Ben S Bernanke: Troubled Asset Relief Program and the Federal Reserve's liquidity facilities

Testimony of Mr Ben S Bernanke, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Financial Services, US House of Representatives, Washington DC, 18 November 2008.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate having this opportunity to review some of the activities to date of the Treasury's Troubled Asset Relief Program, or TARP, and to discuss recent steps taken by the Federal Reserve and other agencies to support the normalization of credit markets.

The legislation that created the TARP put in place a Financial Stability Oversight Board to review the actions of the Treasury in administering the program. That Oversight Board includes the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Chairman of the Securities and Exchange Commission, the Director of the Federal Housing Finance Agency, and the Chairman of the Federal Reserve Board. We have met four times, reviewing the operational plans and policy initiatives of the TARP and discussing possible additional steps that might be taken. Officers for the Oversight Board have been appointed, and the Federal Reserve and the other agencies are providing staff support for the board. Minutes of each meeting are being posted to a special website established by the Treasury.[1] In addition, staff members of the agencies whose heads are participating in the Oversight Board have met with staff from the Government Accountability Office to explore strategies for coordinating the oversight that the two bodies are required to perform under the enabling legislation.

The value of the TARP in promoting financial stability has already been demonstrated. The financial crisis intensified greatly in the latter part of September and spread to many countries that had not yet been touched by it, which led to grave concerns about the stability of the global financial system. Failure to prevent an international financial collapse would almost certainly have had dire implications for both the U.S. and world economies. Fortunately, the existence of the TARP allowed the Treasury to react quickly by announcing a plan to inject $250 billion in capital into U.S. financial institutions. Nine large institutions received the first $125 billion, and the remainder is being made available to other banking organizations through an application process. In addition, the Federal Deposit Insurance Corporation announced that it would guarantee non-interest-bearing transaction accounts at depository institutions and certain other liabilities of depository institutions and their holding companies, and the Federal Reserve expanded its provision of backstop liquidity to the financial system. These actions, together with similar measures in many other countries, appeared to stabilize the situation and to improve investor confidence in financial firms. Notably, spreads on credit default swaps for large U.S. banking organizations, which had widened substantially over the previous few weeks, declined sharply on the day of the joint announcement. Going forward, the ability of the Treasury to use the TARP to inject capital into financial institutions and to take other steps to stabilize the financial system – including any actions that might be needed to prevent the disorderly failure of a systemically important financial institution – will be critical for restoring confidence and promoting the return of credit markets to more normal functioning.

As I noted earlier, the Federal Reserve has taken a range of policy actions to provide liquidity to the financial system and thus promote the extension of credit to households and

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[1] U.S. Department of the Treasury, Emergency Economic Stabilization Act website.

businesses. Our recent actions have focused on the market for commercial paper, which is an important source of short-term financing for many financial and nonfinancial firms.

Normally, money market mutual funds are major lenders in the commercial paper markets. However, in mid-September, a large fund suffered losses and heavy redemptions, causing it to suspend further redemptions and then close. In the next few weeks, investors withdrew almost $500 billion from prime money market funds. The funds, concerned about their ability to meet further redemptions, began to reduce their purchases of commercial paper and limit the maturity of such paper to only overnight or other very short maturities. As a result, interest rate spreads paid by issuers on longer-maturity commercial paper widened significantly, and issuers were exposed to the costs and risks of having to roll over increasingly large amounts of paper each day.

The Federal Reserve has developed three programs to address these problems. The first allows money market mutual funds to sell asset-backed commercial paper to banking organizations, which are then permitted to borrow against the paper on a non-recourse basis from the Federal Reserve Bank of Boston. Usage of that facility peaked at around $150 billion. The facility contributed importantly to the ability of money funds to meet redemption pressures when they were most intense and remains available as a backstop should such pressures reemerge.

The second program involves the funding of a special-purpose vehicle that purchases highly rated commercial paper issued by financial and nonfinancial businesses at a term of three months. This facility has purchased about $250 billion of commercial paper, allowing many firms to extend significant amounts of funding into next year.

A third facility, expected to be operational next week, will provide a liquidity backstop directly to money market mutual funds. This facility is intended to give funds confidence to extend significantly the maturities of their investments and reduce over time the reliance of issuers on sales to the Federal Reserve's special-purpose vehicle. All of these programs, which were created under section 13(3) of the Federal Reserve Act, must be terminated when conditions in financial markets are determined by the Federal Reserve to no longer be unusual and exigent.

The primary objective of these and other actions we have taken is to stabilize credit markets and to improve the access to credit of businesses and households. There are some signs that credit markets, while still quite strained, are improving. Interbank short-term funding rates have fallen notably since mid-October, and we are seeing greater stability in money market mutual funds and in the commercial paper market. Interest rates on higher-rated bonds issued by corporations and municipalities have fallen somewhat, and bond issuance for these entities rose a bit in recent weeks. The ongoing capital injections under the TARP are continuing to bring stability to the banking system and have reduced some of the pressure on banks to deleverage, two critical first steps toward restarting flows of new credit. However, overall, credit conditions are still far from normal, with risk spreads remaining very elevated and banks reporting that they continued to tighten lending standards through October. There has been little or no bond issuance by lower-rated corporations or securitization of consumer loans in recent weeks.

To help address the tightness of credit, on November 12 the federal banking agencies issued a joint statement on meeting the needs of creditworthy borrowers. The statement took note of the recent strong policy actions designed to promote financial stability and improve banks' access to capital and funding. In light of those actions, which have increased the capacity of banks to lend, it is imperative that all banking organizations and their regulators work together to ensure that the needs of creditworthy borrowers are met in a manner consistent with safety and soundness. As capital adequacy is critical in determining a banking organization's ability and willingness to lend, the joint statement emphasizes the need for careful capital planning, including setting appropriate dividend policies. The statement also notes the agencies' expectation that banking organizations should work with existing borrowers to avoid preventable foreclosures, which can be costly to all involved – the borrower, the lender, and the communities in which they are located. Steps that should be taken in this area include ensuring adequate funding and staffing of mortgage servicing operations and adopting systematic, proactive, and streamlined mortgage loan modification protocols aimed at providing long-term sustainability for borrowers. Finally, the agencies expect banking organizations to conduct regular reviews of their management compensation policies to ensure that they encourage prudent lending and discourage excessive risk-taking.

Thank you. I would be pleased to take your questions.