide a $20 billion loan to a commercial bank, and the bank's estimated cash flow is capable of repaying at least $10 billion of the loan, the remaining $10 billion must either be pledged by bank assets or be insured or endorsed by an outside source.

When AIG pledged a 79.9% equity stake via convertible preferred stock (which could be publicly sold off once converted to common stock) in connection with the original $85 billion credit facility, it effectively pledged a mix of its subsidiaries that were deemed financially sound by outsourced financial analysts and the Federal Reserve.

[1] Lessons Learned are distilled from interviews with the principal conducted by YPFS.

Having some prior sense of your internal capacity will be important to enabling a quick response.

In addition, understanding what teams within an organization are needed for implementation, the teams' capabilities, and what information is needed to enact any response plan plays a crucial role in the ability to act quickly. This is especially important when some of the most devastating events are impossible to anticipate. New York handled most of the operational issues for the Fed's programs, but the Board was constantly in touch with them and our decisions and actions were very coordinated.

Rescuing very large, complex organizations requires significant and particular expertise and human capital. Since government agencies have a limited number of staffs with only so much experience, they should seek to hire outside firms for their knowledge and skills in financial, legal, operational, and accounting services.

During the financial crisis, many of the facilities implemented were novel, first-time programs for the Federal Reserve and required an army of people to operationalize and execute them. The staff of the Federal Reserve and most federal departments were already working on day-to-day activities when the crisis hit. So, as the amount of crisis-related activity ramped up, there was little to no bandwidth in terms of time and people to tackle the new demands. Existing staff also did not have the particular expertise in the areas of finance, banking, law and other areas that would be required.

Therefore, it is imperative that leaders know in advance exactly what firms they can look to during a crisis for specialized services that might be needed in order to create and implement new programs. It may also be beneficial for agencies to have a standing plan for hiring outside consultants to ensure that all departments are receiving needed assistance from the best and most capable firms. In recognition of the limited pool of expert talent, such plans should include provisions for dealing with conflicts of interests in order to ameliorate potential problems.

In the case of AIG, because the government's legal teams were stretched so thin and only had limited experience working with non-banking firms like AIG, the government hired many independent consultants. Outsourcing legal services was especially important to research and create many of the AIG-related contracts, the terms of which had to be renegotiated over the course of three years as a response to changing market conditions and the pressures imposed by credit rating agencies.

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