Journal of Financial Crises

Volume 4 | Issue 3

2022

Lessons Learned: Susan McLaughlin

Matthew A. Lieber

Yale Program on Financial Stability
Lessons Learned

Susan McLaughlin

By Matthew A. Lieber

A veteran staff member of the Federal Reserve Bank of New York (FRBNY), Susan McLaughlin served as head of the discount window and chief operating officer of the FRBNY's Markets Trading Desk during the Global Financial Crisis. She was centrally involved in the Fed's policy response to the disruptions to secured and unsecured funding markets during 2007–2008. Following the crisis, McLaughlin coordinated an effective Fed initiative to reform the triparty repurchase agreement (repo) market's settlement infrastructure. The Fed's reform efforts, engaging the financial industry under FRBNY president Bill Dudley, were instrumental in improving the stability of the funding market. This Lesson Learned is based on an interview conducted with McLaughlin on December 2, 2020; the full transcript may be accessed here.

An effective crisis response demands on-the-job learning.

As head of the discount window in 2007, McLaughlin played a key role in the implementation of the Fed's response to crisis events. "My experience during the Global Financial Crisis was one of continual learning about global funding markets. I think many of my colleagues would say the same thing," McLaughlin said. For example, she explained that she and many of her colleagues were surprised in August 2007:

> We had [not] caught up with the reality that so much of dollar funding activity was actually happening offshore, and that so much of the dollar credit creation, particularly in spaces like structured products, was happening through foreign banking organizations as well as through domestic institutions.

Foreign bank branches in the United States "were upstreaming dollars to their parents," she said, while their head offices and regulators did not appreciate the risks they were taking. She and her staff adjusted their response to account for this new information.

In total, the financial crisis and the policy response that it spurred at the Fed wrought a transformation of the US central bank. The New York Fed and its agents identified flaws in wholesale lending markets and, after putting out a series of fires, restructured repo markets along more stable lines.

During a crisis, it is impossible to know in real time when things will get better or how things will unfold; solutions must be flexible.

Between 2007 and 2008, McLaughlin's group launched emergency programs to stave off liquidity hoarding, prop up the largest security dealers, and expand the forms of collateral the Fed would accept. "Every month," she said, "it seemed like some different segment of the financial markets was coming under stress."

In August 2007, with fears of subprime exposure swirling, the largest banks were hoarding liquidity and avoiding the discount window in hopes of projecting stability. Recognizing the perceived stigma associated with discount window credit, the Fed designed the Term Auction Facility (TAF). It was the first big program that the Fed set up to respond to the stressed conditions in US dollar funding markets. McLaughlin noted, however, that the TAF

> was not technically an emergency lending facility; it was actually done under normal discount window authority. But it helped to alleviate stress . . . It was kind of a hybrid of an open market operation and a lender-of-last-resort loan—we were auctioning off discount window funding to banks in much the same way as we auction triparty repo funding to primary dealers in our monetary policy operations.

Risk aversion spread to triparty repo markets, which had taken on unprecedented scale. By 2007, broker-dealers accessed multiple trillions of dollars of funding via triparty repo each day, largely from money market funds. The settlement process was designed for dealer convenience; there was a 10-hour period each day between when those repos unwound and repos for the next day would settle. During this period, the clearing banks became lender as well as clearing agent. "It was not a good design," McLaughlin explained. The clearing bank was "not a pure agent—they were also a creditor. Those interests conflicted."

The design flaw in triparty repo became a factor when Bear Stearns began to falter. McLaughlin said:

> In March 2008, there was a situation where the firm's clearing bank called up the New York Fed and said they weren't going to unwind the repo with Bear Stearns unless they had some assurance that they wouldn't be stuck with the collateral. If the clearing bank had not unwound that repo, it would have pushed the dealer into default and prompted a run on the market that could in turn have led to other dealer defaults and transmitted stress beyond the repo market.

To prevent such a result, the Fed innovated, it made a nonrecourse loan to the clearing bank, then formulated a backstop. "Over that weekend, literally in 48 hours," McLaughlin recalled, "a group of us at the New York Fed put together the Primary Dealer Credit Facility [PDCF], to provide a backstop to triparty repo borrowers." She recalled that her team worked "all day and all night throughout the weekend to get it done in time to announce . . . before Asia trading opened."

Launching the PDCF was a major step that fortunately, prevented a run. But it also made clear that the Fed was operating in unknown territory. For example, the Fed had concerns, McLaughlin said, about moral hazard and about the unknown quantities that were the primary dealers. Normally, at the discount window the Fed was lending to banks that it knew, because they are subject to a well-established supervisory program and prudential oversight. By contrast, the dealers had not been subject to prudential supervision.

After the crisis, the focus should turn to addressing the problematic areas that have been revealed.

"Based on the crisis experience," McLaughlin explained, the New York Fed staff identified three concerns with the triparty repo market that they wanted to address:

> (1) dealers' excessive reliance on intraday credit from the clearing banks
>
> (2) very poor liquidity and risk practices by lenders
>
> (3) the risk of fire sales of risky assets

The Bear Stearns case had shown the Fed the flawed supposition of repo market participants that "dealers and lenders just assumed that the clearing bank would always be there to provide intraday credit," McLaughlin said.

The PDCF experience showed the Fed the depth and extent of poor credit standards at a number of the dealers. The New York Fed sent supervisory teams into each of the largest primary dealers to evaluate the dealers' practices for valuing collateral. She noted:

> We had to pull all these data sources together to validate, and we discovered that there were securities that were being pledged by dealers who had created structured products backed by their own obligations, which presents wrong-way risk to us as the lender.

McLaughlin described how, after the crisis, the New York Fed collaborated with the largest firms in the market to develop and implement recommendations for reform. They were able to successfully address the first two of the three problem areas. Today, the triparty repo market is substantially tighter, as a result of the measures taken and other changes in the financial industry, she said:

> When I first joined the New York Fed, people used to talk about the three legs of the stool: banking supervision, payment systems oversight, and monetary policy implementation. The Global Financial Crisis brought home to many of us that it's a chair, not a stool. Because financial stability is at the core of all of the aspects of our mission, the Fed has a strong institutional commitment to financial stability. There's a financial stability division at the Board now, and they put out a public financial stability report. There is a financial stability element to many of the groups in the New York Bank and in the other Reserve Banks as well.

Going big in a crisis response is good.

Going big with your policy response up front is helpful in a crisis. "It's a way to create confidence," McLaughlin explained, noting that "the announcement of action can by itself create confidence."

The Fed internalized this lesson from 2007–2008, McLaughlin said, citing its response to the COVID-19 crisis of March 2020. Usage of some of the Fed's programs in 2020 was lower than anticipated, she noted. This might be an indication of those programs' success, she said, since "the announcements of the programs calmed markets and created confidence."

Dated: September 2022

YPFS Lessons Learned No. 2020-29