<u>Questions for The Honorable Ben Bernanke, Chairman, Board of Governors of the Federal Reserve System, from Senator Bunning</u>:

1. **Please provide:**

a. **Unreleased transcripts of all F.O.M.C. meetings you participated in as a Governor or Chairman.**
b. **Unreleased transcripts of all Board of Governors meetings you participated in as a Governor or Chairman.**
c. **Transcripts and minutes of meetings of the board of the Federal Reserve Bank of New York during your tenure as Chairman of the Board of Governors.**
d. **Details, including any unreleased administrative notices, on any exemptions granted or denied to Federal Reserve Act sections 23(a) and 23(b) during your tenure as Chairman.**
e. **Details of all discount window transactions during your tenure as Chairman, including the date, amount, identity of the borrower, details of any collateral posted, explanation of the valuation of any collateral posted, any analysis of the health of the borrower at the time of the transaction, and any legal opinions regarding the transaction.**
f. **Details of all transactions at facilities created under section 13(3) of the Federal Reserve Act during your tenure as Chairman, including the date, amount, identity of the borrower, details of any collateral posted, explanation of the valuation of any collateral posted, any analysis of the health of the borrower at the time of the transaction, and any legal opinions regarding the transaction.**
g. **Copies of any swap or other agreements with foreign central banks, legal opinions related to those agreements, and any analysis of the agreements or the need for the agreements.**
h. **Any economic analysis or policy materials regarding the need for or effectiveness of any Federal Reserve facilities created under Federal Reserve Act section 13(3).**
i. **Any economic analysis or policy materials regarding the need for or effectiveness of unconventional monetary policy facilities or actions taken during your tenure as Chairman.**
j. **Any transcripts, minutes, details, legal opinions, economic analysis, phone call logs, policy materials, or any other relevant information from the F.O.M.C., the Board of Governors, the Federal Reserve Bank of New York, or other relevant body not provided under the above requests regarding the use of Federal Reserve Act section 13(3) or actions and decisions regarding AIG, Bank of America, Citigroup, Bear Stearns, Lehman Brothers, General Motors, Chrysler, CIT, or GMAC.**

Without addressing every specific item, I believe that the release of much of the information requested would inhibit the policymaking process or reduce the effectiveness of policy and thus would not be in the public interest.

Making public the information you request regarding policy deliberations (including meeting transcripts and related documents) could stifle the Federal Reserve's policy discussions, limiting the ability of participants to engage in the candid and free exchange of views about alternative approaches that is necessary for effective policy. Although transcripts are not released for five years (and I believe that we are the only major central bank that does make transcripts public), we provide extensive information about our deliberations, including through Committee statements, minutes, quarterly economic projections, testimonies, speeches, the semi-annual Monetary Policy Report to the Congress, and other vehicles.

The detailed information you have requested regarding participation in Federal Reserve's broad-based lending programs would significantly undermine the usefulness of such programs. The critical purpose of these programs is to provide institutions that have temporary liquidity needs with a means to meet those needs by coming to the Federal Reserve. Releasing the names of institutions that borrow would stigmatize such borrowing, making firms less willing to come to the Federal Reserve and so make it more difficult for the Federal Reserve to respond to financial market strains. Moreover the Federal Reserve has been highly responsible in its use of these programs. For example, our discount window loans are fully collateralized, and we have never lost a penny on such operations. Likewise, the loans made under section 13(3) have been fully secured. We provide extensive information regarding the number of institutions to which we are lending under each of our credit programs, and the type of collateral we have accepted, on our website, as well as information on exemptions granted under sections 23A and 23B of the Federal Reserve Act.

Finally, the release of staff analyses could have adverse effects on Federal Reserve policy. In order for the Federal Reserve staff to be able to provide its best policy analysis and advice to policymakers, it is necessary for some staff analysis to be kept confidential for a period of time. Release of such information could expose Federal Reserve staff to political pressure. Such pressure could lead the staff to omit more sensitive material from its policy analyses and more generally might cause the staff to skew its analyses and judgments. That outcome could have serious adverse effects on Federal Reserve policy decisions, to the detriment of the performance of our economy.

The Federal Reserve is very transparent. On a weekly, monthly, quarterly, semi-annual and annual basis, the Federal Reserve provides to the public in-depth and detailed information regarding its operations, activities and policy decisions. These materials include:

- Weekly Balance Sheets - H.4.1 Release (See December 10, 2009 Release, attached as Ex. 1, tab A) (also available on our public website: http://www.federalreserve.gov/monetarypolicy/bst_fedsbalancesheet.htm);

- Monthly Transparency Reports (See November 2009 Report, attached as Ex. 1, tab B)(also available on our public website: http://www.federalreserve.gov/monetarypolicy/files/monthlyclbsreport200911.pdf);

- Policy statements released immediately following each FOMC Meeting (See November 4, 2009 Release, attached as Ex. 1, tab C) (also available on our public website: http://www.federalreserve.gov/newsevents/press/monetary/20091104a.htm);

- Minutes of each FOMC Meeting (See November 3-4, 2009 Minutes, attached as Ex. 1, tab D) (also available on our public website: http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20091104.pdf);

- Semiannual Monetary Policy Report & Testimony (See July 2009 Report, attached as Ex. 1, tab E)(also available on our public website: http://www.federalreserve.gov/monetarypolicy/files/20090721_mprfullreport.pdf);

- Annual audit of the Federal Reserve's financial statement provided by independent accounting firm (See Audit, published in Annual Report and attached separately as Ex. 1, tab F) (also available on our public website: http://www.federalreserve.gov/boarddocs/rptcongress/annual08/pdf/audits.pdf); and

- Voluminous information on policy actions available on our public website: http://www.federalreserve.gov/monetarypolicy/bst.htm.

In addition, the Federal Reserve has submitted one statement for the record and testified before Congress 43 times this calendar year, including:

- Twelve appearances by the Chairman;

- Three appearances by the Vice Chairman;

- Nine appearances by the Governors;

- Twelve appearances by the Staff of the Board of Governors; and

- Six appearances by the Presidents, Vice Presidents and Staff of the Reserve Banks.

Further, the Federal Reserve has already been audited numerous times in 2009, including:

- The Annual Audit (as mentioned); and

- GAO Audits of non-monetary policy, which total 33 to date - 24 completed and 9 in process (reports of the audits are available on GAO's website: http://www.gao.gov/docsearch/repandtest.html).

2. Treasury published the names of banks that received TARP funds without causing a panic. Why would disclosing the names of companies that borrow at the discount window or other Fed facilities be different, especially if only released after a time delay?

It is essential that participants in our liquidity programs remain confident that their usage of these programs will be held in confidence. If borrowers instead fear that market participants and others may learn about their usage of these programs, then they will be less inclined to borrow, reducing the effectiveness of the programs for countering pressures in financial markets. This is not just a theoretical possibility. When the strains in financial markets erupted in August 2007, banks were quite reluctant to utilize the primary credit program out of concern that their borrowing would be discovered by market participants and interpreted as a sign of financial weakness. Indeed, that stigma significantly reduced the effectiveness of the primary credit program, and prompted the Federal Reserve to establish the Term Auction Facility and other programs to more directly address liquidity pressures.

3. What was the involvement of the Board of Governors in each transaction by the New York Fed under Federal Reserve Act section 13(3)? Did the Board materially alter the terms of any such transaction? Did the Board approve each transaction before the New York Fed began negotiations? Please provide other relevant information and documentation.

As required by section 13(3) of the Federal Reserve Act, the Board of Governors considered and approved, by an affirmative vote of not less than the required number of members, each credit facility established under the authority of that provision, after making the required determination that unusual and exigent circumstances existed. Prior to Board of Governors approval of these facilities, Board of Governors and New York Federal Reserve Bank staff worked together to structure the proposal that was presented to the Board of Governors for approval. As authorized by section 13(3), the Board of Governors imposed specific limits and conditions on these credit facilities as appropriate to the particular facility. Detailed information concerning each of the credit facilities authorized by the Board under section 13(3) is available on the Board's public website.

4. Did anyone, including the White House or Treasury, request commitments from you surrounding your re-nomination? Did you make any commitments regarding your re-nomination?

No one has requested any commitments from me in connection with my re-nomination, nor have I made any commitments other than what I said in my statement before the Senate Banking Committee that, if re-appointed, I will work to the utmost of my abilities in the pursuit of the monetary policy objectives established by Congress to promote price stability and maximum employment.

5. We saw the crowding out of the private mortgage market caused by Freddie and Fannie's overwhelming control of mortgages during 2002 to 2006 period. Do you think there is a danger to allowing an extended public-controlled mortgage market? And what steps is the Fed taking to reestablish a private mortgage market?

The U.S. mortgage market has had extensive government involvement for many decades, including Fannie Mae, Freddie Mac, the Federal Housing Administration, Ginnie Mae, and the Federal Home Loan Banks. That involvement has had important benefits, including the development of the mortgage securitization market. However, as the placing of Fannie Mae and Freddie Mac into conservatorship shows, the under-capitalization of the GSEs together with the implicit government guarantee has also imposed heavy costs on the taxpayer. The Congress will need to address the appropriate role of the GSEs in the future of the mortgage market.

The Federal Reserve’s agency debt and mortgage-backed securities purchase programs stabilized the functioning of private secondary mortgage markets during the height of the financial turmoil. These actions also provided significant benefits to primary mortgage markets.

6. Time and energy in macroeconomic analysis is spent attempting to measure business and consumer confidence. Confidence measures are part of macroeconomic forecasting and directly impact monetary policy decisions. Likewise, certain market movements reflect investor confidence or lack of confidence. Gold is at an all-time high because investors have lost confidence in policymakers' handling of fiat currencies. How is the Fed incorporating this market information into its analytical framework? Does the lack of confidence in fiat currencies have the potential to impact monetary policy?

Gold is used for many purposes, including as a reserve asset, as an investment, and for use in electronics, automobiles, and jewelry. Thus, fluctuations in the price of gold can reflect changes in demand associated with any of these uses, as well as changes in supply. In monitoring the price of gold, the Federal Reserve must attempt to interpret which of these factors is responsible for its fluctuations at any point in time. One of the ways we do this is by consulting other indicators of market sentiment. A number of measures of expected future inflation in the United States, including measures taken from inflation-protected bonds and surveys of consumers and professional forecasters, have been well contained. Accordingly, increases in the price of gold do not appear to reflect increases in the expected future of U.S. inflation.

7. Paul Krugman recently wrote about the problem policymakers will face in the future because of the publi’'s lack of trust. The public backlash regarding what it sees as unwarranted bailouts of banks is well-known. What is the Fed doing to restore public confidence and what are the potential negative implications of this lack of trust on the Fed's ability to conduct monetary policy?

The public’s frustration with the support provided banks and certain other financial institutions is understandable. Unfortunately, withholding the support would have resulted in a substantially more severe economic recession with significantly greater job losses. My colleagues and I on the Federal Reserve Board are taking every opportunity, including through speeches and Congressional testimony, to explain to the public the reasons for the Federal Reserve’s actions. Moreover, we fully support the efforts under way--in particular, strengthening supervision of systemically critical institutions and developing a regime to prevent the disorderly failure of systemically important nonbank financial institutions while imposing losses on the shareholders and creditors of such firms--to reduce the odds that similar support will be needed in the future.

Most critical for the Federal Reserve’s ability to conduct monetary policy is the public’s confidence in our commitment to achieving our dual mandate of maximum employment and price stability. The public’s confidence in our commitment should be bolstered by the Federal Reserve’s swift and forceful monetary policy response to the financial crisis and resulting recession and by our careful development of tools that will facilitate the firming of monetary policy at the appropriate time even with a large Federal Reserve balance sheet.

8. What are the limits on the ability of the Fed to engage in quantitative easing?

A central bank engages in quantitative easing when it purchases large quantities of securities, paying for them with newly created bank reserve deposits, to increase the supply of bank reserves well beyond the level necessary to drive very short-term interbank interest rates to zero. The Federal Reserve's large-scale asset purchases have been intended primarily to improve conditions in private credit markets, such as mortgage markets; the increase in the quantity of reserves is largely a byproduct of these actions. In any case, while large-scale asset purchases can help support financial market functioning and the availability of credit, and thus economic recovery, excessive expansion of bank reserves could result in rising inflation pressures. Congress has given the Federal Reserve a dual mandate to promote maximum employment and stable prices. That mandate appropriately gives the Federal Reserve flexibility to engage in quantitative easing to combat high unemployment and avoid deflation while requiring that it avoid quantitative easing that would be so large or prolonged that it could cause persistent inflation pressures.

9. In 2002-2005 period, we learned that there is a cost to keeping interest rates too low for too long. And, we learned it is much more difficult to tighten policy/raise interest rates after a period of low rates for a long time. Now, you have taken rates to unprecedented low levels and have also intervened in the mortgage market to produce historic low mortgage rates. If the US economy bounces back more strongly than currently anticipated, isn't the Fed going to have a very tough time raising interest rates without once again impacting asset prices, especially the housing market?

Federal Reserve policymakers consistently have said, in the statements that the Federal Open Market Committee releases immediately after each of its meetings and in their speeches, that the Federal Reserve will evaluate its target for the federal funds rate and its securities purchases in light of the evolving economic outlook and conditions in financial markets. In that regard, we announced that we plan to end our purchases of mortgage-backed securities at the end of the first quarter of 2010; we also announced--and have implemented--a gradual reduction in the pace of our purchases of such securities. More recently, we made clear that the low target for the federal funds rate is conditional on low rates of resource utilization, subdued inflation trends, and stable inflation expectations. As the economy continues to recover, it will eventually become appropriate to raise our target for the federal funds rate and perhaps take other steps to reduce monetary policy accommodation. Our continuing communication about monetary policy should ensure that market participants and others are not greatly surprised by our actions and thus help avoid sharp adjustments in asset prices.

10. What is the Fed's current thinking about using asset price levels in monetary policy analysis? Does the Fed need to anticipate asset bubbles? How can the Fed incorporate asset prices into their analysis?

Asset prices play an important role in the analysis that underpins the conduct of monetary policy by the Federal Reserve. We carefully monitor a wide range of asset prices (as well as other aspects of financial market conditions) and assess their implications for the goal variables that the Congress has given us, namely inflation and employment. There is a widely held consensus that central banks should counteract the effects of asset prices on the ultimate goal variables in this manner.

What is less clear is whether the Federal Reserve should attempt to use monetary policy to "lean against" bubbles in asset prices by tightening monetary policy more than would be indicated by the medium-term outlook for real activity and inflation alone. To be sure, the experience of the past two years provides a vivid illustration of the economic devastation that can be wrought by an asset price bubble first building up and then bursting. However, three important challenges would have to be surmounted before tighter monetary policy could be deemed an effective response to bubbles: First, we would have to be confident in our ability to detect bubbles at an early stage in their development, given substantial lags in the effects of monetary policy on real activity and inflation, and the general need for policy to ease in response to the economic weakness that follows a bubble's collapse. Second, we would have to be confident that the steps we took to restrain a bubble in one sector would not cause so much harm in other sectors as to leave the economy worse off, on net, than if we had not acted. Finally, we would have to be confident that an adjustment in the stance of monetary policy would be effective in restraining the bubble itself. It is not clear that these conditions can all be met. And even if they could, we would still have to determine that some alternative to tighter monetary policy would not be a better way of responding to the problem.

At this stage, it seems to me that the exercise of regulatory and supervisory policy is likely to be a more effective approach to addressing issues posed by possible bubbles. Regulators have an ongoing responsibility to ensure the safety and soundness of the institutions under their care; and this responsibility implies a need to monitor closely the actions of the firm that might cause it to be exposed to risks of all types, including those actions that might contribute to the development of a bubble as well as the possible effects on the firm of the bursting of an asset price bubble. On balance, therefore, I see a comprehensive and aggressive macroprudential regulatory framework as likely to be the more promising means of preventing and restraining asset-price bubbles.

All that said, we are giving the issue fresh consideration and attempting to incorporate into our analysis the lessons of the last two years in this regard.

11. The Fed appears to have coordinated some of its actions in the past year or so with other policymakers globally. Does the Fed have an obligation to disclose any of these agreements or coordinated efforts? When the Fed engages in agreements with foreign policymakers, it has the potential to abrogate its authority. What procedures are in place to make sure this doesn't happen? What checks and balances are in place?

In the past year or so, the Federal Reserve has implemented and disclosed policy actions that have been coordinated with actions taken by policymakers from other countries. These actions include both the use of central bank liquidity swaps, which have been in place since December 2007, and a reduction in the target for the federal funds rate in October 2008, which occurred in conjunction with similar rate actions by other central banks. The Federal Reserve announced these actions in press releases and maintains detailed information with respect to them on our web site.

The authority for these operations is well established. Policy rate operations clearly fall within the purview of the monetary policy authority of the Federal Reserve, and the Federal Reserve Act and longstanding historical precedent support the authority of the Federal Reserve to engage in swap operations with foreign central banks. We are committed to being as transparent as possible about our policies and operations without undermining our ability to effectively fulfill our monetary policy and other responsibilities. The Federal Reserve regularly reports to the Congress and provides both the Congress and the public with a full range of detailed information concerning its policy actions, operations, and financial accounts, including arrangements with foreign central banks such as the liquidity swaps. The Chairman of the Federal Reserve Board testifies and provides a report to the Congress semiannually on the state of the economy and on the Federal Reserve's actions to carry out the monetary policy objectives that the Congress has established, and Federal Reserve officials frequently testify before the Congress on all aspects of the Federal Reserve's responsibilities and operations, including economic and financial conditions and monetary policy.

12. China is playing a larger and larger role in the growth trajectory of the global economy. And, China is one of the largest U.S. creditors. Yet, the macroeconomic data from China is notoriously untrustworthy. How is the Fed conducting its analysis of the Chinese macroeconomic outlook without access to good data?

While macroeconomic data from China vary in quality, their reliability appears to be improving, and they now provide a reasonable picture of what is going on. In addition to data from China, one can also examine Chinese international trade by looking at the statistics produced by its major trading partners, including the United States. At the Federal Reserve, we monitor a wide range of Chinese and international data in analyzing Chinese economic and policy developments. We also closely follow studies on China performed by independent experts, and keep regular contact with these experts, Chinese academics and authorities, and other U.S. agencies. Through all these means, we are able to put together a satisfactory assessment of the performance of the Chinese economy, allowing us to make an informed projection of the country's economic outlook and its implications for the U.S. economy.

13. There are a number of macro trends at work that do not seem sustainable -- 1) the substantial accumulation of foreign exchange reserves by surplus/creditor nations, 2) the escalation of public debt levels in many of the developed market economies, and 3) excess and deficient savings ratios. These trends do not seem likely to reverse on their own. Rather, they require tough decisions and compromise on the part of governments around the world. What is the role of the Fed in this rebalancing process?

To achieve more balanced and sustainable economic growth and to reduce the risks of financial instability, economies throughout the world must act to contain and reduce global imbalances. In current account surplus countries, including most Asian economies, authorities must act to narrow the gap between saving and investment and to raise domestic demand, especially consumption. As a country with a current account deficit, the United States must increase its national saving rate by encouraging private saving and, more importantly, by establishing a sustainable fiscal trajectory, anchored by a clear commitment to substantially reduce federal deficits over time. By the same token, other countries experiencing large increases in public debt must implement credible fiscal consolidation policies.

Monetary policy, by itself, is not well suited to address external imbalances. Rather, the goal of the Federal Reserve, as given to us by Congress, is to pursue maximum employment and stable prices, not to achieve a particular level of the trade balance. Our role is to ensure the strongest possible macroeconomic environment, by pursuing the two legs of our mandate, and to work with fiscal and other policymakers to create conditions that will foster a sustainable external position. Toward this end, the Federal Reserve participates actively in the G-20 and other international organizations in a cooperative effort to devise strategies for dealing with these issues.

14. Please explain the legality of each version of the AIG bailout/loans. How were each of the loans to AIG collateralized?

Each of the facilities established by the Federal Reserve was authorized and established under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343). Section 13(3) permits the Board, in unusual and exigent circumstances, to authorize a Federal Reserve Bank to provide a loan to any individual, partnership, or corporation if, among other things, the loan is secured to the satisfaction of the Reserve Bank and the Reserve Bank obtains evidence that the individual, partnership or corporation is unable to secure credit accommodations from other banking institutions.

As described in more detail in the Board's *Monthly Report on Credit and Liquidity Programs and the Balance Sheet* and the reports filed by the Board under section 129 of the Emergency Economic Stabilization Act of 2008, the--

- Revolving Credit Facility with AIG is secured by the pledge of assets of AIG and its primary non-regulated subsidiaries, including AIG's ownership interest in its regulated U.S. and foreign subsidiaries;
- The loan to Maiden Lane II LLC (ML-II) is secured by all of the residential mortgage-backed securities and other assets of ML-II, as well as by a $1 billion subordinate position in ML-II held by certain of AIG's U.S. insurance subsidiaries;[1] and
- The loan to Maiden Lane III LLC (ML-III) is secured by all of the multi-sector collateralized debt obligations and other assets of ML-III, as well as a $5 billion subordinated position in ML-III held by an AIG affiliate.

15. The most recent changes to the AIG bailout give the New York Fed equity in AIG subsidiaries in exchange for loan forgiveness. Under what section of the Federal Reserve Act are those equity stakes permissible? Please provide any legal opinions on the subject.

The Federal Reserve Bank of New York received the preferred equity in the two special purpose vehicles established to hold the equity of two insurance subsidiaries of AIG in satisfaction of a

[1] Upon establishment of the ML-II facility, the securities borrowing facility that the Federal Reserve had established for AIG in October 2008 was terminated. Advances under this securities borrowing facility were fully collateralized by investment grade debt obligations.

portion of AIG's borrowings under the revolving credit facility established under section 13(3) of the Federal Reserve Act. As a result of the receipt of these preferred interests, AIG's borrowings under the revolving credit facility were reduced by $25 billion, and the maximum amount available under the facility was reduced from $60 billion to $35 billion. The amount of preferred equity received by the Federal Reserve was based on valuations prepared by an independent valuation firm. The revolving credit facility continues to be fully secured by nearly all of the remaining assets at AIG. We continue to believe, based on these valuations and collateral positions, that the Federal Reserve will be fully repaid.

16. The most recent changes to the AIG bailout give the New York Fed equity in AIG subsidiaries in exchange for loan forgiveness. Does that indicate that the original "loans" were not really collateralized loans at all, rather they were equity stakes?

No. The revolving credit facility established for AIG in September 2008 was and is fully secured by assets of AIG and its primary non-regulated subsidiaries, including AIG's ownership interest in its regulated U.S. and foreign subsidiaries.

The facility is fully secured by the assets of AIG, including the shares of substantially all of AIG's subsidiaries. The loan was extended with the expectation that AIG would repay the loan with the proceeds from the sale of its operations and subsidiaries. AIG has developed and is pursuing a global restructuring and divestiture plan that is designed to achieve this objective and a number of significant sales already have occurred. The credit agreement stipulates that the net proceeds from all sales of subsidiaries of AIG must first be used to pay down the credit extended by the Federal Reserve.

17. When the first nine large banks received the initial 125 billion TARP dollars, Secretary Paulson and you said those nine banks were healthy. Do you now agree with the TARP Inspector General's finding that Citigroup and Bank of America should not have been considered healthy by you and Secretary Paulson?

On October 14, 2008, the Federal Reserve joined in a press release with Treasury and the FDIC to announce a number of steps to address the financial crisis, including announcing the implementation of the Capital Purchase Program ("CPP"). The first nine banks to receive CPP funds were selected because of their importance to the financial system at large. In fact, the SIGTARP report notes that approximately 75 percent of all assets held by U.S.-owned banks were held by these nine institutions. In addition, these first nine institutions were considered to be viable, though some were financially stronger than others. The press release referred to these nine systemically important institutions as "healthy" to indicate that these institutions were viable and were not receiving government funds because they were in imminent danger of failure.

18. In 2008, you came to Congress and warned of a catastrophic financial collapse if we did not authorize TARP. One major problem you predicted was that companies would not be able to sell commercial paper. However, the Fed has the authority to buy that same commercial paper and in fact, you created a lending facility to buy commercial paper the

week after TARP was approved. Did the Fed already have plans to implement this facility before you and Secretary Paulson came to Congress requesting TARP?

The commercial paper market was severely disrupted by the financial crisis, in particular after Lehman Brothers failed on September 15, 2008, and a large money fund broke the buck the following day. The Federal Reserve created three facilities in response to the dislocation in money markets, each of which was designed to finance purchases of commercial paper. The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) was announced on September 19, 2008. The Commercial Paper Funding Facility (CPFF) was announced on October 7, 2008. And the Money Market Investor Funding Facility (MMIFF) was announced on October 21, 2008. Your question refers to the CPFF, which was announced the week after the TARP was approved. All of these facilities helped address strains in money markets, but they did not replace the commercial paper market completely, and the ability of firms to sell commercial paper was severely impaired.

On September 18, 2008, Secretary Paulson and I met with Congressional leadership to discuss the financial situation and explain our view that the global financial system was on the verge of a collapse. We expressed concern about a number of areas of the economy and financial markets, including as one example the potential collapse of the commercial paper market. At that time, the Federal Reserve was working towards developing the AMLF. The Federal Reserve began to think about constructing the CPFF after observing the effects of the failure of Lehman Brothers on the commercial paper market. The limitations on the Federal Reserve's ability to address the numerous problems that were rapidly emerging in financial markets in the fall of 2008 spurred the decision by then-Secretary Paulson and me to approach the Congress. As we explained to Congress, the tools available to the agencies at the time were insufficient to address the serious stresses facing the financial markets, and action by Congress was necessary to stem the crisis.

19. When you came to Congress last September requesting Congress to pass TARP, did you have any inclination that those funds would be used for something else besides buying toxic assets?

Last September, the financial and economic situation was evolving very rapidly. In particular, the situation--which was already very grave when Secretary Paulson and I began our intensive consultations with the Congress--had deteriorated sharply further by the time when the legislation authorizing the TARP was enacted. What was clear from the outset of those intensive consultations was that the financial system was in substantial danger of seizing up in a way that had not occurred since at least the Great Depression, and that would have led to an even worse economic collapse than the one that we have actually experienced. What was not clear, however, was the strategy that would be most effective in arresting that process of seizing up. Initially, the strategy that, indeed, received the most attention envisioned using the resources anticipated to be provided under the TARP to purchase so-called toxic assets off the balance sheets of private financial institutions, in order to improve the transparency of those balance sheets and to create the capacity for the private institutions to engage in new lending. Even until Lehman Brothers fell, the issues plaguing the financial system were closely linked to mortgages, and indeed so too were the options being considered most seriously. Only after the aftershocks of Lehman's failure sapped confidence in the broader set of financial institutions, and interbank markets seized up, did it become clear to Treasury that providing large amounts of capital to viable banks would be a superior response to the profound and rapid deterioration that had become the immediate concern, in substantial part because capital injections could be implemented much more quickly than asset purchases. These capital injections provided a means to reinforce confidence in the banking system and its ability to absorb potential losses while retaining an ability to lend to creditworthy borrowers. The Federal Reserve supported the Treasury's decision to adopt the capital-purchase strategy.

20. In your discussions with Ken Lewis about Bank of America's acquisition of Merrill Lynch, did you mention the consequences he could face regarding his employment if Bank of America did not go through with this deal?

As I indicated in my June 2009 testimony before the House Committee on Oversight and Government Reform, in my discussions with senior management of Bank of America about the Merrill Lynch acquisition, I did not tell Ken Lewis, the CEO of Bank of America, or the other managers of the institution that the Federal Reserve would take action against the board of directors or management of the company if they decided not to complete the acquisition by invoking a Material Adverse Change (MAC) clause in the acquisition agreement. It was my view, as well as the view of others, that the invocation of the MAC clause in this case involved significant risk for Bank of America, as well as for Merrill Lynch and the financial system as a whole, and it was this concern I communicated to Mr. Lewis and his colleagues. The decision to go forward with the acquisition rightly remained in the hands of Bank of America's board of directors and management.

A recent report by the Special Inspector General for the Troubled Asset Relief Program with regard to government financial assistance provided to Bank of America and other major banks confirmed, after review of relevant documents, that there was no indication that I expressed to Mr. Lewis any views about removing the management of Bank of America should the Merrill Lynch acquisition not occur.

21. Why was the SEC not notified of the Bank of America/Merrill Lynch deal?

The SEC was fully aware of the deal by Bank of America Corporation (BAC) to acquire Merrill Lynch. Chairman Cox was present in New York when BAC announced the deal in September 2008. The SEC staff discussed details of the Merrill Lynch acquisition with BAC. The SEC was not a party to the arrangement by the Treasury, Federal Reserve, and FDIC to provide a ring fence for certain assets of BAC in mid-January 2009 and therefore had no role in negotiating the arrangement, though it was informed of the arrangement.

22. When was the first time you became aware of AIG's potential vulnerability? Did anyone raise any kind of red flag to you about AIG exploiting regulatory loopholes?

The Federal Reserve did not have, and does not have, supervisory authority for AIG and therefore did not have access to nonpublic information about AIG or its financial condition before being contacted by AIG officials in early September 2008, concerning the company's potential need for emergency liquidity assistance from the Federal Reserve.

23. According to the TARP Inspector General, the Fed Board approved the New York Fed's decision to pay par on A.I.G.'s credit default swaps. What was your role in that decision, and why was it approved?

I participated in and supported the Board's action to authorize lending to Maiden Lane III for the purpose of purchasing the CDOs in order to remove an enormous obstacle to AIG's future financial stability. I was not directly involved in the negotiations with the counterparties. These negotiations were handled primarily by the staff of FRBNY on behalf of the Federal Reserve.

With respect to the general issue of negotiating concessions, the FRBNY attempted to secure concessions but, for a variety of reasons, was unsuccessful. One critical factor that worked against successfully obtaining concessions was the counterparties' realization that the U.S. government had determined that AIG was systemically important and accordingly would act to prevent AIG from undergoing a disorderly failure. In those circumstances, the government and the company had little or no leverage to extract concessions from any counterparties, including the counterparties on multi-sector CDOs, on their claims. Furthermore, it would not have been appropriate for the Federal Reserve to use its supervisory authority on behalf of AIG (an option the report raises) to obtain concessions from some domestic counterparties in purely commercial transactions in which some of the foreign counterparties would not grant, or were legally barred from granting, concessions. To do so would have been a misuse of the Federal Reserve's supervisory authority to further a private purpose in a commercial transaction and would have provided an advantage to foreign counterparties over domestic counterparties. We believe the Federal Reserve acted appropriately in conducting the negotiations, and that the negotiating strategy, including the decision to treat all counterparties equally, was not flawed or unreasonably limited.

It is important to note that Maiden Lane III acquired the CDOs at market price at the time of the transaction. Under the contracts, the issuer of the CDO is obligated to pay Maiden Lane III at par, which is an amount in excess of the purchase price. Based on valuations from our advisors, we continue to believe the Federal Reserve's loan to Maiden Lane III will be fully repaid.

24. Did Fed regulators of Citi approve the $8 billion loan Citi made to Dubai in December of last year, which was well after the firm received billions of taxpayer dollars? Do you expect we will get that money back?

With the exception of mergers and acquisitions, the Federal Reserve does not pre-approve individual transactions of the financial institutions we supervise. Whether Citi is able to recover this or any other loan it extends is a function of the standards it applied when it underwrote the loan. Nevertheless, the U.S. government's recovery of the TARP funds provided to Citi would not hinge on Citi's ability to collect on one individual debt, but rather on Citi's ability to manage its credit and other risk exposures, which is where the Fed's supervision has and will continue to focus. We are currently in discussion with Citi as well as other recipients of TARP funds to determine the appropriateness of TARP repayment.

25. In response to a question posed by Chairman Dodd, you stated you can give instances where the Fed's supervisory authority aided monetary policy. Please do so with as much detail as possible.

As a result of its supervisory activities, the Federal Reserve has substantial information and expertise regarding the functioning of banking institutions and the markets in which they operate. The benefits of this information and expertise for monetary policy have been particularly evident since the outbreak of the financial crisis. Over this period, supervisory expertise and information have helped the Federal Reserve to better understand the emerging pressures on financial firms and markets and to use monetary policy and other tools to respond to those pressures. This understanding contributed to more timely and decisive monetary policy actions. Supervisory information has also aided monetary policy in a number of historical episodes, such as the period of "financial headwinds" following the 1990-91 recession, when banking problems held back the economic recovery.

Even more important than the assistance that supervisory authority provides monetary policy, in my view, is the complementarity between supervisory authority and the Federal Reserve's ability to promote financial stability. Our success in helping to stabilize the banking system in late 2008 and early 2009 depended heavily on the expertise and information gained from our supervisory role. In addition, supervisory expertise in structured finance contributed importantly to the design of the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, and the Term Asset-Backed Securities Loan Facility, all of which have helped to stabilize broader financial markets. Historically, our ability to respond effectively to the financial disruptions associated with the September 11, 2001, terrorist attacks, to the 1987 stock market crash, as well as a number of other episodes, was greatly improved by our supervisory expertise, information, and authorities. At the same time, the Federal Reserve's unique expertise developed in the course of making monetary policy can be of great value in supervising complex financial firms.

26. In response to a question posed by Chairman Dodd, you stated "we do not see at this point any extreme mis-valuations of assets in the United States." Does that mean you believe the price of gold is not artificially inflated or out of line with fundamentals? If so, what does the rise in the gold price signify to you?

Gold is used for many purposes. It is an input into the production of electronics, automobiles, and jewelry; it is held as reserve asset by governments; and it represents an investment for private individuals. With fluctuations in the price of gold reflecting changes in demand associated with any of these uses, as well as changes in supply, it is extremely difficult to gauge whether or not price changes are consistent with fundamentals. The most recent increases in the price of gold likely reflect diverse influences, including investor concerns about the many uncertainties facing the global economy; however, it is also the case that the rise in gold prices has not been much out of line with the increases in other commodities. According to the Commodity Research Bureau, after fluctuating in a broad range for the previous 1-1/2 years, the price of gold has risen 22 percent since early July, while the CRB's index of overall commodity prices has risen 17 percent. These increases appear to reflect the recovery of the global economy, and it is not clear they have been out of line with fundamentals.

27. In response to a question posed by Senator Johnson, you indicated your concern about the GAO possibly gaining access to "all the policy materials prepared by staff." What is your concern about Congress and the public having the same understanding of the issues surrounding monetary policy decisions as you and the rest of the Fed have?

I think it desirable and beneficial for Congress and the public to have the same understanding of issues surrounding monetary policy decisions that I and my colleagues on the FOMC have. To that end, we explain our policy decisions in frequent testimony and reports to Congress as well as in press releases, minutes, and speeches. In addition, the Federal Reserve makes a great deal of policy-related data and research material, including materials prepared by Federal Reserve staff, readily available to the Congress and the public. But, in order for the Federal Reserve staff to be able to provide its best policy analysis and advice to monetary policymakers, it is necessary for some staff analysis to be kept confidential for a period of time. If instead this material were turned over to the GAO, that could ultimately lead to political pressure being applied directly to the Federal Reserve's staff. Such pressure could lead the staff to omit more sensitive material from its policy analyses and more generally might cause the staff to skew its analyses and judgments. That outcome could have serious adverse effects on monetary policy decisions, to the detriment of the performance of our economy. Also, investors and the general public would likely perceive a requirement to turn confidential staff analyses over to the GAO as undermining the independence of monetary policy, potentially leading to some unanchoring of inflation expectations and thus reducing the Federal Reserve's ability to conduct monetary policy effectively.

28. In response to a question posed by Senator Corker, you stated "On the mortgage-backed securities, we have a longstanding authorization to do that. I do not think there is any legal issue." Please provide the Fed's legal analysis on the authority to purchase such securities, particularly those issued by Fannie Mae and Freddie Mac, which are not full-faith-and-credit obligations of the United States.

Section 14(b)(2) of the Federal Reserve Act (12 U.S.C. 355) authorizes the Federal Reserve Banks, under the direction of the FOMC, to "buy and sell in the open market any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States." The Board's Regulation A (12 CFR 201) has long defined the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Government National Mortgage Association (Ginnie Mae) as agencies of the United States for purposes of this paragraph. All mortgage-backed securities (MBS) acquired by the Federal Reserve in its open market operations are fully guaranteed as to principal and interest by Fannie Mae, Freddie Mac, and Ginnie Mae.

29. In response to question posed by Senator Johanns regarding an exit strategy, you said "The next step at some point, when the economy is strong enough and ready, will be to begin to tighten policy, which means raising interest rates. We can do that by raising the interest rate we pay on excess reserves. Congress gave us the power to pay interest on reserves that banks hold with the Fed. By raising that interest rate, we will be able to raise interest rates throughout the money markets."

In response to a written question I posed to you at the July 22 monetary policy hearing, you said the Fed at that time had no plans to switch to using the new interest on reserves power as the means of setting the policy rate. However, in your response to Sen. Johanns you sound inclined to use the reserve interest rate as the policy rate. Is that correct, and if so, what has changed in the last few months?

In my written response to the question you posed on July 22, I indicated that the Federal Reserve currently expects to continue to set a target (or a target range) for the federal funds rate as part of its procedure for conducting monetary policy. We are already using the authority that the Congress provided to pay interest on reserve balances, and we anticipate continuing to use that authority in the future. For example, when the time is appropriate to begin to firm the stance of monetary policy, the Federal Reserve could increase its target for the federal funds rate. As I indicated in my response to Senator Johanns, the Federal Reserve could affect the increase in the federal funds rate partly by increasing the interest rate that it pays on reserves. The Federal Reserve also has a number of additional tools for managing the supply of bank reserves and the federal funds rate, and these tools could be used in conjunction with the payment of higher rates of interest on reserves.

30. In response to a question posed by Sen. Gregg, you stated "it would be worthwhile to consider, for example, whether regulators might prohibit certain activities. If a financial institution cannot demonstrate that it can safely manage the risks of a particular type of activity, for example, then it could be scaled back or otherwise addressed by the regulator." Do you have examples of such activities in mind? Are there some activities that we should prohibit banks or other financial institutions from engaging in outright?

Congress traditionally has sought to limit the ability of insured depository institutions to engage, directly or through a subsidiary, in potentially risky activities. Therefore, banking supervisors have emphasized safety and soundness, banking organizations' management of risks associated with their activities, and the adequacy of their capital to support those risks. In that regard, the Federal Reserve has the authority to take a series of actions to ensure that bank holding companies and state member banks operate in a safe and sound manner.

As evidenced by the recent subprime lending crisis, even traditional banking activities such as lending may pose significant risks if not safely managed. These activities do not lend themselves to general prohibitions, but rather to institution-specific consideration. The Federal Reserve considers whether a banking organization can effectively manage the risk of its regular or proposed activities through its ongoing supervisory process as well as its analysis of proposals to engage in new activities. Going forward, the Federal Reserve will continue to consider actions under our authority to restrict any activities that present safety and soundness concerns. Such actions that we might take include, but are not limited to:

- Imposing higher capital requirements to address weaknesses in asset quality, credit administration, risk management, or other elevated levels of risk associated with an activity;
- Requiring a banking organization to make more detailed and comprehensive public disclosures regarding a particular activity;

- Exercising our enforcement authority to limit the overall nature or performance of an activity, such as by imposing concentrations limits; and
- Issuing cease and desist orders to correct unsafe or unsound practices.

31. In response to a question posed by Sen. Corker, you mentioned you could provide more detail about problems at the Fed and the actions you are taking to correct them. What specific shortcomings have you identified and what specific steps have you taken to address them?

The financial crisis was the product of fundamental weaknesses in both private market discipline and government supervision and regulation of financial institutions. Substantial risk management weaknesses led to financial firms not recognizing the nature and magnitude of the risks to which they were exposed. Neither market discipline nor government regulation prevented financial institutions from becoming excessively leveraged or otherwise taking on excessive risks. Within the United States, every federal regulator with primary responsibility for prudential supervision and regulation of large financial institutions saw firms for which it was responsible approach failure.

At the Federal Reserve, we have extensively reviewed our performance and moved to strengthen our oversight of banks. We have led internationally coordinated efforts to tighten regulations to help constrain excessive risk taking and enhance the ability of banks to withstand financial stress through improved capital and liquidity standards. We are building on the success of the Supervisory Capital Assessment Program (the "stress tests") to reorient our approach to large, interconnected banking organizations to incorporate a more "macroprudential" approach to supervision. As such, we are expanding our use of simultaneous and comparative cross-firm examinations, and drawing on a range of disciplines--economists, market experts, accountants and lawyers -- from across the Federal Reserve System. We are also complementing our traditional on-site examinations with enhanced off-site surveillance programs, under which multi-disciplinary teams will combine supervisory information, firm-specific data analysis, and market-based indicators to identify emerging issues.

32. What was your role in including in the TARP proposal the ability to purchase "any other financial instrument"? Was inclusion of such a provision your suggestion?

Apart from stating the need for it, I was not involved in the negotiations between the Administration and the Congress on the terms of the TARP. However, the flexibility afforded the TARP to purchase financial instruments as needed to promote financial stability proved crucial in allowing a rapid response to the quickly deteriorating financial conditions in October 2008.

33. What was your role in the decision to make capital investments rather than toxic asset purchases with TARP funds?

It became apparent in October 2008 that the plan to purchase toxic assets was likely to take some months to implement and would not be available in time to arrest the escalating global crisis. Following the approach used in a number of other industrial countries, the Treasury made capital available instead to help stabilize the banking system. The Treasury consulted closely with the Federal Reserve on this decision.

34. As a general matter I do not think the Fed Chairman should comment on tax or fiscal policy, so please respond to this from the perspective of bank supervision and not fiscal policy. Are there any provisions of the tax code that unwisely distort financial institutions' behavior that Congress should consider as part of financial regulatory reform? For example, the tax code allows deductions for the interest paid on debt, which may cause firms to favor debt over equity. Do you have concerns about that provision? Are there other provisions that influence companies' behavior that concern you?

The taxation of businesses and households is a fundamental part of fiscal policy. I have avoided taking a position on explicit tax policies and budget issues during my tenure as Chairman of the Federal Reserve Board. I believe that these are decisions that must be made by the Congress, the Administration, and the American people. Instead I have attempted to articulate the principles that I believe most economists would agree are important for the long-term performance of the economy and for helping fiscal policy to contribute as much as possible to that performance. In that regard, tax revenues should be sufficient to adequately cover government spending over the longer-term in order to avoid the economic costs and risks associated with persistently large federal deficits. But the choices that are made regarding both the size and structure of the federal tax system will affect a wide range of economic incentives that will be part of determining the future economic performance of our nation.

In assessing the lessons of the recent financial crisis, it is difficult to find evidence that the tax treatment of financial institutions played a role in the problems that developed. In particular, the tax structure faced by these institutions did not change prior to the onset of these problems and did not appear to be associated with the buildup of leverage and risk taking that occurred. The more important remedial steps must be taken in the regulatory sphere, and I have outlined a comprehensive program aimed at ensuring that a crisis of this kind does not recur.

35. Do you think a cap on bank liabilities is appropriate? For example, do you think limiting a bank's liabilities to 2% of GDP is a good idea?

In the policy debate about how best to control the systemic risk posed by very large firms, restriction on size is one of the solutions being discussed. However, a cap on a bank's liabilities linked to a measure such as GDP may not be appropriate. In pursuing a size restriction, policymakers would need to carefully analyze the metric that was used as the basis for the restriction to ensure that limits on lines of business reflect the risks the activities present. Broad-based caps applied without such analysis potentially could limit the banking system's ability to support economic activity.

36. AIG still has obligations to post collateral on swaps still in force. Will the Fed post collateral if the deteriorating credit conditions at AIG or general credit market issues require it?

No. The Federal Reserve can only lend to borrowers on a secured basis; the Federal Reserve cannot post its own assets as collateral for a third party. AIG is obligated to continue to post collateral as required under the terms of its derivatives contracts with its counterparties. AIG may borrow from the revolving credit facility with the Federal Reserve to meets its obligations as they come due, including to meet collateral calls on its derivative contracts. AIG itself is obligated to repay all advances under the revolving credit facility, which is fully secured by assets of AIG, including the shares of substantially all of AIG's subsidiaries.

37. If TARP and other bailout actions were necessary because the largest financial firms were too big to fail, why have the largest few institutions actually been allowed to grow bigger than they were before the bailouts? Does it concern you that those few institutions write approximately half the mortgages, issue approximately two-thirds of the credit cards, and control approximately 40% of deposits in this country?

I am concerned about the potential costs to the financial system and the economy of institutions that are perceived as too big to fail. To address these costs, I have detailed an agenda for a financial regulatory system that ensures systemically important institutions are subject to effective consolidated supervision, that a more macroprudential outlook is incorporated into the regulatory and supervisory framework, and that a new resolution process is created that would allow the government to wind down such institutions in an orderly manner. In addition, high concentrations might raise antitrust concerns that consumers would be harmed from lack of competition in certain financial products. For this reason, antitrust enforcement by bank regulators and the Department of Justice would preclude mergers that are considered likely to have significant adverse effects on competition.

38. On May 5, 2009, in front of the Joint Economic Committee, you said the following about the unemployment rate: "Currently, we don't think it will get to 10 percent. Our current number is somewhere in the 9s" . In November it hit 10.2%, and many economists predict it will go even higher. This is happening despite enormous fiscal and monetary stimulus that you previously said would help create jobs. What happened after your JEC testimony in May that caused your prediction to miss the mark?

At the time of my testimony before the JEC, the central tendency of the projections made by FOMC participants was for real GDP to fall between 1.3 and 2.0 percent over the four quarters of 2009 and for the unemployment rate to average between 9.2 and 9.6 percent in the fourth quarter. As it turned out, we were too pessimistic about the overall decline in real GDP this year and too optimistic about the extent of the rise in the unemployment rate. Although we indicated in the minutes from the April FOMC meeting that we saw the risks to the unemployment rate as tilted to the upside, we underestimated the extent to which employers were able to continue to reduce their work forces even after they began to increase production again. These additional job reductions have contributed to surprisingly large gains in productivity in recent quarters and to the unexpectedly steep rise in the unemployment rate.

39. In his questioning at your hearing, Sen. DeMint mentioned several of your predictions about the economy that proved inaccurate. For example:

March 28, 2007: "The impact on the broader economy and financial markets of the problems in the subprime markets seems likely to be contained."

May 17, 2007: "We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."

Feb. 28, 2008, on the potential for bank failures: "Among the largest banks, the capital ratios remain good and I don't expect any serious problems of that sort among the large, internationally active banks that make up a very substantial part of our banking system."

June 9, 2008: "The risk that the economy has entered a substantial downturn appears to have diminished over the past month or so."

July 16, 2008: Fannie Mae and Freddie Mac are "adequately capitalized" and "in no danger of failing."

I do not bring these up to criticize you for making mistakes. Rather, it is important to examine the reason for mistakes to learn from them and do better in the future. Have you or the Fed examined why those predictions were wrong? Have you or the Fed changed anything such as your models, forecasts, or data sets as a result? What has the Fed done to revamp its analytical framework to better anticipate potential macroeconomic problems?

The principal cause of the financial crisis and economic slowdown was the collapse of the global credit boom and the ensuing problems at financial institutions. Financial institutions suffered directly from losses on loans and securities on their balance sheets, but also from exposures to off-balance sheet conduits and to other financial institutions that financed their holdings of securities in the wholesale money markets. The tight network of relationships between regulated financial firms with these other institutions and conduits, and the severity of the feedback effects between the financial sector and the real economy were not fully understood by regulators or investors, either here or abroad. Our failure to anticipate the full severity of the crisis, particularly its intensification in the fall of 2008, was the primary reason for the forecasting errors cited by Senator DeMint.

We also are expanding our use of forward-looking aggregate macroeconomic scenario analysis in supervisory practices to enhance our understanding of the consequences of changes in the economy for individual firms and the broader financial system. In addition, we are conducting research to augment our macroeconomic forecasting tools to incorporate more refined channels by which information on possible financial market stresses would feed back to the macroeconomy.

40. Derivatives such as credit-default swaps played an important role in the financial crisis, and they are central to the financial reforms currently being contemplated. During the Senate Banking Committee's hearing in November 2005 to confirm you as Alan Greenspan's successor, you had the following exchange with Senator Paul Sarbanes:

SARBANES: Warren Buffett has warned us that derivatives are time bombs, both for the parties that deal in them and the economic system. The Financial Times has said so far, there has been no explosion, but the risks of this fast growing market remain real. How do you respond to these concerns?

BERNANKE: I am more sanguine about derivatives than the position you have just suggested. I think, generally speaking, they are very valuable. They provide methods by which risks can be shared, sliced, and diced, and given to those most willing to bear them. They add, I believe, to the flexibility of the financial system in many different ways. With respect to their safety, derivatives, for the most part, are traded among very sophisticated financial institutions and individuals who have considerable incentive to understand them and to use them properly. The Federal Reserve's responsibility is to make sure that the institutions it regulates have good systems and good procedures for ensuring that their derivatives portfolios are well managed and do not create excessive risk in their institutions.

Do you still agree with that statement? If not, why do you think you were wrong?

I continue to believe that OTC derivative instruments are valuable tools for the management of risk and that they are an important part of our financial markets. Events of the last two years have demonstrated, however, that there were significant weaknesses in the risk management systems and procedures for these derivatives at some market participants and that supervisors did not fully appreciate the interconnections among regulated dealers and their unregulated counterparties that magnified these weaknesses. Supervisors have recognized that financial institutions must make changes in their risk-management practices for OTC derivatives by improving internal processes and controls and by ensuring that adequate credit risk-management disciplines are in place for complex products, regardless of the form they take. Efforts are under way to improve collateralization practices to limit counterparty credit risk exposures and to strengthen the capital regime. Regulators both in the United States and abroad also are speeding the development of central counterparties (CCPs) that offer clearing services for some OTC derivative contracts. These CCPs offer financial institutions another tool for managing the counterparty credit risk that arises from OTC derivatives.

41. An important factor in the financial crisis (and a large part of the ultimate cost to taxpayers) was the implicit government guarantee of the GSEs. In part because of decisions you made, there is now an explicit government guarantee of every large firm on Wall Street. Has moral hazard increased or decreased over the past year?

The actions by Treasury, the Federal Deposit Insurance Corporation, and the Federal Reserve were taken to stabilize financial markets during a time of unprecedented turmoil. These actions mitigated the effect of financial market turmoil on the U.S. economy more generally. Moral hazard has been, and continues to be, a significant concern with respect to large financial institutions. The Secretary of the Treasury has proposed significant reforms that include enhanced supervision of systemically important financial firms, a focus on macro-prudential supervision and new resolution authority over systemically important financial firms. These reforms would mitigate moral hazard and I strongly support them.

42. Via the FDIC, the American public now explicitly guarantees the bonds of Wall Street firms where bonuses are surging and individual employees can be paid millions of dollars a year. What is your opinion on the morality of this guarantee?

The Federal Deposit Insurance Corporation's Temporary Liquidity Guarantee Program (TGLP) is one of many necessary actions taken to stabilize financial markets during a time of unprecedented financial stress. These actions helped support the flow of credit and mitigated the most severe potential effects of the turmoil on the economy. Many households and businesses benefited from these guarantees. These and similar actions were taken with the sole objective of better achieving the mandate given to us by the Congress, namely (for the FDIC) to mitigate serious systemic risks and (for the Federal Reserve) to promote financial stability, price stability and maximum employment. Hence, they were justified--indeed necessary and appropriate under our Congressional mandate.

43. The importance you place on the output gap is well known. You have often cited "excess slack" in the economy to justify loose monetary policy, arguing that a large output gap lowers the risk of inflation. But economists such as Allan Meltzer have noted that there are "lots of examples of countries with underutilized resources and high inflation. Brazil in the 1970s and 1980s." Moreover, in a new paper dated December 2009 and titled "Has the Recent Real Estate Bubble Biased the Output Gap?", researchers at the Federal Reserve Bank of St. Louis state "Because this (predicted) output gap is so large, several analysts have concluded that monetary policy can remain very accommodative without fear of inflationary repercussions. We argue instead that standard output gap measures may be severely biased by the bubble in real estate prices that, according to many, started around 2002 and burst in 2007." They conclude with a warning: "We offer a word of caution to policymakers: Policies based on point estimates of the output gap may not rest on solid ground." Please comment on 1) Allan Meltzer's point and 2) the St. Louis Fed's research paper. Why do you continue to put such a high priority on the output gap?

I do find the evidence compelling that resource slack, as measured by an output or unemployment gap, is one factor that influences inflation. But it is not the only such factor, and Allan Meltzer is correct that there have been examples of underutilized resources coinciding with high or rising inflation. This was the case in the United States in the 1970s, for example, when large increases in the price of imported oil both raised inflation and held down production. Furthermore, estimates of the output gap are inherently uncertain, and I agree that it is important to keep that uncertainty in mind when we make decisions about monetary policy. Some estimates, such as the one you cite from researchers at the St. Louis Fed, suggest that the output gap is not large at present. However, the bulk of the evidence indicates that resource slack is now substantial, as evidenced by an unemployment rate of 10 percent and a rate of manufacturing capacity utilization of only 68 percent--lower than seen at the trough of every postwar recession prior to the current one. Thus, I continue to expect slack resources, together with the stability of inflation expectations, to contribute to the maintenance of low inflation in the period ahead.

44. In a scenario in which unemployment remains uncomfortably high, but the dollar continues to fall and commodities including oil and gold continue to rise, what would the Fed do? At what point do market signals take priority over hard-to-measure statistics like the output gap?

The output gap is only one of many economic signals, including a broad array of economic data and market indicators, that the FOMC consults in setting policy. It is difficult to predict what actions the FOMC would take in some future situation. Certainly it would be mindful of its dual mandate to foster price stability and maximum sustainable employment. If declines in the dollar and increases in commodity prices were creating upward pressures on consumer prices and causing expectations of future inflation to rise, those developments would be taken extremely seriously by the Committee, and would have to be balanced against the high rate of unemployment that you posit in your hypothetical. But the clear lesson from the experience of the 1970s and from that of other countries is the high cost that a nation pays in terms of macroeconomic performance when it loses sight of the importance of maintaining a credible plan for the achievement of price stability *and* maximum sustainable employment in the medium and longer terms.

45. The Fed has a dual mandate: maximum employment and price stability. But unemployment is at its highest level in decades. And in early and mid-2008, with oil at $150 a barrel and prices of basic staples skyrocketing, opinion polls showed that inflation was the public's highest concern, even more so than jobs or the housing market. Why has the Fed failed so badly in its mandate? Is employment an appropriate objective for monetary policy? Should the Fed have a single mandate of price stability?

The Federal Reserve’s performance should be judged in terms of the extent to which its policies have fostered satisfactory outcomes for economic activity and inflation given the unanticipated shocks that have occurred. For example, while U.S. consumer price inflation was temporarily elevated by shocks to the prices of energy and other commodities during early and mid-2008 and then dropped sharply after the intensification of the global financial crisis, the Federal Reserve’s policies have been successful in keeping the longer-term inflation expectations of households and businesses firmly anchored throughout this period. Moreover, while the financial crisis led to a severe economic contraction and a steep rise in unemployment, the Federal Reserve’s extraordinary policy measures have been crucial in averting a global financial collapse that would have been associated with far higher rates of unemployment.

I support the Federal Reserve’s dual mandate of maximum employment and price stability. These congressionally mandated goals are appropriate and generally complementary, because price stability helps moderate the short-term variability of employment and contributes to the economy’s employment prospects over the longer run. Under some circumstances, however, there may indeed be a temporary tradeoff between the elements of the dual mandate. For example, an adverse supply shock might cause inflation to be temporarily elevated at the same time that employment falls below its maximum sustainable level. In such a situation, a central bank that focused exclusively on bringing inflation down as quickly as possible might well exacerbate the economic weakness, whereas a monetary policy strategy consistent with the

Federal Reserve’s dual mandate would aim to foster a return to price stability at a lower cost in terms of lost employment.

46. In February 2009, Janet Yellen, president of the San Francisco Fed, said that the Fed needed to fight back against the argument that its liquidity efforts would eventually lead to higher inflation and higher interest rates, calling the notion "ludicrous". Since then, the dollar has fallen precipitously, oil has almost doubled in price, and gold has surged to all-time highs. Do you share your colleague's view on inflation?

The dollar serves as an international reserve currency; hence, short-term fluctuations in the foreign exchange value of the dollar are often linked to global developments rather than to U.S. monetary policy or inflation. Indeed, the intensification of the global economic and financial crisis in the second half of 2008 was associated with a substantial rise in the foreign exchange value of the dollar as investors increased their holdings of relatively safe dollar-denominated assets. As financial markets have recovered this year and the world economy has stabilized, that appreciation has gradually unwound and the foreign exchange value of the dollar has essentially returned to its level prior to the events of the fall of 2008. The prices of energy and other commodities are also closely linked to global economic developments; for example, the spot price for West Texas intermediate crude oil dropped sharply from around $130 per barrel in July 2008 to around $40 per barrel at the turn of the year, but it has subsequently rebounded to about $75 per barrel as the global economic outlook has improved. The Commodity Research Bureau’s index of overall commodity prices indicates that the rise in the price of gold over the past few months is in line with the increased prices of other commodities over the same period.

I do not believe that the Federal Reserve’s credit and liquidity programs will lead to higher inflation. Longer-term inflation expectations appear stable, and as I have emphasized in the past, the Federal Reserve has the tools it needs to withdraw the current substantial degree of monetary policy stimulus when it is appropriate to do so. The Federal Reserve will adjust the stance of policy as needed to fulfill its dual mandate of fostering price stability and maximum employment.

47. What does the surge in gold mean to you? At what price level would it begin to worry you, if it doesn't already? Does gold have any impact on the Fed's policy deliberations?

As mentioned in response to questions #6 and #26, gold is used for many purposes. Movements in the price of gold are determined by changes in the demand for gold for its various uses and changes in supply conditions. Therefore, assessing why gold prices have recently risen and whether the increase is consistent with fundamentals is very difficult. Accordingly, it is also difficult to specify a particular level of the price of gold which, if exceeded, would indicate particularly worrisome developments. As also mentioned earlier, the Federal Reserve looks at a wide array of indicators of market sentiment and inflation expectations. Among those indicators is the price of gold, but for the reasons just noted, its movements are often harder to interpret than those of some of the other indicators. Nonetheless, we will continue to monitor the price of gold going forward.

48. Why does the Fed insist on waiting five years before it releases transcripts of FOMC meetings to the public?

The effectiveness of monetary policy deliberations is facilitated by the policy of maintaining the confidentiality of FOMC meeting transcripts for five years, so that participants can have a candid and free exchange of views about alternative policy approaches. It is noteworthy that the five-year interval prior to publication of FOMC meeting transcripts is much shorter than required under the Federal Records Act, which directs such records to be transmitted to the National Archives and made public after a 30-year period. Moreover, from an international perspective, the Federal Reserve is virtually unique with regard to this aspect of its transparency; no other major central bank publishes transcripts of its monetary policy meetings.

49. Has the Fed ever had an internal debate about how monetary policy contributes to geopolitical tensions via the rising oil prices caused by a falling dollar?

Monetary policy may exert some effect on oil prices through a number of channels, including: the cost of carrying inventories and of investing in productive capacity, the pace of economic growth, and the exchange rate. However, the effects of changes in interest rates and exchange rates on oil prices appear to be relatively small. Accordingly, my sense is that variations in monetary policy have played only a limited role in the wide swings in oil prices observed in recent years.

50. Before the financial crisis there was a widespread sense, especially on Wall Street trading desks, that the stock market was strangely resilient. This encouraged excessive risk-taking in various types of assets. Do you have direct or indirect knowledge of the Federal Reserve or any government entity or proxy ever intervening to support the stock market (or any individual stock) via futures or in any other way? If yes, who decides the timing of such intervention and with what criteria? How is it funded? Which Wall Street firm handles the orders, and who sees them before they are executed?

The Federal Reserve has not intervened to provide support to the stock market or individual stocks by trading in futures or any other financial instrument. I have no knowledge of any other U.S. government entity providing such support.

51. You have repeatedly stated your concern that an audit of the Fed will undermine the independence of the Fed in monetary policy. What do you fear influence from Congress will lead to, tighter or looser policy?

Broadening the scope of the GAO to include a review of monetary policy functions would undermine the safeguards that Congress put in place in 1978 to promote monetary policy independence and insulate the Federal Reserve from short-run political pressures. As a result, households, businesses, and investors might well conclude that the Federal Reserve would not be in a position to combat inflation pressures as effectively as in the past. This loss of confidence could lead to higher inflation expectations, hence boosting interest rates and raising the cost of credit for households and businesses. Moreover, inflation expectations would be more likely to rise in response to monetary policy accommodation undertaken to address high unemployment and weak economic activity. This potentially greater sensitivity of inflation expectations to accommodative monetary policy could limit the Federal Reserve's ability to combat high unemployment and economic weakness without an undesirable boost in inflation.

52. Do you believe our banking system is facing a future like Japan's system faced in the 1990s, with zombie banks as an obstacle to economic prosperity? Why or why not?

I do not believe that the U.S. banking system is facing a future akin to that of Japanese banks in the 1990s. Japanese authorities took a long time to take the steps that were necessary to deal with zombie banks and ensure a sound banking system, because they first had to construct a strong system of bank supervision and regulation. It wasn't until the late 1990s that new laws were passed to deal with bank insolvencies and the Financial Supervisory Agency, which later became the Financial Services Agency (FSA), was established. And it was not until 2002 that the FSA conducted its first round of examinations of major banks aimed at ensuring that they were adequately identifying and provisioning against non-performing loans.

In contrast, U.S. authorities, including the Federal Reserve, have been able to quite rapidly take strong steps to address bank weakness. First, the *Commercial Bank Examination Manual* and the *Bank Holding Company Supervision Manual* have long contained guidance for bank and bank holding company (BHC) examiners on evaluating the adequacy of loan loss reserves, and examiners continue to follow this guidance. In addition, earlier this year, the Federal Reserve and other federal bank supervisors completed a comprehensive forward-looking capital assessment exercise--the Supervisory Capital Assessment Program (SCAP)--on the largest 19 U.S. BHCs. This exercise went further than a regular BHC examination (which produces a snapshot of current BHC health), because it involved estimating losses that might arise over a period of two years under more-adverse-than-expected economic assumptions, and because it ensured consistency across institutions.

53. Do you believe the Fed's policies are enabling banks to put off recognizing their losses?

The Federal Reserve's policies are not enabling banks to defer recognizing incurred loan losses or overstating income. We require institutions to prepare regulatory reports in accordance with generally accepted accounting principles (GAAP). Currently, GAAP requires estimated incurred loan losses to be recognized in the financial statements. We have issued numerous reminders in the form of supervisory guidance that reiterate the need for institutions to take appropriate loan losses. Most recently, we issued guidance on commercial real estate lending that encouraged institutions to work with borrowers while reiterating the importance of recognizing loan losses on restructured loans as appropriate. By no means have we been suggesting any type of forbearance on loan loss recognition. However, we believe that the accounting loan loss model needs to be modified to improve recognition of credit losses.

54. What was your rationale for letting Lehman fail?

Concerted government attempts to find a buyer for Lehman Brothers or to develop an industry solution proved unsuccessful. Moreover, providers of both secured and unsecured credit to the company were rapidly pulling away from the company and the company needed funding well above the amount that could be provided on a secured basis. As you know, the Federal Reserve cannot make an unsecured loan. Because the ability to provide capital to the institution had not yet been authorized under the Emergency Economic Stabilization Act, the firm's failure was, unfortunately, unavoidable. The Lehman situation is a clear example of why the government needs the ability to wind down a large, interconnected firm in an orderly way that both mitigates the costs on society as whole and imposes losses on the shareholders and creditors of the failing firm.

55. Reportedly, the Fed is requiring banks to report their derivatives positions to the Fed. Does the Fed have the expertise and analytical capacity to understand and act on that information?

Yes. The Federal Reserve has staff members with both financial economics and financial analysis expertise. These staff members contribute both to the analysis of financial data at the macro or market level and to the understanding of models used by individual institutions in their derivatives activities.

56. Given that some economic conditions have worsened beyond what was assumed in the "stress tests" earlier this year, do you still believe the stress tests to be useful or accurate representations of the institutions examined?

I believe that the stress tests are still a useful representation of the risks of the examined institutions in a more stressful environment than expected. It is true that since the scenarios for the stress tests were specified, the unemployment rate has risen sharply and will be above the rate that was assumed for 2009 in the more adverse scenario. However, the latest private forecasts indicate that the unemployment rate next year will be noticeably below the rate assumed in the more adverse scenario, and the rebound in real GDP next year will be larger than was assumed. Further, incoming data on house prices have been considerably better than expected, which should reduce losses, and a significant part of the estimated losses in the stress tests at the examined institutions were related to the substantially lower house prices assumed in the more adverse scenario.

57. In your recent Washington Post op-ed, you recognized that the Fed "did not do all that it could have" under your leadership to prevent the financial crisis, why should the public have any confidence that the next time the Fed will do all it can?

The regulatory framework that was in place at the onset of the crisis had not kept pace with dramatic changes in the structure and activities of the financial sector. Specifically, U.S. and global regulations did not adequately address the possibility of significant losses in the trading book, securitizations, and some other capital market activities that had become a significant feature of the financial system. The Federal Reserve has already taken steps, working with domestic supervisors and the Basel Committee on Bank Supervision, to increase capital requirements for trading activities and securitization exposures. The Federal Reserve is moving toward agreement with international counterparts on measures to improve the quality of capital, with a particular emphasis on the importance of common equity. We are also discussing options under which systemically important firms could supplement their capital base in times of stress through instruments that, for example, would trigger conversion into common equity when economic conditions or a firm's individual condition had weakened substantially. In addition, we are implementing strengthened guidance on liquidity risk management to better capture the complex financing characteristics of large, wholesale funded institutions, and are weighing proposals for quantitatively based requirements. It is important to couple these enhancements with legislative action to redress gaps in the regulatory framework by, for example, extending the perimeter of regulation to ensure that firms like AIG and Lehman Brothers are subject to robust consolidated supervision.

58. Are you concerned that the debt to GDP ratio in this country is more than 350%? Do you believe a high debt to GDP ratio is reason for tightening Fed policy? Why or why not?

The current ratio of public and private debt to GDP, including not only the debt of the nonfinancial sector but also the debt of the financial sector, is about 350 percent. (Many analysts prefer to focus on the debt of the nonfinancial sectors because, they argue, the debt of the financial sector involves some double-counting--for example, when a finance company funds the loans it provides to nonfinancial companies by issuing bonds. The ratio of total nonfinancial debt to GDP is about 240 percent.) Private debt has been declining as households and firms have been reducing spending and paying down pre-existing obligations. For example, households, who are trying to repair their balance sheets, reduced their outstanding debt by 1.3 percent (not at an annual rate) during the first three quarters of this year.

In contrast, public debt is growing rapidly. Putting fiscal policy on a sustainable trajectory is essential for promoting long-run economic growth and stability. Currently, the ratio of federal debt to GDP is increasing significantly, and those increases cannot continue indefinitely. The increases owe partly to cyclical and other temporary factors, but they also reflect a structural federal budget deficit. Stabilizing the debt to GDP ratio at a moderate level will require policy actions by the Congress to bring federal revenues and outlays into closer alignment in coming years.

The ratio of government debt to GDP does not have a direct bearing on the appropriate stance of monetary policy. Rather, the stance of monetary policy is appropriately set in light of the outlook for real activity and inflation and the relationship of that outlook to the Federal Reserve's statutory objectives of maximum employment and price stability. Of course, government indebtedness may exert an indirect influence on monetary policy through its potential implications for the level of interest rates consistent with full employment and low inflation. But in that respect, fiscal policy is just one of the many factors that influence interest rates and the economic outlook.

59. The FDIC is seeing significant losses on the mortgages of failed banks. Why shouldn't we assume the Fed will see similar losses on the mortgages on the Fed's balance sheet? How is the Fed valuing those assets?

In conducting open market operations to support the availability of mortgage financing to households, the Federal Reserve has purchased only mortgage-backed securities (MBS) that are fully guaranteed as to principal and interest by Fannie Mae, Freddie Mac, and Ginnie Mae; accordingly, the Federal Reserve has no exposure to credit losses on the mortgages that underlie these MBS. Each week, the Federal Reserve publishes, in its H.4.1 statistical release, the current value of these securities, measured as the remaining principal balance on the underlying mortgages. The Federal Reserve also reports, in the Monthly Report on Credit and Liquidity Programs and the Balance Sheet, the end-of-month fair market value of these MBS. The fair market value is determined using market values obtained from an independent pricing vendor.

The Federal Reserve also holds mortgage loans, MBS, and collateralized debt obligations that are backed by mortgage-related assets through Maiden Lane LLC, Maiden Lane II LLC, and Maiden Lane III LLC. At the end of each quarter, the assets of these entities are revalued and the fair value of the assets is reported in the H.4.1 statistical release and in the Monthly Report on Credit and Liquidity Programs and the Balance Sheet. As explained in the Appendix to the Monthly Report, because of the mix of assets held by these entities, the terms on which the Federal Reserve acquired these assets, the equity or subordinated debt positions in these entities held by others, and the longer term nature of these facilities (which allows the assets to be held to maturity or sold as markets stabilize and asset values recover), the Board does not anticipate that the Federal Reserve or taxpayers will incur any net loss on the Federal Reserve's loans to these entities.

60. I am concerned about the falling value of the dollar. China has disclosed that it has taken as much as a $350 billion loss on its dollar holdings since March, and believes it may take another $220 billion should the dollar fall a further 10%. Under what scenario do you see China continuing to buy our debt when your actions, along with Treasury's, wipe out half a trillion dollars of value in the assets purchased from us?

Since March, the value of China's dollar holdings as measured in its own currency has not been affected by fluctuations in the U.S. dollar against other currencies, because operations by Chinese authorities in their foreign exchange markets have kept the value of the renminbi essentially unchanged against the U.S. dollar over this period. The cited losses of $350 billion may represent the gains China would have recorded had all of its foreign holdings been in currencies other than the dollar, but this is a hypothetical measure of foregone value rather than a realized loss, and, in any event, would just offset gains recorded as the dollar rose between the summer of 2008 and March 2009.

Absent a policy shift in China that entails a discontinuation of official operations to resist upward pressure on the country's currency, China will continue to accumulate external assets and thus likely will continue to invest in U.S. assets. In fact, China has continued to purchase U.S. Treasuries in recent months. More generally, U.S. balance of payments data show that purchases of Treasury securities this year by all foreign official entities have been sizable, even during times when the dollar moved lower. Foreign countries, including China, find Treasury securities attractive because the market for U.S. government securities is one of the deepest and most liquid markets in the world and because the U.S. dollar is widely accepted as the premier reserve currency.

61. Some observers see a new asset bubble forming in the stock market. Does it concern you that under some measures the current price to earnings ratio on the S&P 500 is

considerably higher than the ratio when Alan Greenspan gave his "irrational exuberance" speech?

While assessing the fundamental values of financial assets is inherently very difficult, there is not much evidence to suggest that the stock market is currently in a bubble. Broad stock-price indexes have increased markedly since their troughs early this year. However, share prices have yet to retrace all their losses since September 2008, and are substantially below their peaks in 2007. Even more to the point, measures of risk premiums on broad stock-price indexes, despite having narrowed substantially relative to their record highs in late 2008, are still very wide by historical standards, suggesting that investors are not overly sanguine about the risks of investing in the stock market. Consistent with that view, implied volatilities on broad stock-price indexes have hovered at elevated levels in recent months, even as the economy has begun to recover. All that said, stock values ultimately depend on the evolution of company earnings, which in turn depend on the path of the economy. Because economic forecasts are inherently very uncertain, the appropriate valuations of stocks are also uncertain.

62. According to the transcript of the June 24-25 FOMC meeting you said "Ambiguity has its uses but mostly in noncooperative games like poker. Monetary policy is a cooperative game. The whole point is to get financial markets on our side and for them to do some of our work for us. In an environment of low inflation and low interest rates, we need to seek ever greater clarity of communication to the markets and to the public." If you still believe that, why are you concerned about opening more information about monetary policy to the public eye through an audit or other means of increasing transparency?

I believe that transparency is critical to the effective conduct of monetary policy. Indeed, over the past several years, the Federal Reserve has taken significant steps to enhance the clarity of its communications to the public and the Congress. In the autumn of 2007, the FOMC began publishing the economic projections of Committee participants four times per year rather than semiannually. In early 2009, the FOMC extended the horizon of these forecasts to include longer-run projections, which provide information about participants' estimates of the longer-run sustainable rates of economic growth and unemployment and about their assessments of the longer-run average inflation rate that best fulfills the Federal Reserve's dual mandate. Last June, the Federal Reserve began publishing a monthly report entitled "Credit and Liquidity Programs and the Balance Sheet" that presents detailed information about the Federal Reserve's programs to foster market liquidity and financial stability.

Moreover, the Congress--through the Government Accountability Office--can and does audit all aspects of the Federal Reserve's operations except for deliberations on monetary policy and related issues. The Congress specifically exempted those deliberations to protect monetary policy from short-term political pressures. The repeal of this exemption could lead households, businesses, and investors to conclude that the Federal Reserve would not be in a position to combat inflation pressures as effectively as in the past. As a result, inflation expectations would likely move higher, boosting interest rates and raising the cost of credit for households and businesses.

63. Did you or anyone else at the Fed realize the extent to which bailing out AIG would benefit European banks?

At the time the decisions were made to provide financial assistance to AIG and subsequently to restructure that assistance, we knew that the company was a very large, diversified financial services company that had extensive interconnections with the financial markets in this country and globally. As I indicated in my testimony earlier this year before the House Financial Services Committee, the range of parties that had potential exposure to AIG was sweeping: millions of policyholders of its insurance subsidiaries in the United States and elsewhere, state and local governments, workers whose 401(k) plans had purchased insurance from AIG, banks and investment banks that had loans or lines of credit to the company, and money market funds and others that held AIG's outstanding commercial paper. Those with AIG exposure consisted of individuals and businesses, financial institutions and commercial enterprises, private and governmental entities, and domestic and foreign parties.

64. Did the effect of a failure of AIG on European banks in any way contribute to the decision to rescue AIG? If so, why did you not request European governments provide financial assistance as well?

As noted in the answer to question 63, the decisions to provide financial assistance to AIG and subsequently to restructure that assistance were based on a wide range of factors, including the potential exposure of a broad spectrum of financial market participants to the company. During the recent financial markets crisis, the Federal Reserve has coordinated with foreign central banks and bank regulators in implementing measures to stabilize the banking system globally. Several European governments provided financial assistance to banks within their jurisdictions as part of these efforts.

65. Why were the monoline insurers allowed to fail while AIG was rescued, when they had significant derivatives exposure just like AIG?

AIG's near-failure occurred at an extraordinary time. Global financial markets were under unprecedented strains. Major financial firms were under intense stress and three very large firms--Fannie Mae, Freddie Mac, and Lehman Brothers--had recently failed or been placed into conservatorship. The Federal Reserve and the Treasury judged that, given the severe market and economic stresses prevailing at that time, the failure of AIG would have posed an unacceptable risk for the global financial system and our economy. A disorderly failure on the part of AIG would have directly affected insurance policyholders in the United States and worldwide, state and local government entities that had lent to AIG, 401(k) plans that had purchased insurance from AIG, financial institutions with large exposures to AIG, and money market mutual funds and others that had invested in AIG's commercial paper. More broadly, AIG's failure would have further damaged already fragile market confidence and could have precipitated a broad-based run on financial institutions around the world.

In contrast to AIG, the monoline insurers came under substantial pressure in an earlier period when market and economic strains were much less pronounced, and the effects of the failure of monolines were judged as being less likely to have serious adverse effects on the financial system and the economy.

66. In November 2009, the AIG bailout was revised to give the New York Fed ownership of several AIG subsidiaries in exchange for a reduced balance owed on loans by the New York Fed. What was the valuation used by the Fed for these subsidiaries, and how was that valuation determined? Did the Fed or AIG try to sell the subsidiaries to private entities? If so, what was the result, and if not, why not? What is the Fed's plan to dispose of the equity stakes?

The revolving credit facility is fully secured by all the unencumbered assets of AIG, including the shares of substantially all of AIG's subsidiaries. The loan was extended with the expectation that AIG would repay the credits with the proceeds from the sale of its operations and subsidiaries. The credit agreement stipulates that the net proceeds from all sales of subsidiaries of AIG must first be offered to pay down the credit extended by the Federal Reserve. AIG has developed a plan to divest its non-core business in order to repay U.S. government support.

Most recently, AIG has begun the process of selling two of its insurance subsidiaries with significant business overseas, American International Assurance Co. (AIA) and American Life Insurance Company (ALICO). The step taken last week by the Federal Reserve to accept shares in two newly created companies that hold the common stock of AIA and ALICO, respectively, in satisfaction of a portion of the credit extended by the Federal Reserve facilitates the sale of these two companies and the repayment of the Federal Reserve. The value of the Federal Reserve's preferred interests represents a percentage of the market value of AIA and ALICO, based on valuations provided by independent advisers. AIA has announced plans for an initial public offering in 2010 and ALICO has announced that it has positioned itself for an initial public offering or a sale to a third party. AIG also continues to pursue the sale of other subsidiaries, the net proceeds of which would be applied to repay the AIG loan.

67. Have you recommended any candidates to fill the empty seats on the Board of Governors? If so, who?

No. The selection of Board members of the Federal Reserve is the responsibility of the President of the United States. Every President takes this responsibility seriously and I am therefore confident he is committed to filling the vacant seats with well-qualified individuals.

68. Andrew Haldane, head of financial stability at the Bank of England, argues that the relationship between the banking system and the government (in the UK and the US) creates a "doom loop" in which there are repeated boom-bust-bailout cycles that tend to get cost the taxpayer more and pose greater threat to the macroeconomy over time. What can be done to break this loop?

The "doom loop" that Andrew Haldane describes is a consequence of the problem of moral hazard in which the existence of explicit government backstops (such as deposit insurance or liquidity facilities) or of presumed government support leads firms to take on more risk or rely on less robust funding than they would otherwise. The new financial regulatory structure that I and others have proposed to counteract moral hazard would address this problem. In particular, a stronger financial regulatory structure would include: a consolidated supervisory framework for all financial institutions that may pose significant risk to the financial system; consideration in this framework of the risks that an entity may pose, either through its own actions or through interactions with other firms or markets, to the broader financial system; a systemic risk oversight council to identify, and coordinate responses to, emerging risks to financial stability; and a new special resolution process that would allow the government to wind down in an orderly way a failing systemically important nonbank financial institution (the disorderly failure of which would otherwise threaten the entire financial system), while also imposing losses on the firm's shareholders and creditors. The imposition of losses would reduce the costs to taxpayers should a failure occur.

69. Mervyn King, governor of the Bank of England, argued in his recent Edinburgh speech that re-regulating the financial system will not effectively reduce its risks. And history suggests that Big Finance always gets ahead of even the most able regulators. Governor King insists instead that the largest banks should be broken up, so they are no longer "too big to fail." Paul Volcker and Alan Greenspan, in recent statements, have supported the same broad approach. Can you explain why you differ from Mervyn King, Paul Volcker, and Alan Greenspan on this policy prescription?

I agree that no financial institution should be too big to fail. The policy of the Federal Reserve is that systemically important institutions should be regulated in a way that recognizes the full panoply of risks that they present to the financial system and to the economy more broadly. Such risks include but may not be limited to credit, liquidity, operational, and systemic risks. A difficulty of the prior regulatory framework is that sufficient charges and requirements were not imposed on such institutions, leaving them with an inappropriate incentive to become large and complex for the sake of possibly becoming recognized as too big to fail. The regulatory approach we are currently working to develop and implement seeks to correct this important shortcoming by imposing a comprehensive and robust set of safeguards, capital charges, and other measures that are designed to reflect the full range of risks posed by large, complex organizations. While significant challenges to developing and implementing such an approach exist, an appropriately calibrated system along these lines should help reduce the potential for any firm to be too big to fail. An important complement to stronger regulation and supervision, however, is the development of an effective resolution regime that would allow the government to wind down in an orderly way a troubled financial firm even in cases where a disorderly failure would pose a threat to the financial system and the economy.

70. In the time between the bailout of Bear Stearns and the failure of Lehman, should you or the Treasury have more clearly communicated that firms should not expect government assistance? Why do you think Lehman, AIG, and others continued to act like there would be such assistance? Are there any lessons we should learn from that period that are applicable to efforts to reform our financial regulation?

Between the time of the near failure of Bear Stearns and the collapse of Lehman, a number of troubled financial institutions did in fact fail or were acquired by other financial institutions in private transactions. Moreover, in the aftermath of JPMorgan Chase's acquisition of Bear

Stearns, many financial firms took steps to strengthen their financial positions, including writing down troubled assets, raising capital, and reducing leverage. However, these steps were not sufficient in many cases to allow the firms to survive the worsening of the financial crisis in the fall of 2008. Our decisions at that time, like those we took at each stage of the crisis, depended critically on the details of the circumstances then prevailing. As I have outlined elsewhere, a concerted effort was made to find a private-sector solution to the problems at Lehman. Had a viable buyer emerged, the Federal Reserve would have strongly supported the sale, but in the event, no such buyer was forthcoming. Moreover, providers of both secured and unsecured credit to the company were rapidly pulling away from the company and the company needed funding well above the amount that could be provided on a secured basis. Before the enactment of the legislation authorizing the TARP, the government lacked the ability to inject capital to prevent the disorderly collapse of a failing systemically important non-banking institution. In light of these circumstances, failure was the only possible outcome for Lehman. Two critical lessons should be gleaned from the Lehman experience. First, Congress must ensure that all systemically important firms are subject to robust consolidated supervision. Second, going forward, there is an acute need for the Congress to enact a resolution regime that would allow the government to wind down a failing systemically important nonbank financial institution in an orderly way, and to impose losses as appropriate on shareholders and creditors.