Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Scott Alvarez[1] General Counsel, Federal Reserve Board of Governors
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Introduction:

The Yale Program on Financial Stability (YPFS) reached out to Scott Alvarez to request an interview regarding his time as General Counsel at the Federal Reserve Board of Governors and, more specifically, his involvement with the American International Group (AIG) intervention[2]. Alvarez began working at the Federal Reserve Board in 1981 and became the Board's General Counsel in 2004. Throughout his career at the Federal Reserve Board of Governors, Alvarez experienced working on the rescue of Continental Illinois, the savings and loan crisis of the late 1980s, and the 2007-2009 Global Financial Crisis. Alvarez retired from the Federal Reserve Board of Governors in 2017.

On September 16, 2008, the Federal Reserve Bank of New York (FRBNY) announced an $85 billion rescue package, in the form of a fully secured revolving credit facility, for AIG, one of the largest insurance and finance companies in the world, with over $1 trillion in assets. In return for access to the credit line, AIG was to provide the FRBNY a series of convertible voting preferred stock equal to a 79.9% voting interest in AIG, to be held by an independent trust. The credit line would be only the first of a series of government investments in AIG (totaling $185 billion) as it restructured. The FRBNY exited its investment in AIG on January 14, 2011.

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

Transcript

Early Crisis: Bear Stearns and Section 13(3) Facilities

YPFS: **Could you start by giving us some background of your experience working at the Federal Reserve Board of Governors?**

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

Alvarez: I received a job at the Federal Reserve Board in Washington right after law school in 1981. I never expected to be there for 36 years, but I really enjoyed the work, the people, the atmosphere, and the challenges. I became the General Counsel in 2004, well before the crisis. Early in my career in the 1980s and 90s, I got a taste of what it was like to work in crises with the Thrift Crisis and Penn failure and Continental Illinois rescue, also during the downturn in the 90s when banks were struggling. Of course, 2007 to 2009 was a whole different level; but my prior experience in the smaller crises allowed me to learn a little bit about the speed and the creativity that's required in a crisis. So I was at the Board in 2007 when the crisis began and I guess when you say, "When did we become aware that the crisis had begun?," it's sort of like there's a little bit of fog in the water as it's heating up kind of experience. It's not like one day you wake up and the sky has turned red and a plague has hit. Things change slowly, but by the fall of 2007, we were all aware that the economy was struggling, and the markets were starting to react in an unfavorable way. It wasn't exactly crisis yet, but it was the beginning, and everyone knew it. The FOMC talked about it and they started lowering interest rates. We started having discussions about how to get folks to use the discount window, so it was warm by then, not super-hot. We all understood it at that point. The question was how deep of a crisis it would become and would providing liquidity to banks and lowering interest rates be enough? Things got worse through the fall of 2007 and by the wintertime of 2008, that's when our attention turned, at least for me. I noticed others at the Fed paying a lot more attention to the broker dealers. There was a lot of monitoring of tri-party repo markets and other markets that the primary dealers are involved in. We began to talk more regularly to Bear Stearns, to Goldman Sachs, to Merrill Lynch, and Lehman Brothers. But we didn't have legal supervisory authority over them, so our ability to get information was entirely based on the banks' willingness to provide information to us. We were talking a lot with the FCC as well.

YPFS: Were the investment banks cooperative and willing to provide information at that early stage?

Alvarez: They were willing to be cooperative, but in a very optimistic kind of way. They all believed they were in good shape, that they had plenty of liquidity and capital. They weren't providing us with the kind of detailed information we received about banks to independently verify or assess their financial condition. So the information we were getting was qualitatively different at that point.

YPFS: So how did that change when Bear Stearns had an emergency in March?

Alvarez: From my perspective, that developed pretty quickly. Folks knew that there was a need to provide some liquidity to primary dealers and so we developed the Term Securities Lending Facility (TSLF), which was the very first crisis-related facility. One of the interesting things about the TSLF is that when the Fed announced it a week before Bear Stearns went down, but we did not announce that we were using our emergency authority to sponsor that facility.[3] That was because folks were very nervous about the signaling effect that would have and the fear was that the markets would seize up if they thought the Federal Reserve believed that it had to use an authority that it had not used since the Great Depression. We were sort of low-key about it. Then Bear Stearns lost liquidity very quickly in spite of that announcement and that week they were in a lot more contact with Federal Reserve Bank of New York (FRBNY) and with Tim Geithner. Tim and Bernanke talked all the time, so we were aware what was going on in New York. From Tuesday to Thursday, the situation became increasingly dire and we were thinking about what kinds of things we might have to do.

YPFS: **One of the things that we found interesting about Bear Stearns is that the loan went through JP Morgan and that originally the Fed was not going to invoke Section 13(3) of the Federal Reserve Act. Then the legal determination was that you needed to invoke the emergency authority. Can you talk us through these developments, please?**

Alvarez: Correct. Yeah, I can and that determination was mostly because of me. The original proposal from the FRBNY was to lend to JP Morgan through a regular discount window loan and have them on-lend money to Bear Stearns. That would have been perfectly fine if JP Morgan had been on the hook in some way, shape, or form. But as things progressed, it became clear that JP Morgan would not put up any collateral and the FRBNY would have no recourse to JP Morgan. The obligation to repay the Federal Reserve would have been based on Bear Stearns's ability to pay any collateral. If you want to get laser close to the line, you might be able to say the documentation would demonstrate this with a discount window loan, but I felt very uncomfortable with that because in reality it was a loan to Bear Stearns for Bear Stearns to be repaid by Bear Stearns. The 13(3) authority was available so we didn't have to be so close to the line with discount window lending and I was afraid of the reaction we might get if we tried to be too clever. I talked to Chairman Bernanke about it and he agreed. We went to the Board and the Board authorized the 13(3) loan and so it was documented as a loan to JP Morgan and then an on-loan to Bear Stearns, but because the substance was really more a loan to Bear Stearns, we used the authority under 13(3).

YPFS: **If I'm not mistaken, I think that was when the Board announced it was using the emergency authority, correct?**

Alvarez: Yes. At that point, we decided to use that to announce that. So we changed our strategy in a week. The weekend before, we weren't going to send that signal to the market. But then with Bear Stearns, we thought we needed to signal.

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[3] The March 11, 2008 press release by the Federal Reserve Bank of New York announcing the Term Securities Lending Facility can be found at https://som.yale.edu/sites/default/files/FRB%20Press%20Release%20FOMC%20Statement%20Fed%2003-11-2008.pdf (Accessed on 10/17/2018).

YPFS: **Was that because this was a loan to a specific entity, as opposed to the TSLF which was more market-based?**

Alvarez: I think that at that point, there was nothing we could do about the signaling. Bear Stearns' failure was going to be a big signal. With the announcement, we gained the advantage of saying, "Okay, when there is a big calamity, we are willing to pull out our tools and use them." So it actually had the reverse signaling at that point, that was the judgment. Now we would say, "The Fed is on the scene and the Fed is going to do what it can." This was meant to be reassuring since the market was already panicking from Bear Stearns.

YPFS: **Understood. The Primary Dealer Credit Facility (PDCF) was put in place right after the Bear Stearns rescue, also under 13(3), to provide more support for the investment banks.**

Alvarez: Correct and that was because the Federal Reserve believed that the broker dealer business model was being questioned by the markets; a broader facility to provide liquidity was needed to keep those firms going. We required as a condition for participation in the PDCF that the primary dealers provide us access to their financial information and allow us to come on site to talk with them in more detail about their financial condition. So we gained an awful lot of insight from the broker dealers through the PDCF.

YPFS: **There was an issue of stigma with PDCF. In hindsight, do you think that there were ways to have structured the PDCF so that banks would have used it more and helped the liquidity issues get better**?

Alvarez: I think that's just the way the market was at the time. I think we would have changed the PDCF if we could have. We encouraged people to use it. It was tested, but banks were pretty clear that they feared that using it would be a sign of weakness.

YPFS: **A lot of this was being run specifically through the FRBNY, but obviously to invoke 13(3) you needed the Board of Governors to vote on it. How involved were you in creating the TSLF, the PDCF, Bear Stearns, and each transaction? Did you have daily communication with the General Counsel of the FRBNY, Tom Baxter, or did Tom take the lead on most of these programs? What was the dynamic between the legal teams at the Board of Governors and the FRBNY?**

Alvarez: The way I think of it, is that Tom and I had a partnership with a division of labor and he was invaluable. No question about it. He was on the scene and it was phenomenal in some of the things that he was able to accomplish. The way we worked was that I took care of the legal end of the Board of Governors where I dealt with the [inaudible 00:16:44] parties, briefing the Board of Governors on the overarching terms on proposals and deals. Now we had a couple of sitting governors who were actually the ones who developed a lot of these terms; I was working with them very readily.

We had teams at the Board and teams with the regional Reserve Bank where we were collaborating with each other, but also learning things from a different perspective. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) was actually advanced by the Federal Reserve Bank of Boston. The Term Asset-Backed Securities Loan Facility (TALF), involved Treasury quite a lot, so those kind of facilities had different makeups depending on who was going to be administering the features of the program.

There was a lot of collaboration. Tom was involved in the actual negotiation of contracts and the nitty-gritty of what a lawyer does in operationalizing the programs. On the other hand, I reviewed all of the contracts, like the AIG contracts. Tom and I would talk about the contracts and we would come to an agreement on the language used for various terms, and then Tom would work with outsourced law firms to get those things accomplished. He and I worked together all the time on just about everything.

YPFS: **During the summer of 2008, was the Board doing forecasting when things were looking not so great and planning for if things got worse? Was the Board getting some more information from the investment banks and sharing that with New York?**

Alvarez: Oh yeah. We had teams that were constantly trying to imagine what problem might come up and how we might respond to it. We'd come up with ideas and send them to Bernanke and Geithner to review. They'd say, "Okay, hold that in reserve," or "we'll flesh out the idea," or "That one needs more work." We shuffled through a lot of different ideas throughout the summer. Some of those went into facilities we created, but most of them just were left on the cutting room floor. So you may know then that Tim's style, which affected both New York very directly and Washington, was to get competing groups to work on the same problem from different points of view. Then we would make presentations to him and he would provide new ideas and send the teams off into a new direction. Tim was kind of frenetic in that way. Bernanke was much more linear in his approach – "Here's a problem, let's move forward in solving that problem." He was also very creative, but he didn't send staff scurrying around as much as Tim did. And both approaches have advantages. Tim's approach was that he could come up with some very creative ideas, which affected how each of the teams would work at the Board versus the FRBNY.

YPFS: **Did the Board and New York subscribe to different perspectives although looking at the same problems? Would Washington see a problem from more of a policy standpoint, while New York viewed more of the impact on financial markets, or was it kind of a mix?**

Alvarez: That's a good question. It's not as cut and dry as you might think. Everybody was looking at the same market information. I think the perspective that New York brought that was different than Washington was how to operationalize a facility. The FRBNY answered questions like “We have this great idea, but how do we actually get the documentation done? How do we actually do the computer work? How do we get the money from here to there?” They're very operational, which was a terrific and critical element. I think what the Board brought to it that was a little different was answering questions like “What is going to be the broader market reaction? What's the political reaction going to be? How does this fit into a broader policy kind of approach to dealing with the crisis?” We both had lots of insight into how the markets were working and what kind of solution was needed to help the markets regenerate.

<u>**Fannie Mae and Freddie Mac**</u>

YPFS: So after the initial market unrest in the spring of 2008, the next big episode is Fannie Mae and Freddie Mac. We understand that Bernanke was talking with [Hank] Paulson and [Jim] Lockhart about what the new legislation should look like and what the Fed’s role would be in addressing the concerns with Fannie and Freddie. But before legislation was passed, the Fed extended a line of credit to Fannie and Freddie under Section 13(13) of the Federal Reserve Act, correct?

Alvarez: We didn't actually extend credit. The Board authorized the FRBNY to lend to Fannie and Freddie if they needed it and they never drew on that. 13(13) is a little different because it doesn't require emergency findings.

YPFS: To your knowledge, was that the first time an extension of Section 13(13) had ever occurred?

Alvarez: Oh no, 13(13) was used during the Depression quite a lot. In fact, I think the Federal Reserve probably used it at least as much as they used the 13(3) authority, in part because 13(13) allows lending on U.S. government securities.

YPFS: Had it been used since the Depression?

Alvarez: No, not that I’m aware of.

YPFS: We've heard from others that the conservatorship of Fannie and Freddie was such a big action that there was the hope that it would calm the markets. The notion that the government would be taking over these trillion-dollar entities might give people some assurance that it was on the case and trying to address concerns. However, that didn't happen. Can you talk about it from

your perspective, what the expectation was and how the action was perceived?

Alvarez: Yeah. It was actually pretty straightforward. I think the idea was to remove any doubt about whether Fannie and Freddie would stop operations and stop providing mortgage guarantees. At the time, they were guaranteeing something like 50% of the mortgage. The second thing the conservatorship did was make explicit, what had been implicit, that the U.S. government stood behind the guarantee of Fannie and Freddie. The hope was that it would lessen people's fears about losses on mortgages. In the end, it didn't quite have that effect. I think the governors were particularly hoping it would ease the burden on Lehman Brothers, but it just didn't.

<u>Lehman Brothers</u>

YPFS: There's been a lot of opinions on Lehman Brothers and even recently we did a Q&A[4] with Secretary Geithner, but from your perspective as a lawyer, how did you advise them on the critical issue of, what Section 13(3) required? Were you advising them on a daily basis? Was it strictly a legal determination or was it a determination of how that legal analysis applied?

Alvarez: Well, it's actually not as mysterious as I think many people have tried to make it. So let's start with the first part about the legal advice. Things were happening pretty fast when that happened and so there wasn't time to write polished legal memos in advance of a lot of the actions, though we did have the legal division write, and I wrote as well, a bunch of memos explaining the legal advice that we gave to the Board at the time they made the decision. So that's been documented and that's all in the Federal Reserve files. Now whether they make those public is another thing, but there is documentation for most, maybe not all, but most of the legal decisions.

But then from a lawyer's point of view, I had a phenomenal client. We talked about 13(3) lending at the very beginning in the Fall of 2007, through the Bear Stearns crisis, and then through the summer. I was talking with the Chairman and with the Board members and the economists that were in charge of developing facilities about what 13(3) meant, what the history was, what the limits were, and they integrated all of that into their thought process. When it came time for the Lehman and AIG decisions to be made, it wasn't like I had to run upstairs with a memo and say, "Hey, there's this 13(3) thing and here's what it says." The Board members understood what Section 13(3) was by heart, they knew what the limits were, they had been living with it for a year, and it was integrated into their

[4] The Q&A, called *Ten Years after the Financial Crisis: A Conversation with Timothy Geithner,* can be found at https://som.yale.edu/news/2018/09/ten-years-later-conversation-with-timothy-geithner (Accessed on 10/17/2018).

thought process. That helped me a lot because when I would have discussions with them, they were already pretty close to where I was in terms of understanding Section 13(3).

YPFS: **That group would include the team in New York?**

Alvarez: Yes. Though the team in New York I think was more willing to probe the edges of 13(3), which was good. They came up with plenty of ideas that we would all look at and say, "That just can't work." Like, for example, there was a strong urge to put capital into the broker dealers and there were efforts made to try to design ways of putting capital in and we all came to the conclusion, that's just not legally possible and we need help from Congress on that. But it was worth exploring. I never thought we got over the line. The decision about Lehman and whether it was a legal decision or not a legal decision? I think it is both a legal decision and not a legal decision. They fit each other perfectly because the part of 13(3) that was the sticking point was having security that was to the satisfaction of the lending Reserve Bank. So once the Reserve Bank said, "Look, we just don't feel comfortable that we are going to get repaid, that we have enough collateral to be repaid," then that was both a judgment that it wasn't a good loan to make, which is sort of a policy and credit kind of decision, and it was a legal decision because if you don't meet that criteria then the statute doesn't allow you to lend. It was really a judgment about the ability to be repaid and that's what caused them to decide not to do it and to make it illegal at the same time.

YPFS: **On the term "secured to the satisfaction," there isn't a definition in the U.S. code on the word "satisfaction," correct?**

Alvarez: No, there sure isn't. (laughs)

YPFS: **I'm sure this is a conversation that was brought up multiple times but, does using the word "satisfaction" mean implicitly, "If we're going to loan this bank $20 billion, we have to make sure that the posted collateral is valued at $20 billion or more?" Or does the word "satisfaction" mean, "We'll be satisfied if this loan is effective and making it [essentially] saves the market?"**

Alvarez: Yeah, that's a good question. The way we were thinking about it was that "satisfaction" meant that we had the authority to lend with the expectation of repayment. It could not be simply, "We're going to do good things for the market and we're going to lose all our money. Who cares? The market is saved." It wasn't meant to be a grant or a giveaway. It wasn't meant to be capital in that sense, loss absorbing money. It was meant to be something that would be repaid.

Then the question became: "How much collateral or security do you need to be repaid?" I wrote a memo to this effect that is in the public domain as part of the Starr litigation. It doesn't have to be the same amount as you're lending. For example, if you make a $20 billion loan, you may be satisfied with $10 billion worth of collateral if you think the borrower has the capacity and a steady cash flow to repay the remaining $10 billion, that allows you to feel comfortable. Maybe somebody else is going to endorse the credit through a stand-by letter of credit, a guarantee, insurance, or something else that provides some other way to be satisfied that you'll be repaid. It’s more nuanced than simply that the amount of collateral has to match the amount of the loan. It changes a little bit when you do the kind of lending we did for the Maiden Lane special purpose vehicles. In the Maiden Lane situations, we were doing asset-based lending, not recourse lending. So in that situation, the only source of repayment was the collateral, and we felt that they had to have more collateral than the principal amount of the loan. But that wouldn't have been legally required necessarily.

YPFS: **That is partly what Secretary Geithner and Professor Metrick talked about in their recent Q&A, that the reality was that Lehman was failing and that understanding was considered in making the decision not to lend.**

Alvarez: Yes, exactly.

YPFS: **Did the Board communicate with the UK authorities at the time regarding a possible acquisition by Barclays? Did you as General Counsel of the Fed have any communication with the legal side of the UK authorities?**

Alvarez: There was communication with Tim and Ben. But no, I didn't have very much communication with them around the Lehman time. I had a bunch of communication at other times when we were trying to work things out like the international swap lines and things of that nature, but not on Lehman.

American International Group, Inc.

YPFS: **So let’s jump to AIG, which happened on September 16th, the day after Lehman. How involved were you compared to Tom Baxter in the negotiation and write-up of the original $85 billion loan?**

Alvarez: Initially I was involved in the Board side, authorizing the loan and talking with Tom about what the terms of the loan would be. I also reviewed the contract for the loan and the contracts for the entire setup facility that we did with AIG.

YPFS: **You’ve mentioned before that Tom was pretty much the legal representative during the negotiations. So it was him and his team leading the charge?**

Alvarez: So yes, though, as I mentioned, I reviewed and commented on all of the contracts before they were signed and I was actually a part of a couple of the negotiations, but Tom was certainly the lead on that.

YPFS: **You also mentioned that during the summer Federal Reserve teams would go through exercises, taking examples of what might happen and how they might tackle it if the problem arose. When AIG's CEO Robert Willumstad came to Secretary Geithner in the beginning of the summer of 2008, was the possibility of using Section 13(3) considered for AIG at that point or not until later?**

Alvarez: When AIG reached out to New York initially, they received a "No," that the Fed wouldn't lend. As the summer progressed, AIG started making overtures at the Board. The week before Lehman failed, I was on at least one phone call with Willumstad where I told him, after talking with the Chair, that we would not lend and that he should pursue a private sector solution. So AIG was trying to get credit from both New York and Washington.

They did get private funding. In fact, we were being briefed on that pretty regularly and through Lehman weekend there was a lot of optimism that AIG would get private funding.

YPFS: **Do you believe that the private funding of AIG might have gone through if Lehman hadn't declared bankruptcy?**

Alvarez: Yeah, I do think so. It didn't go through as a result of market pullback after Lehman. Another thing that I think was a factor is that AIG's management was not willing to accept the terms that the investors were putting forward. There was a lot of new management, like Robert Willumstad who became AIG's CEO in June 2008. AIG had chronically underestimated its need for liquidity. When they first came to us they were asking for $20 billion, then $40 billion, and then $60 billion. It turned out that even the original $85 billion line of credit we provided was not near enough. I think AIG's management just weren't willing to accept what the private sector investors were putting forward, which was another way of saying, "You're in deeper trouble than you think."

That may have been a factor of much of the crisis as well. Lehman's CEO Dick Fuld never really accepted that Lehman was in dire straits; he was way more optimistic than he should have been. John Thain, Merrill Lynch's CEO, was very optimistic until Secretary Paulson had a heart-to-heart conversation with him about what was going on and what the future might entail. You found that with everybody; everybody thought they were in better shape than they actually were.

YPFS: **But when the private funding fell through at that point, it became the Fed's turn to step in. Was the Credit Agreement for AIG based on the private sector terms or previous cases that the Fed had done?**

Alvarez: Yes. Not so much Fed agreements because we hadn't done anything quite like that. But the FRBNY did hire an outside law firm and they had templates that we used. It became a matter of us changing the terms and renegotiating terms to get it the way we wanted it. In a crisis, it is really important that the government makes use of outside law firms, financial analysts, and a whole variety of consultants because you need an army of people to do these things and the government just doesn't start with that big an army and with that kind of expertise. It was hopeful that we were able to retain firms.

YPFS: **The government obviously wants firms that know this business, but then most of those same firms are working for the banks and the primary dealers participating in Federal Reserve programs and supervised by other government agencies. Did you ever ask for associates to be seconded to your department, so that there would be a little more separation and avoid conflicts of interest?**

Alvarez: We didn't ask for secondment, but we would ask some firms to pick a side: you're either with us or you're with them. There were other situations where we were willing to have teams from the same firm that were separate, who didn't communicate, and would have to sign confidentiality agreements.

So just to add a little wrinkle to that, one of the things that made it even worse was that each of the government agencies – the Fed, the FDIC and the Treasury – had to have a team of consultants. And because each was worried about conflicts and the different perspectives of the agencies on the firms, they each had to find different firms, which created problems because you run out of firms that are available.

There were some fights between the Treasury and the FDIC about using some financial analysts in particular because they couldn't use the big broker dealers or the banks as financial analysts because those same firms were the ones receiving assistance. They had to find independent, second-tier firms that had the level of sophistication necessary.

YPFS: **Were there any specific, differing opinions between you and Baxter about how to frame the AIG Credit Agreement?**

Alvarez: Tom and I argued over a bunch of terms in the contract, but we always came to a mutually satisfying conclusion. If we hadn't had discussions with different points of view, then we wouldn't each have been lawyers.

YPFS: **Were there any previous cases where a trust format had been used by the Fed in connection with any loans or credit agreements? Why was a trust necessary to hold the AIG equity rather than holding the equity in another format?**

Alvarez: So to answer the first question, as far as I know I don't know whether the Fed or the rest of the government had used a trust before in this manner. The government has made loans to all kinds of industries including the steel industry and others, where they may have used trusts, but I just don't know. There's a whole series of issues around owning stock and one of them is, legally can we do it? I think we were absolutely crystal clear and in agreement that we could accept stock as a consideration for a loan, banks do it all the time.

But the question was, could we hold it? And while there is a good argument that we could, we just didn't want to get to that bridge because there were a variety of policy implications and other reasons. First is that if we owned 80% of the stock, then they would be a nationalized company and the Federal Reserve didn't want that. Second, we also would be in control of the entity and be responsible for the day-to-day decisions as the major shareholder and the Federal Reserve didn't want that. Third, we didn't want to have AIG accounted on our balance sheet as a company which the accountants were telling us would be required if we owned all this stock, and we just didn't want our balance sheet corrupted with AIG assets. There were a whole variety of reasons and then some political reasons as well to hold the stock, but a whole variety of reasons we didn't actually want to hold the stock.

One of our initial thoughts was, "Should we give the AIG stock to the Treasury or sell it to the Treasury?" The Treasury couldn't buy it because they didn't have appropriated funds and the Anti-Deficiency Act prevents them from using funds for non-appropriated purposes. The question then became: Could the Treasury accept the stock as a gift from us? They came to the conclusion that if the stock was held in a trust they could accept it. The trust fit their needs and our needs at the same time.

YPFS: Was it for similar reasons, that Treasury didn't hold AIG stock directly? Could Treasury's General Fund have managed the equity considerations instead of using a trust or did they also not want AIG's assets on the government's balance sheet?

Alvarez: Yeah, they were also a little uncomfortable with holding the stock directly. But then once TARP was passed in early October, Treasury could have held it and they did end up buying stock directly in AIG after TARP.

YPFS: Once AIG recovered and the preferred stock from the trust and the preferred stock that the Treasury bought under TARP was converted to common stock, Treasury held 92% of AIG's stock in total. The common stock converted from the trust's shares were held by the General Fund and the common stock converted from the TARP shares was held by the Office of Financial Stability, two different units. How did the Treasury really separate the two pools of common stock without saying AIG is a nationalized company? How was it legally possible to hold an aggregate 92% of the company, but not manage the day-to-day?

Alvarez: So some of that I think is probably better directed to Jim Millstein because he was the genius behind dividing that up. Some of that I think is dictated by the terms of TARP. You know, warrants were held in a certain place and stock, some of these assets that they required had to be repaid into certain funds. I'm not an expert on that, but Jim knows that in and out.

Jim was a genius. We managed to get repaid fully by AIG because of his approach and, of course, Tim Massad, Assistant Secretary of Treasury, had a great hand in it at the end. But Jim was the one who put the pieces in place and designed the strategy for AIG.

YPFS: One other thing that sticks out with the AIG rescue was that there were a lot of different moving parts: the credit facility, the TARP investments, and the Maiden Lane special purpose vehicles (SPVs). Maiden Lane II and Maiden Lane III were different vehicles from what had been done before and have received a lot of criticism, particularly the Maiden Lane III that held the CDO portfolio.

Alvarez: Let me start from a legal point of view. I don't think there was any question about the legality of those special purpose vehicles. As I mentioned, those vehicles involved asset-based lending and the SPVs were constructed in a simple way effectuating asset-based lending that was good for both borrower and the lender. I think that was pretty straightforward. A lot of the criticism, and maybe your finding other criticism that I'm not aware of, but a lot of the criticism on Maiden Lane III in particular was whether we were bailing out Goldman Sachs and other broker dealers through backdoor subsidies.

I worked with Tom on this quite a lot, but he's the one who had the actual phone call with the counterparties, but there were foreign creditors of AIG, in particular the French creditors, that said they absolutely would not take a discount on the collateral that was required on the repayment of the CDO portfolio. In that situation, I think we were sort of left with the question: Do we just walk away, or threaten to walk away, and see how that plays out? That is what a private sector person might do while negotiating a deal. But in the middle of the financial crisis where you've got a very brief period of time and the consequences are huge, is that the responsible thing to do? Especially when we figured out that the discounts that we could get if we really negotiated hard were pretty small in the grand scheme of things.

So we decided not to give discounts and decided to put the facility forward, ultimately getting a lot of flak for that. It wasn't really because we thought that Goldman needed the money or somebody else needed the money. Rather, it was because we thought that we couldn't let AIG go down and the credit rating agencies were pretty relentless in their criticisms of AIG's prospects for repaying its debts, even with the Federal Reserve and the Treasury providing assistance.

But Tom will be able to tell you and he had the actual conversation with some of the counterparties.

YPFS: **Yeah, that's very consistent with what Tim has relayed too. That if we're going to renegotiate with counterparties, it would take a lot of time and effort, that how much do you actually gain in that time since you have a thousand of other things to do and address**.

There were lots of different classes of stock issued to the government in AIG's rescue. Is the legal substance of those particular shares really important or was it just the best way to work through resolving it all and getting it done?

Alvarez: Yeah, so this again, a question for Jim. But the answer that I would give is that it was really more expediency than anything else. One of things about the corporations is they have only the stock that they're authorized to issue and you need shareholder votes to create new classes of securities and they were using everything they had available, anything already authorized without having to go back to the shareholders. Every time you go back to the shareholders, they don't necessarily see that things are going badly. They want something for themselves.

YPFS: **There were also special purpose vehicles that were created to hold the equity in two life insurance subsidiaries of AIG. Were there specific rules around those special purpose vehicles regarding the Federal Reserve's or Treasury's ability to accept and hold that stock? Was it all asset-based lending at that point, or did it involve recourse lending too?**

Alvarez: Yeah. That's a good question, but the legal theory was different at that point. Those facilities we considered incidental to the collection of debt. There's a concept in banking, "DPC", or Debt Previously Contracted. In getting repayment for an existing debt the lender is allowed, under the banking laws, to do a variety of things that they couldn't normally do, like owning stock because that may be the collateral that was presented for the loan. Then when the loan goes into the fold or has to be repaid, this stock is given to the lender to sell and recoup its loan. So at that point, the insurance SPVs were set up specifically as a mechanism for repaying the Fed's loans and we considered that incidental to the extension in credit.

When the Maiden Lanes were making new loans, they were asset-based lending. The AIA and ALICO facilities were created as part of the repayment to the FRBNY for the revolving credit facility, where the equity interest in the facilities could be sold.

YPFS: **Something we've come across in other interviews focused on AIG[5], interviewees found it difficult to communicate to the public and Congress. Did you also find it difficult explaining the legal aspects of the contracts to the executives at AIG, the shareholders, Congress, staff or even members of the Board at the Federal Reserve?**

Alvarez: I didn't find it difficult communicating the legal side, certainly not at the Board. And then, I didn't find any difficulty in the public sector. They weren't questioning the legality, except for the Starr plaintiffs in the shareholder's court case.[6]

The rest of the world wasn't questioning the legality of what we were doing. I had conversations with folks on the Hill to explain the Maiden Lane facilities because there was a lot of curiosity about how they worked, and I got no blowback at all. They didn't like the idea of helping AIG, but that was the policy decision and they didn't argue over the legalities.

When you think about legalities, there's a lot of semantics involved. For example, we didn't think we were "nationalizing" AIG. We were trying to limit our control of AIG. But terms like that, which were used to describe the rescue, bring a legal component to the situation. Use of terms like that though, are really policy judgements, and I didn't consider the criticisms of nationalizing or being in control of AIG or other companies, and not asserting ourselves more as legal criticisms.

General Crisis Lessons

YPFS: **We want to take a little broader perspective here with and ask about some broader issues. When the Fed announced the Large Scale Asset Purchase Program (LSAP), where the Fed would buy agency debt and guaranteed mortgage-backed securities from Fannie Mae and Freddie Mac[7], we found that the announcement came under the Chairman's standing authority. It was approved by the FOMC a couple weeks later. Can you talk about why it was done that way?**

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[5] YPFS previously conducted interviews with Sarah Dahlgren, Former Head of Supervisory Group at the FRBNY, and Jim Millstein, Former Chief Restructuring Office at the Treasury, about their experience working on AIG during the financial crisis as well.

[6] The reference is to *Starr International v. the United States* court case in the U.S. Court of Federal Claims, where AIG's majority shareholder, Starr International, sued the United States government for unlawful takeover of the company through the acquisition of common shares.

[7] The Federal Reserve's press release announcing the LSAP can be found at https://som.yale.edu/sites/default/files/Fed%20Res%20Press%20Release%20Nov%2025%202008.pdf (Accessed on 10/17/2018).

Alvarez: Chairman Bernanke felt that he needed to make an announcement quickly because of the strains in the markets at the time. So while the announcement of the program occurred earlier than the authorization was given, no purchases were made until after the FOMC voted on the program.[8] He spoke with nearly all the FOMC members before the announcement, so he felt that he had good support across the FOMC, even though he didn't bring it to a vote.

YPFS: Could you just give a couple other examples about when the Chairman's standing authority has been used prior to a vote?

Alvarez: There have been a couple situations like that, but it doesn't happen very much. I believe Alan Greenspan made an interest rate adjustment during his tenure in between FOMC meetings.

YPFS: One thing you often speak to in your congressional testimonies during the crisis is about the lack of a resolution authority for investment banks and other non-banking entities. However, with Dodd-Frank's implementation of an orderly resolution process, do you think it solved the problem?

Alvarez: So we won't know until we have to use it. From a lawyer's point of view, I think that as an authority it really is a game changer. It is like Federal Reserve lending, but on steroids, because the FDIC would be able to take over an institution and lend to it, provide capital, and guarantee obligations. It could do all the things the Federal Reserve could not do, in addition to what we could do. However, it comes with consequences like shareholders are wiped out and the management of the company has to be replaced, removing the people responsible for the operation of the company in one way or another.

Another great feature of the resolution process is that it's not funded by the taxpayer. Initially it is, but the industry has to repay any losses that might occur, thus the taxpayer doesn't absorb any losses. The way the FDIC is hoping to use it is that they would spin it off, either through a sale or to the debt holders, which should result in no loss to the industry or the taxpayer. While the FDIC is a very capable organization, trying to resolve IndyMac, which was only $23 billion, was quite a challenge for them. In the future, trying to resolve a $1 trillion banking organization or broker-dealer will be even more challenging.

The existence of a resolution authority should give more confidence to the industry, similar to the conservatorship of Fannie Mae and Freddie Mac. It shows the government is standing behind the company, while it's being reorganized, liquidated, or restructured and sold.

[8] On December 16, 2008, the Federal Open Market Committee unanimously voted in favor of authorizing the Large Scale Asset Purchase Program. The December 16 meeting minutes for details can be found at https://www.federalreserve.gov/monetarypolicy/files/fomcminutes20081216.pdf (Accessed on 10/04/2018).

YPFS: **Of course, another aspect to consider is fairly large systematically important financial institutions (SIFIs), especially those that are global, that the FDIC may not have a lot of experience with.**

Alvarez: Right, and ring-fencing is becoming more prominent, but it's just not clear how that's going to work out.

YPFS: **Another issue you raised in your testimonies is with respect to compensation. Since the Fed issues new guidelines on compensation in its supervisory role, do you think it's having a positive effect?**

Alvarez: The regulation of compensation is difficult, and I'm unsure as to whether the agencies will actually follow through with proposals on compensation, since they are still being discussed. The really interesting, but tricky part is how to claw back compensation after a company shows losses due to the decisions made by senior management that already received their compensation. There are a lot of legal and computational issues. Banks in some ways are very different from other organizations, since the losses associated with business decisions don't show up immediately. Losses take time to mature, so any proposals should seek to match up compensation with those maturing potential losses.

It's a struggle worth working through. One thing that was really bad was that after TARP was enacted and compensation was given out in 2008, Congress imposed compensation restrictions that companies couldn't have anticipated in advance. That really added a stigma to participating in TARP, causing people to flee the program, thus undermining some individual programs. Any restrictions should be conducted on the front-end.

YPFS: **One other truly interesting and creative programs that the Fed undertook was the Commercial Paper Funded Facility (CPFF). There were criticisms on how it functioned and that the commercial paper being bought didn't meet the requirements of Section 13(3). We were curious as to why the legal memo you wrote to the Board of Governors on the legalities of the CPFF[9] was made public, and was it released on purpose?**

Alvarez: No, I didn't purposefully release it, so someone else must have. In terms of the legality of the program, I understood it like this. There are two kinds of commercial paper that we were buying through the CPFF: One was collateralized and secured commercial paper, or a loan that's made to a corporation and secured by its assets. We could discount and directly buy secured commercial paper, a straight-forward exercise of Section 13(3) authority.

[9] The legal memo on the authority of the Federal Reserve to provide credit extensions through the Commercial Paper Funding Facility can be found at https://som.yale.edu/sites/default/files/Alvarez%2C%20Scott%20extending%20credit%20in%20connection%20with%20commercial%20paper%20funding%20facility%2003-09-2009.pdf (Accessed on 10/17/2018).

The second kind of commercial paper is unsecured. Section 13(3) says assets musts be endorsed or secured to the satisfaction of the lending Reserve Bank. So for unsecured commercial paper, we focused on the term “endorsed,” which can mean a lot of things. One of the most common meanings of endorsement in banking is if the assets have a third party that has agreed to guarantee the credit. Another way to be endorsed is if the assets are insured.

What we decided to do in the CPFF was set up an insurance pool that would be funded by a special premium charged to the unsecured commercial paper issuers. There's an economics memo on this where the amount of the premiums was computed based on what a third party insurer would charge to insure the paper. The special insurance pool was like a mutualization of the losses funded by an insurance pool, which in turn provided an endorsement for the unsecured commercial paper.

Of course, we also had other assets in the CPFF that we could liquidate in order to pay off any losses. Therefore, we felt it was reasonable to expect that the CPFF would be fully repaid on all the commercial paper without losses. That was probably the most creative of all of the facilities that we came up with.

YPFS: **Is it the general theory that if the Fed could make the loan directly, it can make it through an SPV?**

Alvarez: Yes.

YPFS: **Many of the programs that utilized the Section 13(3) emergency authority were sustained by the Fed for 18 months, and then began winding down. How does the Federal Reserve determine when the term “unusual and exigent” is no longer applicable?**

Alvarez: We understood “unusual and exigent” as when the markets were not operating normally. The terms of the facilities were more stringent or expensive than they would the markets were operating normally, so that the facilities would automatically begin to unwind as the economy normalized and markets normalized. That's when we started winding down some of the facilities. As fewer and fewer firms participated, it became clear that the markets were returning to normal, no longer functioning as “unusual or exigent.”

YPFS: **What is it that you know now you would do differently?**

Alvarez: I think I’d be a calmer than I was at the time. It was a pretty stressful period and there was a lot of hard work by a lot of people. The only institutional thing that I would change is how we explained what we were doing to Congress and to the public. I’m not sure if we should have tried to communicate more in advance or if more people should have been talking or if our method of communication should have been different, but I don't think that in a crisis it's ever going to be the case that people accept what the government does or doesn't do. The public will always be second-guessing with a lot of arguing and criticism. We felt our way throughout the crisis since we didn't really know what was going to work, which made it trickier.

YPFS: **Were your communications people integral to the strategic meetings?**

Alvarez: Yeah, we had communications people in our meetings, but I think there were a couple of things that hindered us. One is our history and our worry about signaling. We were worried that saying too much or being too flamboyant might panic the markets or give more reassurance than we were providing. I think the communications people did some positive things like having Chairman Bernanke appear on 60 Minutes, and setting up interviews with all the popular magazines, such as USA Today. That helped get our message to a broader audience than only the financial press. I do think we should have broken out of our banker's mindset more to communicate with more people.

It turned out that despite our best efforts, most of the communication was through testimony on The Hill, which is a horrible way to communicate to the public because it's very rancorous and doesn't work effectively. Our communications people were involved, creative, and innovative, but I think we needed to try some new things.

YPFS: **It’s been mentioned that during the Great Depression President Roosevelt was on the radio communicating the government’s actions to the American people. During the Great Financial Crisis though, it was always Bernanke, Paulson, and Geithner speaking. Was having the White House take more of a communications role ever discussed? Do you think that might be a useful strategy in the future?**

Alvarez: It was discussed, though at a level that was above me, but I do think it is a strategy that could be helpful. There's only so much you can get the President to do. It was an awkward time, because the election was occurring and there was public debate between Obama and McCain about what to do.

YPFS: **Is there anything outside of the communications, that you didn't anticipate and that took you by surprise during the crisis***?*

Alvarez: The thing that took me most by surprise during the crisis was AIG. I really thought that AIG had been solved, until Lehman weekend when the Federal Reserve said, "No, we got to make a loan." But AIG wasn’t something you could have prepared for. There's always going to be surprises. The best advice I could give in preparation is to think about the law and to know about where things are as much in advance as you can, because you won't have very much time to think about it once a crisis occurs.

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