Board of Governors of the Federal Reserve System

Testimony

Chairman Ben S. Bernanke

U.S. financial markets

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Chairman Bernanke presented identical testimony before the Committee on Financial Services, U.S. House of Representatives, on September 24, 2008

Chairman Dodd, Senator Shelby, and members of the Committee, I appreciate this opportunity to discuss recent developments in financial markets and the economy. As you know, the U.S. economy continues to confront substantial challenges, including a weakening labor market and elevated inflation. Notably, stresses in financial markets have been high and have recently intensified significantly. If financial conditions fail to improve for a protracted period, the implications for the broader economy could be quite adverse.

The downturn in the housing market has been a key factor underlying both the strained condition of financial markets and the slowdown of the broader economy. In the financial sphere, falling home prices and rising mortgage delinquencies have led to major losses at many financial institutions, losses only partially replaced by the raising of new capital. Investor concerns about financial institutions increased over the summer, as mortgage-related assets deteriorated further and economic activity weakened. Among the firms under the greatest pressure were Fannie Mae and Freddie Mac, Lehman Brothers, and, more recently, American International Group (AIG). As investors lost confidence in them, these companies saw their access to liquidity and capital markets increasingly impaired and their stock prices drop sharply.

The Federal Reserve believes that, whenever possible, such difficulties should be addressed through private-sector arrangements--for example, by raising new equity capital, by negotiations leading to a merger or acquisition, or by an orderly wind-down. Government assistance should be given with the greatest of reluctance and only when the stability of the financial system, and, consequently, the health of the broader economy, is at risk. In the cases of Fannie Mae and Freddie Mac, however, capital raises of sufficient size appeared infeasible and the size and government-sponsored status of the two companies precluded a merger with or acquisition by another company. To avoid unacceptably large dislocations in the financial sector, the housing market, and the economy as a whole, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac into conservatorship, and the Treasury used its authority, granted by the Congress in July, to make available financial support to the two firms. The Federal Reserve, with which FHFA consulted on the conservatorship decision as specified in the July legislation, supported these steps as necessary and appropriate. We have seen benefits of this action in the form of lower mortgage rates, which should help the housing market.

The Federal Reserve and the Treasury attempted to identify private-sector approaches to avoid the imminent failures of AIG and Lehman Brothers, but none was forthcoming. In the case of AIG, the Federal Reserve, with the support of the Treasury, provided an emergency credit line to facilitate an orderly resolution. The Federal Reserve took this action because it judged that, in light of the prevailing market conditions and the size and composition of AIG's obligations, a disorderly failure of AIG would have severely threatened global financial stability and, consequently, the performance of the U.S. economy. To mitigate concerns that this action would exacerbate moral hazard and encourage inappropriate risk-taking in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors. The chief executive officer has been replaced. The collateral for the loan is the company itself, together with its subsidiaries.[1] (Insurance policyholders and holders of AIG investment products are, however, fully protected.) Interest will accrue on the outstanding balance of the loan at a rate of three-month Libor plus 850 basis points, implying a current interest rate over 11 percent. In addition, the U.S. government will receive equity participation rights corresponding to a 79.9 percent equity interest in AIG and has the right to veto the payment of dividends to common and preferred shareholders, among other things.

In the case of Lehman Brothers, a major investment bank, the Federal Reserve and the Treasury declined to commit public funds to support the institution. The failure of Lehman posed risks. But the troubles at Lehman had been well known for some time, and investors clearly recognized--as evidenced, for example, by the high cost of insuring Lehman's debt in the market for credit default swaps--that the failure of the firm was a significant possibility. Thus, we judged that investors and counterparties had had time to take precautionary measures.

While perhaps manageable in itself, Lehman's default was combined with the unexpectedly rapid collapse of AIG, which together contributed to the development last week of extraordinarily turbulent conditions in global financial markets. These conditions caused equity prices to fall sharply, the cost of short-term credit--where available--to spike upward, and liquidity to dry up in many markets. Losses at a large money market mutual fund sparked extensive withdrawals from a number of such funds. A marked increase in the demand for safe assets--a flight to quality--sent the yield on Treasury bills down to a few hundredths of a percent. By further reducing asset values and potentially restricting the flow of credit to households and businesses, these developments pose a direct threat to economic growth.

The Federal Reserve took a number of actions to increase liquidity and stabilize markets. Notably, to address dollar funding pressures worldwide, we announced a significant expansion of reciprocal currency arrangements with foreign central banks, including an approximate doubling of the existing swap lines with the European Central Bank and the Swiss National Bank and the authorization of new swap facilities with the Bank of Japan, the Bank of England, and the Bank of Canada. We will continue to work closely with colleagues at other central banks to address ongoing liquidity pressures. The Federal Reserve also announced initiatives to assist money market mutual funds facing heavy redemptions and to increase liquidity in short-term credit markets.

Despite the efforts of the Federal Reserve, the Treasury, and other agencies, global financial markets remain under extraordinary stress. Action by the Congress is urgently required to stabilize the situation and avert what otherwise could be very serious consequences for our financial markets and for our economy. In this regard, the Federal Reserve supports the Treasury's proposal to buy illiquid assets from financial institutions. Purchasing impaired assets will create liquidity and promote price discovery in the markets for these assets, while reducing investor uncertainty about the current value and prospects of financial institutions. More generally, removing these assets from institutions' balance sheets will help to restore confidence in our financial markets and enable banks and other institutions to raise capital and to expand credit to support economic growth.

At this juncture, in light of the fast-moving developments in financial markets, it is essential to deal with the crisis at hand. Certainly, the shortcomings and weaknesses of our financial markets and regulatory system must be addressed if we are to avoid a repetition of what has transpired in our financial markets over the past year. However, the development of a comprehensive proposal for reform would require careful and extensive analysis that would be difficult to compress into a short legislative timeframe now available. Looking forward, the Federal Reserve is committed to working closely with the Congress, the Administration, other federal regulators, and other stakeholders in developing a stronger, more resilient, and better regulated financial system.

Footnotes

1. Specifically, the loan is collateralized by all of the assets of the company and its primary non-regulated subsidiaries. These assets include the equity of substantially all of AIG's regulated subsidiaries. Return to text

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