

Elizabeth A Duke: Unusual and exigent – my first year at the Fed

Speech by Ms Elizabeth A Duke, Member of the Board of Governors of the Federal Reserve System, at the Economics Club of Hampton Roads, Norfolk, Virginia, 18 February 2010.

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Thank you so much for being here. It's great to be home with so many friends, former colleagues, and former customers, and all of you who make Hampton Roads such a great place to live and do business. I am truly honored to receive the Economic Impact award from the Economics Club of Hampton Roads, joining such company as Paul Sarbanes, former senator from Maryland and coauthor of the Sarbanes-Oxley Act, and Arthur Levitt, former chairman of the Securities and Exchange Commission. By honoring me, you recognize the extraordinary work of all the talented, knowledgeable, and dedicated men and women of the Federal Reserve System. So I would like to take this opportunity to express my admiration for the Fed staff and my colleagues on the Board of Governors, especially Chairman Ben Bernanke. I witnessed firsthand the leadership, the concern for the U.S. economy, and the political courage the chairman displayed as he led us through this tumultuous time. I wholeheartedly believe that without the actions taken by the Federal Reserve to fight the financial crisis, our financial system would have frozen and the outcome for the economy would have been unthinkable. It is hard to believe that it has only been 18 months since I left here. So I thought I would tell you a little about what I have been doing.

I was officially sworn in as a member of the Board of Governors of the Federal Reserve System on August 4, 2008, at 8 o'clock in the morning. Just a half hour later, I attended my first meeting of the Federal Open Market Committee (FOMC). (The FOMC, composed of the Board of Governors and the 12 Federal Reserve Bank presidents, is the body that makes decisions about interest rates and other aspects of monetary policy.) Six weeks later I attended my second FOMC meeting. Normally, the Board of Governors convenes right after the FOMC meeting for a quick vote on Reserve Bank requests to change the discount rate. My second such meeting was anything but routine. We voted to lend \$85 billion to prevent the collapse of American International Group, Inc. (AIG), whose failure at such a fragile time could have had disastrous results. In between those two meetings were some of the darkest hours of the financial crisis. On September 7, the Treasury Department placed Fannie Mae and Freddie Mac into conservatorship, essentially putting the government in charge of the mortgage giants. On September 15, Lehman Brothers filed for bankruptcy protection. A day later, a prominent money market mutual fund "broke the buck" – that is, its share price went below \$1 – sparking fears that no investments were safe as the financial crisis rapidly spread around the globe. That was the same day we made the loan to AIG – not exactly a lot of time to ease into a new job.

We realized that if we didn't act rapidly, the panic that we saw in financial markets – the worst in 80 years – could quickly trigger a global depression. In fighting the crisis, the Fed acted as a first responder of sorts using a wide range of tools, including lowering interest rates; maintaining a steady flow of dollars to meet demand abroad; providing liquidity to sound institutions to support faltering financial markets; and providing emergency loans to specific, troubled institutions whose failures would have had disastrous consequences for the financial system and the economy. Later, the Fed created additional programs to unlock lending, the lifeblood of the U.S. economy.

While the economy today is by no means nearly as strong as we'd like it to be and some parts of the financial system are still not functioning smoothly, the forceful actions by the Federal Reserve in the fall of 2008 helped prevent the apocalyptic scenario that we all

feared. I'd like to explain how we acted swiftly, responsibly, and effectively in response to the financial crisis.

Lowering interest rates

During more normal times, the Federal Reserve's policymaking is focused on short-term interest rates, our main tool for steering the economy. The Fed influences the costs of borrowing to buy everything from cars to condos to computers by controlling short-term interest rates. Interest rates can be lowered to stimulate borrowing and spending when demand is otherwise weak or raised to damp demand and curb inflation.

Before I arrived, the Fed had already responded to the weakening in the economy by aggressively lowering its federal funds rate target from 5-1/4 percent in September 2007 to 2 percent. Two percent is extremely low for interest rates, but as the financial crisis intensified and the economic outlook grew more dire in the fall of 2008, the Fed continued to cut rates. For more than a year now, our policies have pushed down short-term interest rates close to zero.

Once our main short-term interest rate lever was effectively at zero, we moved beyond traditional monetary policy to push down longer-term interest rates. In November 2008, the Fed began purchasing large volumes of longer-term, U.S. government debt and agency mortgage-backed securities, eventually increasing the commitment to more than \$1.7 trillion. The added demand for these securities pushed up their prices, thus lowering their yields, and put downward pressure on other long-term rates, including those for home mortgages and corporate bonds.

Such actions by the Federal Reserve have led to lower borrowing costs for consumers and businesses, including on business lines, credit cards, mortgages, and car loans. I have spoken to many small business owners in Hampton Roads and across the country who say that without such low interest rates, they might not have survived the severe economic downturn. In addition, in response to the Fed's moves, the nationwide average rate for a 30-year fixed-rate mortgage dropped from 6-1/2 percent to below 5 percent, the lowest level since the 1940s, and rates remain near historic lows. The low rates have helped some people buy a home for the first time and others to refinance. In 2009, millions of households refinanced their mortgages, thus reducing their monthly payments and giving them more money to spend, reduce debt, or save. For example, on a \$200,000 30-year mortgage, refinancing from a 6.5 percent mortgage into one with a 5 percent rate saves the homeowner \$190 a month, or nearly \$2,300 a year – a significant difference.

But, as we all know, lower interest rates only help if you can actually get a loan. And as the financial crisis unfolded, credit began to shut down for even the best borrowers. So while lowering interest rates helped, we knew we had to do more.

Providing liquidity

I don't want to give you a full laundry list of all the actions we have taken to help restore the flow of credit – it's been tough keeping track of all the acronyms for the programs we have set up in response to the crisis – but I'll mention a few of the most important.

For centuries, central banks have calmed financial crises by lending to financial institutions against good collateral. Because central banks step in when other sources of funds retreat, central banks acting in this capacity are known as lenders of last resort. Banks rely on short-term funding such as overnight interbank loans or customer deposits to make the longer-term loans their customers need. If funding becomes scarce, banks become less willing to extend credit. To maintain the flow of credit, the Federal Reserve has made clear that it will provide short-term credit to sound depository institutions as needed. The lending

program, known as discount window borrowing or primary credit, is provided at an above-market rate so that banks use the facility only as a backup source of funds.

In theory, it is the higher rate that keeps banks from using the discount window as a regular source of funds. In practice, bankers are quite suspicious that borrowing from the Federal Reserve will bring additional regulatory scrutiny. In my banking days, I always described it as being like borrowing from my father. I was always sure that at some point I would have to answer uncomfortable questions. And since bank borrowing in normal times is rare, markets would likely view any such borrowing as a sign of weakness. While the Fed doesn't release individual borrower information, it does publish the total amount of outstanding loans weekly. The sudden appearance of new discount window lending would likely send market participants scurrying to identify the borrower, and it would at a minimum lead to rumors about who was borrowing and why. The resulting negative view of the discount window is known as stigma. When uncertainty about the health of individual institutions or the industry as a whole increases, stigma intensifies as the market tries to identify the weaker players. The dilemma facing the Fed is that when discount window borrowing is most needed to keep credit flowing, it is most stigmatized.

The discount window is the Fed's main tool for distributing money to the banking system in emergencies when bank-to-bank lending isn't functioning, which is precisely the situation that prevailed in late 2007. But because banks were very reluctant to use the window, that key tool was broken. To offset the stigma effect, the Fed took a number of steps. We reduced the spread – the difference between the primary credit rate and the federal funds target rate – ultimately from 100 basis points to 25 basis points. And we increased the maximum term from overnight to 90 days. But banks' concerns about stigma still more than offset the attractiveness of the lower rate.

In December 2007, the Fed went further, launching the Term Auction Facility, or TAF, which provided term loans to banks through regular competitive auctions. The competitive nature of the auction and the three-day deferred settlement of the TAF likely signaled that participants did not face an immediate shortage of funds. Thus, TAF loans did not carry the same stigma as primary credit. Finally, banks began to increase their usage of both primary credit and the TAF, perhaps due to lower spreads, longer terms, and reduced stigma, but no doubt in large part because market funding had become much less available.

Unlocking nonbank markets

As the crisis unfolded, it became clear that the normal tools of the Federal Reserve – lower interest rates and loans to banks – were not going to be enough to maintain the flow of credit to consumers and businesses. In today's world, much of the credit that acts as the lifeblood of the economy is no longer funded on banks' balance sheets. To sustain credit markets in the system outside the banks, the so-called shadow banking system, we employed the seldom-used emergency lending authority in section 13(3) of the Federal Reserve Act. Congress originally approved the 13(3) authority in response to business lending problems during the Depression. It allows the Fed broad authority to lend to a wide range of borrowers using good collateral in unusual and exigent circumstances as long as at least five governors – all we currently have on the Board – approve. The circumstances were certainly unusual and exigent, and for the most part, the authority was used to target critical markets that performed the same function as bank lending but were outside the banking system. Initially, 13(3) was used to establish lending facilities for securities dealers around the time of the near failure of Bear Stearns. And when runs on money market mutual funds caused the funds to stop buying commercial paper, it was used to support the commercial paper market, a key source of funding for businesses.

Section 13(3) was also used to support the market for asset-backed securities (ABS), which are made up of loans such as auto loans, credit cards, student loans, loans guaranteed by the Small Business Administration (SBA), and loans to businesses for equipment purchases.

Many major lenders in these markets fund their lending by packaging the loans into securities and selling them to investors. In the fall of 2008, ABS issuance came to a standstill, which pushed up the cost of credit and greatly reduced its availability. As market after market started to freeze, we were swamped with stories from a steady stream of trade associations, businesses, individuals, lenders, and others about the consequences of problems with ABS. Knowing that families and firms need access to loans to pay for college, replace worn-out cars, or upgrade computer systems, staff at the Fed worked around the clock to develop a credit facility that would help individuals and small businesses by jump-starting new issuance of ABS.

In late November 2008, the Federal Reserve, working with the Treasury, created the Term Asset-Backed Securities Loan Facility (TALF). Under the TALF, the Fed extends loans to investors to help finance their purchases of highly rated ABS. Banks and other intermediaries were then willing to renew their lending to consumers and small businesses because they knew that investors would purchase securities backed by the new loans.

The TALF has helped encourage loans to households by facilitating a resumption of activity in securities made up of auto loans, student loans, and credit card loans. The TALF also helped enable mortgage modifications aimed at keeping people in their homes. Mortgage servicers need funds to make the payments on delinquent mortgages while the loans are being modified. Smaller servicers have been able to bundle the payment advances as TALF-eligible securities, easing the pressure on the servicers to foreclose.

The TALF has also supported small business lending through equipment loans, fleet financing, SBA loans, and floor-plan financing for everything from automobiles to lawnmowers. In addition, thousands of small businesses were able to finance the purchase of property and casualty insurance by taking out insurance premium loans that were, in turn, securitized. In total, more than 3 million auto and student loans to households have been facilitated through the TALF as well as nearly half a million loans to small businesses and millions of credit card accounts to both consumers and businesses.

TALF loans also have been used to finance purchases of commercial mortgage-backed securities (CMBS), a market that until late 2009 had been completely frozen for more than a year. In fact, in November 2009, TALF funds were used to help bring to market the first new issue CMBS since June 2008. And since that first deal, two others have funded without assistance from the TALF, and several more are in various stages of development. We hope that our work in the commercial mortgage sector will help alleviate some of the strains in commercial real estate funding. As many of you know all too well, this sector is particularly troubled as layoffs and business closures have led to vacant retail, office, and industrial spaces across the United States and refinancing options for maturing loans remain quite limited.

I have to admit, I was originally quite skeptical about the TALF. I was so skeptical, in fact, that I was asked to take the lead working with staff on its development. Those of you who have worked with me before know what a conservative lender I am. So you can imagine the effort required by staff to overcome every concern and objection that I had. In the end, we created a program that was really quite safe from the standpoint of the taxpayer, yet quite successful from the standpoint of those who found loans that otherwise would have been unavailable.

As pleased as I was to see that the TALF worked, I am even more pleased to see that it is becoming unnecessary. In recent months, market conditions for auto and credit card ABS have improved so much that new issues are increasingly being funded by non-TALF sources. Moreover, even though TALF loans have three- and five-year terms, investors have already repaid almost one-fourth of TALF loans.

Lending to AIG

Undoubtedly, the most difficult actions and the least popular from the public's view were our assistance to individual firms, the so-called bailouts of investment bank Bear Stearns and insurance company AIG. I wasn't there for Bear Stearns, but I did have to vote on the AIG loan. And I can tell you it was the hardest decision I have ever made. Remember, as I mentioned earlier, the vote had to be unanimous. So let me see if I can put you in that moment.

The government had already put Fannie and Freddie into conservatorship to preserve the mortgage market. Lehman had just failed, and we were getting the initial reports of the fallout, like reports of battlefield casualties, that market after market was damaged or frozen. Credit spreads, the difference between the rate in any given market and the risk-free rate, were blowing up, bringing financial activity to a near standstill. Panic was so heavy in the markets that it was almost a physical presence. I kept having this image in my head of the panic being like the monster called "the Blob" that I saw years ago in an old movie. Like the Blob, panic attacked one institution after another, and with each institution it ate, it grew bigger and stronger. We had just watched it eat Lehman. We could not stop it there because we are only authorized to lend against collateral, and Lehman did not have enough collateral. Now it was focused on AIG. Unlike the situation with Lehman Brothers, we were presented with an action we could take, a loan we could make to avoid the collapse of AIG. Our knowledge of the company was limited because we had never supervised AIG, but the loan could be secured with collateral. Based on our assessments of the collateral, we believed the risk of the loans to be limited. And while the risk of making the loan was limited, the risk of not making the loan – of letting AIG, which was significantly larger than Lehman, fail – was certain to be huge. And no other entity – not a private company, not a consortium of private companies acting together, not any other branch or agency of the government – was in a position to do anything. The clock was ticking, and default was imminent. There was no time to gather more information or find another solution. So I ask you, what would you have done?

It was in this context that the Federal Reserve, with the full support of the Treasury, made a loan to AIG to prevent its failure. The loan imposed tough terms, senior management was replaced, and shareholders lost almost all of their investments.

If I had to cast that vote again, even knowing all that followed, including the criticism that we have received, I wouldn't change it. I still believe that the consequences would have been far worse for all businesses and consumers if we had let AIG fail. Despite the claims by some that healthier Wall Street firms or even the small businesses and consumers on Main Street did not benefit from assistance to AIG, I would argue that no business or individual was immune to the effects of a sequential collapse of key financial intermediaries. As it was, we still had frozen credit markets that necessitated the facilities I discussed earlier. In the wake of the Lehman failure and the near failure of AIG, it was as if someone turned off a switch on business activity. Almost overnight, businesses went into full protection mode, halting all capital expenditures, shedding inventory, and slashing expenses. In the face of massive unemployment caused by layoffs and business failures, consumers stopped spending.

This first became clear to me during the October 2008 board of directors meeting at the Federal Reserve Bank of San Francisco. The Federal Reserve System has 12 Reserve Banks, each with a board of directors representing the economy of the district. We rely upon these board members for real-time insight into conditions in the real economy. Usually, as they go around the room reporting on conditions in their industry or part of the region, you hear the full spectrum of emotion from gloom to caution to outright enthusiasm. But I will never forget the chill that went down my spine as every single person at that meeting talked about hunkering down and conserving cash. They were retailers, manufacturers, food and energy producers, providers of private capital, bankers, and nonprofit leaders. And they were spooked.

Do you remember all the predictions for Y2K, when the fear was that the economy would be technologically unable to function? As the financial crisis unfolded, it seemed as if the economy was psychologically unable to function. Everyone was frozen with fear. Then, gradually, with the support of the liquidity facilities designed by the Fed, panic began to recede. With the funds approved by the Congress for the Troubled Asset Relief Program, also known as the TARP, and used by Treasury to inject temporary capital into viable banks of all sizes, the U.S. government reassured the world that it would not allow its financial system to collapse. To help markets better assess risk, the Federal Reserve led a horizontal review, popularly known as the stress test, of the 19 largest financial institutions to estimate the likely losses and capital requirements if economic conditions turned out to be even more severe than anticipated. After publication of the stress test results, those banks raised significant private capital, and confidence slowly returned to the markets. And, just as slowly, the economy began to function again.

Putting the tools back on the shelf

It's a bit quieter at the Fed these days. All of our emergency credit facilities except for the TALF and TAF were shut down by the beginning of this month in response to improving financial market conditions. The TALF and TAF, meanwhile, are winding down. The final TAF auction will take place in early March. The TALF will remain open until June for new CMBS, but the March subscriptions will be the last for all other ABS and previously issued CMBS. We are also tightening the term on primary credit as we return to normal discount operations. Earlier today, the Board announced that we had approved an increase in the discount rate, and that we are shortening the typical maturity for primary credit loans to overnight. With these changes, we expect that banks will use private sources for normal funding and only use primary credit as a backup source of funds. As I mentioned earlier, the discount rate is the rate we charge banks that borrow at our discount window. It is not the rate we target for monetary policy purposes. I'd emphasize that the changes are simply a reversal of the spread reduction we made to combat stigma and like the closure of a number of extraordinary credit programs earlier this month, represent further normalization of the Federal Reserve's lending facilities; they do not signal any change in the outlook for monetary policy and are not expected to lead to tighter financial conditions for households and businesses.

If you look at all our liquidity facilities and add up the maximum levels reached by each, we loaned approximately \$2 trillion to combat the crisis. Using the experience, knowledge, and ingenuity that were available throughout the Fed, we put together new facilities to meet new challenges as the crisis unfolded. We responded with care and with speed. Most of the funding was disbursed in a period of a few months, and now, roughly 18 months after the start of the crisis, the nearly \$2 trillion in credit provided through the liquidity facilities have been paid down to slightly more than \$100 billion. The funds were repaid without a single penny of loss, and we still expect to collect every dollar of the loans that remain outstanding. We also continue to expect that we will ultimately incur no losses on the credit we extended to support Bear Stearns and AIG. Lending such enormous sums under such extreme conditions and with such speed will always entail risk. But I believe the Federal Reserve was able to do it as safely as it could possibly be done.

Since its inception, the Fed has been responding to crises. Indeed, the Federal Reserve was created in 1913 in response to a series of banking panics that occurred in the early part of the 20th century. In fighting the recent crisis, we made extensive use of the 13(3) authorities that were assigned to us after the trauma of the Great Depression when such tools were not initially available. Our ability to respond so quickly and so safely is due to the unique blend of experience and expertise developed as part of our normal activities. We have research economists who have spent a lifetime studying all the various markets that make up our economy. And in New York, where open market operations are conducted, we have market experts who interact with financial markets every day. We have the expertise to monitor

transactions and evaluate payment infrastructure through our check-clearing and wire transfer operations in the Reserve Banks and our supervision of key clearinghouses. Through our supervisory activities, we have banking industry experts and bank examiners who continuously monitor the condition of financial institutions. We have personnel on site in the largest banks. So we knew our borrowers and were able to evaluate the collateral that secured the loans.

Unusual and exigent

The Federal Reserve has been entrusted with special authority to act in unusual and exigent circumstances. Webster's dictionary defines unusual as "not usual, uncommon, rare." It defines exigent as "requiring immediate aid or action." I sincerely hope that financial panics such as the one we just experienced remain rare and uncommon. But I am proud of the Federal Reserve's ability to take immediate and forceful action. As policymakers appropriately debate reforms to ensure that this never happens again, I hope they also ensure that if the unusual does happen, the Federal Reserve – or if not the Fed, some government entity – has all the tools and capabilities necessary to meet it head on. And I further hope that wherever the authority resides, there are men and women of the caliber of those with whom I have been so fortunate to work at the Federal Reserve.

As for me, I am still hoping to find out what a normal time at the Fed feels like. Thank you for honoring me and, by extension, all my colleagues with this distinguished award.