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Interview with FRB Officials re 13(3)

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MEMORANDUM FOR THE RECORD

Event: Interview with Scott Alvarez, Bill Nelson, Bill English, and Kieran Fallon

Type of Event: In person interview

Date of Event: Thursday, July 29, 2010

Team Leader: Chris Seefer

Location: Federal Reserve Board, Eccles Building, 20th and Constitution, Washington, D.C.

Participants - Non-Commission:

- Scott Alvarez
- Bill Nelson
- Bill English
- Kieran Fallon
- Dave Caperton
- Rich Ashton

Participants - Commission:

- Chris Seefer
- Tom Greene
- Art Wilmarth
- Bruce McWilliams
- Sarah Knaus

MFR Prepared by: Sarah Knaus

Date of MFR: July 30, 2010

Summary of the Interview or Submission:

This is a paraphrasing of the interview dialogue and is not a transcript and should not be quoted as such.

Seefer: We're from the FCIC, established by a statute last year. I've talked to both Scott and Dave on the phone before. We are currently looking at the issue of TBTF. We are also looking at that amongst other things, including Wachovia and Lehman. We wanted to talk to folks at the Fed because we know about Section 13(3) of the Federal Reserve Act and know that it was not invoked for Lehman but was for others, institution-specific and non-institution-specific. We know that the Citi bid was approved under the systemic risk part of FDICIA. We're interested in how the FRB identifies and monitors institutions that are "systemically important," what happens

when they get in trouble, and can you tell us the issues with Lehman and why 13(3) was not invoked? Can you tell us about Wachovia? Even more general, we know that 13(3) has been invoked for institution-specific and non-institution specific assistance.

Alvarez: We did the best we could with what few tools we had. Let me start with the first question. How do we monitor institutions that are systemically important? It's easy to look backwards and say there should be somebody monitoring institutions that are systemically important, but anyone who's a student of supervision and the statues, that's now how it worked and how we walked into the crisis. Certainly, it's how we adjusted ourselves during the crisis. Beforehand it was a compartmentalized system of who regulated what. We had to defer to the SEC and securities broker-dealers. We had no authority over thrift holding companies. There were whole swatches of the banking industry that no one was empowered to supervised. It was not a system built around the concept of systemically important intuitions. Interestingly, I think systemically important institutions were more than just banks, they were banks, securities firms, insurance firms. There was no one grouping that explained them all. We didn't approach the problem in quite that way. That said, as the crisis progressed and we began to understand how a big institution that was interconnected and had a special role in that market and could affect the market, and as the economy was getting more sour, we began to use what authority we had to monitor situations. We talked to other agencies how had authority to monitor the situation. There was more or less sharing. Protocols for assistance, I think that was similar. Going into the crisis, we didn't really have a play book for large institutions failing like they did in the crisis. Going into the fall of 2007, I think the playbook we had was based on 9/11, what do you do when there's some kind of terrorist attack or natural disaster that happens outside the industry that requires the closing of markets. How do you stabilize folks in that kind of situation? That's not built on 13(3), that's built on redundancy of operations, making sure we talk to all the important people. Everyone knows everybody's role. We're working within the statutory frame work we had. 13(3) is a very interesting authority. It's very limited in the sense that it only allows lending, which is a normal thing for a central bank to do. Secured lending is not buying equity, it's not resolving institutions, it doesn't give you power to put anyone into bankruptcy. It just allows you to make a loan on a secured basis with the expectation of being repaid. The first opportunity that seemed to be the useful thing to do, was when BS was facing collapse. That was a situation when we found out late Thursday night that they were going to have trouble opening the next morning. There was the hope that if we lent to them, they had plenty of collateral for them to make it to the weekend. That would give us the opportunity to see what our options were, to see if there were any purchasers and stave off market turmoil. They needed but one days of operating funding. It wasn't a particularly large sum as life goes. We lent to them on a secured basis and they repaid us at the end of the day. I contrast that to the situation with Lehman six months later. We worked very hard to find a partner for Lehman. As you guys know, there were several candidates but by the end of the weekend there were none. We also tried to manage a private sector solution, we had all of the large financial firms and securities firms at the NY Reserve Bank, the Secretary of the Treasury, the President of the Reserve Bank,

the Chairman of the SEC. All were talking to those institutions about a private solution for Lehman Brothers. When there was no solution, there was very little for what we could do. One thing we had found from BS, was that while we could provide one day of funding that looked like it was just struggling, we could not do what a broker-dealer needed, which was to stand prepared to guarantee all of its obligations. What allowed BS to open on Monday, when it was working out the JPMC deal, was the guarantee JPMC publically for all of the assets. Lehman Brothers had collateral, but they didn't have sufficient collateral for us to give a guarantee of all of its obligations. They did borrow some for the broker-dealer from out PFCF until it got to the bankruptcy deal. Without collateral, 13(3) isn't really much good. It's expected to be secured lending. It wouldn't have been prudent for us to lend to Lehman on an unsecured basis. That's one of the reasons we began calling for resolution authority. That's something we hope to be a better solution the next time around. Citigroup, several months after Lehman Brother, had their own crisis of confidence, which began with an outflow of deposits in Asia. There was concern that if they couldn't announce a way to support the CMBS and RMBS, that the market was finding low in value at the time, that Citi would collapse. We worked with Treasury who had TARP authority and the FDIC to construct a ring fencing arrangement. We didn't have to lend anything, we were just the last stop if Citi couldn't get its losses covered by Treasury and FDIC. We were pretty far down the line. A year later, Citi bought its way out of the ring fencing arrangement. If we had lent at that time, we would have lent against a portfolio of designated assets that had a value in excess of the amount we would have liked. Wachovia isn't a 13(3) issue, it's a systemic risk determination, which was made before the Citi ring fence arrangement FDIC stood ready to provide a loss-share agreement with Citi if they were the winning bidder for Wachovia. As you know Wells Fargo came in and gave a better bid and didn't need the support. That's the Reader's Digest condensed version of all this. We're happy to talk to you about this in more detail.

Sefer: Let's back up to the first part. There's certain systemically important institutions you don't have jurisdictions for. For the ones you do have jurisdiction to supervise, were there things you did to determine that these bank holding companies are big and important and we supervise them differently than others?

Alvarez: Sure. We examine all bank holding companies. We spend less time on the shell companies, and much more time on ones that have operations. An organization like Citi, BofA, JPMC, Wachovia, we examine on a regular basis. The largest ones we have a continuing presence at the organization. It could be a dozen or 2-3 folks on site all the time, talking to management about the risk they are taking, seeing their risk management reports, exploring different parts of the organization on a sequential basis so that we over a period of time could see all of the operations and major areas of risk. We have regular meetings with their board of directors and with management to address our concerns and their areas of weakness. During the crisis we stepped that up. We were spending more time and being tougher to give them less

leeway to fix problems quicker. We pushed organizations to raise capital at any opportunity. We cut off dividends, we were ratcheting off derivatives.

Wilmarth: I understand that the resident teams were joint teams, you had examiners, the SEC had examiners, and the OCC might have had examiners attached to the team. There are different reports to how seamless that operation was. To what extent did you feel that you got adequate support? Was there less than a seamless flow of information between your examiners and the OCC examiners?

Alvarez: I would say a couple of things. First, we feel like we have good relationships with the OCC. The institutions we're talking about are national banks. Through the years we've had our tussles, but we've gotten to where we share information regularly. Some of it depends on the personalities of the people involved, there's some of that in any inter-human relationship. I don't think we saw anything that was immaterial at the large institutions.

Wilmarth: You mentioned that you don't have direct authority over the broker-dealers, you had backup authority. You had to ask the SEC for information or for permission to go into the broker-dealer. What about that relationship?

Alvarez: That relationship is a little different for a couple of reasons. The SEC wasn't a prudential regulator at the time. Cox was trying, but it's a monstrous change in culture and the amount of resources needed and they didn't have the resources. To some degree there just wasn't enough information available.

Wilmarth: Even for Citigroup?

Alvarez: They just weren't examining the broker-dealer in the way we would examine the broker-dealer for prudential strength. The relationship between the SEC and the Fed is much newer. We don't have as smooth of a relationship to start with. We are organized in different ways. We have exam teams that know Citi. They have traveling teams that stop in at each bank. They don't have experts in a particular organization. That makes it harder to have liaisons, because by the time we need them to tell us about the Citigroup broker-dealer, we're a low priority. There was also a concern for a long time that the SEC, while they had less information for us, information we gave them would not be used for informational purposes, but for securities law purposes. We were concerned that our examiners judgments, how we should rate someone on an exam, would affect how the SEC would look at the Proxy statements for the broker company. We haven't trained our examiners to speak and think like they should if they are going to talk about public disclosure. We think about them and train them to think about safety and soundness. Chairman Cox had worked out a protocol for sharing information with the two agencies, by summer 2008 that largely dealt with that information problem.

Fallon: To go back to a question on the structure we use in supervising the larger institutions. In the fall of 2008, we issued a Comprehensive Supervisory Guidance for FRB's consolidated

functions and responsibilities. That guidance had been in the works for some time and it divvies up the various portfolios so for regional organizations, LCBOs, the largest financial institutions. It provides in good detail how we see out supervisory regime in the broadest sense. For the larger organizations, one of the goals of the enhanced guidance was to focus our energies and examiners, to the extent that we could, in the existing limited safety and soundness authority we had, on the activity of the organizations that posed the greatest risk to the financial system. For example, it focused examiner resources and supervisor resources with respect to core clearing and settlement activities, kind of risk management for key business lines. On the sharing piece, with the OCC and FDIC, both of those organizations have online access to our full database for supervisory information for all of the organizations we supervise (exam reports, etc.)

Sefer: One of the things that I've seen in some documents about Wachovia and in public documents, about preventative failures going back to the '70s, when a systemic risk exception in invoked, whether it is 13(3) or FDICIA, it was that we can't let the unsecured creditors take a hit because it's going to cause disruption. It's always that type of issue. I'm wondering for the large institutions that you do have jurisdiction over, is there separate supervisory issues to take a real close look at the unsecured creditors, and the liabilities for these banks, so if they do get in trouble, that's the issue that always comes up.

Alvarez: You don't have control over who the unsecured creditors are. It's the market confidence in the institution, the ability to raise capital, to continually raise debt. These institutions survive based on the debt. It's important to understand how much more than who's who. You can't stop the failure of the institution by focusing on that. You have to look at the risk generally. There are other things that cause somebody to be systemically important. For example, Citigroup is involved in 400 payments around the world. If they failed and would be unable to meet its obligations there, that would have many knock-on effects around the world. With the AIG situation, there were derivatives exposures across huge swaths of institutions across the world, not to mention the individuals relying on AIG. Clearly, some of the literature focuses on unsecured creditors and they're something to pay attention to, but I wouldn't say that was the only or even the most important thing universally that folks worry about.

English: There's a panoply of customer relationships and the question is, is that easy to replace? It's not that this institution is systemically important, it's is this one you want to take strong steps in a given situation because in that situation disorderly failure could have bad consequences for the financial markets, for other financial institutions, for the customers and clients of that firm, and for the economy. Whereas, in a different situation that firm could fail and it wouldn't be disorderly or unmanageable. One of the things we were doing was trying to assess the whole situation in markets and institutions to try to figure out what was the appropriate policy response rather than just trying to judge independent of the environment is this institution a systemic institution.

Alvarez: This is one thing where the Chairman's historical knowledge was helpful. One of the differences between the 30s and the one that we just went through was that it was a severe recession with a collapse of the banking system, and that's one of the reasons it became more of a depression. We were at the beginning of a severe recession and a faltering of the financial system. There was a lot of concern that if this financial system collapsed, we'd be in a deeper recession than the '30s. The economic context becomes really important to deciding what you do and how you react to different firms doing different things. If you look at the previous recessions, there wasn't the crisis in the financial system, which is one of the reasons you didn't see the same kind of responses around the large institutions.

Nelson: The alternatives to institutions not being funded by unsecured creditors are not particularly attractive from the perspective you're asking this question. They are funded by secured creditors, then those assets are unavailable to payback the unsecured creditors or the FDIC to compensate the FDIC for any payments that the FDIC makes on insured deposits. And if they're funded by insured deposits, then the taxpayers are on the book to compensate for any losses there as well. It isn't an obviously preferable strategy for an institution to be funded less by unsecured creditors. The noted worthy thing in the recent crisis that surprised many people, is the fact that secured funding were unreliable sources.

Caperton: For the record, Rich Ashton from the Legal Department has joined us.

Sefer: From the Fed, as a prudential regulator, with big bank holding companies, what do you do? Essentially on the liability side of the balance sheet with short term funding? When you do see what's happened with other cases in the past and look at Wachovia, that seems to be the focus of whether FDICIA or 13(3) will be invoked. It's what are the repercussions or the domino effect? A lot of that is the creditors in the company, both secured and unsecured. That's what we see in the memos. That's why I ask as a general question.

Alvarez: We don't mean that's not a good question. Part of the other side we were fighting against, just as Bill said. While we would have loved to have these institutions lengthen the maturities of this debt, during the crisis, exactly the opposite was happening. The maturities were shortening and shortening to the point where some were funding overnight on a regular basis. We can yell as much as you want, bring as many civil actions as you want. If the market's not going to give you longer term debt. I say that to indicate that it's not always possible to have the supervisory result that you want obtained. We try, but we're dealing in the realities of the marketplace.

Sefer: I get that once you get to the crisis, but before the crisis - we've seen in the cases from before, it seems like for the most part the institution where government assistance had been provided seem to follow same path: fairly high leverage, funded by short-term liabilities. You know that by looking at public filings. Given that we've seen that from bank failures from as early as 1974 and earlier than that, and banks that were much smaller than the trillion dollar

institutions in '07 and '08, is there any thinking within the Fed that we can tell these folks before the crisis not to get into these practices and have long term capital funded by long term liabilities?

Alvarez: I'd like that, but one thing we didn't count on was that secured lending was going to become problematic. That had not happened during my 30 years of supervision. You could always get funding if you had enough security. Liquidity plans were strongly built on borrowing. That just didn't turn out to be reliable. The other thing is, I think it's important as a structural matter that there be some institutions that do maturity transformation, turning short term liabilities into long term assets. That's what the banking industry has done traditionally. Ideally, you'd want to have everything match, the assets and liabilities, but society and the economy just don't work that way. Someone's going to be vulnerable to pressures during difficult times in transformation. We just didn't expect to have this added complication that you couldn't borrow, even on a secured basis.

English: I think that's right. We don't have a supervisor here, but I think if someone were here, they'd say that we did focus on Lehman and the things that you're talking about, and to the extent that they were not, it would be things like secured financing, securitizations. One of things that happened was that institutions got caught with things they were going to securitize, they were funding them short because they were just going to hold them for a short time, but ended up holding those assets when they had funded them short, so they had a funding issue. That funding became hard to roll over. I think that there were a variety of risks that were underappreciated. Broadly, I think supervisors were aware of a lot of risks and were presumably addressing that.

Wilmarth: There are certain similarities between Citi and Wachovia. There is the commonality on CDO exposure, highly leveraged transaction exposure. At what point did those begin to appear on your radar screen? I know the CDOs and SIVs bridge between the bank and broker-dealer, but were your examiners and field supervisors seeing this build up of off-balance sheet exposures and show concern? Were you pushing on management saying how are you going to manage that? When did that begin to rise on your radar screen? And to what extent were the management responsive in trying to tell you no, I think we have a handle on it?

Alvarez: We'll need to get some of our supervisors here to help with that.

Nelson: I think we were aware of growth in securitization, that's something that we talked about. But to the extent that the supervisors were aware of the off-balance sheet, I'm not sure -

Non-beard: It's also true that there are a large number of smaller institutions that are failing now. I'm not sure I agree with the premise that the situation ended with the government getting involved, the FDIC is writing a lot of checks to those smaller institutions. That the preconditions for that are being a very large, complex institution that's very - banks are highly levered, so if a

bank fails, it's going to be highly levered. If you made losses on something then your presumption is that you were engaged in something risky. I'm conscious of the fact that there are small institutions that failed as well. The economy weakened substantially, the banking industry is a cyclical industry.

Seefer: Let me ask you another question. We've seen in the literature that in terms of how the Fed approaches a macroeconomic policy and otherwise. I think both Greenspan and Bernanke have been on the record saying we're not going to use policy to burst the bubble. We'll watch it, but when it does we'll use the tools we have to stabilize the markets and deal with the repercussions. Is this representative of the fed's policy?

English: I think that's right. I think the standard view as expressed by Greenspan was that bubbles or asset prices ... whatever you want to call them, excesses in the asset market are hard to judge in real time. It's difficult to know that asset prices are wrong. You have to judge that a whole lot of market participants have it wrong. That's hard to do with great confidence. You then have to judge second that you can use monetary policy to address that misalignment in asset markets and move the asset prices back to where they should be. Third, that you can do that without adversely affecting your ultimate goals of stabilizing crisis and minimizing unemployment. That's a high set of bars to get over. It's been difficult to be sufficiently confident that you want to do something. You'd have to raise rates a lot to discourage people investing in what they see as a profitable activity. Raising rates a lot doesn't just put pressure on that narrow activity, it's the whole economy. It could cause a recession and cause broader problems. Monetary policy is a blunt tool to go after asset price bubble. It's better to try to use supervisory tools to go after excessive risk taking by a particular set of institutions in a particular market or whatever it is in a much more tailored way, to address that in an annotative way than to use monetary policy. A speech that the Chairman gave a couple of years ago, he ended the speech by saying that you used the supervisory tools and that suggests that cleaning up afterwards is difficult, but maybe you shouldn't rule out using monetary policy. He still thinks that's low down on the list of things you put into play.

Seefer: Is that policy still the policy of the Fed? I think the answer is yes.

English: The federal open market committee hasn't taken a stand on this, his is what he said.

When was that speech?

Wilmarth: It's fairly recent.

English: Ask, and I'll send the link.

Nelson: Just to emphasis, this is about monetary policy, the setting of interest rates. There is a sense that interest rates will be increased when an asset price increases, whether it's for fundamental reasons or non-fundamental reasons, because an increase in asset price makes

people wealthier and economic activity increases. Interest rates were increased in part as the stock markets grew. The sense in which the Federal Reserve would respond to a collapse in an asset price is in precisely the same way. It's not as if interest rates would be reduced by more than was appropriate to respond to the macroeconomic consequences of the fall. So, it's equal on the way up and on the way down. What's different is the movement of asset prices tend to be a-symmetric in their move. When they collapse, there tends to be more of a disorderly action, which may require more of a monetary policy response. Whether on the way up or the way down, a monetary policy response is calibrated to monetary objectives. It's not, as Greenspan put, to keep assets higher or put them down lower. The monetary policy response in both cases is to address the macroeconomic issue.

Wilmarth: Do you think there was some concern that the market was perceiving it as a-symmetric? That the market was seeing it as a floor here and an upside there?

Nelson: I'm just not sure. There was an important phenomenon that contributed in a key way, which was the great moderation. I think the great moderation really happened, I just wasn't sure of what the central bank would do. In fact, there really was a moderation in economic activity and asset prices, which I certainly thought and many thought that it meant risk was lower. I don't think there was some false impression that the Federal reserve would protect against a decline in asset prices, but I do think that it contributed to an environment of stability. That stability led to a growth in shadow banking and instability. The other thing I would not is that there were supervisory actions taken in response to the easing of standards in subprime and commercial real estate lending. Now during the financial crisis, those actions weren't sufficient, but there were responses taken prior to the crisis. Monetary policy was not used, but even in the past, supervisory tools were used to combat what was perceived as a departure from asset prices.

Wilmarth: If we go back for a moment to the eve of Lehman, you know they're in trouble and you haven't found a private sector solution, you have to decide whether to pull the plug on Lehman, to what extent did you say if Lehman goes and defaults on these obligations there will be repercussions, what did you see those obligations as being? Was there some concern that they couldn't be contained? There's a question about authority with 13(3), but also what are the potential downsides if we don't act. What did you see those downsides as being?

English: I wasn't involved.

Alvarez: I think there were a couple of factors in Lehman that I would mention. One is that Lehman was – Bear Stearns, when they fell, that was really unexpected. We didn't have any facilities out there. The industry had been picking at Bear Stearns, they were clearly the weaker sister of broker-dealers. That Friday they went into demise wasn't the day people thought they would fail. Once they did collapse and get sold off, they were looking at Lehman as the next to fail, but there was more preparation. We opened up PDCF and TSLF. We had better arrangement with the SEC. The GSEs started to shake and we used our – we stood ready to

make a loan to the GSEs and then they were put into conservatorship. The market had signs that they should protect themselves from Lehman. They had the indication that if we would provide the support then it was there. It was the PDCF. People started to say that if only Bear Stearns had access to the PDCF they would have made it through. We had the Lehman weekend where we brought together all of the market participants and said here it is, this is the last weekend for Lehman, you've got to come up with a solution. This one was one where there was a lot more preparation. The market had the opportunity to shield itself. I think we thought that the market was preparing itself better, and then when Lehman failed it really did send reverberations through the market that were greater than we expected. Then AIG started to crumble just two days later. So it began to feel like a collapse of the system, instead of just an isolated incident. The money market funds, they started collapsing.

Wilmarth: Did money-market participants in that fateful weekend tell you that we can't save Lehman, but they shouldn't go?

Alvarez: So that whole weekend, Hank Paulson at the Federal Reserve was saying, we're not saving Lehman. You've got to do this. He's written a whole book, which basically says we were not going to save Lehman.

Greene: How correct was that statement by Secretary Paulson? In Mr. Valukas's report, there's an indication that Chairman Bernanke, Sec. Paulson, and then-President Geithner were ready to extend some level of government support to someone who would purchase Lehman. Was that correct?

Alvarez: I think that was the difference between the public message and what was in folks' minds. I think that what Paulson and Geithner were saying to the folks publically and in the room was we're not prepared to provide any assistance.

Wilmarth: No assistance?

Alvarez: No assistance. I think on the other hand, what you hear from the Chairman that in the back of his mind, he wasn't at the Lehman weekend, he was here in Washington preparing for the F-1C. In the back of his mind, if someone comes to me and says Lehman's going to fail unless you give a 13(3) loan for a few billion dollars and it's something we could do within our authority and collateral, we would have to think about it. Don't know if we would have done it, but we would have had to think seriously about it. That offer never happened.

Greene: We have an FRBNY document, FRBNY to Exam 003516, which is their Game Plan document. On page 2, under the heading FRBNY Financial Commitments, the first line says, "we should have in mind the maximum number we are willing to finance before the meeting starts, but not divulge our willingness to the consortium." Was there a number?

Alvarez: No. I think you should in mind what this document was. There is staff at my level and lower that are coming up with numbers to prepare. As we became more aware of the affect of systemic institutions, we started to have these role playing, game planning groups and what they would do. There were a lot of alternatives that we would never do. Some that were illegal. Some that are wildly interesting, but impractical, and some that were possible. The idea was that you had to think through options. We wanted to think through alternatives. That's what this was. This was not approved by the board. It wasn't approved by the Board or then-President Geithner. It doesn't reflect anybody's decisions, it reflects staff musings. I think Paulson and Geithner were saying what they thought was the right thing, which was to in some sense, I think, to try to offset the moral hazard of helping Bear Stearns, to get the industry to really focus on the problem and to let them know that they had responsibility for this one and that this one was in the estimation of Paulson and Geithner and the Fed that this one was a bit out of reach for us, and it turned out it was out of reach for us.

Greene: Some of the public documents suggest that Chairman Bernanke was in Washington in the event that a 13(3) meeting might have been needed to bailout Lehman? Is that part of why he stayed in DC?

Alvarez: Under 13(3), we have to have a vote of at least five. One of our members, Kevin Warsh was in New York. I think the Chairman could have been in New York, if it would have been useful, but this one was before a big FORMC decision and so I think being here to prepare for the FORMC was the most important thing at the time. Kevin was very capable and able to deal with that decision from New York. The chairman was available by phone.

Greene: There was obviously a run-up to the Lehman situation, the BofA situation. In some of the documents, Mr. Dudley suggests in July 2008 a Maiden Lane type of approach for Lehman. I have a July 2008 email from him –

Alvarez: Yeah, that was another game planning –

Greene: Was there a decision point where there wouldn't be a Maiden Lane approach? Did someone decide that or was it discussed? The principals do go through a long-term capital approach and it didn't seem to be on the table at all. What happened?

Alvarez: A Maiden Lane approach meant an acquisition of Lehman. So somebody buys Lehman and we deal with a small portion of assets. In July there was no purchaser and in August/September there was no purchaser. It didn't match a Bear Stearns situation at all. Was there a decision? No per say. It didn't rise to the level of a decision, because we never had a purchaser step forward.

Greene: That leads to the BofA situation. There is a suggestion that BofA decided not to further pursue Lehman mostly because it couldn't get guarantees and a ring fencing around what they regarded as toxic assets. Is that –

Alvarez: That's not my impression. My impression of the events was that BofA was always more interested and comfortable with Merrill Lynch than with Lehman. Lehman is a wholesale broker-dealer, BofA is a retail bank, Merrill Lynch is a retail broker dealer. The fit was better culturally and business plan-wise. They were willing to bid on Lehman Brothers, because it would have been a big jump into the securities business. In some sense, it wasn't the business they understood very well. The more they looked, the more uncertain they became they could manage the risk there. Each time they looked, their sense of risk got bigger and bigger. They clearly went into the negotiations without any expectation of any kind of assistance. They went into it and started getting more uneasy. They started talking about more assistance and different kinds of assistance. That's when Merrill Lynch said we're available, and they just dropped off of Lehman. The fact that they were interested in Merrill Lynch, you can see in the fact that it took no time to come to a deal with Merrill Lynch that afternoon and announce it that evening. Whereas with Lehman, they had been struggling with due diligence for a long period of time and were still struggling along.

Greene: What were the numbers for Lehman and did they come to you with a 13(3) proposal?

Alvarez: No, I think they came to us and said there's a hole at Lehman and the size of the whole kept growing. That was different than saying they needed a 13(3) loan. That could've been satisfied, for example, by the parallel effort to bring the private sector folks together to do a capital injection. It was really more a hole. That's the way I remember them describing it. I don't remember the numbers very well, so I'd hesitate to state them.

Greene: There was presumably a calibration of what the hole must have looked like, reflected presumably in the amount of private money, which as I understand it resulted in roughly \$30 billion in commitment. Was that the size of the hole as the experts perceived it?

Alvarez: No. I wish they were calibrating the assistance by the size of the hole, but I think they were trying to figure out how much they were each willing to spare. How much they could each put into a pot to solve a problem and not hurt themselves. My memory is that the whole was bigger than what the private sector were putting forward.

Greene: Was there a sense of how what remained would have been filled?

Alvarez: No.

Greene: I'm curious too about the purpose of the Lehman weekend. I've seen two perspectives. One is the purpose was potentially to try and save Lehman Brothers, to try and keep it as a separate stand-alone company. The other was to provide short-term funding for a disciplined wind down of Lehman Brothers.

Alvarez: I think the purpose was to solve an institution that was getting deeper into trouble. We didn't have a particular solution to the exclusion of others. If we could have worked out a

solution and there could have been a capital injection and a wind down, fine. If there was an acquisition by somebody else or splitting up the organization among seven or eight different people, fine. We were open to different solutions. I think it was more driven by the fact that Lehman couldn't continue the way that it had, and that it had blown through its liquidity and capital. We were open to any kind of solution.

Greene: In that regard, one suggestion of why the Lehman weekend did not fulfill whichever purpose it had, whether the proper wind down or the saving, was this guarantee problem vis-à-vis Barclays, which indicated the FSA. What as the size of the problems in terms of dollars and timeline?

Alvarez: It's a guarantee of the implication. I don't know what that number is.

Greene: Was this a \$10 or \$15 billion?

Fallon: Multiples of that. Whatever the outstanding liabilities of Lehman were.

Alvarez: It was a big problem. The biggest problem was the uncertainty.

Greene: And the time line? Was this a two week problem or a two month problem?

Alvarez: Yes, yes it was. Don't know how long that would have had to be out there. Bear Stearns had a guarantee from JPMC. Their acquisition was outstanding for a month, March 23rd until -

Asher: I think it was the end of June.

Alvarez: Three months then.

Sefer: If you were looking for any type of solution that would have worked, including a wind down, don't you think about how long it would take Barclays to get shareholder approval? Didn't you think you could give them cash for a few days and the deal would get done?

Alvarez: Life isn't as knowable as that. It's the uncertainty about it that was the problem. You shouldn't focus too much on the length of time. Barclays was facing an FSA requirement needing shareholder approval to get the guarantee. I don't think they were worried about the duration. That's not what kept them from giving the guarantee. It was that they didn't think they could get shareholder approval period. They couldn't have gotten shareholder approval before they opened Monday. Lehman was without guarantee and protection until they could get shareholder approval. If it took thirty days or one week to get approval, Lehman wouldn't have made it through the week, as we know. Without the guarantee they went directly into bankruptcy. They would have had to go into bankruptcy.

Greene: As I understand it, one perspective on why you couldn't be as helpful as you might have been otherwise is the lack of collateral Lehman had. That Monday they go into bankruptcy, you do extend significant, I mean billions to them. What was different, either legally or physically?

Alvarez: We lent to the broker-dealer against the collateral they had. We limited the loan to the collateral they had available.

Greene: Was it roughly \$60 billion?

Alvarez: I think it was \$42 – I think it was in the 40s.

Asher: I will check.

Alvarez: It was somewhere in that neighborhood. That went to the broker-dealer and met its funding needs. The broker-dealer was only about half the size of Lehman. The rest of the organization, which is what went into bankruptcy, didn't have the same amount of collateral available to it and needed more.

Greene: Was there an assumption that undergirded that extension of liquidity, that Barclays would buy the broker-dealer portion of Lehman, which of course they do instantly? Did you know that at the time of the extension?

Alvarez: I don't know if they did that on Monday or Tuesday. I don't know when they first became aware of Barclays. I don't know the timing vis-à-vis the lending, which came first.

Greene: Hypothetically, if they didn't know that Barclays was prepared to purchase, with the support of the FSA, the broker-dealer, why would those loans have made sense? What would the rationale have been?

Fallon: The rationale behind PDCF was to provide stability to the markets that were supported by the primary dealers. That's the lending being done to Lehman, through the PDCF. One of the reasons the PDCF was established was to support the triparty repo market, because of concerns about what disruptions in that market could have on broader market circumstances. If we haven't provided those loans, there would be serious questions about what would happen to the triparty repo market, which not only allowed Lehman to get financing for its broker-dealer, but was also a significant source of financing for the other broker-dealers that were still in existence. As Scott pointed out, the loans there were more than fully secured by the collateral that was regularly pledged through the tri-party repo system. Those were significant reasons. The other part was, part of the concern about the triparty repo market, was it depends on clearing banks to provide significant amounts of intraday clearing credit. And if the clearing banks are not comfortable, they are going to be able to roll over the tri-party repo funding. They take the collateral that they've been holding for themselves during the day, and roll it back out to the investors, they're not likely to allow that funding to go. The collateral will go back to the

triparty investors, many of which don't want those assets, which could spark a fire sale with all that. The PDCF financing allowed that process to continue while the broker-dealer was looking for a solution.

Caperton: Can I interrupt about time. I didn't know what other topics you wanted to cover, how to budget your time.

Sefer: We only wanted to cover TBTF, institutions, where you did invoke 13(3) or FDICIA risk exception. I don't know where we are in terms of finishing up. I'd like to finish by 5:30.

Alvarez: I have somebody in at 5pm.

Sefer: We can always follow up later.

Greene: One of the mysteries that we're trying to unpack, was the suggestion that Lehman's collateral had been locked up based on its clearing banks. JPMC and Citi. I've read that they had perhaps as much as \$25 billion locked up. It was in their liquidity pool, but it was locked up. Is that generally correct, the orders in magnitude?

Asher: I'll have to check. It's in the bankruptcy examiners report. There was clearly some collateral that was secured to JPM.

Greene: The trustee cites an SEC email to the effect that there was \$25 billion.

Fallon: That arose from the recording keeping uncertainty as to what the collateral was pledged for. I think most of that came up after the sale with Barclays when the clearing banks were searching for arrangements.

Alvarez: There were definitely deposits on the orders of \$20 billion that I remember there was concern about whether they would be available for the liquidity pool for Lehman Brothers and did folks know that that was tied up by JPMC or Citi and not available as ready liquidity. We realized at the end of July and August, that time frame generally, that deposits were tied up and wouldn't be available in liquidity. We told them we thought their liquidity was shoddy, because it couldn't count to their liquidity pool. I'm not sure how that fits in to 13(3) lending. That's certainly not an asset that's available to be pledged, because it is pledged to somebody else. That only becomes an issue on the day they want to borrow.

Greene: I'm trying to get illumination on – were these the assets against which you provided \$40 or 50 billion. Were those the same assets subject to these collateral requirements?

Alvarez: No, we would only take unencumbered collateral.

Greene: Because the liquidity pool as I understand it from your September 12 daily report, was in the order of \$33-35 billion –

Alvarez: And that did not include the \$25 billion.

Seefers: And that's considered unencumbered.

Alvarez: We're talking in apples and oranges and grapes here. So the liquidity pool is a money pool available to them to pay off debt as they come due. The \$25 billion wasn't counted as that, so we couldn't count on them having \$50 billion, we had to count on them having \$30 billion. One of the reasons of the urgency of the Lehman weekend was that that \$30 billion was shrinking. When it comes to lending, we only accept unencumbered collateral, so we were never counting on that collateral as a deposit for our loans. I don't remember whether that loan was a broker dealer or the company.

Seefers: When you look at that report and see there's \$34 billion in leverage and there's cash and box inventory, would that be \$32 billion of unencumbered collateral that could be used to secure a 13(3) loan?

Alvarez: I don't know which report you're looking at. Rich was referring to the Lehman Bankruptcy Examiner's Report. He follows it throughout the summer and where it was part of the liquidity pool. For example, did the SEC know it was encumbered? Did we consider it part of our liquidity pool? He has a whole chapter on that.

Greene: Let me ask you a couple of legal questions. This is a memo to file from the legal division. Is that something you're generally familiar with?

Alvarez: Sure.

Greene: Is that a fair representation of the substance and key provisions of 13(3)? It may have changed since it was March of last year, but it's the most recent thing I could find that seemed to capture your legal perspectives.

Alvarez: This memo deals with a particular facility. It doesn't try to capture all of our thoughts on 13(3). It just tries to capture what we thought about 13(3) and the CPFF. There's a variety of memos about different things, depending on what the kind of loan was that we were dealing with.

Greene: Would it be fair to say in general questions of what exigent circumstances might be? What security might mean?

Alvarez: Yep.

Greene: Is there something that's more definitive and complete?

Alvarez: No, we didn't do a single, in depth article. They're more ad hoc. When we were at Bear Stearns, we did a Bear Stearns memo. CPFF, TALF, we did an AIG memo. We did one for each extension.

Greene: Would it be the case that insofar as these kinds of memoranda and decisions, do they interpret in relatively vague terms, 13(3), do you guys regard that as worthy of Chevron deference?

Alvarez: Absolutely. Even I will admit that Chevron deference is strongest when rule making is involved, and this wasn't a rule making. We are an expert agency of our own statute, and we have a long history in these interpretations, so I think we get some deference.

Wilmarth: It gives you some cover.

Alvarez: Right, but it's still letter.

Greene: I'll read you some key conclusions, on pages 6-7. This relates to security acceptable to a Reserve Bank. And the conclusion appears to be, "therefore, a Reserve Bank has the discretion to accept as collateral, securing the section 13(3) discount of an IPC note collateral of any value, including collateral that at the time of the extension of credit, may have a current market value that is less than the amount of credit extended, provided that the credit is secured to the Reserve Bank's satisfaction." My layperson's take on that is that for example, if the face value of something is 100 and its current value is 50, the Reserve Bank could grant credit up to 100, maybe more, but at least 100.

Alvarez: Right. I understand that a layperson would come to that conclusion, but it's the ifs that come around. To be "secured to the Reserve Bank's satisfaction," it's a pretty strong hurdle. As the rest of the memo explains, you have to be pretty confident you'll be repaid. I think it might be the kind of situation where if we believed that a loan at a hundred dollars based on collateral with a value of \$95, where the collateral was appreciating and you have reasonable expectations that the collateral would continue to appreciate, or you were lending with recourse and you expected that the borrower had sufficient financial resources to repay the collateral, those situations you may feel secured. But in a situation where you would be lending without recourse, even when the assets were declining, I think it would be very difficult to justify that under 13(3). That by the way is more of the Lehman situation. The shares of its subsidiaries and its assets, the only collateral it had, were depreciating.

Greene: Is there any additional official or semi-official color around this collateral issue?

Alvarez: I'm not sure what you mean.

Greene: There are some footnotes in one of the analyses of Maiden Lane that suggests that taxpayers won't have a loss on these Maiden Lane assets, because the Fed will either hold them to full term or sell them over time and our assumption is that at that point we'll get the value that we want. Is that one of the considerations?

Alvarez: Sure. That's part of the thought process on being adequately secured.

Fallon: For the Maiden Lane facilities we had very strong projections from our financial advisors that the assets would overtime pay out sufficient to repay the principal and interest.

Alvarez: The other thing is that we never did lend throughout this crisis against assets whose value were lower against the value of the loan.

Nelson: Including the CPFF.

Greene: This is what the law is?

Alvarez: Yeah, I do think the law allows that.

Greene: I think your statute would allow that. Consistent with the purpose of the statute it would be wholly appropriate. If there was a fire sale, they could assume that the prices would go up in the fire sale.

Alvarez: We do have the advantage that we can hold the assets at a cheaper funding rate than just about anybody. And if the assets have the opportunity to appreciate, then we can recover the money.

McWilliams: Did the same Bear Stearns analysis with projections for returns exist for Lehman? Assessing that their assets would support the collateral?

Alvarez: Nope.

Sefer: Then how did you know you couldn't make a loan under 13(3)?

Alvarez: Folks had a good feeling for the value of Lehman during that weekend. There was no memo prepared that documented why we didn't lend. It was just the thought that we are not going to lend, because the decision makers who were involved in the negotiations, who were on the scene, who were talking to the BofAs and the industry and the Lehman people, they understood that there wasn't enough there for us to lend against and they weren't willing to go forward.

Nelson: This is just a general point that I wanted to make. 13(3) is not the same as TBTF. 13(3) is one of the authorities under which we exercise our lender of last resort authority. You're not lending to an insolvent institution. The benefit comes from an unorderly – that's based on the premise that you're not lending to an insolvent institution. The benefit comes from avoiding that unnecessary liquidity failure. That logic extends to an institution of any size. We do that under 13(3) and 10(b). We would and have lent to very small institutions to avoid the liquidity issues. They're not quite the same thing. There's overlap. There's cost to lending and moral hazard exposure. That's why there is a high hurdle to exercise the authority.

Sefer: Was there an understanding of how much the loan needed to be?

Alvarez: We were face with having to give an open ended guarantee. Lehman didn't come to us and say can we borrow \$10 billion. They came to us and said will you guarantee our operations tomorrow? How big is that loan?

English: That's an open-ended loan, because there's nobody to take us out.

McWilliams: Wasn't AIG an open-ended guarantee?

Alvarez: Nope. AIG was an \$85 billion revolving line of credit to an institution that was solvent and had lots of assets. They truly had a liquidity crisis. They had value in their insurance subsidiaries, but no cash to pay their bills.

Nelson: That's exactly the point I was trying to make about Lehman. I wasn't involved, but perhaps I wasn't involved with Lehman because the institution didn't appear to be solvent.

Seefer: Could the Fed have actually gotten the assets of the insurance companies at AIG?

Alvarez: We do. We have a protected interest in the shares of the insurance companies. We are well-secured and getting repaid.

Seefer: It's a win-win.

Alvarez: I'd rather not be in this game.