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YPFS Lessons Learned Oral History Project: An Interview with Thomas Baxter

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Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Thomas Baxter[1], Former General Counsel, Federal Reserve Bank of New York
Interviewer Name	Rosalind Z. Wiggins, Director & Sr. Editor, Yale Program on Financial Stability Alec Buchholtz, Research Associate, Yale Program on Financial Stability
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Introduction:

The Yale Program on Financial Stability (YPFS) reached out to Thomas Baxter to request an interview regarding his time as General Counsel for the Federal Reserve Bank of New York (FRBNY) and, more specifically, his involvement with the American International Group (AIG) intervention[2]. Baxter started at the FRBNY counsel's office in the summer of 1980 and he became General Counsel – and therefore, also Deputy General Counsel of the Federal Open Market Committee – in 1995, serving in those roles until 2016. During his tenure, he was regarded as the principal behind the Federal Reserve's assistance towards AIG, among other Federal Reserve crisis programs. Since his time at the Federal Reserve, Baxter has joined Sullivan & Cromwell in New York, NY as of counsel for their Financial Services Group.

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

Transcript:

Background

YPFS: **Could you give us some background about yourself and your career at the Federal Reserve? When did you start there? What kinds of things did you do until the Global Financial Crisis began?**

Baxter: I began my career working as a law clerk for an appellate division judge. I started at the Federal Reserve (the Fed) in the summer of 1980 as a staff attorney and I became General Counsel of the Federal Reserve Bank of New York (FRBNY) in

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

1995.So I had been serving as General Counsel for quite a while before the crisis. When you become General Counsel of the FRBNY the tradition is you also become Deputy General Counsel of the Federal Open Market Committee FOMC), so those two jobs go hand in hand. There are a couple of these positions that are by tradition shared positions between the FOMC and the FRBNY. For example, the President of the FRBNY is also the Vice Chairman of the FOMC. The account manager of the FOMC, by tradition, is also the Executive Vice President in charge of markets. I was General Counsel of the FRBNY and Deputy General Counsel of the FOMC from 1995 through 2016.

YPFS: **Just for clarity, that means you're participating in the FOMC meetings as well?**

Baxter: Yes, but put "participation" in quotes, given that I'm a lawyer. I was there for legal reasons. I had some non-legal responsibilities as well towards the FRBNY's Board of Directors, towards the compliance function, towards an area called "Banking Applications," and, of course, the legal area.

Bear Stearns Intervention

YPFS: **It's our understanding that the Fed's actions started with the need to increase liquidity for banks in late 2007, which is when the Fed needed to start doing more unusual programs. Based on your definition, what event marks the start of the crisis for you and what were you doing at the FRBNY at the time?**

Baxter: When I talk about the crisis, to me it began in the summer of 2007 and ended in the summer of 2009, about a two-year period. I know different people have different views as to how long it lasted. With respect to the crisis itself, my principal demands all related to providing legal advice to the FRBNY, with respect to the programs that the Fed has long held in operation – like traditional discount window lending – the extraordinary measures that we took during the crisis, and some of the supervisory implications of financial institutions that were under our supervision at the time.

To me, the crisis begins with the non-support of the Bear Stearns funds and then the action by BNP Paribas in August 2007. My recollection of August 2007 is that there was heightened sensitivity to market conditions, concerns that we might be moving into a new period of fragility, and discussions about whether the Fed should start to reduce rates. I couple that with a generalized sense that things were not normal and that we needed to start being much more attentive to where the economy was headed.

For me, the real move into uncharted territory didn't happen until Bear Stearns in March of 2008. The surprise from my point of view was how fast Bear Stearns' trouble happened. We were aware of the unusual conditions in markets and the

Term Securities Lending Facility (TSLF)[3] was developed principally because of those abnormal conditions. The announcement of the TSLF was one of the factors that played into the run on Bear Stearns.

We announced the TSLF on Tuesday, March 11th, and shortly after the announcement, Charlie Gasparino from CNBC went on air and said something along the lines of, "The Fed made this announcement this morning and people should understand that it's a program designed to save Bear Stearns," which was not true. The markets reacted to how the media portrayed the program and that's what started the run on Bear Stearns. The surprise was that by Thursday, March 13th, Bear was illiquid.

YPFS: **Did the Fed act in anyway after Gasparino's comment just to restate clarify the intent of the program?**

Baxter: No. The way the Fed works is we made the announcement. We spent a lot of time crafting the announcement. For better or for worse, the Fed, from experience lets the announcement speak for itself. If you go in afterward and try to explain it, it typically doesn't help the situation.

Nothing was done by the Fed on that Tuesday following Gasparino's announcement. I didn't realize how bad things had gotten until Mike Silva, who at the time was Chief of Staff and Senior Vice President of the Executive Group at the FRBNY, came into my office on Thursday night and said that Tim Geithner was coming back into the office following a conversation he had with Rodge Cohen (of Sullivan & Cromwell) and Alan Schwartz (CEO of Bear Stearns).

YPFS: **The TSLF, the Bear Stearns facility, and the Primary Dealer Credit Facility (PDCF) were the first uses of the Federal Reserve's Section 13(3) authority. What kinds of research, briefings, or meetings were held to get to the point of utilizing the authority, especially since the Federal Reserve had not used that power since the Great Depression?**

Baxter: I would separate those two. The original discussion surrounding the TSLF focused on determining whether we had sufficient authority under Section 14 of the Federal Reserve Act to create such a facility. Some of us at the FRBNY, including me, believed that we did because that was the authority that historically we had used for securities lending. In the discussions on the TSLF, the wrinkle came with respect to the types of securities lending that were going to be done and more specifically, what type of specific mortgage-backed securities. Ultimately, the types of mortgage-backed securities we wanted to borrow were ones that we could not purchase at the open markets desk.

[3] The TSLF was a program established by the FRBNY that permitted primary dealers to lend certain securities to the FRBNY in exchange for Treasury securities, which the dealer would then use as collateral for loans. This accounted for the increased restrictions in the market on certain types of securities which had caused increased lending costs and restricted availability.

We had to aim the program specifically at that asset class, because the TSLF was designed to cure the dysfunction of the markets for that asset class. This led people to say, "Section 14 is not sufficient for this purpose because you couldn't buy these particular securities under Section 14." We then realized that , "The only other real authority is 13(3)," and that's what led to the focus on discussing Section 13(3), with the understanding that the authority had never really been used in 70 years and required the Fed's Board to determine that circumstances were exigent and unusual. Because of this, the announcement of the TSLF was a big deal for the Fed.

The PDCF didn't come about until Sunday, March 16th, at the end of Bear Stearns weekend. When we started the weekend, it wasn't clear if Bear Stearns was going to be rescued. If Bear Stearns had not been rescued, we would have made a Lehman-style announcement that anticipated that all the primary dealers would be looking for funding. That was really the genesis for developing the PDCF and having it operational by Monday, March 17th when markets reopened.

YPFS: **We also interviewed Scott Alvarez, former General Counsel of the Board of Governors. He talked to us a little bit about how you all coordinated across the legal issues between the Board and the FRBNY. One thing we spoke about was ultimately granting the authority to lend to Bear Stearns through JPMorgan. Was there a preference not to use Section 13(3) if there was another way to do it? But ultimately, it was decided that that was what was required?**

Baxter: On the night of Thursday, March 13th, Mike Silva came into my office and said, "Tim Geithner is heading back to the Bank from his home in Larchmont." Once Tim returned, he said, "We have to be ready to lend to Bear Stearns on Friday, March 14th because we're just not going to have enough time to design, in the space of a few hours, a more durable rescue. So, we need and we want to come up with a device whereby we can at least maintain Bear's operations and have more time over the weekend to figure out what to do."

By the time that decision is made, it's about midnight on Thursday night. Tim said to me, "Figure out a way that we can do this." So, Section 10B, which is the provision of the Act that we normally would utilize for discount window lending, that provision permits lending only to depository institutions, or banks. Bear Stearns was a securities company and not a bank. What do you do in that circumstance?

Well, what we did was create what you could think about as back-to-back mirror image lending. The FRBNY would lend to JPMorgan Chase (a bank), who would then on-lend to Bear Stearns on the same terms. You'd use the same collateral to secure both the lending from JPMorgan to Bear and the lending from the FRBNY to JPMorgan. The wrinkle was that JPMorgan said, "There's no way we're going to put our credit on the line, so this lending has to be non-recourse." What that

meant is that, if Bear did not re-pay Chase, then Chase would not have to re-pay the Fed. Instead, we would keep the collateral.

Over the course of that night, we structured the facility as a loan to a bank, but it's understood that JPMorgan is going to do a mirror image of that lending to bring the liquidity to Bear Stearns. But there was confusion in the morning over was the term of the lending among the three parties, that is Bear Stearns, the Fed, and JPMorgan.

In the early morning of Friday, there was a back and forth between me and Steve Cutler, the General Counsel of JPMorgan, as to what was the term of the lending. [I think originally the term of the loan was proposed to be 28-days, so Bear Stearns was expecting a 28-day loan, but instead it ended up being only an overnight loan. Note you don't count weekend days. An overnight loan made on Friday is due on Monday.] The reason that's important is that it meant that we had only until Monday [to find a more durable long-term solution for Bear]. That ultimately also created a deadline for JPMorgan to get the Bear transaction done. If you look at the loan documents, that's what you'll see.

On Friday, there was a lot of discussion at the Board of Governors about the structure of the back-to-back loan and its non-recourse term. Maybe, they thought that simply authorizing an extension of credit under Section 13(3) to Bear Stearns directly would be a better structure, and that is in fact what the Board of Governors did on March 14th, when they authorized the bridge loan of $12.9 billion to Bear Stearns through JPMorgan. What was ultimately done was consistent with the loan documents, which was back-to-back non-recourse lending, but authorized under Section 13(3).

The bridge loan essentially enabled Bear to live through the weekend. Over the weekend, we focused on a more durable rescue for Bear Stearns which included some non-recourse lending to Bear Stearns, which is what was announced on the Sunday evening of March 16th.[4] That was not the deal that was ultimately done, however.

YPFS: **When the original bridge loan was done on the Friday, it wasn't known that Bear Stearns would be bought. Was the Fed's thinking that the loan would be renewed while it figured out what the long-term plan would be?**

Baxter: The original loan was for the exclusive purpose of carrying Bear Stearns through the weekend only. There was no implied suggestion from the Fed that it would be renewed on Monday morning. This is what created the urgency to come up with a more durable solution and it was during the weekend that JPMorgan said, "Look, we're interested in buying Bear Stearns, but not with $30 billion of troubled

[4] Bear Stearns announced their acquisition by JPMorgan Chase in a press release which can be found at https://www.sec.gov/Archives/edgar/data/19617/000089882208000286/pressrelease.htm (Accessed on 12/19/2018).

assets. You've got to find a way to get the troubled assets out of Bear Stearns and then we'll contemplate buying it, assuming we can agree on terms." It was the negotiation of those terms over the weekend that led to the announcement on Sunday night.

What happened between March 17th and 24th was essentially a significant renegotiation of what was announced that Sunday night.

Summer of 2008

YPFS: **We have received some good background about the several different programs that were used by the Fed and Treasury to help AIG. But we'd like to get your legal perspective from the Fed on this assistance.**

Baxter: I don't remember a dollar amount being discussed with regard to AIG and I was not personally in a meeting with *AIG's CEO* Willumstad when he first reached out to Tim and the FRBNY in June and asked for possible liquidity. What I do remember is Tim coming to me and asking- "Baxter, could AIG establish a primary dealer? If they could and did, could they borrow from the Fed?" That's a pretty easy thing to answer because as of March 17, 2008, we had the Primary Dealer Credit Facility (PDCF), which was open to all primary dealers. So, if AIG had a primary dealer, then yes, they would have been able to borrow.

The issue, though, was that AIG didn't have a primary dealer and you can't become a primary dealer overnight. There's a whole process involved, which typically could take anywhere from one to two years, which is not to say that is the end of the analysis, because as you know, we did a lot of things pretty quickly during the crisis. It was a possibility that AIG could have formed a primary dealer and then could borrow from the PDCF, so we were going to look into it further and get back to him; I don't remember there being a sense of urgency to Tim's question. I have a recollection that Bill Dudley, who was then the Executive Vice President of the Markets Group at the FRBNY, and I had a conversation or an exchange over email to do a little preliminary work on this, but nothing more than that happened in the summer.

YPFS: **By September, everything was ablaze. But at the time, in the early summer, do you recall how people were feeling and whether they believed there was a way to get a handle on the markets?**

Baxter: What I remember is that I had gone away with my family for two weeks in the summer of 2008, sometime near the end of July or the beginning of August. When I came back, there was a completely different atmosphere than when I had left. It

was probably mid-August when I returned, and things had deteriorated significantly over those two weeks. I certainly didn't anticipate what would happen in September and had no clue that things would get that bad, where, by the end of September, we'd be standing at the edge of the abyss.

YPFS: **Did you feel like the deterioration in the overall environment when you returned was directed at the general state of the overall markets, or at Lehman specifically? Was AIG on your radar at all by that time?**

Baxter: AIG was not on my radar at that time. Lehman certainly was, and so was Merrill Lynch. I had been in a number of conversations with Tim, Rodge Cohen, and people from Lehman about the negotiations with the Korean Development Bank about the possibility of a sale and I knew that those discussions had not gone very well. AIG was not, as I remember it, a factor in August 2008. Lehman certainly was, Merrill Lynch certainly was, and clearly, market conditions were deteriorating, but I remember AIG only becoming a factor after the government-sponsored enterprises (GSEs) were placed into conservatorships.

Lehman Brothers

YPFS: **Through some of our other interviews, we've gathered that many people thought that the conservatorships might have calmed or reassured the markets a bit, because they were so big, and it was such a major action by the government. But it didn't seem to have worked that way because Lehman happened right after. Can you share your views on the effect of the conservatorships on the market?**

Baxter: My take is exactly the opposite. My view is that I think the conservatorships of Fannie Mae and Freddie Mac were a significant aggravating factor that accelerated the deterioration of markets. I don't think the conservatorships helped at all. I think they played a significant negative role in Lehman's deterioration.

Sometimes markets react in a surprising way. For me, it's similar to the Charlie Gasperino story surrounding the announcement of the TSLF and the run on Bear Stearns. I think the announcement of the conservatorships were one of the triggers for the run on Lehman. Not that Lehman was in good condition in the beginning of September, but it was fragile and all it needed was a trigger to set the run off. For me, that trigger was the GSE conservatorships.

YPFS: **From our interview with Scott Alvarez, we were told that throughout the summer the teams across Fed branches were conducting what-if scenarios and training projects. Since Section 13(3) hadn't been used since the PDCF, was that something teams would analyze and discuss more leading up to Lehman's rescue in September, or was Section 13(3) brought up just the week prior to Lehman's rapid deterioration?**

Baxter: By September, we all understood that Section 13(3) was a tool that was available to us. The declaration that the situation was "exigent and unusual" by the Federal Reserve, had already been done and we knew how to use the statute. We understood that it was available as discussions with respect to Lehman and Merrill Lynch began the week prior to Lehman's bankruptcy. The discussions were about what kinds of things could we do? Would we contemplate another Bear Stearns, or could we do a variation on what we did with Bear Stearns and avoid some of the criticism that came in the wake of the Bear Stearns rescue?

Sometime on September 9th, we had a meeting: Tim, myself and a few others, and we started to talk about what I'll call "an adaptation of the rescue of Long-Term Capital Management (LTCM) in 1998." I was involved in the LTCM rescue, so I shared my experience with others at the Fed of what we did. Essentially, it was to call the creditors of LTCM in a room at the Fed to explain why it was in their self-interest to save LTCM and to persuade them to finance a rescue. We thought that we could use that type of technique if we needed to rescue Lehman or Merrill Lynch; we could call their largest creditors together and persuade them to fund a vehicle that would buy troubled assets from the target institution. If you took the troubled assets out (like in Bear Stearns), then you would need an acquiring institution to purchase Lehman.

We started to talk about that as a concept and it ultimately became the model, Plan A, for what we tried to do over Lehman weekend. There is actually an outline modeled on LTCM created by Michael Nelson, a lawyer who was working at the Fed under me at the time.[5] There was also a Plan B, which was that we knew we had the PDCF. If we could have the parent company file for bankruptcy, we could wind down the broker-dealer's book over time using liquidity from the PDCF to fund its operations. We ended up using Plan B, lending nearly $70 billion to Lehman's broker-dealer, the primary dealer, through the PDCF on September 15th, 16th, and 17th.

YPFS: There's an argument from Lawrence Ball, a professor from Johns Hopkins, that as a third option, the Fed could have lent to the Lehman parent long enough to keep it operating until another acquirer could be found. Do you think that could have been feasible?

Baxter: Where I think Professor Ball is mistaken is to offer an abstract idea out of context. You can always come up with alternative plans, but when you're in a crisis, and you've got two plans on the table, once you've concluded that Plan A can't work, you have to go to Plan B because you have only a couple of hours, which is not enough time to talk through a new or different Plan C or D or E or F.

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[5] This document can be accessed from the YPFS Resource Library at http://ypfs.som.yale.edu/sites/default/files/FED%20LBB%20Gameplan.pdf , or by searching Author: Michael Nelson and/or "The Federal Reserve's Liquidation Consortium Gameplan for Lehman."

What happened over Lehman weekend, with this marvelous LTCM improvement on what we did with Bear, involved three key ingredients. First, we needed an acquiring institution to take over the target. But to do this, you needed to arrange for a sale of the bad or toxic assets. To sell those assets, you needed a vehicle (the buyer) and the vehicle needed funding. In our plan, the funders were the large Lehman creditors who were willing to extend credit to a vehicle that would then use the proceeds from those credits to buy the troubled assets out of the target, Lehman. Then you would need, an open-ended and unlimited guarantee of the target's trading obligations by the acquiring institution. When I talk in law schools about this, I try to emphasize the importance of this guarantee because it's the guarantee that stops the run. If you go back and study what happened between March 17th and March 24th, you'll see that the entire Bear Stearns deal was essentially renegotiated because of the terms of the Chase guarantee.[6]

At the start of Lehman weekend, we had two potential acquirers in Bank of America and Barclays. But then Bank of America bought Merrill Lynch on Sunday, September 14. While we lost one of Lehman's potential acquirers, we all felt good because the purchase eliminated another major concern in the official sector. The concern was about the possible insolvency of Merrill Lynch. That left us only with Lehman and at the time we had only one potential acquirer left in Barclays.

On the morning of Sunday, September 14, we learned two things. First, I felt that we had secured the financing from the Lehman creditors; they were willing to provide financing to the vehicle that would have bought Lehman's troubled assets, which was the major impediment to rescuing Lehman. Second, I heard the news from the UK that Barclays, a British charter, needed to have a shareholder vote before it could issue an open-ended, unlimited guarantee, under the rules of the London Stock Exchange. But a shareholder vote would take approximately eight to ten weeks, meaning there could be no immediate guarantee. Without a guarantee, there was no way to stop the run on Lehman and save all of Lehman. So, the deal that we thought we had stated to unravel

Now people have asked me, could the Fed have made an open-ended, unlimited guarantee and I say, "No, because we [the Fed] could only lend, provided the loan was secured to our satisfaction." Lending unsecured is different from lending secured and we didn't have the legal authority to make an unsecured guarantee, not that it was a good idea. That's why, on the afternoon of September 14th, the plan to rescue Lehman fell apart. Barclays would not offer a guarantee and the Federal Reserve could not.

At that point in time, what do you do? Well, we had an alternative Plan B, which the SEC had been working on, where we had done some [game planning] as to

[6] The March 24, 2008 terms between Bear Stearns and JPMorgan Chase were released by the FRBNY in a statement which can be found at https://www.newyorkfed.org/newsevents/news/markets/2008/rp080324b.html (Accessed on 12/19/2018).

how many weeks we'd need to continue the broker-dealer's operations as it wound down its trading book. The decision was made to go with Plan B, but our next worry was dealing with Lehman Brothers itself, which was expecting to be rescued the afternoon of September 14th. There were a number of difficult discussions with Lehman and its CEO, Dick Fuld, to make it clear that the parent would need to file for bankruptcy under Plan B.

YPFS: **Just to play devil's advocate, do you think that providing liquidity to Lehman's parent would have been a really useful tactic to get them through the weekend?**

Baxter: No, because the run would have continued. It probably would have even accelerated because, remember, over the weekend, all of Lehman's large creditors were closely scrutinizing its books. Those creditors knew Lehman was insolvent.

They know a whole lot more about Lehman's books, so when Monday came, what were they going to do? From our point of view, we were past the point of non-viability and Lehman as a whole could not be saved. There wasn't any real discussion about some kind of alternative bridge loan in view of what we had done over the weekend. It was pretty clear to many of us that day, and became clearer later on, that there was no way the British government was going to go along with the proposed merger with Barclay's because, to borrow the phrase from Paulson's book, the British government's perspective was that they thought that "we were trying to export an American cancer," which was mistaken because the British already had it. From their perspective, we were trying to export our problems.

It became clear that Barclays was not going to be able to go forward to assist all of Lehman and in those circumstances, we felt we had to go to our fallback plan. There was no real discussion about any kind of alternative and it was difficult enough trying to convince the Lehman Board of Directors that they didn't have an alternative, that it was necessary to file for bankruptcy. The Lehman board kept thinking they were going to be rescued and they didn't want to file. They had just hired Weil, Gotshal, & Manges as bankruptcy counsel and their new counsel was thinking, "Why are we going to file? We just were engaged, and we need to work on in a rescue plan."

Given the effort over the course of Sunday that it took to transition from Plan A to Plan B, anyone who has participated in a real crisis like this would understand there's no time to talk about alternative theories. With apologies to Professor Ball, it wasn't possible in the course of that Sunday. One could fault us for maybe not thinking more creatively in August, July, or June to come up with alternative rescue plan, but not in one day on September 14th.

American International Group

YPFS: **Moving on to the Federal Reserve's assistance to AIG, what kind of analysis was the FRBNY's legal team conducting over the course of the week while advancements were being distributed to AIG under the newly established revolving credit facility?**

Baxter: The first night, on Tuesday, September 16th, there was drama with having to lend on the basis of demand notes and getting the collateral in order to protect our interests. That first night, we actually sent a detail of police officers over to 80 Pine Street, AIG's headquarters, to collect the securities that we were then going to lend against for the demand notes.

Earlier in the day, we had no idea that AIG was going to be illiquid that day, so this was a very improvised solution. At the time, we were getting a signature on the term sheet for the Revolving Credit Facility, but then, we also realized that we were going to have to extend credit through another method because the revolving credit facility wouldn't be operational in time. So that's what led to this fallback plan of lending on demand notes and getting a security agreement done and getting collateral into the Fed's vaults where it could be safe kept and also valued. All of those things had to happen by the end of the day on Tuesday for lending to happen.

That also was significant in terms of negotiating the revolving credit agreement because the demand notes arguably gave us the power to call the notes at any time and AIG would not have another option in terms of credit availability, and that would essentially shut them down.

YPFS: **Did the stress on AIG of a potential bankruptcy give the FRBNY leverage in negotiating terms that were in the Fed's favor?**

Baxter: The technical answer would be, "Yes," but that answer presumes that the Fed is in the position of a normal commercial lender because the ability to call those notes does give you leverage over the borrower. The counterpoint to that is our objective was to restore financial stability. We didn't have a commercial objective; we had a public policy objective.

So, part of the dynamic in the negotiations was, "We're working toward a revolving credit agreement. We're in a position where if we don't reach an agreement on the revolving credit facility, then we can call the demand notes." But you could question if we, as the government, would ever use that leverage (actually calling the demand notes) because we were trying to rescue AIG and not kill it, but that all played into the negotiation of terms and moving toward the actual execution of what became the revolving credit agreement.

I think there were people at AIG who believed that we would act like a commercial actor and use that as leverage, but it was never really contemplated by the policymakers at the Fed because we were always focused on rescuing AIG,

not to close it down. While we had that theoretical bargaining power, we never really felt we could use it, and from time to time, where we thought AIG was taking an unreasonable position in the negotiation, we might posture, but it was never serious.

YPFS: How did the industry effort to organize private funding for AIG begin and why did it fail?

Baxter: At least from my view, it started when we called Lehman's creditors together on that Friday night, September 12th, to meet with President Geithner and Secretary Paulson. It started around 6pm and in the course of that night, both Jamie Dimon and Lloyd Blankfein mentioned AIG in passing, but also said, "We're taking care of that problem." The first sense that I had was that this was an early warning that AIG was a problem, but the good news was that Jamie and Lloyd were working on a solution for AIG.

So, over the course of the weekend, I knew that Goldman Sachs and JPMorgan were working on this private sector syndicated lending deal that was going to solve the AIG problem. However, I think it was that Sunday that Michael Wiseman, who was representing AIG at the time, came into the Fed with JPMorgan and Goldman and said "We're working on a solution for AIG. We could get it solved, but there's a possibility that the Fed might have to intervene. For now, the deal is working and we'll let it unfold." Michael Wiseman is one of our partners here at Sullivan and Cromwell now.

By Monday, things soured, especially because Lehman failed, which changed the attitude of both JPMorgan and Goldman. Before Lehman filed, they were willing to be lenders. After Lehman filed, the willingness disappeared. But they had a term sheet, which I asked Davis Polk (who was representing the consortium that was headed by JPMorgan and Goldman Sachs) for on Tuesday when it became clear that Fed was going to step in to lend to AIG. That term sheet had terms very similar to the terms that were eventually done. The difference was that the private sector's interest rate was lower than ours and the amount they were going to lend was $75 billion rather than $85 billion. There was an equity participation feature in there as well.

Essentially, the creation of the Fed's term sheet was based largely on the JPMorgan and Goldman term sheet. I felt that that was important, particularly given that Jimmy Lee from JP Morgan was the officer responsible for the negotiation of the term sheet and was considered one of the most prominent and qualified experts in the field. It was horrible to have to construct a facility in hours that normally would take months of due diligence to complete, so that was the bad part. The good part was that we had a term sheet.

YPFS: Do you remember the conversations around why the interest rate was increased for the Fed's loan?

Baxter: I don't know the reason for that; I never really got a satisfactory explanation why that occurred. I know it happened, but I can't tell you why. It turned out to be a bad decision because we had to lower the rate later in November. Perhaps that is why we have never located the father of that provision.

YPFS: After the Revolving Credit Facility was established on September 23rd, the FRBNY began work on another Section 13(3) facility to deal with AIG's residential mortgage-backed securities (RMBS) portfolios, which became the Securities Borrowing Facility. How did the new facility come about and why weren't the RMBS portfolios addressed originally?

Baxter: Our first reaction on day one was, "There's basically no centralized management information system [at AIG]. This place doesn't look anything like what we are accustomed to seeing in the banks we supervise." There was the initial shock and then we had to start getting a detailed understanding of the kind of problems that got AIG into trouble.

There were two different problems. First, there was the problem that gets all the attention in the press, the Financial Products division. Second, there was also this problem in the domestic life subsidiary, which had a securities lending program where AIG lent treasuries for cash. The cash was then used by domestic life to buy residential mortgage-backed securities (RMBS), largely to increase yield. Of course, that play for increased yield worked out badly given the problems in the RMBS market, but it was also incredibly imprudent because it gave AIG this portfolio of RMBS at the worst of all times. Further, when the securities lending transaction matured, AIG had to monetize those RMBS so that it could redeem its treasuries which it had lent out. The consequence of liquidating the RMBS was that the sale took place at the worst time, and AIG was going to take really substantial losses.

The alternative was for the Fed to borrow those RMBS, which led to this new facility that we established in the second week of October. The new facility was put together on the backbone of the TSLF and it was understood that it would be a short-term solution to the problem that had been discovered in the domestic life subsidiaries. The long-term, more durable solution was the Maiden Lane II special purpose vehicle, which came later in November.

YPFS: The securities lending transactions between the Fed and AIG were one-day or overnight terms but had the ability to be extended for multiple terms. Therefore, the Fed's loans could end up being seven days if extended seven times. Why were the term limits only overnight and not longer if loan terms would be extended multiple times?

Baxter: My recollection is that we basically borrowed the structure of the TSLF, an overnight facility, and incorporated it into AIG's facility. One was overnight, so the other was overnight. You're absolutely right that if you extend over and over

again, an overnight facility can become evergreen, meaning that it could really last in perpetuity. That was not the intention, it was simply to use what was available at the Fed. What was available was the TSLF from March 2008.

Going back to the summertime discussion about AIG becoming a primary dealer, if they became a primary dealer, they would have had access to the TSLF. The thinking in real time was, "We've got this facility that's working well for primary dealers. We can just extrapolate it to work for an insurance company that's having the same kind of problems as primary dealers, in this case with RMBS." That was the thinking at the time from how I remember it.

Another useful point was that at the beginning of October 2008, we had fires burning everywhere and part of the thinking was that we have to solve this new problem, but let's not try to reinvent the wheel. Let's take something that we know works and adapt it if we can, that's kind of emergency room type of thinking we used.

YPFS: The Securities Borrowing Facility was created to be a short-term solution, but the facility had a duration of two years under its terms. Did the Fed think it could last longer than a year or was it expected to stay operational for only a month or two, and the Fed would come up with a long-term solution in that time?

Baxter: I don't remember why that was part of the terms.

YPFS: Was the interest rate of the Securities Borrowing Facility also based off of the terms of the TSLF?

Baxter: I don't remember.

YPFS: As the month went on, the first restructuring of AIG's assistance was initiated with the creation of Maiden Lane II and Maiden Lane III. How was the Fed's legal team working during that time to drive the creation of the vehicles? How did the Fed work alongside with Treasury at this time?

Baxter: Maiden Lane II was the more durable solution to the problem with domestic life subsidiaries and Maiden Lane III was the solution for Financial Products. Both were driven in large part by the rating agencies. With respect to the Treasury Department's participation, we were aggressively pursuing Treasury to become involved in the early fall because we thought AIG needed capital. We thought that capital needed to come from the fiscal authority and not the Fed, which could provide liquidity, but which is not positioned to provide capital. The discussions with Treasury were really oriented towards providing AIG capital, and using the TARP legislation.

So, even though TARP was enacted in early October which created the authority to inject capital, that wasn't to say that the Treasury had decided how to use the new authority. There was significant debate within the Treasury. Some people urged Secretary Paulson not to invest in AIG. Of course, the rating agencies played a large part in the government's decisions because of the threat of downgrades to AIG's credit rating. The threat of the downgrade was related to the amount of interest that the Fed was charging on the credit facility loan. In the end, we did utilize [TARP], but my recollection is that it wasn't an easy decision for Secretary Paulson.

It was the worst of all times to be getting Treasury involved because it was right before November in a presidential election year. After President Obama was elected, that meant we were going to have a change of administration and the people who were currently at Treasury would only be there until January. This made the dynamics pretty difficult.

Another thing that happened was that Tim Geithner informed me, probably the week after the election, that he was contemplating becoming the next Secretary of Treasury. For me that meant that the person who essentially was the main policymaker of the FRBNY was going to disappear on very short notice. Of course, that did happen when the president-elect announced his intention to nominate Tim, which I remember occurred in the third week of November.

YPFS: **Do you remember what the debate surrounding TARP funds was? Was it solely a debate about buying troubled assets and injecting capital, or was part of the debate about providing capital to AIG, which may have been seen as farther afield from firms like Citigroup or Merrill Lynch?**

Baxter: AIG was seen as further out on the spectrum. It was also not at all popular and, from what I remember, there was real resistance from Treasury staff against Treasury putting capital into AIG.

YPFS: **Is there a scenario where AIG could have survived without capital?**

Baxter: I think they certainly could have survived in November, mainly because AIG was receiving liquidity from the Fed in a variety of ways. I think it would have worked for a while. However, when we got into 2009 and the horrible hearings involving executive compensation and bonuses at AIG arose, I'm not sure they could have survived.

YPFS: **Was it a benefit to have Tim Geithner appointed Secretary of the Treasury because he was coming from being President of the FRBNY and you had worked closely with?**

Baxter: Yes, but not initially. He wouldn't step into the Secretary position until January 20th. In the interim, the expectation was that he would not be actively involved at

his current job at the FRBNY after being nominated in late November and that he would devote his time to preparing for the new administration and his confirmation hearing.

That period from the end of November until he was sworn in as the new Treasury Secretary on January 20th was a terrible period for me because he was pretty much gone. It was very sudden and not something we could prepare for. The other thing that was happening in November was that we were dealing with Citigroup, which Tim had been very much involved in. Then, he was gone.

YPFS: **Fast-forwarding a couple of months, in aligning with the terms of the credit facility, a trust was created in late January 2009 for the benefit of Treasury to manage the equity interests in AIG that the Fed and government received. How much interaction did you have with the members of the trust over the next couple of years before the Fed exited its investments in AIG in January 2011?**

Baxter: I would say I was the principal contact to the trustees.

YPFS: **Do you recall what the discussions were with the Trust, the Fed, and Treasury surrounding the creation of a divestiture plan and what the main goals were under such a plan?**

Baxter: Yes. The first order of business for the trust was to get away from the idea that they would quickly sell off the equity interest as soon as they had the capability and instead, they would hold the AIG equity for longer than originally anticipated. Because of that decision, the trustees also came to the realization that they needed to focus on AIG's governance, in particular, its Board of Directors. The trust's attention in its first year and a half was really focused on getting who the trustees felt to be the right people to replace some of AIG's directors'. As financial conditions began to restore, the trust began thinking about what an exit strategy could look like.

YPFS: **So, the lesson is that while the initial thought might be that it would be beneficial to exit any taxpayer investment quickly, it may take much longer than originally expected.**

Baxter: Any exit should be done in a safe manner for the company and for financial markets, and the process requires patience on the part of not only the government and the investee, but taxpayers as well. Especially when you're financing a low interest rate loan and you've acquired a portfolio at one of the worst points in the crisis, you hold the assets until the crisis abates. You're almost sure to benefit taxpayers when the asset values recover as the markets recover. That is in fact what happened, if you look at the Maiden Lane vehicles.

YPFS: **Since AIG is an insurance company, what was the role of the insurance regulators and their interaction with the Fed during this time?**

Baxter: Part of the reason some people were not comfortable that the Trust owned 80% of AIG was because the investment could be subject to the jurisdiction of state insurance supervisors. . We worked with multiple state insurance supervisors and their national organization, the National Association of Insurance Commissioners (NAIC). From the perspective of a federal supervisor, you are working with a collection of state insurance commissioners with very different financial support and very different capabilities. With that understood, the insurance commissioners have significant political power. That combination is one of the complicating factors for AIG and this became an issue with respect to the Trust.

When we were establishing the Trust, one of the gating questions was, "Would the trust be subject to the jurisdiction of the insurance commissioners?" The insurance commissioners and I disagreed over this. From our perspective, the Trust was established for the benefit of the Treasury and the American people, essentially the federal fiscal power, and to have the Trust subject to the jurisdiction of the state insurance supervisors was quite a concern. The disagreement ended in sort of détente where the Trust would not try to challenge the jurisdiction of state insurance supervisors , but state insurance supervisors wouldn't formally try to assert their jurisdiction over the Trust. We would essentially stay in our respective corners. There is a series of letters [7]that document this. The insurance commissioners really didn't help the rescue of AIG, but they didn't harm it either.

One of the fears was that if things had gone in another direction and AIG had to be wound up, each one of the state commissioners would have had its own proceedings. That was part of what created systemic risk for AIG, where there would be a fragmented series of resolutions and every insolvency official appointed by a commissioner would try and seize AIG assets.

All of these insurance companies would have been run off and running off claims results in payouts. You can only payout claims if you have assets. If you think about a classic bank run, what's really happening now is depositors are running on the bank. What would have happened in multiple insurance run offs is each of the insolvency officials appointed by an insurance commissioner would be seizing assets to play claims

The other thing that I'll share with you is that we didn't feel that we could speak plainly about what multiple insolvency proceedings affecting an insurer would look like in 2008 and 2009. When you go back and look at the discussions of what caused financial problems at AIG, you see the story dominated by Financial

[7] Letter from the National Association of Insurance Commissioners to Thomas C. Baxter can be accessed at http://ypfs.som.yale.edu/file/3404

Products, and that's in part because people didn't want to criticize the state insurance supervisors..

When you look at what happened with AIG's securities borrowing program, in a nutshell, AIG's insurance companies held Treasury securities, which they lent out for cash. Then they used that cash to buy MBS, knowing that in the future they would have to sell the MBS to then redeem their Treasuries. No supervisor stepped up and said, "Wait a minute. You're making a play for yield, you're putting yourself at risk of being illiquid," which is exactly what happened. But we didn't feel free to discuss this supervisory failure. We felt freer to talk about Financial Products. If you're a federal official and it looks like you're being critical of the state official, that can be a bad position to be in.

Crisis Wrap-Up

YPFS: **If someone else held your position in a future crisis, what are a couple lessons that you learned through this crisis or things you wish you had at the time that others should be aware of?**

Baxter: I believe in the classic Bagehot dictum, that in a financial crisis you should lend freely, and it should be at a penalty rate and against good collateral. I also think that you need the right people in central banks to take the lead. You need people who understand markets and you need people who understand crises. You need a blend of doers and thinkers, and in the last crisis, we were fortunate enough to have both of those skills.

YPFS: **In a crisis, many programs are done at the drop of a dime, e.g., you might have to prepare a $Billion loan agreement in a day as opposed to weeks. How do you prepare staff for the challenges of a crisis?**

Baxter: We take a lot of grief for the so-called "doomsday book." It should have never been called that, but we did think through how we would respond to various scenarios and had a discipline for "war games". It really started after the '87 market break when Gerald Corrigan was the FRBNY president. We went through a series of "war games" to simulate what we would do in certain crisis situations. I think this type of exercise is a really useful thing for people in central banking who are charged with the responsibility for maintaining financial stability. It's important to think through the "what ifs" before you get yourself into a situation where you have to respond.

I also think that having people who have experienced other crisis situations helps. We had a group of people at the FRBNY during the crisis who had lived through not only 1987, but Long-Term Capital Management in 1998 and 9/11. Being "battle tested" makes a difference.

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