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Yale Program on Financial Stability
Lessons Learned

James (Jim) Millstein

By Alec Buchholtz and Rosalind Z. Wiggins

Millstein, who was the Chief Restructuring Officer, U.S. Department of the Treasury, during the Global Financial Crisis and instrumental in the rescue of American International Group, gives us his take on how best to prepare for future crises.[1]

Rescuing very large, complex organizations requires financial expertise to manage, even they may not have a good handle on all their systems and accounts across the entire organization, but that information is critical to knowing how much support they may need to survive.

With a financial institution, it is really all about liquidity risk management. AIG was not the only financial institution to have been naïve about the rollover risk and refinancing risk they faced. Going into the financial crisis, an investment grade company like AIG or the other investment grade companies that had very, very high credit ratings (single-A, double-A), had a lot of access to the capital markets. So they had gotten used to managing their liquidity on a decentralized basis. When the crisis hit and all of the interbank lending and other funding markets (the commercial paper market, the repo market, and the securities lending market) dried up and their loans were coming due, nobody wanted exposure to anybody else, so AIG faced a liquidity crisis and there was nobody there to refinance them. So they turned to the Fed as the lender of last resort. But when the Fed asked them in early September, "How much cash do you need to meet your maturing liabilities?" They had no idea because they hadn't managed their liquidity in that fashion. They didn't have a detailed forward forecast of maturing liabilities on a consolidated basis, firm-wide, globally. They had to go calculate estimates and as it turns out, even when the Fed added a huge margin in order to avoid having to do it again, it turned out that it was not enough.

Haircuts may sound like a good thing during a crisis, but for several reasons they may, in fact, backfire and increase the government's total spend.

Credit ratings are critical for the revitalization of a struggling firm. Asking for a haircut from a bondholder or other counterparty could severely hurt the firm that you are trying to support because it could negatively affect the firm's credit rating. Credit rating agencies deal with distressed exchange offers—assistance that comes at a discounted value from the par value of a security—by assigning a rating of "D" for default to the company in question, which can result in massive collateral calls and potential illiquidity of the already weak firm. For example, if the Treasury had done this out of AIG's Financial Products subsidiary as we were

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

being urged to do, it would have resulted in an immediate downgrade of the subsidiary's rating to this temporary default rating and potentially of the parent company's credit rating. The credit rating downgrade also would have triggered a massive collateral call, which would have forced us to put more "good money" into the firm after what then would have proven to be "bad money" because of the credit rating downgrade. Also, what principle should the government have applied to determine which counterparties to demand discounts from?

Haircuts can also impair the government's efforts in a crisis because one or another government authority is often on both sides of a deal. If AIG had insisted on haircuts, the counterparty firms that did not receive the full benefit of CDS or insurance contracts might have been at risk of their credit ratings being downgraded. The consequences of such a situation might have caused the firms to seek government assistance, especially in a crisis when liquidity is scarce.

Another major issue is that as soon as there is any hint of insolvency, financing becomes extremely tricky and the systemic risk becomes a major concern. Depositors, investors, and short-term creditors tend to run at the first sign of insolvency, since there is no incentive to hang around and find out what happens next. Haircuts signal that, even with government assistance, the weak firm is not able to pay its bills as they become due. Because of the interconnectedness of the major financial institutions, any potential insolvency of one institution creates the risk of spillover onto another and the potential that the government's total assistance may increase. Thus, while they may seem attractive, discounts during a crisis may lead to a series of negative consequences and an increase in the government's total spend.

Many policymakers lack an understanding of financially complex situations.

Many policymakers and people outside the government believe we could have received discounts from individual institutions when conducting interventions using taxpayer money, however, discounts can't be asked for off the cuff. There exists a financial structure to the way government interventions are implemented that most policymakers don't understand, especially how federal assistance can affect a company's credit rating and thus, affect its ability to secure future financing from market sources. Regulators should be prepared to explain in depth and be patient with policymakers who lack the knowledge needed to understand balance sheets, the idea of leverage, and how bailouts affect these factors.

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