



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

December 21, 2010

Mr. Philip Angelides, Chairman
Mr. William Thomas, Vice Chairman
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue N.W., Suite 800
Washington, D.C. 20006

Dear Chairman Angelides and Vice Chairman Thomas:

In response to your inquiries about the role of the Federal Open Market Committee (FOMC) in the financial crisis, I wanted to take this opportunity to provide some information about matters considered by the FOMC during that period. As you know, detailed minutes of FOMC meetings are made public shortly after each meeting and provide excellent summaries of the substantive discussions and the views of members. By contrast, my comments below are less comprehensive but instead attempt to address some specific points raised by your staff.

During the run-up to the financial crisis, the FOMC was monitoring developments in the housing market but found it difficult to develop a consensus on the extent of any overvaluation in housing prices or the potential systemic effects of developments in house prices and mortgage lending. For example, at a meeting in the summer of 2005, members received a briefing consisting of five staff presentations on the status of the housing market and associated risks. A range of issues were discussed and different viewpoints taken. One staff presentation argued that, even in the face of a large drop in housing prices, the national mortgage system might bend but would likely not break and that neither borrowers nor lenders appeared particularly shaky at that time. The briefing included discussion of non-traditional mortgage products, such as interest-only loans, but the argument was made that interest-only loans were not an especially sinister development and risks of such loans could be cushioned by large down payments. In fact, loan-to-value ratios were rising on a small share of interest-only loans, but remained around 80 percent on most such loans, according to a presentation.

Another presentation suggested that housing activity could be the result of solid fundamentals underlying the housing market. Still another concluded that the magnitude

of the potential effect of changes to housing wealth on household spending was perhaps only half as large as that of the stock market bubble of the 1990s. Given these and other analyses, it was hard for many FOMC participants, in the summer of 2005, to ascribe substantial conviction to the proposition that overvaluation in the housing market posed the major systemic risks that we now know it did.

While most participants at that meeting agreed that the probability of spillovers to financial institutions from lower housing prices seemed moderate, they recognized that circumstances could change for the worse. One participant noted potential problems including low diversification and high correlation risks in RMBS, the rapid growth of subprime lending, and lenders' inadequate information about borrowers, but added that record profits and high capital levels in financial institutions allayed those concerns. Another noted that some of the newer, more intricate, and untested credit default instruments had caused some market turmoil. A third expressed concern that subprime lending was an accident waiting to happen in certain regions. A fourth said that we could be seeing the final gasps of house price appreciation, expressed concerns about "creative financing", and worried that piggybacks and other nontraditional loans could be making the books of GSEs look better than they really were. On the last point, however, staff replied that the GSEs were not large purchasers of private-label securities.

By the spring of 2006, FOMC participants expressed nervousness about the growing "ingenuity" of the mortgage sector. A participant noted, for example, that negative amortization has the pernicious effect of stripping equity and wealth from homeowners without them taking an action to do so; the same participant raised concerns about some nontraditional lending practices that seemed based on the presumption of continued increases in home prices.

At that time (which was shortly after I became Chairman), I (as well as other members) predicted a decline in housing prices but was uncertain whether the decline would be slow or fast. At the time, I believed that some correction in the housing market from its then-current levels would be healthy, and that our goal should not be to try to prevent a correction but rather to ensure that the correction did not overly affect growth in the rest of the economy. I had in mind increased regulatory oversight, such as the guidance restricting nontraditional mortgage products that the Board issued in the fall of 2006, as well as increased vigilance regarding the implications of housing developments for monetary policy.

During 2007, while the overall economy continued to expand at a moderate pace, the housing market remained a key source of uncertainty for the economic outlook. At

meetings of the FOMC during the summer of 2007, staff noted in its briefings to the Committee that the subprime market in particular was very unsettled and reflected deteriorating fundamentals in the housing market.

The FOMC was also briefed in June 2007 about the liquidation of subprime securities at two hedge funds sponsored by Bear Stearns Asset Management (BSAM). The BSAM situation was compared to the troubles faced by Long-term Capital Management (LTCM), the subject of a coordinated rescue by private sector investors and creditors in 1998. While the stress faced by the BSAM hedge funds was a warning sign of troubles in the subprime market, at the time Bear Stearns, which was not regulated by the Federal Reserve, publicly stated that the BSAM hedge funds could be liquidated in an orderly fashion with assistance from Bear Stearns. At the time, it appeared that the Bear Stearns hedge funds were relatively unique among sponsored funds in their concentration in subprime mortgages. I believed that the problems experienced by the BSAM hedge funds were a good example of how leverage can increase liquidity risk, especially in stressed situations in which counterparties were unwilling to allow time for an orderly liquidation that might allow a realization of whatever value might exist in the fund's positions.

At the time, some members of the FOMC were concerned about the lack of transparency around hedge funds and the consequent lack of market discipline on valuations of hedge fund holdings. This lack of transparency and the fact that the Federal Reserve could not systematically collect information from hedge funds because they were outside the jurisdiction of the Federal Reserve caused members to be concerned about our understanding of the scope of the problem. One participant wondered what would happen when positions thought to be somewhat liquid became illiquid. While not advocating taking any action as a Central Bank, the participant felt the size of the credit derivatives market, its lack of transparency, and activities related to subprime debt could be a gathering cloud in the background of policy.

By the August 2007 meeting of the FOMC, the subprime mortgage market was experiencing considerable financial turbulence, and some firms deeply involved in the subprime market were showing some strain as problems intensified. Some staff and members believed that the data did not indicate that a collapse of the housing market was imminent, and, if the more optimistic scenarios proved to be accurate, we might look back and be surprised that the financial events did not have a stronger impact on the real economy. At the same time, participants expressed concern that the effects of subprime developments could spread to other sectors and noted that we had been repeatedly surprised by the depth and duration of the deterioration of these markets. One participant, in a paraphrase of a quote he attributed to Churchill, said that no

amount of rewriting of history would exonerate us if we did not prepare for the more dire scenarios discussed in the staff presentations.

While the FOMC had no decision-making role, in September 2008 the FOMC was briefed about the failure of Lehman Brothers, and about the implementation by the Board of Governors of the various emergency lending facilities instituted that fall. The views on whether the U.S. Government should provide funds to prevent the failure of a large firm like Lehman varied and have been well-documented in public speeches by various FOMC participants. Some believed that the U.S. Government should have no role in preventing firms from failure because doing so would only strengthen the perception that some firms were “too big to fail” and erode market discipline. These members believed that assisting Lehman would have created market expectations that others would get support from the U.S. Government and that letting Lehman fail was the only way to provide credibility to the assertion that no firm was “too big to fail.” According to one view expressed at the meeting, the market was beginning to “play” the Treasury and Federal Reserve, and letting Lehman fail had been was a proper response to restore market discipline.

Other meeting participants believed that the disorderly failure of a key firm could have a broad and disruptive effect on financial markets and the economy, but that the appropriate solution was capital injections, which represent fiscal intervention rather than the type of liquidity or monetary policy intervention appropriate for the central bank. I believed that, while the broader economic data supported easier monetary policy during the fall of 2008, monetary policy alone could not solve the problems faced by financial markets and institutions. My own view at the time was that only a fiscal and perhaps regulatory response could address the potential for wide-scale failure of financial institutions during that period. Such an approach would involve tools such as a robust resolution authority and a capital injection program, neither of which was authorized at that time. One FOMC participant argued that deposit insurance was a sort of well-contained, well-defined fiscal intervention. I believed that, in some situations, deposit insurance was inadequate and direct capital injections were also required.

At that time, the FOMC was also briefed about the situation at AIG, another firm over which the Federal Reserve had no supervisory authority. In mid-September, staff noted that money market funds had even broader exposure to AIG than to Lehman and that the parent company could run out of money quite soon, even within days. The view was that AIG faced a liquidity crisis, although it was noted that sometimes liquidity issues are really solvency issues, and the situation with AIG remained somewhat unclear at that time.

The FOMC did, however, take action to address problems with credit and liquidity. The FOMC authorized the expansion of existing swap arrangements with foreign central banks as needed and the establishment of such arrangements with additional foreign central banks to address strains in money markets. In the interest of sustaining market confidence, I advocated that the FOMC establish these lines without an express upper limit.

Because so much was happening, the FOMC met again at the end of September 2008; at about that time it had been announced that Citigroup would acquire Wachovia, and that the Board of Governors and the FDIC Board had recommended to the Treasury that the systemic risk exception to least cost resolution be invoked. The planned merger of two very large institutions led to some concern among FOMC participants that bigger and bigger firms were being created that would be “too big to fail.” I shared this concern and voiced my hope that TARP would create options other than mergers for managing problems at large institutions and that subsequently, through the process of regulatory reform, we might develop good resolution mechanisms and decisively address the issues of financial concentration and too big to fail. I made the same point at another meeting of the FOMC held in early October, where I reiterated that I didn’t think that monetary policy or liquidity policy was going to solve the problem, but that fiscal and perhaps some new regulatory and other related policies that did not presently exist would be required. As one FOMC member noted, there was a feeling that we were running out of ammunition to address the crisis we faced.

I hope this information is helpful to you as you complete your important work.

Sincerely,

A handwritten signature in black ink, appearing to be the name 'A. P.' or similar, written in a cursive style.