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Lessons Learned: Zachary Taylor

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Yale Program on Financial Stability Lessons Learned

Zachary Taylor

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Zachary Taylor joined the Federal Reserve Bank of New York (FRBNY) in January 2009 to lead the team responsible for managing and unwinding the central bank's Maiden Lane II[1] and III[2] portfolios, which were acquired in connection with the intervention to assist American International Group (AIG). Taylor later took over responsibility for the Maiden Lane[3] portfolio consisting of former Bear Stearns assets as well as the unwinding of the Term Asset-Backed Securities Loan Facility (TALF)[4], another crisis-era program. All told, those portfolios amounted to more than $140 billion in residential mortgage-backed securities (RMBS), collateralized debt obligations (CDO), credit default swaps (CDS), commercial and residential mortgages, and other loans and securities.

This interview was conducted in July of 2020, when Taylor was the Federal Reserve Bank of New York's Vice President-Director of Counterparty, Valuation & Credit Risk. He emphasized that this interview represents his own opinions, not those of the Federal Reserve Bank or the Federal Reserve System.

Complex tasks require expertise: Unwinding the portfolios called for people with a wide range of expertise, both internal FRBNY staff and external contractors.

Taylor was the first outside hire to join the FRBNY team tasked with overseeing and unwinding the AIG-related Maiden Lane portfolios. He came to the job with more than a decade of private-sector experience in structured finance, including CDOs. He knew, "how

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1 Maiden Lane II was a special purpose vehicle created by the FRBNY to purchase from an AIG subsidiary a certain investment portfolio relating to its securities lending program, in which AIG lent securities in exchange for cash. AIG invested a significant portion of these cash proceeds into residential mortgage-backed securities (RMBS). Beginning in 2007, market stresses relating to subprime mortgages caused the RMBS to lose value and become illiquid creating liquidity strains for AIG with respect to repaying counterparties who sought to return the borrowed securities and regain their cash.

2 Maiden Lane III was a special purpose vehicle created by the FRBNY to purchase from AIG counterparties certain collateralized debt obligations (CDOS) in order to cancel the credit default swaps that AIG had written on them. CDS are like a type of insurance that protects the buyer from a drop in value of the CDO. If the value of the underlying CDO drops, even if there has been no actual loss, the owner may be entitled to additional collateral under the CDS. In 2008, collateral calls with respect to the CDSs were creating great liquidity stresses on AIG).

3 Maiden Lane was a special purpose vehicle created by the FRBNY to purchase from Bear Stearns a certain portfolio of assets in connection with its acquisition by JPMorgan in March 2008.

4 The Term Asset-Backed Securities Loan Facility (TALF) was established by the Federal Reserve to support the flow of credit to consumers and businesses. The TALF enabled the issuance of asset-backed securities backed by student loans, auto loans, credit card loans, loans guaranteed by the Small Business Administration (SBA), and certain other assets at a time when these markets were extremely strained and near frozen.

the sausage is made and where all the bonds were placed," he recalls. That background complemented traditional Federal Reserve staffer strengths.

> I think we internally quickly realized that the complexity of managing these portfolios was such that the initial premise that we could rely on our vendors and external expertise to sort of see us through what we hoped would be a faster unwind of these vehicles was just not really tenable, that we had to build out that internal expertise. . . . After I joined, we continued to expand the team of expertise, which required hiring in many of the different asset classes that we owned. So, for example, we needed to hire workout specialists who had experience in commercial real estate, we needed to hire residential mortgage expertise, and we ultimately built out a team—it was somewhere in the neighborhood of about 30 people internally—to work on the unwind of these three facilities.

But the outside contractors, particularly BlackRock, the big asset management firm, played an important partnership role, he says.

> I think having that external vendor in place, no matter how much expertise we build up, even if we had all of the same level of expertise that BlackRock had in this case, it was still extremely valuable to have this external face to the financial markets, where we were not negotiating with other broker-dealers and investors around restructuring and selling assets, and we could be the face behind the curtain. That made it much easier for us to operate in the financial markets as a central bank.

Lessons learned then about vendors have carried through to the 2020 crisis; they allow the central bank to respond quickly and effectively, but hiring vendors does pose issues. Taylor says, "So we have also made it clear that to the extent that we needed to react very quickly in this crisis to hire external vendors, in that those vendors did not go through a competitive bidding process, that we would revisit each of those contracts and ensure that we did open them up over time."

Processes that work in theory don't always work in practice: Listening to markets is key.

Taylor's team determined that it would auction off the securities in the Maiden Lane II portfolio—residential mortgage-backed securities—to investors over time. Relying on accepted auction theory, they designed an open process where almost 65 broker-dealers participated in weekly auctions. For about six weeks in the spring of 2011, Taylor recalls, the auctions ran as expected, with healthy demand and good prices.

> Then a strange thing happened, and this sort of went against that auction theory. What we realized was, by opening up the auctions to any broker-dealer that wanted to participate, we actually were creating a chilling effect for the investor community. The broker-dealers were representing end investors, and if the end investor wanted

> to buy one of the assets in our auction, they would submit an offer through one of these broker-dealers. But because there were 60 broker-dealers participating in the auction, the investors didn't really know who to submit their bids through, and oftentimes they would submit them through a lot of broker-dealers, and they were being bombarded with inquiries from salespeople from every single desk on the street.

The result was investor fatigue, which led to lower prices being obtained at auction. "This happened pretty quickly, and it really happened across the board. We saw this sort of cliff effect, where there was a big drop-off in the prices we were seeing in the auctions, and we realized that we went from getting a strong investor bid to getting a weak broker-dealer bid," he says. The FRBNY halted the auctions that spring. It restarted them in December, but this time with just a handful of broker-dealers permitted to bid for large blocks of securities.

> The lesson … that we took from that is that sometimes it's easier to do things in a less complicated manner. Auction theory might tell you one thing, but the markets might tell you another. You need to listen to the markets. You need to closely evaluate what investors are telling you—what you're seeing through pricing—and you need to be able to shift strategy and reevaluate your approach.

Transparency is not dangerous.

The Federal Reserve System, long known for being opaque, gradually became more transparent about its actions through the financial crisis and its aftermath. That embrace of transparency continues, as Taylor points out.

> One of the big lessons that we learned, which … I think you can see through our actions here with the current intervention: transparency for a central bank is critical. We learned lessons and became more transparent over time with these [Maiden Lane, ML II, ML III and TALF] and our other facilities that we set up in the 2008 financial crisis. I think there were times in which we were too focused on a fear that transparency might impact our maximization of returns for the taxpayer. As we started to test the waters with becoming more and more transparent, I think we quickly realized that increased transparency had little negative impact on our ultimate return.

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