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Lessons Learned: Kieran J. Fallon

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Presently the senior deputy general counsel for regulation and government affairs at PNC Financial Services Group, Kieran Fallon completed a 16-year tenure in the legal division of the Board of Governors of the Federal Reserve System in 2011. As associate general counsel during the Global Financial Crisis (GFC), he helped design the Federal Reserve's Commercial Paper Funding Facility, restructure American International Group (AIG), and implement the Dodd-Frank Act. Relatedly, Fallon also served as general counsel for the Financial Stability Oversight Board from 2008 to 2011. This Lessons Learned is based on an interview conducted with Fallon on August 13, 2020; the full transcript can be accessed here.

Leadership matters.

As the financial crisis began, Fallon was an accomplished lawyer in the legal division of the Federal Reserve. He shared a mutual respect and commitment for his fellow Fed staff and especially appreciated the breadth of their expertise. The wide variety of professional perspectives among his colleagues—regulators, economists, regional bank officials, market surveillance experts, and traders—provided for a broad vision, he said.

In 2007, the initiatives that Fed leaders tasked to Fallon and his colleagues took on a new urgency. Moreover, the hotspots were cropping up at institutions that the Fed did not regulate. Mortgage originator New Century Financial collapsed in April. In June, subprime problems mounted at Bear Stearns, only to intensify in March 2008. In September 2008, the insolvency of Lehman Brothers and AIG presented the Fed with the start of a global financial meltdown. Money market funds stopped buying commercial paper, forcing American companies to finance operations overnight and threatening to freeze the whole economy.

The Federal Reserve enacted emergency measures to reintroduce liquidity to interbank funding and stabilize a system on the brink of collapse. Doing so was far from simple, as Fallon explained: "We had to act to fashion a program *without* fiscal backing." It took until October 3 for Congress to authorize Treasury's Troubled Assets Relief Program (TARP). Because the Federal Reserve Act says that the Fed can only lend to nonbanks in emergency situations if such loans are secured to the satisfaction of the Reserve Bank, any intervention had to be self-standing; the Fed could not lose money.

Fallon helped the Fed design and implement the novel Commercial Paper Funding Facility (CPFF), structuring it to ensure that the Fed was adequately secured. The CPFF was an effective crisis response because it got liquidity through to where it was needed, while it avoided saddling the Fed with significant legal and financial risks, explained Fallon.

How did US leaders stave off system collapse? Fallon pointed to "the willingness of our principals—then Fed chairman Ben Bernanke, Treasury Secretary Henry M. Paulson, Jr., and Federal Reserve Bank of New York president Timothy Geithner—to make tough decisions:"

> We were blessed to have Ben Bernanke as chair of the Federal Reserve Board at the time—someone with the greatest knowledge of financial crises and central bank intervention. Having Hank Paulson willing to advocate with Congress and the administration for unpopular decisions—for actions that would not normally have been acceptable—made a major difference.

The leadership of Bernanke and Paulson is defined by a willingness to identify, advocate, and implement extraordinary measures. The results of the interventions they steered can be debated. But their record shows that leadership that reacts boldly and with a willingness to constantly adapt can be effective.

Constant communication and coordination within individual teams and among the top leaders and agencies is critical.

The successful aspects of the US government response—exemplified in effective initiatives like the CPFF—owed much to the knowledge base, experience, professionalism, and flexibility of the staff team at high levels and through the ranks. Fallon called the Fed–Treasury group "the brightest, most dedicated people I've ever worked with. It was day in and day out for weeks and months. We had a saying then, 'Thank God it's Friday—only two more working days until Monday.'"

The crisis response spurred leaders and staff to new levels of external outreach—working more seamlessly than usual with their counterparts at the Treasury, Capitol Hill, and foreign central banks, which the Fed believes greatly assisted the response. Notes Fallon: "In crisis mode we went into hyperdrive. There were regular ongoing contacts between the principals. Whereas in normal times the chairman of the Board of Governors will hold regular monthly meetings with the Treasury Secretary, they were having daily conversations during the crisis." Fallon also credited Fed Governors Don Kohn and Kevin Warsh with ensuring strong working relationships between Bernanke, Paulson, and Geithner. In addition, throughout the crisis, this trio had regular, frequent contacts with congressional leaders.

Today's COVID-19 situation, Fallon said, also highlights the importance of coordination, specifically, the initial Fed–Treasury–Congress efforts that enabled a robust fiscal and monetary policy response to the economic shock. Leaders at the Fed and in the executive and legislative branches used crisis policy templates from the last crisis to act as one, to pass the CARES Act, and to enable the Treasury to support more ample lending with a loss backstop.

The highly fragmented nature of the US financial regulatory system complicated the job of US leaders and remains a continuing source of systemic vulnerability.

The US has one of the most fragmented financial regulatory systems in the world, Fallon pointed out. There are a lot of regulatory agencies, and there is potential for informational silos and blind spots. This makes the coordination that was so key during the GFC hard to achieve. For example, in 2007, the Securities and Exchange Commission, not the Fed, was the regulator of independent investment banks such as Lehman Brothers. However, the SEC had no ability to provide liquidity to these entities when they became stressed. Constrained to be the lender of last resort for these entities of which it had only limited knowledge, the Fed adopted the Primary Dealer Credit Facility and began monitoring the investment banks as the potential lender of billions of dollars to them.

The strenuous coordination and communication efforts across agencies that developed during the crisis were exceptional, said Fallon, but even then, traditional barriers to information flow hampered decision making for Fed leaders. He stressed that in a crisis, having real-time actionable information is important. Efforts should be made to maintain communication across agencies in peace time so as to facilitate crisis-time information sharing.

Post-crisis reforms stabilized the US financial system, albeit imperfectly, enabling a robust but incomplete economic response to the COVID-19 pandemic crisis.

Overall, Fallon credited the Dodd-Frank Wall Street Reform and Consumer Protection Act for several "salutary effects" on the financial system: (1) bank capital levels today are multiples of what they were before the crisis; (2) an orderly liquidation authority enables regulators to wind down a systemically important institution; (3) improvements in regulating derivatives, including centralized clearing of swaps and rules governing margins; and (4) a single dedicated agency, the Consumer Financial Protection Bureau, should improve consumer protections.

However, shadow banking, in Fallon's view, is a continuing concern and potential source of vulnerability for the system. Dodd-Frank has "pushed" some activities to the nonbank area, Fallon said—collateralized loan obligations, private-equity funds, hedge funds, and nonbank mortgage originators. He cited the Fed's 2020 action to intervene in the Treasury market in response to hedge fund activity as a new form of moral hazard, with the Fed intervening in the nonregulated hedge fund space. Regulators and market participants still do not have a full understanding, he feared, of the scale and scope of the nonbank markets.

Take big actions early and convey a clear and credible plan.

Acting early with decisiveness and the demonstrated power of government resources can renew market confidence, said Fallon. If the intervention is credible to market actors—based on a correct diagnosis, with a clear plan and adequate resources—they may not test it at all. Alternatively, moving early with big actions has risks; it depends on the analysis, capabilities, and messaging of the policymakers. If any part is lacking, the action may not resonate in the minds of market actors with the force required to achieve its effect.

Some Fed programs achieved their desired effect merely by presenting an alternative or backstop to frozen markets, altering behavior by restoring confidence in the flow of credit, said Fallon. He described the early positive response to the Fed's 2008 programs to aid the money market mutual funds and to jumpstart consumer spending by supporting asset-backed securitization: "We were prepared to make more loans than we made. But there was an announcement effect instead that stabilized the markets."

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