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Yale Program on Financial Stability

Lessons Learned

Alejandro Latorre

By Maryann Haggerty

At the time of the 2007-09 global financial crisis, Alejandro Latorre was an assistant vice president at the Federal Reserve Bank of New York (FRBNY). He was active in the bailout of American International Group (AIG) from its inception to the end, when AIG repaid its outstanding obligations to both the Federal Reserve and the U.S. Treasury. This Lessons Learned summary is based on a Feb. 26, 2020, interview. He emphasized that the views discussed here are his own, not the views of anyone else currently or previously within the Federal Reserve System or the views of his current employer.

The right information is key: Finding and analyzing it will evolve as the crisis develops.

Good information is critical to good decisions and yet may be difficult to get in a crisis. “Obtaining needed information at the right time was one of the biggest challenges policymakers faced in the financial crisis,” Latorre said. He stressed that the “kind of information you need varies across the phases” of a rescue as large as that of AIG.

To understand how information needs evolve in a crisis, Latorre said, it helps to think of the AIG rescue in three phases: The initial decision on whether to intervene, the decision to provide additional support via Maiden Lane III¹, and the monitoring and oversight needed to make sure the aid given to the company would be repaid. He said,

It’s about knowing—and this is I think is a key lesson—knowing what you know, and knowing what you don’t know, and knowing what you need. I think we were pretty effective at understanding the information we had, and the information we needed, and the challenge then was how to close those gaps.

Before the crisis, the Federal Reserve, which did not regulate AIG, had little access to detailed firm data. At that stage, Latorre said, “the key piece of information [needed] is really firm-specific information about the balance sheet, the income statements, in other words, the capital, as well as the liquidity risk profile of the organization.”

He emphasized that several levels of information can be critical in the midst of a crisis:

¹ 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 similar to 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).

And you need that information both at an aggregated or enterprise-wide level and, importantly, you need that information, particularly liquidity information, at the legal entity or subsidiary level.

According to Latorre, understanding the company's role in the broader system is also key. He said,

Importantly we also didn't have a lot of detailed and consolidated, coherent information about the ecosystem in which AIG was operating. ... You also need to understand the interconnectedness of a firm that is potentially at risk with the rest of the market, especially when you're in the midst of a crisis.

Latorre talked about how access to company information is not enough. The information must be questioned and validated. He said,

In the beginning we relied to a large extent on AIG's description and understanding of what their exposures were and how those exposures were performing. But, importantly, we validated that with the assistance and support of third parties working for us at the time. For example, with respect to liquidity, we challenged the accuracy and integrity of that information before making any decisions.

In the second phase of the rescue, after the Fed's initial \$85 billion loan facility was put in place, the goal was to balance concerns about the company, the financial system, and the public interest. The role of information shifted. Latorre explained, "We kind of understand the company a little bit better, so I would say that while the information considerations are important, they weren't necessarily the binding constraint in this phase."

At this point, the challenge became structuring the next part of the rescue, which involved understanding the rating agencies' positions. The rating agencies believed AIG was still in trouble, Latorre said. He explained,

The rating agencies had seen the continued liquidity outflows due to the CDS [credit default swap] positions and the size of the facility that the Fed had provided with the support of Treasury. They were concerned about whether or not the firm could avoid insolvency given these factors and the continued deterioration in markets. The constraint here [was] really finding a solution. One that's going to alleviate the liquidity pressures on the firm, arising from the continued deterioration of these positions, in a way that gives the rating agencies the confidence that these issues have been addressed, but also, importantly, ensuring that the public interest is protected. Ensuring that whatever risks that we're taking in the solution are prudent and ensuring that the economic gains for those risks would accrue appropriately to the public.

And I would say lastly, continuing to ensure and promote financial stability. Because at this juncture, the markets were still very fragile, and the worst of all possible outcomes would have been for the company to have failed after the Fed and Treasury committed to supporting it. This would have called into question the credibility of the

Federal Reserve and Treasury and created more instability for markets and the economy.

In the third phase, monitoring the company to protect the public interest was the prime objective. At this point, AIG and the government moved to unwind the firm's complicated positions in derivatives markets and make other changes. The government needed enough information to ensure that AIG's decisions were prudent and did not jeopardize taxpayer money. Latorre said,

The goal was to monitor [the AIG Financial Products subsidiary's] approach and progress. We were not directing the company to eliminate certain exposures at the expense of others, we weren't guiding them in terms of what levels that they should exit at. Where we challenged them was, "what's your framework for determining that? How are you confident that the level at which you're unwinding the portfolio is the best one in order to achieve the orderly wind-down objective as well as preserve values for the taxpayer?"

Latorre summarized, "Your information needs—knowing what you have and what you don't have and what you need—it's very critical to maintain that awareness across these three phases."

You need help: Success requires all hands on deck.

Latorre shared that to overcome its information gap and ensure the credibility of data, the AIG team at the FRBNY turned to a valuable internal asset: experts from throughout the Federal Reserve System. He said,

I think one of the strengths of the Federal Reserve System is, and continues to be, the diversity of talent and experience within the organization across different disciplines—regulation and supervision, financial markets, and monetary policy. So, when you're faced with an information gap of the size and magnitude that we had, and the stakes are as high as they were, closing the information gap always comes down to the people.

Learn from experience: The AIG rescue still holds valuable lessons.

In Latorre's eyes, there is still much the financial community and financial supervisors can learn from the largest corporate rescue in U.S. history. He identified four topics that industry and regulators should explore further.

- *Firms need proper incentives to manage their risk prudently.* Although he approves of many of the post-crisis regulatory developments, Latorre also underlined the need to refocus on basic risk management as a supervisory tool.

I think there's been a lot of emphasis, certainly in the financial community as well as the regulatory community, around building up liquidity and capital buffers, and all of that's very important in terms of stress testing. But in my view, those are means to an

end. The end is to ensure that you have better-run firms so that they don't find themselves in the predicament that many of them found themselves in. How do you ensure that firms have the proper internal governance to create incentives so that they avoid races to the bottom like we saw in 2008? Importantly, how can both macroprudential and microprudential supervisors contribute to that?"

- *Market discipline still has a role.* Latorre stressed the importance of market discipline, which he said has fallen somewhat out of favor.

I think market discipline, post-crisis, has gotten a really bad reputation. But I feel like there's been a little bit of throwing the baby out with the bathwater. I think there's a question of how do we resurrect market discipline in a way so that it works in congruence with prudent risk management as well as macroprudential and microprudential objectives. I would say that is kind of critical. I know the agencies are focused on ensuring firms are better run, but trying to really get at the incentives is kind of critical.

- *Increased transparency about risk management is a worthy goal.* Latorre recognized that this is a "delicate" topic—"Obviously, because you don't want to reveal too much information," he said. He also acknowledged that "there's some constructive trends happening in ... the regulatory community on that score," but questioned whether there were opportunities for regulators to reveal more information because it is so important to monitoring systemic risk.
- *Supervisors should receive both macroprudential and microprudential training, so they are prepared for both systemic and firm-specific events.* Latorre talked about how regulating systemic risk has come to mean macroprudential regulation. However, he questioned whether such a singular focus is appropriate, and suggested that a more well-rounded approach might have significant benefits. He said,

I would say in the fog of war, it's very difficult to differentiate a firm-specific event, or a microprudential event, from a macroprudential event. It's very difficult to distinguish between a liquidity event and a solvency event. ... So, I think more training and more support from the academic community around what does effective supervision look like—how do you achieve not just effective macroprudential supervision but also microprudential supervision—is warranted. I'm not suggesting macroprudential is unimportant—only that it is incomplete.

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