Lessons Learned: James (Jim) Millstein

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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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