

Ben S Bernanke: Federal Reserve programs to strengthen credit markets and the economy

Testimony by 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, 10 February 2009.

The original speech, which contains various links to the documents mentioned, can be found on the US Federal Reserve System's website.

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Chairman Frank, Ranking Member Bachus, and other members of the Committee, I appreciate this opportunity to provide a brief review of the Federal Reserve's various credit programs, including those relying on our emergency authorities under Section 13(3) of the Federal Reserve Act. I will also discuss the Federal Reserve's ongoing efforts to inform the Congress and the public about these activities.

Federal Reserve programs to strengthen credit markets and the economy

As you know, the past 18 months or so have been extraordinarily challenging for policymakers around the globe, not least for central banks. The Federal Reserve has responded forcefully to the financial and economic crisis since its emergence in the summer of 2007. Monetary policy has been especially proactive. The Federal Open Market Committee (FOMC) began to ease monetary policy in September 2007 and continued to ease in response to a weakening economic outlook. In December 2008, the Committee set a range of 0 to 25 basis points for the target federal funds rate.

Although the target for the federal funds rate is at its effective floor, the Federal Reserve has employed at least three types of additional tools to improve the functioning of credit markets, ease financial conditions, and support economic activity.

The first set of tools is closely tied to the central bank's traditional role of providing short-term liquidity to sound financial institutions. Over the course of the crisis, the Fed has taken a number of extraordinary actions, including the creation of a number of new facilities for auctioning short-term credit, to ensure that financial institutions have adequate access to liquidity. In fulfilling its traditional lending function, the Federal Reserve enhances the stability of our financial system, increases the willingness of financial institutions to extend credit, and helps to ease conditions in interbank lending markets, reducing the overall cost of capital to banks. In addition, some interest rates, including the rates on some adjustable-rate mortgages, are tied contractually to key interbank rates, such as the London interbank offered rate (Libor). To the extent that the provision of ample liquidity to banks reduces Libor, other borrowers will also see their payments decline.

Because interbank markets are global in scope, the Federal Reserve has also approved bilateral currency liquidity agreements with 14 foreign central banks. These so-called swap facilities have allowed these central banks to acquire dollars from the Federal Reserve that the foreign central banks may lend to financial institutions in their jurisdictions. The purpose of these liquidity swaps is to ease conditions in dollar funding markets globally. Improvements in global interbank markets, in turn, promote greater stability in other markets at home and abroad, such as money markets and foreign exchange markets.

The provision of short-term credit to financial institutions exposes the Federal Reserve to minimal credit risk, as the loans we make to financial institutions are generally short-term, overcollateralized, and made with recourse to the borrowing firm. In the case of the currency swaps, the foreign central banks are responsible for repaying the Federal Reserve, not the

financial institutions that ultimately receive the funds, and the Fed receives an equivalent amount of foreign currency in exchange for the dollars it provides foreign central banks.

Although the provision of ample liquidity by the central bank to financial institutions is a time-tested approach to reducing financial strains, it is no panacea. Today, concerns about capital, asset quality, and credit risk continue to limit the willingness of many intermediaries to extend credit, notwithstanding the access of these firms to central bank liquidity. Moreover, providing liquidity to financial institutions does not directly address instability or declining credit availability in critical nonbank markets, such as the commercial paper market or the market for asset-backed securities.

To address these issues, the Federal Reserve has developed a second set of policy tools which involve the provision of liquidity directly to borrowers and investors in key credit markets. For example, we have introduced facilities to purchase highly rated commercial paper at a term of three months and to provide backup liquidity for money market mutual funds. In addition, the Federal Reserve and the Treasury have jointly announced a facility – expected to be operational shortly – that will lend against AAA-rated asset-backed securities collateralized by recently originated student loans, auto loans, credit card loans, and loans guaranteed by the Small Business Administration. Unlike our other lending programs, this facility combines Federal Reserve liquidity with capital provided by the Treasury. If the program works as planned, it should help to restart activity in these key securitization markets and lead to lower borrowing rates and improved access in the markets for consumer and small business credit. This basic framework could also be expanded to accommodate higher volumes as well as additional classes of securities, as circumstances warrant.

These special lending programs have been set up to minimize credit risk to the Federal Reserve. The largest program, the commercial paper funding facility, accepts only the most highly rated paper. It also charges borrowers a premium, which is set aside against possible losses. As just noted, the facility that will lend against securities backed by consumer and small-business loans is a joint Federal Reserve-Treasury program; capital provided by the Treasury from the Troubled Asset Relief Program will help insulate the Federal Reserve from credit losses (and the Treasury will receive most of the upside from these loans).

The Federal Reserve's third set of policy tools for supporting the functioning of credit markets involves the purchase of longer-term securities for the Fed's portfolio. For example, we recently announced plans to purchase up to \$100 billion of the debt of government-sponsored enterprises (GSEs), including Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, and up to \$500 billion in agency-guaranteed mortgage-backed securities (MBS) by midyear. The objective of these purchases is to lower mortgage rates, thereby supporting housing activity and the broader economy.

The Federal Reserve is engaged in an ongoing assessment of the effectiveness of its credit-related tools. Measuring the impact of our programs is complicated by the fact that multiple factors affect market conditions. Nevertheless, we have been encouraged by the responses to these programs, including the reports and evaluations offered by market participants and analysts. Notably, our lending to financial institutions, together with actions taken by other agencies, has helped to relax the severe liquidity strains experienced by many firms and has been associated with considerable improvements in interbank lending markets. For example, we believe that the aggressive liquidity provision by the Fed and other central banks has contributed to the recent declines in Libor and is a principal reason that liquidity pressures around the end of the year--often a period of heightened liquidity strains--were relatively modest. There is widespread agreement that our commercial paper funding facility has helped to stabilize the commercial paper market, lowering rates significantly and allowing firms access to financing at terms longer than a few days. Together with other government programs, our actions to stabilize the money market mutual fund industry have also shown some measure of success, as the sharp withdrawals from funds seen in September have given way to modest inflows. And our purchases of agency debt and MBS seem to have had

a significant effect on conforming mortgage rates, with rates on 30-year fixed-rate mortgages falling close to a percentage point since the announcement of the program. All of these improvements have occurred over a period in which the economic news has generally been worse than expected and conditions in many financial markets, including the equity markets, have worsened.

We evaluate existing and prospective programs based on the answers to three questions: First, has normal functioning in the credit market in question been severely disrupted by the crisis? Second, does the Federal Reserve have tools that are likely to lead to significant improvement in function and credit availability in that market, and are the Federal Reserve's tools the most effective methods, either alone or in combination with those of other agencies, to address the disruption? And third, do improved conditions in the particular market have the potential to make a significant difference for the overall economy? To illustrate, our purchases of agency debt and MBS meet all three criteria: The mortgage market is significantly impaired, the Fed's authority to purchase agency securities gives us a straightforward tool to try to reduce the extent of that impairment, and the health of the housing market bears directly and importantly on the performance of the broader economy.

The use of authorities under Section 13(3) of the Federal Reserve Act

Section 13(3) of the Federal Reserve Act authorizes the Federal Reserve Board to make secured loans to individuals, partnerships, or corporations in "unusual and exigent circumstances" and when the borrower is "unable to secure adequate credit accommodations from other banking institutions." This authority, added to the Federal Reserve Act in 1932, was intended to give the Federal Reserve the flexibility to respond to emergency conditions. Prior to 2008, credit had not been extended under this authority since the 1930s.¹ However, responding to the extraordinarily stressed conditions in financial markets, the Board has used this authority on a number of occasions over the past year.

Following the Bear Stearns episode in March 2008, the Federal Reserve Board invoked Section 13(3) to make primary securities dealers, as well as banks, eligible to borrow on a short-term basis from the Fed.² This decision was taken in support of financial stability, during a period in which the investment banks and other dealers faced intense liquidity pressures.³ The Fed has also made use of the Section 13(3) authority in its programs to support the functioning of key credit markets, including the commercial paper market and the market for asset-backed securities. In my view, the use of Section 13(3) in these contexts is well justified in light of the breakdowns of these critical markets and the serious implications of those breakdowns for the health of the broader economy. As financial conditions improve and circumstances are no longer "unusual and exigent," the programs authorized under Section 13(3) will be wound down, as required by law. Other components of the Federal Reserve's credit programs, including our lending to depository institutions, liquidity swaps with other central banks, and purchases of agency securities, make no use of the powers conferred by Section 13(3).

In a distinct set of activities, the Federal Reserve has also used its Section 13(3) authority to support government efforts to stabilize systemically critical financial institutions. The Federal

¹ The Federal Reserve invoked this provision twice in the 1960s to authorize lending but no credit was drawn.

² Primary dealers are broker-dealers that trade in U.S. government securities with the Federal Reserve Bank of New York. The New York Fed's Open Market Desk engages in trades on behalf of the Federal Reserve System to implement monetary policy.

³ Most other major central banks already provide short-term credit to a broader range of financial institutions, so in making this change, the Fed was conforming to international practice for the period of the financial emergency.

Reserve collaborated with the Treasury to facilitate the acquisition of Bear Stearns by JPMorgan Chase & Co. and to prevent the failure of the American International Group (AIG), and we worked closely with the Treasury and the Federal Deposit Insurance Corporation to help to stabilize Citigroup and the Bank of America. In the cases of Bear Stearns and AIG, as part of a strategy to avoid impending defaults by the companies, the Federal Reserve made loans against pools of collateral.

Activities to stabilize systemically important institutions seem to me to be quite different in character from the use of Section 13(3) authority to support the repair of credit markets. The actions that the Federal Reserve and the Treasury have taken to stabilize systemically critical firms were essential to protect the financial system as a whole, and, in particular, the financial risks inherent in the credits extended by the Federal Reserve were, in my view, greatly outweighed by the risks that would have been faced by the financial system and the economy had we not stepped in. However, many of these actions might not have been necessary in the first place had there been in place a comprehensive resolution regime aimed at avoiding the disorderly failure of systemically critical financial institutions. The Federal Reserve believes that the development of a robust resolution regime should be a top legislative priority. If the specification of this regime were to include clear expectations of the Federal Reserve's role in stabilizing or resolving systemically important firms--a step we very much support--then the contingencies in which the Fed might need to invoke emergency authorities could be tightly circumscribed.

Transparency and disclosure

I would like to conclude by discussing the Federal Reserve's ongoing efforts to inform the Congress and the public about its various lending programs.

I firmly believe that central banks should be as transparent as possible, both for reasons of democratic accountability and because many of our policies are likely to be more effective if they are well understood by the markets and the public. During my time at the Federal Reserve, the FOMC has taken important steps to increase the transparency of monetary policy, such as moving up the publication of the minutes of policy meetings and adopting the practice of providing longer-term projections of the evolution of the economy on a quarterly basis. Likewise, the Federal Reserve is committed to keeping the Congress and the public informed about its lending programs and balance sheet. For example, we continue to add to the information shown in the Fed's H.4.1 release, which provides weekly detail on the balance sheet and the amounts outstanding for each of the Federal Reserve's lending facilities. Extensive additional information about each of the Federal Reserve's lending programs is available online, as shown in the appendix to this testimony. Pursuant to a requirement included in the Emergency Economic Stabilization Act passed in October, the Fed also provides monthly reports to the Congress on each of its programs that rely on the Section 13(3) authorities. Generally, the Fed's disclosure policies are consistent with the current best practices of major central banks around the world.

That said, recent developments have understandably led to a substantial increase in the public's interest in the Fed's balance sheet and programs. For this reason, we at the Fed have begun a thorough review of our disclosure policies and the effectiveness of our communication. Today I would like to mention two initiatives.

First, to improve public access to information concerning Fed policies and programs, Federal Reserve staff are developing a new website that will bring together in a systematic and comprehensive way the full range of information that the Federal Reserve already makes available, supplemented by new explanations, discussions, and analyses. Our goal is to have this website operational within a few weeks.

Second, at my request, Board Vice Chairman Donald Kohn has agreed to lead a committee that will review our current publications and disclosure policies relating to the Fed's balance

sheet and lending policies. The presumption of the committee will be that the public has a right to know, and that the nondisclosure of information must be affirmatively justified by clearly articulated criteria for confidentiality, based on factors such as reasonable claims to privacy, the confidentiality of supervisory information, and the effectiveness of policy.

Thank you. I will be pleased to respond to your questions.

Appendix: Online Sources of Information on the Federal Reserve's Balance Sheet and Lending Programs

Information Regarding Recent Federal Reserve Actions

Board of Governors of the Federal Reserve System, "Information Regarding Recent Federal Reserve Actions," website.

H.4.1 Statistical Release

Board of Governors of the Federal Reserve System, H.4.1 Statistical Release, "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks."

Open Market Desk Annual Report

Federal Reserve Bank of New York, Markets Group (2009). "Domestic Open Market Operations during 2008 (392 KB PDF)," report prepared for the Federal Open Market Committee, January.

Agency Discount Notes

Federal Reserve Bank of New York (2008). "Statement Regarding Planned Purchases of Agency Debt," press release, September 19.

Agency Purchase Program

Federal Reserve Bank of New York (2008). "FAQs: Purchasing Direct Obligations of Housing-Related GSEs," website, December 3.

Agency Mortgage-Backed Securities Purchase Program

Federal Reserve Bank of New York (2008). "FAQs: MBS Purchase Program," website, December 30.

Term Primary Credit

Board of Governors of the Federal Reserve System (2007). "Federal Reserve Board Discount Rate Action," press release, August 17.

Term Auction Facility

Board of Governors of the Federal Reserve System (2007). "Federal Reserve and Other Central Banks Announce Measures Designed to Address Elevated Pressures in Short-Term Funding Markets," press release, December 12.

----- (2009). "Term Auction Facility Questions and Answers," website, January 12.

Primary Dealer Credit Facility

Federal Reserve Bank of New York (2008). "Federal Reserve Announces Establishment of Primary Dealer Credit Facility," press release, March 16.

----- (2008). "Primary Dealer Credit Facility: Frequently Asked Questions," website, December 8.

Term Securities Lending Facility

Federal Reserve Bank of New York (2008). "Term Securities Lending Facility: Frequently Asked Questions," website, December 2.

TSLF Options Program

Federal Reserve Bank of New York (2008). "SOMA TSLF Options Program: Frequently Asked Questions," website, December 2.

Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility

Board of Governors of the Federal Reserve System (2008). "Board Approves Two Interim Final Rules in Connection with Initiative to Provide Liquidity to Markets by Extending Loans to Banking Organizations to Finance Their Purchases of High-Quality Asset-Backed Commercial Paper (ABCP) from Money Market Mutual Funds," press release, September 19.

Commercial Paper Funding Facility

Federal Reserve Bank of New York (2009). "Commercial Paper Funding Facility: Frequently Asked Questions," website, January 23.

Money Market Investor Funding Facility

Federal Reserve Bank of New York (2009). "Money Market Investor Funding Facility: Frequently Asked Questions," website, January 7.

Term Asset-Backed Securities Loan Facility

Federal Reserve Bank of New York (2009). "Term Asset-Backed Securities Loan Facility: Frequently Asked Questions," website, February 6.

Bear Stearns

Federal Reserve Bank of New York (2008). "Statement on Financing Arrangement of JPMorgan Chase's Acquisition of Bear Stearns," press release, March 24.

----- (2008). "Summary of Terms and Conditions Regarding the JPMorgan Chase Facility," press release, March 24.

American International Group (AIG)

Board of Governors of the Federal Reserve System (2008). "Federal Reserve Board and Treasury Department announce restructuring of financial support to AIG," November 10.

Citigroup

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and U.S. Department of the Treasury (2008). "Joint Statement by Treasury, Federal Reserve, and the FDIC on Citigroup," joint press release, November 23.

----- (2008). "Summary of Terms," term sheet, November 23.

Bank of America

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and U.S. Department of the Treasury (2009). "Treasury, Federal Reserve, and the FDIC Provide Assistance to Bank of America," joint press release, January 16.

----- (2009). "Summary of Terms," term sheet, January 15.

Supplementary Financing Program

U.S. Department of the Treasury (2008). "Treasury Announces Supplementary Financing Program," press release, September 17.

Federal Reserve Bank of New York (2008). "Statement Regarding Supplementary Financing Program," statement, September 17.

Central Bank Liquidity Swaps

Board of Governors of the Federal Reserve System (2008). "Federal Reserve, Banco Central do Brasil, Banco de Mexico, Bank of Korea, and Monetary Authority of Singapore Announce the Establishment of Temporary Reciprocal Currency Arrangements," press release, October 29.

----- (2008). "Federal Reserve and Other Central Banks Announce Further Measures to Address Elevated Pressures in Funding Markets," press release, September 18.

----- (2008). "Federal Reserve and Reserve Bank of New Zealand Announce the Establishment of a Temporary Reciprocal Currency Arrangement," press release, October 28.

----- (2008). "Federal Reserve and Other Central Banks Announce Additional Measures to Address Elevated Pressures in Funding Markets," press release, September 24.

----- (2007). "Federal Reserve and Other Central Banks Announce Measures Designed to Address Elevated Pressures in Short-Term Funding Markets," press release, December 12.

Selected Federal Reserve System Speeches and Articles

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Bernanke, Ben S. (2008). "Federal Reserve Policies in the Financial Crisis," speech at the Greater Austin Chamber of Commerce, Austin, Texas, December 1.

Evans, Charles (2009). "Economic Update," speech, January 15.

Fettig, David (2008). "The History of a Powerful Paragraph: Section 13(3) Enacted Fed Business Loans 76 Years Ago," *The Region*, Federal Reserve Bank of Minneapolis, June.

Federal Reserve Bank of San Francisco (2009). "Fed Views" (the topic regards unconventional monetary policy actions and the economic outlook), Economic Research and Data website, January 8.

Plosser, Charles (2009). "The Economic Outlook and Some Challenges Facing the Federal Reserve," speech, January 14.

Willardson, Niel (2008). "Actions to Restore Financial Stability: A Summary of Recent Federal Reserve Initiatives," *The Region*, Federal Reserve Bank of Minneapolis, December.