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NOMINATION OF BEN S. BERNANKE

HEARING

BEFORE THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

ON

THE NOMINATION OF BEN S. BERNANKE, OF NEW JERSEY, TO BE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

DECEMBER 3, 2009

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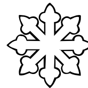

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NOMINATION OF BEN S. BERNANKE, OF NEW JERSEY, TO BE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

THURSDAY, DECEMBER 3, 2009

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–106, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. The Committee will come to order. We are here this morning to consider the nomination of Ben Bernanke to be the Chairman of the Federal Reserve.

Mr. Chairman, let me begin by welcoming you once again to the Senate Banking Committee. You have been before us on numerous occasions over the last couple of years, and we welcome your participation, and we want to thank you for joining us again here today.

Today we are faced with, as I see it, two separate questions—and before I begin, let me just say, for the purposes of Members' information, we are going to have a series of votes on the floor of the Senate. My intention would be to go until about 11:45, the next hour and 45 minutes, adjourning at 11:45, and then coming back at 1 p.m., because we will have these series of votes, Mr. Chairman, and rather than having it sort of be disjointed going back and forth, we will have it in two parts. And we will get as much done as we can.

When it comes time, I am going to have just opening statements by Senator Shelby and me, and then we will hear the statement by the Chairman, and then I am going to have 8 minutes to 10 minutes for questions. What I will do is put the yellow light on at 8, and, again, I have never been rigid about banging a gavel down, but I would ask Members to try and keep their questions in that timeframe so we can get to as many of our colleagues as possible and limit, to the extent possible, this afternoon.

Obviously, if you want a second round, we will do that as well. I do not want to deprive any Members of the opportunity to be heard. But that is the way in which we will proceed.

So, again, today we are faced, as I see it with this nomination, with actually two separate questions. First, should Ben Bernanke

here, our nominee, stay on as the Chairman of the Federal Reserve? And, second, as this Committee works to create a financial regulatory structure for the 21st century, what should be the role of the institution that our Chairman here, the nominee, would oversee? Does the existing structure of the Federal Reserve deserve to be maintained? Too often that question has been dominated by the personality of the Fed Chairman. But in my view, this is not about the nominee or the Chairman, nor is it about the Members of this Committee, including the Chairman of this Committee. This is about the institution that will be around long after the nominee or the Members of this Committee are gone. What makes the most sense for the success of this institution, the Federal Reserve?

So first let me address the nomination for another term as Chairman of the Federal Reserve. This is an incredibly important job during a crucial time in our Nation's history, as we all know. Over the last year, our Nation has been rocked by a devastating economic crisis. This Committee has met dozens of times to talk about its impact on our constituents, the millions of Americans who have lost their jobs, families who have lost their homes, and those who have watched their wealth evaporate as home values dropped and investments were wiped out.

Under your leadership, Mr. Chairman, the Federal Reserve has taken extraordinary actions to right the economy, providing liquidity to depositories, sustaining the commercial paper market, working with the United States Treasury to restart the asset-backed securities market, and providing very critical support to the housing market. These efforts have played, in my view, a very significant role in arresting the financial crisis, and financial markets have begun to recover.

For that, Mr. Chairman, you and the Federal Reserve deserve, in my view, praise for your acumen and gratitude for the role in preventing a far worse outcome than we might have otherwise seen. And I believe that you deserve another term as Chairman of the Federal Reserve, and I intend to vote for your nomination, both in this Committee and on the floor of the U.S. Senate, because I believe that you are the right leader for this moment in our Nation's economic history, and I believe your reappointment sends the right signal to markets.

And while I congratulate you for these efforts, I remain very concerned, as you know, about the weaknesses in the overall financial regulatory system that allowed the financial collapse to occur in the very first place, which brings me to the second question.

Does the structure of the institution you will oversee deserve to be maintained as it presently is constituted? Today we have a regulatory structure, as I see it, created by historic accidents as Government reacted to problems with piecemeal solutions over nearly a century. You and I, I think, agree that the Federal Reserve should be strong and very, very independent—and I feel very strongly about that second word—and be able to perform its core functions: conducting monetary policy, supervising payment systems, and acting as the lender of last resort.

I worry that over the years loading up the Federal Reserve with too many piecemeal responsibilities has left important duties without proper attention and exposed the Fed to dangerous

politicization that threatens the very independence of this institution.

Congress gave the Federal Reserve the authority to protect consumers in mortgage markets in 1994. We have talked about this many, many times in this Committee. But for many years, many of us in the Senate were frustrated in our efforts to get the Fed to address predatory lending, and the Federal Reserve failed to develop meaningful mortgage guidelines and regulations until the housing bubble burst.

There have been other lapses in consumer protections with the Fed doing little, in my view, over the years to protect users of credit cards and checking accounts from abusive company practices.

In addition, in my view, the Fed failed to rein in excessive risk taking by some of the largest holding companies which it supervised. Many of the firms whose irresponsible actions contributed to the crisis and ultimately required a taxpayer-funded bailout did so under the Fed's watch.

The lesson I believe we can learn from these mistakes is that the country is best served by a strong, focused central bank, not one that is saddled with too many diverse missions and competing responsibilities, that its independence and competency—when its independence and competency are called into question.

It has been proposed that the Fed assume yet another role in controlling threats to overall financial stability. But I fear these additional responsibilities would further distract from the Fed's core mission and leave it open to dangerous politicization, undermining its critical independence.

And so as Congress takes up the financial reform this year, I have proposed creating new entities outside the Federal Reserve to focus responsibilities for bank regulation, consumer protections, and systemic risk so these important duties will not need to compete for the Federal Reserve's attention. Appreciating that conducting effective monetary policy requires full access to information on banks, my proposal, our proposal, preserves and expands the Fed's involvement and ability to access information directly from financial institutions and the new bank regulators, the ability to participate in bank exams, new authority to regulate systemically important payment and financial utilities, and a seat on the boards of the bank regulator, the systemic risk agency.

What I am proposing does not exclude the Fed from involvement in these issues but, rather, expands the participants in this effort. We share the goal of a strong, focused, independent Federal Reserve that can operate successfully as part of a new regulatory framework that will restore our Nation's economic security, and I look forward to working with you on this very important task.

I know there are many important issues that my colleagues, of course, want to discuss here today with you as they consider your nomination. Again, I think you are deserving of renomination and confirmation by the U.S. Senate. I believe you have done a very good job in helping us avoid the kind of catastrophe that could have occurred in this country. But I also believe we bear responsibility to consider the institution which you lead beyond the role of our tenure, either as Chair of this Committee or Chair of the Federal Reserve, and that is why I raise these issues as part of an

overall reform of the financial regulatory structure that has been the desire of many people over many, many years. And in the absence of the situation we find ourselves in today, I suspect we would not be dealing with it.

So, again, I welcome your participation here today, congratulate you on the work you have done, and let me turn to Senator Shelby for any opening comments. Then we will hear from you and proceed with questions.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Chairman Dodd. Welcome, Mr. Chairman.

We all know Chairman Bernanke's academic accomplishments prior to joining the Board of Governors, first as a member and then as its Chairman. He was and remains one of our Nation's leading scholars on the Great Depression. I believe that his expertise in this area has served him well during our current crisis.

It is important to note, however, that every crisis has a beginning, a middle, and an end. And while we learned a great deal about crisis management from the Great Depression, it appears that we have learned precious little about how to avoid the situation in the first place.

Prior to the recent financial crisis, the Federal Reserve kept interest rates, I believe, far too low for too long, encouraging a housing bubble and excessive risk taking. In addition, the Fed failed to use its available powers to mitigate those risks.

Congress also bears some responsibility. Often over my objections here, we enacted housing policies that imprudently encouraged homeownership to levels we now know were unsustainable. We also failed to curtail the activities of the housing GSEs—Fannie Mae and Freddie Mac. My record on that topic I think is well known here.

After the recession that ended in 2001, which was preceded by the bursting of the dotcom bubble, the Fed was concerned about a sluggish economy and the specter of deflation. Given those concerns, the Fed chose to hold interest rates remarkably low for years. Indeed, the effective Federal funds rate was well below 2 percent between 2001 and November of 2004.

During most of that period, now-Chairman Bernanke served as a member of the Board of Governors of the Federal Reserve and supported the low interest rate policies. In 2002, then-Governor Bernanke warned of deflation. He stated, and I will quote,

> . . . the Fed should take most seriously . . . its responsibility to ensure financial stability in the economy. Irving Fisher (1933) was perhaps the first economist to emphasize the potential connections between violent financial crises, which lead to "fire sales" of assets and falling asset prices, with general declines in aggregate demand and the price level. A healthy, well-capitalized banking system and smoothly functioning capital markets are an important line of defense against deflationary shocks. I believe the Fed should and does use its regulatory and supervisory powers to ensure that the financial system will remain resilient if financial conditions change rapidly.

The Governor's warning was clear. Deflation is a potential danger which could ignite a financial crisis. The policy prescriptions seem equally clear: keep interest rates low, liquidity flows high,

and lean against deflation pressures. However, while keeping interest rates low for a protracted period of time, the Fed appeared remarkably unconcerned about the possibility of igniting a financial crisis by inflating the housing price bubble, which, ironically, led to the same result: a violent financial crisis and a fire sale of assets.

As housing prices soared and risk taking escalated, Wall Street investors pressed on as if a "Fed put" was assured. The notion was that in adverse market conditions, the Fed would absorb faltering assets and flood the markets with liquidity. Indeed, Governor Bernanke at that time assured markets that the Fed stood ready to use the discount window and other tools to protect the financial system, a reassurance that the "Fed put" was in place.

In 2004 and 2005, Chairman Bernanke and other members of the Board of Governors spoke of the possibility of a great moderation involving potential permanent reduction in macroeconomic volatility and risk, no doubt a result of vigilant and adept monetary policy.

In retrospect, this misperception left market participants believing that large risks had been mitigated, opening the door for greater risk taking. In the face of rising home prices and risky mortgage underwriting, the Fed failed to act. The Fed chose not to use its rulemaking authority over mortgages to arrest risky lending and underwriting practices. And although numerous statutes such as TILA, HOEPA, the Equal Credit Opportunity Act, the Real Estate Settlement Procedures Act—RESPA—and the Home Mortgage Disclosure Act gave the Fed the authority to act, nothing was done.

The Fed also made major forecasting errors leading up to the recent crisis. Then after the housing market bubble began to burst in 2006, the Fed was slow to entertain possible spillovers from the housing sector into the general economy and the financial system. Finally, in response to the growing crisis, the Fed took actions that often appeared to be *ad hoc* and piecemeal.

Many of the Fed's responses, in my view, greatly amplified the problem of moral hazard stemming from too-big-to-fail treatment of large financial institutions and their activities. In addition, some Fed actions were taken in concert with the Treasury, blurring the distinction between fiscal policy functions of the Congress and Treasury and the central bank's monetary policy and lender of last resort functions.

Under Chairman Bernanke's watch, the Federal Reserve vastly expanded use of its discount window, including the provision of funds to some institutions over which the Fed had no oversight. The Fed also created new lending facilities to channel liquidity and credit to markets that were deemed most stressed and systemically important.

Consequently, the Fed's balance sheet has ballooned from a pre-crisis level of around $800 billion to more than $2.2 trillion through credit extensions and purchases of risky private assets, GSE debt, and U.S. Treasury debt. Many Fed actions were innovative ways to provide liquidity to a wide variety of financial institutions and market participants. Some actions, however, amounted to bailouts. When dealing with individual institutions deemed systemically important by the Fed, shareholders were wiped out and management

replaced. However, in many instances, bond holders were made whole even though they were not legally entitled to such favorable treatment. Using powers granted under Section 13(3) of the Federal Reserve Act, the Fed made it explicit that certain institutions and activities would not be allowed to fail.

Recently, certain Fed Governors have stated that private risk absorbed by the Fed involved only a small portion of its enormous asset holdings. Furthermore, some have suggested that the Government might even make money on some of its risky bills. And while some of this might be true, I do not believe potential profit is the appropriate metric for evaluating Government support of private risk. Taxpayers simply should not be subjected to possible losses from private risk.

Mr. Chairman, for many years I held the Federal Reserve in very high regard. I had a great deal of respect for not only its critical role in the U.S. monetary policy, but also its role as a prudential regulator. I believe it to be the Nation's repository of financial expertise and excellence, and over the years we have enacted a number of laws which demonstrated our confidence in your institution. We trusted the Fed to execute those laws when deemed prudent and necessary. I fear now, however, that our trust and confidence were misplaced in a lot of instances.

The question before us now, Mr. Chairman, is: What are we to do about it? Currently, the Committee is discussing, as Senator Dodd said, the future of our regulatory system. To the extent that we can identify weaknesses that contribute to the crisis, we should address them. But not everything that went wrong can be blamed on the system because the system also depends on the people who run it. It is those individuals who need to be accountable for their actions or their failure to act.

Mr. Chairman, I believe in accountability. The Senate's constitutional authority to advise and consent can be a highly effective means by which this body can hold individuals accountable. It is a process through which we can express our disapproval of past deeds or our lack of confidence in future performance.

We continue to face considerable challenges, including still stressed financial markets, rising nonperforming commercial real estate loans, tight credit conditions, record high mortgage delinquency rates, double-digit unemployment, hemorrhaging deficits and public debt, and concerns about the size of the Fed's balance sheet, the value of the dollar, and the possibilities of yet more bubbles.

Certainly, we are still deep in the woods, Mr. Chairman. The question before us is whether Chairman Bernanke is the person best suited to lead us out and keep us out of trouble.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Chairman Bernanke, welcome again to the Committee.

STATEMENT OF BEN S. BERNANKE, OF NEW JERSEY, TO BE CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you. Chairman Dodd, Senator Shelby, and Members of the Committee, I thank you for the opportunity to ap-

pear before you today. I would also like to express my gratitude to President Obama for nominating me to a second term as Chairman of the Board of Governors of the Federal Reserve System and for his support for a strong and independent Federal Reserve. Finally, I thank my colleagues throughout the Federal Reserve System for the remarkable resourcefulness, dedication, and stamina they have demonstrated over the past 2 years under extremely trying conditions. They have never lost sight of the importance of the work of the Federal Reserve for the economic well-being of all Americans.

Over the past 2 years, our Nation, indeed the world, has endured the most severe financial crisis since the Great Depression, a crisis which in turn triggered a sharp contraction in global economic activity. Today, most indicators suggest that financial markets are stabilizing and that the economy is emerging from the recession. Yet our task is far from complete. Far too many Americans are without jobs, and unemployment could remain high for some time even if, as we anticipate, moderate economic growth continues. The Federal Reserve remains committed to its mission to help restore prosperity and to stimulate job creation while preserving price stability. If I am confirmed, I will work to the utmost of my abilities in the pursuit of those objectives.

As severe as the effects of the financial crisis have been, however, the outcome could have been markedly worse without the strong actions taken by the Congress, the Treasury Department, the Federal Reserve, the Federal Deposit Insurance Corporation, and other authorities both here and abroad. For our part, the Federal Reserve cut interest rates early and aggressively, reducing our target for the Federal funds rate to nearly zero. We played a central role in efforts to quell the financial turmoil, for example, through our joint efforts with other agencies and foreign authorities to avert a collapse of the global banking system last fall; by ensuring financial institutions adequate access to short-term funding when private funding sources dried up; and through our leadership of the comprehensive assessment of large U.S. banks conducted this past spring, an exercise that significantly increased public confidence in the banking system. We also created targeted lending programs that have helped to restart the flow of credit in a number of critical markets, including the commercial paper market and the market for securities backed by loans to households and small businesses. Indeed, we estimate that one of the targeted programs—the Term Asset-Backed Securities Loan Facility—has thus far helped finance 3.3 million loans to households—excluding credit card accounts—more than 100 million credit card accounts, 480,000 loans to small businesses, and 100,000 loans to larger businesses. And our purchases of longer-term securities have provided support to private credit markets and helped to reduce longer-term interest rates, such as mortgage rates. Taken together, the Federal Reserve's actions have contributed substantially to the significant improvement in financial conditions and to what now appear to be the beginnings of a turnaround in both the U.S. and foreign economies.

Having acted promptly and forcefully to confront the financial crisis and its economic consequences, we are also keenly aware that, to ensure longer-term economic stability, we must be pre-

pared to withdraw the extraordinary policy support in a smooth and timely way as markets and the economy recover. We are confident that we have the necessary tools to do so. However, as is always the case, even when the monetary policy tools employed are conventional, determining the appropriate time and pace for the withdrawal of stimulus will require careful analysis and judgment. My colleagues on the Federal Open Market Committee and I are committed to implementing our exit strategy in a manner that both supports job creation and fosters continued price stability.

A financial crisis of the severity we have experienced must prompt financial institutions and regulators alike to undertake unsparing self-assessments of their past performance. At the Federal Reserve, we have been actively engaged in identifying and implementing improvements in our regulation and supervision of financial firms. In the realm of consumer protection, during the past 3 years, we have comprehensively overhauled regulations aimed at ensuring fair treatment of mortgage borrowers and credit card users, among numerous other initiatives. To promote safety and soundness, we continue to work with other domestic and foreign supervisors to require stronger capital, liquidity, and risk management at banking organizations, while also taking steps to ensure that compensation packages do not provide incentives for excessive risk taking and an undue focus on short-term results. Drawing on our experience in leading the recent comprehensive assessment of 19 of the largest U.S. banks, we are expanding and improving our cross-firm, or horizontal, reviews of large institutions, which will afford us greater insight into industry practices and possible emerging risks. To complement on-site supervisory reviews, we are also creating an enhanced quantitative surveillance program that will make use of the skills not only of supervisors, but also of economists, specialists in financial markets, and other experts within the Federal Reserve. We are requiring large firms to provide supervisors with more detailed and timely information on risk positions, operating performance, and other key indicators, and we are strengthening consolidated supervision to better capture the firm-wide risks faced by complex organizations. In sum, heeding the lessons of the crisis, we are committed to taking a more proactive and comprehensive approach to oversight to ensure that emerging problems are identified early and met with prompt and effective supervisory responses.

We also have renewed and strengthened our longstanding commitment to transparency and accountability. In the making of monetary policy, the Federal Reserve is highly transparent, providing detailed minutes 3 weeks after each policy meeting, quarterly economic projections, regular testimonies to the Congress, and much other information. Our financial statements are public and audited by an outside accounting firm, we publish our balance sheet weekly, and we provide extensive information through monthly reports and on our Web site on all the temporary lending facilities developed during the crisis, including the collateral that we take. Further, our financial activities are subject to review by an independent Inspector General. And the Congress, through the Government Accountability Office, can and does audit all parts of our operations, except for monetary policy and related areas explicitly ex-

empted by a 1978 provision passed by the Congress. The Congress created that exemption to protect monetary policy from short-term political pressures and thereby to support our ability to effectively pursue our mandated objectives of maximum employment and price stability.

In navigating through the crisis, the Federal Reserve has been greatly aided by the regional structure established by the Congress when it created the Federal Reserve in 1913. The more than 270 business people, bankers, nonprofit executives, academics, and community, agricultural, and labor leaders who serve on the boards of the 12 Reserve Banks and their 24 branches provide valuable insights into current economic and financial conditions that statistics alone cannot. Thus, the structure of the Federal Reserve ensures that our policymaking is informed not just by a Washington perspective or a Wall Street perspective, but also by a Main Street perspective.

If confirmed, I look forward to working closely with this Committee and the Congress to achieve fundamental reform of our system of financial regulation and stronger, more effective supervision. It would be a tragedy if, after all the hardships that Americans have endured during the past 2 years, our Nation failed to take the steps necessary to prevent a recurrence of a crisis of the magnitude we have recently confronted. And as we move forward, we must take care that the Federal Reserve remains effective and independent, with the capacity to foster financial stability and to support a return to prosperity and economic opportunity in a context of price stability.

Thank you again for the opportunity to appear before you today. I would be happy to respond to your questions. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Mr. Chairman. Again, I will ask the clerk to keep an eye on the clock here so we move along with the questions this morning.

Let me begin, in a sense, in talking about both systemic risk obligations as well as the whole issue of the supervisory authority. You wrote your piece for *The Washington Post* a few days ago in which you raised the concern that if you lacked the supervisory capacity here, it would directly affect your ability to conduct monetary policy. And yet we have had witnesses before this Committee over the last number of months, including the former Fed Vice Chair Alice Rivlin, former Fed Monetary Affairs Director Vince Reinhart, and Alan Meltzer, who is a long-time scholar of the Fed, among others. And their testimony says that the Fed's bank supervisory authority plays very little role in the formation of monetary policy.

Under the proposal that we have proposed and put before the Committee, the Fed would not be a bank supervisor, but it would have access, which was not necessarily reflected in your piece, but it would have access, as you know, to all the information it currently has about banks, could participate in examinations of any bank or bank holding company, and would be part of the systemic risk regulator.

Wouldn't this information allow you to carry out the Fed's core functions of setting monetary policy and acting as the lender of last resort since it is the access to the information that really is critical

for the conduct of monetary policy and, therefore, the objections to the proposal we have made here are really not as well founded as they might appear to be in the piece?

Mr. BERNANKE. Thank you Mr. Chairman. As you know, I do think that taking the Federal Reserve out of active bank supervision would be a mistake for the country. First, I think it should be noted that the Federal Reserve has unparalleled expertise that arises from its work in monetary policy. We have a great group of economists, financial markets experts, and others who are unique in Washington in their ability to address these issues. And as we go forward, as we try to supervise complex, multi-company firms, holding companies, and as we try to look at the system as a whole from a so-called macroprudential perspective, which involves looking at the interactions of companies and markets, we need not just bank supervisors who can go in and read a loan file, but also financial market experts and economists who can create the context and the supplementary analysis that will make these more difficult analyses possible. And we demonstrated the value of this in the stress tests earlier this year.

The second argument, the one that you alluded to specifically, Mr. Chairman, has to do with the benefits to the Federal Reserve of having these supervisory authorities. You mentioned monetary policy. There is some benefit to monetary policy, and I can give instances. But I think the greater benefit is actually to our ability to help maintain financial stability and to be an effective lender of last resort.

In the current crisis, for example, our ability to respond to the crisis, to address problems in the banking system, to help stabilize key markets was critically dependent on our ability to see what was going on in the banking system and to have the expertise inside the Federal Reserve to evaluate what was happening. There is no way we could have been as involved or effective in this crisis if we did not have that expertise and that information.

If you go back into history, there are many other examples. Just to give one more, after 9/11, the Federal Reserve played a central role in restoring the financial system to operational capacity, and our knowledge of what was happening in the banks, their funding positions, their need for liquidity, the risks that they faced operationally and otherwise, was absolutely critical in our ability to do that. And there are many other examples.

So I do believe that monetary policy is benefited, but financial stability is even more important in that the ability of the Fed to play its role in stabilizing the financial system and being lender of last resort, in addition we need to be able to look at collateral and understand the solvency of banks to make loans to banks, requires our involvement in bank supervision.

My belief, and looking at other countries where now the trend is very much toward reversing earlier decisions to strip regulatory powers from central banks, the trend now is to go back exactly the opposite direction. In Europe and the United Kingdom, for example, the political discourse is leaning very heavily toward increasing and adding the supervisory and macroprudential responsibilities to the central bank, and that comes from an experience of the last couple of years where the inability to have complete informa-

tion greatly hampered the function of those central banks in addressing the financial stability issues.

Being on a board, having the ability to go along on an exam will never substitute for having your own expertise, your own information, your own ability to go in when you believe that there is an issue. Mr. Chairman, I understand your objectives here, but I do believe it is a very, very serious matter to take the Fed essentially out of financial stability management, which this I think would do.

Chairman DODD. Well, it is not our intention to take it out, at all, but rather expand the number of eyes that are looking at these situations so we have better judgments, because clearly, one of the problems occurred in the supervisory role of bank holding companies, of course, that was an abysmal failure. Now, I am talking about before your tenure.

But nonetheless, looking at systemic risk and while we are examining ways to have resolution mechanisms here that will avoid the kind of moral hazards associated with giving the implicit backing of the Federal Government should an institution become deeply troubled, it seems to me it is in our interest to try to avoid that occurrence from happening, and the way they do that, obviously, is having the kind of supervisory function here that would allow a decision to be made where an institution was getting precariously close to causing systemic risk—and again, my concern is here about institutional issues rather than the individuals involved in decision making.

But here we were at a time when we are now looking back, all the signs were so blatantly clear, and yet in conducting its supervisory capacity within the Fed, it failed terribly, and giving us the kind of warnings that we should have had as a country of where we were headed, particularly in the bank holding company area.

And so my concerns about this are based on recent history where there has been a failure in performing that function, and therefore the concerns that maybe we ought to be looking at something different that would provide us with the greater warnings, the predictions, the ability to respond so you are not spending the last 2 years as we were.

And I admire what you have done over the last 2 years, but it shouldn't have gotten to that. We never should have arrived at that moment. We shouldn't have had to go through what we did for the last 2 years had there been cops on the street doing their job, telling us what was going on and allowing us to avoid the problem in the first place.

Why should I give an institution that failed in that responsibility the kind of exclusive authority we are talking about here?

Mr. BERNANKE. Mr. Chairman, it is true that there were weaknesses in that supervision, and I described in my testimony some of the steps we are taking to strengthen it. But the Federal Reserve was not the systemic regulator. It had a very narrowly described set of supervisory responsibilities, bank holding companies, primarily, as you point out. But if you look at the firms and the markets and the instruments that caused the problems, a great number of them, and Senator Shelby mentioned one or two, were mostly outside of the Federal Reserve's responsibility.

And so there was a failure across the system, and we all have to do better, that is for sure. But in terms of changing the structure, I think what we need is not only to do a better job, but we need to make a structure whereby we are looking at the system as a whole, that we are not looking just individually at each individual institution. We are trying to look at the whole system collectively. And I believe that the changes that have been proposed that will create a Systemic Risk Council and so on would do that and would help us, independent of who is Chairman or who is head of the FDIC or the SEC, would help us have a better chance of identifying those system problems in advance.

Chairman DODD. Let me jump quickly, because time is about up here for me and I don't want to exceed it, and I am sure others will ask you about the commercial real estate. Senator Shelby has already raised it. And the jobs picture, which if I had had exclusive time with you, I just want to talk about where we are going with jobs.

But let me raise the issue, because an economist by the name of—I may mispronounce his name—Roubini, who correctly, we are told, predicted the global financial crisis that we are now in, and many other economists are concerned that the world's central banks are flooding the financial institutions with too much cash, setting the stage for another asset bubble burst. I don't know if you have been familiar with his predictions at all or not. With interest rates near zero in the United States, the dollar has dropped 12 percent in the past year against a basket of six major currencies. According to Mr. Roubini, investors worldwide are borrowing dollars to buy assets, including equities and commodities, fueling huge bubbles that may spark another financial crisis.

Quickly, can you tell us whether or not you think this threat has legitimacy, and if so, what we are doing about it?

Mr. BERNANKE. It is certainly something we want to pay close attention to, but let me distinguish between the United States and abroad. In the United States, of course, it is inherently very difficult to know if asset prices are appropriate or assets are correctly valued, but we have been trying to do our best to look at valuation models and other metrics and we do not see at this point any extreme mis-valuations of assets in the United States. Of course, all that is contingent on your beliefs about where the economy is going to go. Mr. Roubini is very pessimistic about the economy, and, of course, if the economy were to weaken tremendously, then asset prices would be overvalued where they are today, but only in that case.

There have been complaints about U.S. monetary policy contributing to bubbles abroad, and I think it needs to be understood that the United States monetary policy is intended to address both financial and economic issues in the United States and countries which have their own tools to address bubbles in their own economies, including the flexibility of their exchange rate, their own monetary policies, their own fiscal policy, their own supervisory policies. So it really is not the United States's responsibility to make sure that there are no misalignments in every economy in the world when those countries have their own tools to address them.

Chairman DODD. Well, thank you, but this is an issue we want to stay in close contact with you and others on this matter to see if this thing emerges as a growing problem as this economist and others are warning us.

Senator Shelby.

Senator SHELBY. Thank you, Chairman Dodd.

I want to stay on some of the subjects, Chairman Bernanke, that Senator Dodd has raised. In the past, you have argued—and still do—that there are certain synergies between supervision and regulation of financial firms and the conduct of monetary policy and the Fed's lender of last resort function. If we were to go back, Mr. Chairman, and review the minutes and transcripts of all FOMC meetings between 2003 and 2008, I wonder what fraction of the time would have been devoted to issues involving supervision and regulation of, say, your holding companies, or our holding companies. Was it half the time? Was it a fourth of the time? An eighth of the time? A tenth of the time? In other words, give us your judgment on that.

Mr. BERNANKE. Well, in a typical meeting, there would be very little discussion. Let me take that back. Recently, we have talked about it quite a bit because of the financial——

Senator SHELBY. Sure.

Mr. BERNANKE. ——financial crisis. But it depends on the situation. There are periods like recently, but also, for example, in the early 1990s—when the banking system faced what were called the financial headwinds and were holding back economic growth—where those issues were important and were discussed. Under normal circumstances, they would be discussed much less. That is absolutely right.

But to reiterate what I said to Chairman Dodd, although I do think that the bank supervision is helpful in monetary policy, it provides us with information we otherwise wouldn't have, and there are some academic studies which show that there is a link between bank supervision information and Fed monetary policy responses, I again would put a much heavier weight on the financial stability function whereby in order to be a lender of last resort and to know how to respond to an ongoing crisis or threat of crisis, we need to have the expertise, information, and authorities associated with being a bank supervisor.

Senator SHELBY. Would it be fair to say that before the crisis in the last couple of years, that not a lot of time was spent on regulatory supervision——

Mr. BERNANKE. Well——

Senator SHELBY. ——talking, discussion?

Mr. BERNANKE. Let me remind you of the structure of the Fed. The Federal Open Market Committee is about monetary policy primarily, and so the general economy—inflation, unemployment, and so on—are the primary issues——

Senator SHELBY. It is foremost, is it not?

Mr. BERNANKE. I am sorry?

Senator SHELBY. That would be foremost what you——

Mr. BERNANKE. That would be the foremost issues in the FOMC. Of course, the Board of Governors, as opposed to the FOMC, has responsibility for overseeing the system's bank supervision activi-

ties, and, of course, there, that activity is ongoing, and particularly recently, as we worked hard to try to both address the crisis and to correct the problems, it has been a major priority for the Federal Reserve.

Senator SHELBY. Mr. Chairman, do you believe—you have been on the Fed for quite a while now and you have been Chairman, this is your fourth year—do you believe that the Federal Reserve, even under your tenure, not your predecessor's, before the crisis hit, when you first went there, the first year or two, was doing more than an adequate job of supervising and regulating the holding companies which subsequently got in such trouble, not just Citicorp, but a lot of them, and that was all under your watch at the Fed as a regulator?

Mr. BERNANKE. Well, again, as I said before, there are failures all through the system. We heard this morning the Bank of America is paying back its TARP——

Senator SHELBY. Good news.

Mr. BERNANKE. ——that is good news——

Senator SHELBY. When are they going to pay it back?

Mr. BERNANKE. Immediately.

Senator SHELBY. Any day?

Mr. BERNANKE. In its entirety, immediately.

Senator SHELBY. OK.

Mr. BERNANKE. So as we go through the bank holding companies, as I said, we ran a stress test through the bank holding companies in the spring, and of the 19, I think it was nine were declared to be in good health and they paid back their TARP and then the rest have all raised capital. So those firms, in some sense, have not been the crux of the crisis. The real problems have been mostly outside of the bank holding companies.

Senator SHELBY. Let us go back just to your tenure, 2005, 2006, early 2007. Where was the Fed as a regulator to try to prevent the crisis? Do you believe that the Federal Reserve knew what was going on with, say, the holding companies, and if so, why the debacle if they really knew? They either knew or they didn't know. A lot of people believe—Senator Dodd alluded to this—that the Fed has done a horrible job as a regulator, and now yet you are wanting to continue as a regulator, which is only part of your real job——

Mr. BERNANKE. Well, Senator, it was an extraordinary crisis which has tested every single regulator, both here and abroad. Did we do everything we could? Absolutely not. I talked in my testimony about things we were doing to improve.

I think the question that lies before you, if you fight a battle and you lose the battle, does that mean you never use an army again? You have to improve and fix the situation. You don't have to necessarily eliminate the institution.

So I think that we did certainly not a perfect job, by any means, but I don't think we stand out as having done a worse job than other regulators. And again, many of the critical firms and markets that were the worst problems were outside of our purview.

Senator SHELBY. Do you believe that a bank should have a role or a say in any way of who their regulator might be, such as the Reserve banks?

Mr. BERNANKE. No, I don't, and in the——

Senator SHELBY. Do you believe that 13 Act should be changed?

Mr. BERNANKE. Well, of course, the Congress created that structure, but——

Senator SHELBY. Absolutely.

Mr. BERNANKE. ——but the way it actually functions is that there is no connection—the Reserve banks—the banks who are members of the boards of the 12 Reserve banks select—vote for——

Senator SHELBY. Explain to the audience and the Committee again how the members of the Reserve banks, say the Federal Reserve of Atlanta, Richmond, New York, San Francisco——

Mr. BERNANKE. I would be glad to do that——

Senator SHELBY. Tell them how they are selected on the Board.

Mr. BERNANKE. OK. So——

Senator SHELBY. Who does the nomination?

Mr. BERNANKE. Yes, sir. So again, as provided by the Federal Reserve Act, each of the 12 Reserve banks has a Board of Directors with a chairman. The directors, 12 at each bank, are in three classes. One class is drawn from banks in the district. Most of them are community banks. The second class, so-called B class, are people who are technically elected by the banks. And the C class is supposed to represent the general public.

Senator SHELBY. Elected by the banks who they supervise, right?

Mr. BERNANKE. But let me describe how the process actually works. The way the process actually works is that, first, the directors are chosen for the most part by the leadership of the Reserve bank. They are nominated by the leadership of the Reserve bank in order to be a wide representative cross-section of economic and community leaders in the district. So, for example, among the 70 or so B and C directors, there are three from financial services. There are many more from manufacturing, wholesale, retail trade, agriculture, all different kinds of areas. They are not bankers. Then, moreover, both the directors and the Reserve bank president must be approved by the Board of Governors in Washington.

Senator SHELBY. But, Mr. Chairman, we understand that. But do you believe that anybody that is going to be supervised by a banking regulator should have a say-so in choosing that regulator? It seems to me and others it is an inherent conflict of interest and an incestuous financial relationship that is not good for the Federal Reserve. It is not good for banks. It shows conflicts of interest to me.

Mr. BERNANKE. Well, I can see why in terms of the way the law is written, you might think that, but the way it has actually been structured, the way it actually operates is that the boards of directors are drawn in practice from a wide cross-section of the public and I should add, that there are very strong firewalls. They have no ability to influence or even be informed about supervisory policy.

Senator SHELBY. I know my time is up, but last, do you believe that the Federal Reserve Bank, say the Federal Reserve of New York and Richmond, San Francisco, and so forth, that they basically are the regulator and that you, as the Chairman of the Board of Governors, have outsourced that to the Reserve banks?

Mr. BERNANKE. Absolutely not.

Senator SHELBY. Why haven't you?

Mr. BERNANKE. The Board of Governors has the legal authority and responsibility to manage that supervision. They function as operational arms of the Board of Governors, but we set the policy, we do the quality control, we do the reviews, we set the budgets. So your earlier criticism, to the extent you are correct, the buck stops here, we are responsible for that and we are, if anything, continuing to strengthen, centralize, and continuing to work to make sure that that supervision is as strong as possible.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Johnson.

Senator JOHNSON. Welcome to the Committee, Chairman Bernanke. I want to join Chairman Dodd in voicing support for your confirmation. While I certainly think that transparency is important, it is the Fed's independence and its ability to carry out day-to-day decisions about monetary policy without intrusion of Congress that strengthens the Fed's credibility and allows it to follow policies that maximize price stability and economic stability.

What do you think about current proposals being considered by Congress to audit the Fed's monetary policy decisions and to change the way that boards of regional Fed Reserve banks are chosen by making them political appointees? If agreed to, how would these proposals change the way the Fed operates?

Mr. BERNANKE. Senator, first of all, thank you for the question. I think there is, at least among the public, some misunderstanding of the word "audit." Audit sounds like a financial term. I believe that the Congress should have all the information it needs about the Federal Reserve's financial operations, its financial controls, to have appropriate oversight of our use of taxpayer money. We are, in fact, very transparent about our financial operations and I have listed some of the things in my testimony that we provide, including an audited balance sheet, regular reports, and the like.

In addition, the GAO has the authority to audit every aspect of the Federal Reserve except for monetary policy and related functions, as provided for by an exemption passed by the Congress in 1978. And the GAO is, in fact, actively engaged in looking at supervision and many other aspects. We have currently 14 engagements with the GAO, including looking at our consolidated supervision and some of the things that Senator Shelby referred to.

So to be very, very clear, I in fact I welcome transparency about the Fed's activities and the Fed's financial position, both to the public and to the Congress. I am, however, concerned with the auditing of monetary policy. What that means is that the GAO would be empowered to come in essentially immediately after a policy decision to look at all the policy materials prepared by staff, to interview members, and to basically second-guess the Fed's decision in very short order with very few protections.

My concern is that, as you mentioned, Senator, the Fed's credibility depends on the market's perception that we are independent in making monetary policy decisions and we will not be influenced by short-term political considerations. My fear is that if we were to take what might be perceived as an unpopular step, that Congress would order an audit, which would be a way, essentially, of

applying pressure, or be perceived as a way of providing pressure to our policy decisions.

And so I would ask the Congress to consider retaining the 1978 exemption, which is a very wise exemption. It allows full access to our financial operations and controls and access to almost all of our policy activities, but gives the appropriate distance to monetary policy to maintain the independence and credibility of that policy.

Senator JOHNSON. I am very concerned that if banks aren't lending to small business, we will not be able to create the jobs we need to decrease our Nation's unemployment. What is the Fed doing to encourage banks that lend to small businesses that are ready to hire?

Mr. BERNANKE. Senator, first of all, I very much agree with you. I talked about this in a speech in New York a couple of weeks ago. Many of the credit markets are functioning much better and larger firms are pretty well able to get access to credit, as Bank of America showed overnight. But firms that are dependent on banks, like small businesses, are having much more difficulty. And since small businesses are such a major source of job creation, particularly in an upswing like we are hoping will continue from here, their being constrained by lack of access to credit has direct implications for employment growth and it is very significant.

The Fed has been very much engaged in trying to improve credit access for small businesses. We have provided guidance to banks which emphasizes that it is very important that they not be so over-conservative, that they not make loans to creditworthy borrowers, including small businesses. And we have backed up that guidance with, first, training programs for our examiners to make sure that they understand the importance of taking a balanced perspective, that while we want banks to be very careful and prudent, we don't want them to fail to make loans to creditworthy borrowers, such as small businesses.

We recently put out guidance which is relevant here to banks on how to manage commercial real estate. This is relevant because many small businesses borrow against their premises, against real estate collateral. In that guidance, we showed in quite a bit of detail how examiners and banks should work together to make sure that there is not undue pressure put on banks not to make loans, that good loans are not marked down inappropriately, that loans that can pay off even if the collateral value has declined can still be made. And so a small business that uses its store or its place of business as collateral can still get credit.

So we continue to work with the banks. We have urged them to raise capital, as you know. As I mentioned, the stress test led to an enormous amount of capital raising by the banks, which will over time improve their ability to lend, as well. And even more directly, we have been working to increase the flow of funds from investors to small businesses, primarily through our TALF program, which has been trying to restart the securitization markets. That TALF program, as I mentioned in my testimony, has greatly improved the ability for SBA loans to be securitized and sold to investors and has led to extension of hundreds of thousands of small business loans. In addition, we are also helping to securitize commercial mortgage-backed securities, which again help small busi-

nesses to the extent that it frees up the commercial real estate financing situation and allows them to borrow against their place of business, for example.

Senator JOHNSON. There has been much discussion about the effectiveness of the economic stimulus package that was enacted in February to create and save jobs. In your judgment, is the stimulus package creating jobs and vindicating some of the effects of the economic crisis? Are there additional fiscal policy responses that Congress can take to help the current economic situation?

Mr. BERNANKE. Senator, I think it should first be noted that only about 30 percent of the funds that were authorized last February have been disbursed, and probably something less than that have actually been spent. And so in some sense, it is still rather early to make a judgment.

The judgment is also made more difficult by the fact that you have to ask the question, where would we be without this package? What would the counterfactual be? And that, of course, requires models and analysis which reasonable people can disagree about. So I think it is a little bit early to make a strong judgment, a little bit early to decide whether or not to do additional fiscal actions. But we will continue to analyze it and try to estimate the effects on the economy.

Senator JOHNSON. Mr. Chairman, I yield back.

Chairman DODD. Thank you very much.

Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Welcome, Chairman Bernanke. I am not going to go down the same road as many of my colleagues because I think that ground is going to be pretty well plowed, to mix two metaphors here.

[Laughter.]

Senator BENNETT. So I am going to discuss something I think somewhat different, and let me set the stage for it. We all talk about the Great Depression. I was born during the Great Depression, but I have no memory of it. But I was running a business during the Great Inflation and I have a very clear memory it. And the speed with which the Great Inflation disappeared from our economy has somewhat removed the pain, but my memory is still very strong.

In the Carter years, and one of your predecessors had to deal with that, Mr. Volcker, I remember going to a bank and begging, and that is the operative word, for a loan to allow me to meet payroll after having maxed out my credit card, because I was the CEO of that company, and being absolutely delighted when the banker finally gave it to me at 21 percent interest. Mr. Volcker, with some assist—let the historians work out who gets most of the credit—from President Reagan ultimately broke the back of the Great Inflation and set the stage for a long period of economic growth that came after that.

We are now looking ahead in a circumstance that many economists say are laying the groundwork for the next Great Inflation. Let me quote from Bob Samuelson's column this morning. He says this week's White House Jobs Summit will try to revive economic growth, but it will be a hard slog. Job creation is fundamentally a

private sector process and the private economy is experiencing a broad retreat from credit-driven spending.

Mark Zandi of Moody's reports this astonishing figure. Since last spring, the number of bank credit cards has dropped 100 million, about 25 percent. Banks are tightening credit standards, partly in reaction to new credit card legislation designed to protect borrowers from rate increases, and consumers are canceling cards.

Meanwhile, empty office buildings, shuttered retail stores, and underutilized factories have depressed business investment spending. In the third quarter, it was down 20 percent from its 2008 peak. Despite huge Federal budget deficits, total borrowing in the economy dropped in the first half of this year. This hasn't happened in statistics since 1952.

Then he goes on, in the short run—and this will take me where I am going—Zandi doesn't worry about the effects on the Federal budget deficit because borrowing by consumers and companies is so weak. But the perception that the administration will tolerate, despite rhetoric to the contrary, permanently large deficits could ultimately rattle investors and lead to large, self-defeating increases in interest rates. There are risks in over-aggressive government job creation programs that can be sustained only by borrowing or taxes.

All right. As I look at the projections we are getting out of the administration, they are saying that the deficits are going to run at 4.2 percent of GDP as far as the eye can see, and I don't see the economy growing any faster than, say, 2 percent, at least in the foreseeable future. And that, to me, is a recipe for the Japanese disease, where this economy becomes like the Japanese economy and ultimately for major inflation.

Now, if we confirm you, that is going to be on your plate, maybe not in the next six to 12 months, but certainly during your 4-year term. Is inflation going to come back? And if it comes back because of these massive Federal deficits to which Samuelson refers, how are you going to deal with it and what do you see in your crystal ball?

Mr. BERNANKE. Thank you, Senator. Let me just first say that in terms of your reminiscences about the 1970s, I remember those periods, too, although I wasn't a businessman at the time, and inflation is very corrosive. It is very bad for the economy. And I just want to reiterate that the Fed has a strong commitment to price stability and we will maintain that commitment. In particular—you didn't ask about this, and I won't go into detail—we are thinking a great deal about our exit strategy from our current monetary policy actions, including the size of our balance sheet and our special programs.

I can't help but just take the opportunity to—your reference to Chairman Volcker. Nineteen-seventy-eight was when the Congress passed the law that made monetary policy independent of GAO audits. Subsequently, the support of President Carter and President Reagan for Chairman Volcker to let him do what he had to do, was the reason that inflation was conquered and it did set the stage for many years of prosperity. Again, it is just a case study of why Federal Reserve policy independence is so critical.

With respect to deficits, and though I agree very much that we cannot continue to have deficits that make our debt relative to our GDP rise indefinitely, we need to come down, deficits that are closer to 2 to 3 percent at most, not 4 or 5 percent. If we do that in the medium term, we can begin to stabilize the amount of debt growth to GDP. It is——

Senator BENNETT. Let me interrupt you——

Mr. BERNANKE. Sure.

Senator BENNETT. ——to make this point.

Mr. BERNANKE. Yes.

Senator BENNETT. I am an appropriator, which is maybe not a good thing to be in this election year, but I am an appropriator. The Appropriations Committee has influence over one-third of the Federal budget. The other two-thirds is on automatic pilot in mandatory spending for entitlement programs. We are discussing on the floor of the Senate the creation of another major entitlement program, and the percentage that we have any control over keeps going down. Further, of the one-third, half is the defense budget. So in terms of discretionary spending on domestic—well, not entirely domestic, this includes all our embassies overseas, the National Parks, education, transportation, everything else—is roughly one-sixth of the Federal budget.

So as you are commenting on, gee, we need some fiscal discipline, the trajectory is entirely in the other way as mandatory spending takes over. And I think you are going to be looking at a situation where the Congress will be unable to provide any kind of fiscal discipline because of the mandatory spending. This year, Federal revenue is projected at $2.2 trillion. Mandatory spending at $2.2 trillion. Every single thing we spend money on in the government other than mandatory spending, we have had to borrow every single dime, and I don't see that structural circumstance changing. I see it going in the other direction, and that puts an enormous burden on your plate.

Mr. BERNANKE. Well, Senator, I was about to address entitlements. I think you cannot tackle this problem in the medium term without doing something about getting entitlements under control, reducing the costs particularly of health care. It is only mandatory until Congress says it is not mandatory, and we have no option but to address those costs at some point, or else we will have an unsustainable situation.

As far as the Fed is concerned, we will not monetize the debt. We will maintain price stability. But we would not be able to do anything about interest rates going up if creditors began to lose confidence in the U.S. Fiscal sustainability. This is obvious, but I think it is worth saying, and you are right to raise it, that we need not only an exit strategy from monetary policy; we very much need an exit strategy from fiscal policy in the sense we need to get back to—we need to have a plan, a program to get back to a sustainable fiscal trajectory in the next few years.

Senator BENNETT. If I may, Mr. Chairman, very quickly, when you say the Fed will not monetize it, that means that if my son starts a business in a few years, he is going to be paying 21-percent interest rates as well?

Mr. BERNANKE. No, sir, not if the 21 percent comes from inflation, which is where a lot of that came from in the 1970s. We are not going to support inflation, but we might not be able to stop rises in real interest rates even given a stable price level.

Senator BENNETT. Thank you.

Chairman DODD. Thank you very much, Senator.

Senator Reed.

Senator REED. Welcome, Mr. Chairman. Was the trajectory of Federal spending and Federal Reserve policy more appropriate at the end of 2000 or the end of 1999 than it is today?

Mr. BERNANKE. Well, we have certainly faced a lot more challenges since then.

Senator REED. I seem to recall we had a surplus.

Mr. BERNANKE. We did have a surplus.

Senator REED. And we had unemployment rates that were about 4.6 percent. We had economic growth and income growth across the spectrum at every level. So what happened?

Mr. BERNANKE. Well, going back to some of the themes that Senator Shelby raised, the stock market boom was not sustainable. It popped, and that contributed to the recession of 2001. And now, of course, we have had a financial crisis and a deep recession, which has dragged down tax revenues and created needs for supporting people out of work and other important objectives.

So a lot of what is happening right now, of course, these enormous deficits we have this year and next year are not permanent. They are reflecting the current situation. But some of it will be permanent unless we begin to address particularly the entitlement issue and the aging issue.

Senator REED. So you would concur that our effort today to pass health care reform is critical to our economic future.

Mr. BERNANKE. I am not going to comment on the overall health care bill. What I will just say is that I think an essential element would be to try to reform health care in a way that controls costs going out, and that is going to be essential.

Senator REED. And that is what the CBO has concluded in their evaluation of the Senate plan before us. Is that correct?

Mr. BERNANKE. They have talked about some premiums. I do not think they have made a strong statement about the share of GDP devoted to health care, for example.

Senator REED. They have indicated that going forward there would be cost savings. I think from my view, the faster we get this accomplished, then we can move on to some of the other issues we have talked about today.

I recall in the 1990s, because I was here, that there was only really two ways you can deflect this deficit, and that is either by cutting expenditures or raising income taxes or other forms of taxes. Can you think of another way?

Mr. BERNANKE. To reduce deficits?

Senator REED. Yes.

Mr. BERNANKE. Well, just logically, there are other kinds of taxes besides income taxes.

Senator REED. No, no. I concede that. Some type of tax.

Mr. BERNANKE. And on the spending side, again, you know, Willie Sutton robbed banks because that is where the money is, as

he put it. The money in this case is in entitlements. Those are the programs which are growing. At the rate we are going, in about 15 years the entire Federal budget will be entitlements and interest, and there will not be any money left over for defense or any of the other activities.

So, clearly, we are facing a very difficult structural problem in that we have an aging society and rising health care costs, and the Government has very substantial obligations. I am not in any way advocating unfair treatment of the elderly who have worked all their lives and certainly deserve our support and help. But if there are ways to restructure or strengthen these programs that reduce costs, I think that is extraordinarily important for us to try to achieve.

Senator REED. Would you take taxes off the table?

Mr. BERNANKE. I would not do anything. Those decisions are up to Congress.

Senator REED. Well, your predecessor signaled very strongly that the tax cuts in 2000 were appropriate.

Mr. BERNANKE. I have not done that. I have done my best to leave that authority where it belongs—with the Congress.

Senator REED. One of the most pressing issues that we face across the country is employment, frankly, and you have made the point that you will begin to reduce the stimulus, the aid that the Fed is providing at some point. That will be done, I hope, with the recognition that until we restore employment across the country, we have not brought back the economy. We have not restored confidence in the economy, and we have not made it productive for the working people of this country. Is that your view?

Mr. BERNANKE. Yes. I think jobs are the issue right now, and I think it is not just today's incomes, today's production. It is also about the future. We have a situation where 30 percent of African American young people are unemployed, very high fractions of young people in general. People who begin their work careers without a job, obviously, are going to be losing opportunities to gain on-the-job training, to learn skills, and it will affect them for many years down the road.

So there are very severe, long-lasting costs associated with unemployment rates at the level we are seeing and with the duration of unemployment we are seeing, and it really is the biggest challenge, the most difficult problem that we face right now.

Senator REED. What do we do about it? I mean, I do not want to be glib, but there are both fiscal and monetary consequences, and what we have seen, particularly in the last several months, is that the actions of the Federal Reserve together with fiscal actions, are effective, we hope, in some cases. So what would you propose to do about the employment situation?

Mr. BERNANKE. Well, on the Federal Reserve side, we have continued to keep interest rates close to zero to try to stimulate growth, and we have seen now positive growth in output, which will translate into jobs, we are hoping soon.

I think a very important issue is credit. If there is not credit, then that affects the ability of people to buy autos and other goods and services. It affects the ability of small businesses to hire and maintain their inventories. So I have discussed earlier some of the

steps we are taking to try to unfreeze credit, including pushing banks to give creditworthy borrowers access to loans, have banks raise capital, try to restart securitization markets and other steps. So the Fed has a program we are employing which is focused on getting jobs created.

Now, on the fiscal side, obviously there are a whole number of different options. Christina Romer had an op-ed in *The Wall Street Journal*—I think it was yesterday—where she listed some of the things that the administration is thinking about. Obviously, all of these issues will have fiscal consequences, and, again, the Congress will have to make those trade-offs.

Senator REED. Let me get to an issue that is under your control, that is, your supervisory responsibility with some of the largest financial institutions in the country, and some of the data I have seen suggest that local community banks are much more aggressive in terms of lending through the Small Business Administration, in lending to those small companies that are creating jobs, at least maintaining jobs. And if you look at the bigger financial institutions, they are not doing enough. Can you, through your supervisory responsibilities, get them to perform better, frankly?

Mr. BERNANKE. Well, first, on the small banks, that is not uniform. But it is true that, for the most part, the small banks did not engage in some of the activities that got the big banks into trouble. They do have commercial real estate issues, many small banks do. But it is also true that in many cases where large banks have withdrawn or reduced their lending, small banks have stepped up and have provided credit, particularly to small business, and that is one of the reasons why community banks are such a valuable part of our banking system.

We face a dilemma, which is we want banks to lend, and we are encouraging them to lend, but we certainly do not want them to make bad loans because, of course, that is what got us in trouble in the first place. And so as I described earlier, we are pushing banks to make loans to creditworthy borrowers. We are making sure our examiners are appropriately balancing the needs of the borrowers in the economy against avoiding excessive risk aversion. We are pushing banks to raise capital, as the Bank of America example shows, and we have done quite a bit to restore the securitization market, which is very important in the United States. That is about a third of our credit system, and that was mostly shut down during the crisis, except for the Government-guaranteed mortgage markets. And our activities both in small business lending and also in commercial real estate have gotten those markets to look like they are in better shape and starting to function, and that is very important because it provides a source of funding for the banks that they can then pass on into loans.

Senator REED. Thank you, Mr. Chairman.

Chairman DODD. Thank you. Just 30 seconds, Jim, before I turn to you. The Bank of America you mentioned to Senator Shelby and just again referenced here. Are you supportive of their decision to pay off these TARP monies? And do you see any negative implications of them doing so?

Mr. BERNANKE. We as their supervisor, along with OCC and others, evaluated their situation, and we felt that it was safe and rea-

sonable and appropriate for them to pay off the TARP, and we signed off on that.

Chairman DODD. Thank you very much.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Four years ago, when you came before the Senate for confirmation to be Chairman of the Federal Reserve, I was the only Senator to vote against you. In fact, I was the only Senator to even raise serious concerns about you. I opposed you because I knew you would continue the legacy of Alan Greenspan, and I was right. But I did not know how right I would be and could not imagine how wrong you would be in the following 4 years.

The Greenspan legacy on monetary policy was breaking from the Taylor rule to provide easy money and, thus, inflation bubbles. Not only did you continue that policy when you think control of the Fed, but you supported every Greenspan rate decision when you were on the Fed earlier this decade. Sometimes you even wanted to go farther to provide easier money than Chairman Greenspan.

As recently as a letter you sent me 2 weeks ago, you still refuse to admit Fed action played any role in inflating the housing bubble despite the overwhelming evidence and the consensus of economists to the contrary. And in your effort to keep filling the punch bowl, you cranked up the printing presses to buy mortgage securities, Treasury securities, commercial paper, and other assets from Wall Street.

Those purchases, by the way, led to some nice profits for the Wall Street banks and dealers who sold them to you, and the GSE purchases seemed to be illegal since the Federal Reserve Act allows only the purchase of securities backed by the Government.

On consumer protection, the Greenspan policy was, "Do not do it." You went along with his policy before you were Chairman, and you continued it after you were promoted. The most glaring example is it took you 2 years to finally regulate subprime mortgages after Chairman Greenspan did nothing for 12 years. Even then you only acted after pressure from Congress and after it was clear subprime mortgages were at the heart of the economic meltdown.

On other consumer protection issues, you only acted as the time approached for your renomination to be Fed Chairman. Alan Greenspan refused to look for bubbles or to try to do anything other than to create them. Likewise, it is clear from your statements over the last 4 years that you failed to spot the housing bubble, despite many warnings.

Chairman Greenspan's attitude toward regulating banks was much like his attitude toward consumer protection. Instead of close supervision of the biggest and most dangerous banks, he ignored the growing balance sheets and increasing risk. You did no better. In fact, under your watch, every one of the major banks failed or would have failed if you had not bailed them out.

On derivatives, Chairman Greenspan and other Clinton administration officials attacked Brooksley Born when she dared to raise concerns about the growing risk. They succeeded in changing the law to prevent her or anyone else from effectively regulating derivatives.

After taking over the Fed, you did not see any need for more substantial regulation of derivatives until it was clear that they were headed into the financial meltdown thanks in part to those products.

The Greenspan policy on transparency was talk a lot, use plenty of numbers, but say nothing. Things were so bad, one TV network even tried to guess his thoughts by looking at the briefcase he carried to work.

You promised Congress more transparency when you came to the job. You promised more transparency when you came begging for TARP. To be fair, you have published more information than before, but those efforts are inadequate, and you still refuse to provide details on the Fed's bailout last year on all the toxic waste that you have bought. And Chairman Greenspan sold the Fed's independence to State through the so-called Greenspan put. Whenever Wall Street needed a boost, Alan was there.

But you went even farther than that when you bowed to political pressure of the Bush and Obama administrations and turned the Fed into an arm of the Treasury. Under your watch, the Bernanke put became a bailout for all large financial institutions, including many foreign banks, and you put the printing presses into overdrive to fund the Government spending and hand out cheap money to your masters on Wall Street, which they used to rake in record profits while ordinary Americans and small businesses cannot even get loans for their everyday needs.

Now I want to read a quote to you, Mr. Greens—Mr. Bernanke. [Laughter.]

Senator BUNNING. That is a Freudian slip, believe me.

Here is the quote:

> I believe that the tools available to the banking agencies, including the ability to require adequate capital and an effective banking receivership process, are sufficient to allow the agencies to minimize the systemic risks associated with large banks. Moreover, the agencies have made clear that no bank is too big too fail, so that bank management, shareholders, and uninsured debt holders understand that they will not escape the consequences of excessive risk taking. In short, although vigilance is necessary, I believe the systemic risk inherent in the banking system is well managed and well controlled.

That should sound familiar to you since it was part of your response to a question I asked about the systemic risk of large financial institutions at your last confirmation hearing. I am going to ask that the full question and answer be included in today's hearing record.

> **Q.8.** The Fed has been on the record with their fears of Fannie Mae and Freddie Mac being systemic risks to our financial system. Are you worried about other large financial institutions with portfolios similar to the GSE's being systemic risks?
>
> **A.8.** Market discipline is typically the governing mechanism that constrains leverage and ensures that firms do not undertake excessive risks. The market system generally relies on the vigilance of creditors and investors in financial transactions to assure themselves of their counterparties' current condition and the soundness of their risk management practices.
>
> Because of the availability of deposit insurance, market discipline is not by itself sufficient to control risk-taking in the banking system; for this reason, the Federal Reserve and the other banking agencies supervise and regulate banks. I believe that the tools available to the banking agencies, including the ability to require adequate capital and an effective bank receivership

process are sufficient to allow the agencies to minimize the systemic risks associated with large banks. Moreover, the agencies have made clear that no bank is too-big-too-fail, so that bank management, shareholders, and uninsured debtholders understand that they will not escape the consequences of excessive risk-taking. In short, although vigilance is necessary, I believe the systemic risk inherent in the banking system is well-managed and well-controlled.

In the case of the GSE's, market discipline is problematic. Market participants recognize that the GSE's are closely tied to the Federal Government and such ties create a view among market participants that the GSE's are implicitly backed by the Federal Government, thereby weakening market discipline. Consequently, strong regulatory authority and controls on GSE risk-taking are needed to ensure that they do not create systemic risks. Unfortunately, the GSE regulator's constrained capital authority, the ineffective receivership process, and other limitations weaken regulatory oversight of GSE's. Capping the size of GSE portfolios, which beyond a certain size do not contribute to the GSEs' housing mission, is also important for controlling potential systemic risk.

Senator BUNNING. Now, if that statement was true and you had acted according to it, I might be supporting your nomination today. But since then, you have decided that just about every large bank, investment bank, insurance company, and even some industrial companies are too big to fail. Rather than making management, shareholders, and debt holders feel the consequences of their risk taking, you bailed them out. In short, you are the definition of a moral hazard.

Instead of taking that money and lending it to consumers and cleaning up their balance sheets, the banks started to pocket record profits and pay out billions of dollars in bonuses to their management. Because you bowed to pressure from the banks and refused to resolve them or force them to clean up their balance sheets and clean up the management, you have created zombie banks that are only enriching their traders and executives. You are repeating the same mistakes of Japan in the 1990s on a much larger scale while sowing the seeds for the next bubble.

In the same letter where you refused to admit any responsibility for inflating the housing bubble, you also admitted you do not have an exit strategy for all the money you have printed and the securities you have bought. That sounds to me like you intent to keep propping up the banks for as long as they want.

Even if that were not true—and I am a little over my time, but this is very important—the AIG bailout alone is reason enough to send you back to Princeton. First, you told us AIG and its creditors had to be bailed out because they posed a systemic risk, largely because of the credit default swap portfolio. Those credit default swaps, by the way, are over-the-counter derivatives that the Fed did not want regulated.

Well, according to the TARP Inspector General, it turns out the Fed was not concerned about the financial conditions of the credit default swap partners when you decided to pay them off at par—not at a discount, but at 100 percent. In fact, the Inspector General makes it clear that no serious efforts were made to get the partners to take haircuts, and one bank offered to take a haircut and you declined it. I can only think of two possible reasons you would not make then-New York Fed President Geithner try to save the taxpayers some money by seriously negotiating or at least taking up UBS on their offer of a haircut.

Sadly, those two reasons are incompetence or a desire to secretly funnel more money to a select few firms, notably Goldman Sachs, Merrill Lynch, and a handful of large European banks. I cannot understand why you did not seek European governments' contribution to this bailout of their banking system.

From monetary policy to regulation, consumer protection, transparency, and independence, your time as Fed Chairman has been a failure. You state time and again during the housing bubble that there was no bubble. After the bubble burst, you repeatedly claimed the fallout would be small, and you clearly did not support the systemic risk that you claimed the Fed was supposed to be looking out for.

Where I come from, we punish failure, not reward it. That is certainly the way it was when I played baseball, and it is the way across all America presently. Judging by the current Treasury Secretary, some may think Washington does reward failure, but that should not be the case.

I will do everything I can to stop your nomination and drag out this process as long as I can. We must put an end to your and the Fed's failure, and there is no better time than now. Your Fed has become the creature from Jekyll Island.

Thank you.

Chairman DODD. Would you care to respond to that?

[Laughter.]

Mr. BERNANKE. Let me just correct one point.

First, I think there was some misunderstanding or misinterpretation of the SIGTARP's report, but we absolutely believed that AIG's failure would be an enormous systemic risk and would have imposed enormous damage not just on the financial system—and this is the key point—but on the entire U.S. economy and on every American. It is not reasonable to talk about letting large firms fail as if that would have no effect on credit extension and on the broader economy. The Lehman example should be enough for everybody.

With respect to the counterparties, there is a long discussion there which I will not go into, but I will just point out one issue you raised. UBS offered a 2-percent discount if and only if all the other counterparties would accept one. That was not the case. We did our best to get a reduction there, but given that AIG was not bankrupt and given that we were not going to abuse our supervisory power, we really had no way to create a substantial discount.

Senator BUNNING. Mr. Chairman, may I? I do not want to take any more time, but the fact of the matter is AIG was 80 percent owned at that time by the Federal Government.

Chairman DODD. I want to just say—and then I am going to quickly turn to others, let me say I disagree with my friend and colleague from Kentucky about the conclusion of what ought to happen to your nomination. But I got to tell you, Mr. Chairman, I mean, going through that period at that time when all the headlines were about the $168 million in bonuses that went out to AIG and virtually no reporting whatsoever on the counterparty issue, and the fact of the matter that we allowed 100 cents on the dollar to go out to the counterparties with little or no negotiation just is—

I have raised the issue with others before. I do not understand that at all, and most Americans do not. That was billions of dollars. One company alone was $12.5 billion. And it is just hard to accept the notion that we could not negotiate with the counterparties at that time.

Mr. BERNANKE. We had no leverage. If we did not pay off, they would say, "You are bankrupt," and that would——

Chairman DODD. We wrote a check for $180 billion to AIG. If we had not done that, they would have been in trouble.

Mr. BERNANKE. To AIG, but not——

Chairman DODD. The counterparties would have been in trouble, too.

Mr. BERNANKE. Well, that is all true, but most——

Chairman DODD. A good deal——

Mr. BERNANKE. Most of the firms were foreign. We had no authority or leverage over them.

Chairman DODD. You are the Chairman of the Federal Reserve. You have got power.

Mr. BERNANKE. I do not abuse my supervisory power.

Chairman DODD. Apparently not in that case.

Senator Bayh.

Senator BAYH. Well, where to begin?

I am struck by the fact that Senator Bunning and Senator Sanders find themselves in agreement on this question, perhaps proving the old adage that ideology may be circular rather than linear.

Some of us, however, Mr. Chairman, find ourselves—and I associate myself with the position of Chairman Dodd—in a different position on the question of your nomination. I will support you, not because I think you did not make mistakes—as you have admitted here today, you did—not because I do not think we should hold everyone accountable for doing better—I think we should—but because I think you are in the best place to improve the situation, to maximize the chances that we do not have a recurrence of some of these things, including the AIG situation that Senator Dodd mentioned.

You know, there is a lot of culpability to go around. The Fed made mistakes, as you have indicated. The Treasury made mistakes. Virtually every other regulatory body made mistakes. Congress made mistakes. Those on the left made mistakes. Those on the right made mistakes. Virtually every other government and their institutions made mistakes. Virtually every institution of any magnitude in the private sector made mistakes.

So should there be accountability? Absolutely. Do we need to maintain a sense of urgency to change those things that led to those mistakes? You bet. But some degree of modesty and introspection I think is in order, and perhaps even a good long look in the mirror, before engaging in too much Monday morning quarterbacking. Clairvoyance is an attribute in short supply around here, all the way around.

So my question to you is: With the benefit of hindsight, what would you have done differently?

Mr. BERNANKE. Well, there are two areas. Senator Dodd has alluded to both of them. First, I think—and Senator Bunning—we were slow on some aspects of consumer protection. Senator

Bunning was not exactly correct. We did have nontraditional mortgage guidance and subprime guidance out very early in my term, and it took a year to do the HOEPA rules, and that is why it took until 2008 for those to come out. But I think that is an area where, if we had been more proactive—we, the Federal Reserve, had been more proactive—it would have been helpful, because I believe—again, responding to Senator Bunning—that it was not monetary policy so much as problems in the mortgage market that led to the housing boom and bust.

Second, while, again, as you kindly put it, there were mistakes made all around, including other regulators, the private sector, Congress, and so on, in the area where we had responsibility in the bank holding companies, we should have done more. We should have required more capital, more liquidity. We should have required tougher risk management controls.

You talked about clairvoyance. I did not anticipate a crisis of this magnitude and this severity. But given that it happened, many of the banks—but not all of them, certainly, but at least some of them—were not adequately prepared in terms of their reserves, in terms of their liquidity. That is a mistake we will not make again, and I advocate not only strengthening regulation and strengthening supervision, but restructuring the nature of our financial regulatory system in a way that it will provide a more holistic macroprudential approach so that we are not reliant on each individual regulator in their own narrow sphere, that we have some broad interaction among regulators that allows us to assess problems that are arising in the system as a whole.

Senator BAYH. I know you are concerned about the independence of the Fed and perhaps the risk that there could be some politicization, for lack of a better term, of some of the functions that you perform if we do not institute the appropriate reforms going forward. My own view is that the last thing that we want is the political branches of Government getting, you know, more involved in setting these policies on a day-to-day basis, and yet at the same time we have to have accountability and we have to have oversight.

What is it about some of the proposals that have been made that you believe go too far in the direction of oversight that run the risk of politicizing the functions of the Fed?

Mr. BERNANKE. Well, first, I would draw a distinction between our supervisory functions and so on and our monetary policy functions. As a supervisor, we have exactly the same status as every other supervisor, which is that Congress controls the regulatory environment. It controls the objectives. It is responsible for ensuring accountability. And the independence is at the level of making individual decisions about individual institutions and so on where you don't want politics there. But there, we don't claim any special exemption or protection beyond what any supervisor or, in fact, any regulatory agency would use.

Senator BAYH. You are overseen and just as accountable as anybody else——

Mr. BERNANKE. Exactly.

Senator BAYH. ——for those——

Mr. BERNANKE. Exactly. On monetary policy, there is something of a special case, which is that monetary policy by its very nature has to look ahead over a longer period of time, whereas political necessities sometimes push for a shorter horizon. And so there is a very, very strong finding—one of the major contributors is Larry Summers—I am sure you know him in other contexts—which shows that countries that have independent central banks, that make monetary policy without political intervention, have lower inflation, lower interest rates, and better performance than those in which the central bank is subject to considerable political control.

Now, the Federal Reserve is a very transparent central bank with respect to monetary policy. We are, for example, the only major central bank to my knowledge that provides detailed minutes of each meeting 3 weeks after the meeting. We provide extensive quarterly projections, a monetary policy report twice a year, testimonies, all kinds of information which gives Congress and the public all the opportunities that would reasonably be needed to evaluate what we are doing and to second guess us, as always happens.

What I am concerned about is a set of policies that would create the right of Congress essentially to send in investigators whenever a monetary policy decision potentially went against their short-term preferences, and I believe that the signal that would send to the markets and to the public is that Congress is no longer respecting that zone of independence and is making its will known and intends to influence and to effect short-term monetary policy decisions, which would not be constructive and again is very inconsistent with what we have learned about central banking around the world in the last 20, 25 years.

Senator BAYH. It might have the ironic consequence of making interest rates higher——

Mr. BERNANKE. Absolutely.

Senator BAYH. ——because there would be an additional element of risk in the marketplace.

My final question, Mr. Chairman, has to deal with your testimony regarding your role in both setting monetary policy and as the occasional lender of last resort and the importance of having not just theoretical models, but some empirical evidence and understanding about what is going on in the marketplace in terms of performing those two functions.

My concern would be that the Fed would become, if we just completely removed that authority, it becomes sort of an isolated entity completely divorced from an understanding of how your decisions were playing out in the real world. So my question to you would be twofold. Number one, how would you preform a function of lender of last resort if you didn't have some insight into the goings on in these institutions that you were being asked to perhaps support, number one. How would that be possible? Number two, how important is some empirical data, a hands-on understanding of what is going on in the financial sector? How important is that to maximizing the chances you get monetary policy right?

Mr. BERNANKE. Well, on the discount window lending, I guess if we didn't have any examination authority, we would have to rely on the good will of other supervisors. I think we much prefer to have our own information and our own knowledge of what is hap-

pening in those banks. More significantly, in periods of crisis or stress, as the Fed uses its lender of last resort authority to try to stabilize a troubled financial system, in order to do that accurately and effectively, we need to know what the funding positions are of individual banks, what is going on in those markets, what the solvency position is.

I gave the example of 9/11, when the Fed opened up its discount window to provide liquidity to help the financial system begin to function again. We could not have done that effectively without the information we got on the ground from our supervisors in the banks. The 1987 stock market crash is another example where our information from the banking system helped us to address potential threats to the integrity of the clearinghouses that cleared futures contracts.

Recently, an example of this kind of problem in the U.K., over the past few years, the Government of Britain removed from the Bank of England most of its supervisory authorities and invested them in the Financial Supervisory Authority, the FSA. But when the crisis hit, and, for example, when Northern Rock Bank came under stress, the Bank of England was completely in the dark and was unable to address effectively what turned into a very disruptive run and a problem for the British economy.

So currently, the trend in the U.K. and elsewhere is quite the opposite to take away those authorities. It is to give the central bank the information and authorities it needs to know what is going on in the banking system.

Now, Senator Shelby asked me about the role in monetary policy and I would say that the role in monetary policy is there. It is more unusual. It doesn't happen all the time. But for financial stability maintenance, I think it is very, very important that the Fed have that kind of information and insight into the banking system.

Senator BAYH. Thank you, Mr. Chairman.

Chairman DODD. Let me just quickly, before I turn, on both of those points, Mr. Chairman, I say respectfully, if we looked over in the G20, more than half of our colleagues in the G20 separate supervisory and monetary policy. In fact, the countries that have weathered the storm rather well over the last couple of years have been countries that have separated both.

The British system, the FSA was what they call the light touch in regulation. They didn't have deposit insurance very well, so you had the problem there. And frankly, they didn't have the information. When they set up the system, they basically didn't allow the central bank even to get information. I think both of those factors contributed more to what happened in Great Britain than the fact that you had a separation of supervisory and monetary policy.

I say that—I mean, that is a legitimate debate and discussion, but I don't think it can be said with absolute certainty that the other was true.

Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Chairman, I want to focus during my questions on how we should establish our financial regulatory system. As you know, this Committee is working on financial regulatory reform right now and one of the biggest concerns I have is that as we move forward in

that, that we do not institutionalize the “too big to fail” syndrome. I, for one, believe that we have allowed companies that should have been resolved to continue with being propped up by the Federal Government or by the Fed and that that has led to a moral hazard that we need to deal with in our structuring of our system.

You have very often said that we need a new resolution authority so that you and others can have the tools to deal with allowing large institutions to be wound down or resolved. And yet at the same time, I believe in your testimony you indicate that you believe that we need to have the ability, and you and others need to have the ability to provide necessary liquidity at times of crisis.

There is obviously a problem there, and my question to you is how do we make the determination of what systemic risk is? And maybe to put it a different way, how do we make the determination of when it is that we should provide liquidity as opposed to when it is that we should—to sustain and maintain an institution as opposed to when we should wind down or resolve an institution?

Mr. BERNANKE. Well, Senator, first, on the liquidity function, that is to be very sharply distinguished from bailouts. The liquidity provision is short-term credit which is fully collateralized and which is made only to sound institutions and is meant only to provide a backstop when sources of short-term funding for whatever reason disappear. In the old days, when retail depositors ran on a bank, this was a way to prevent the collapse of a bank just because of lack of liquidity.

Senator CRAPO. Well, let me interrupt right there. Do you believe that we could structure a resolution authority and a systemic risk regulator in such a way that we could achieve that kind of assurance that liquidity efforts would be limited in that way?

Mr. BERNANKE. I do. I do, and I think it is very, very important. Let me just say, to be absolutely clear, the actions we took last fall to stabilize these firms were done extremely reluctantly and only because we had no good mechanism to allow them to fail without having severe consequences for the financial system and the broader economy. It is imperative, the most important thing that Congress can do is find a way to solve the “too big to fail” problem. I think that is absolutely essential. And the only way to do that is to find a way to let those firms fail.

And I do believe that that can be done. It can be done in a way also that forces creditors to take losses, shareholders and other creditors to take losses, and done in a way that is sufficiently predictable that it will not cause as much disruption as the problems that we had last year. So I do believe it is possible and I think the model we can use is the model we already have for resolving failing banks, that the FDIC has, just applied to larger, more complex institutions.

Senator CORKER. And what type of institution would you say should have that authority? Would it be the Fed or would it be a council of regulators or would it be a new financial regulator that we should establish?

Mr. BERNANKE. I think the institution with the most experience in these kinds of resolutions is the FDIC. So I think the FDIC should play a significant role. The Treasury should probably play

a significant role, as well, just to represent the political end of the decision making.

The Fed is not interested in being part of this process except insofar as Congress views a temporary liquidity provision as part of the wind-down process, as being appropriate. But we—let me just say this as strongly as possible—we do not want any more AIGs. We do not want any more Lehman Brothers. We want a well established, well stated, identified, worked out system that can be used to wind down these companies, allow them to fail, let the creditors take losses, let counterparties, like the AIG counterparties, take losses, but without completely destabilizing the whole economy, as can happen.

Senator CRAPO. As a part of all of this, I am concerned that we will not reestablish the kinds of proper approaches and the principle of moral hazard until we end TARP, provide an exit strategy from the recent government guarantees, and decide how we are going to proceed with Fannie Mae and Freddie Mac. Wouldn't you agree with that?

Mr. BERNANKE. I do agree with that. Fannie Mae and Freddie Mac are particular problems and issues have to be addressed. But under the current situation, the TARP was used to bail out companies and make all creditors whole—except for the shareholders—under a well-designed resolution regime. Many creditors could—would—should lose money, which would create market discipline going forward, which is what is desperately needed to avoid the moral hazard problem that you are referring to.

Senator CRAPO. The recent SIGTARP quarterly report states that there is $317.3 billion of unobligated TARP funds available right now. Do you support allowing the TARP authority to expire on December 31, 2009?

Mr. BERNANKE. Well, I think it is very appropriate to begin winding it down. I think we should be clarifying what additional needs, if any, are still remaining to make sure that the financial system is still stable and will not run into any new problems. But I certainly think that the TARP has mostly served its purpose and that it is time to start thinking about how we are going to unwind that program. In addition, as I have noted several times, many banks are paying back the TARP and a lot of the money that was put out is now coming back to the Treasury.

Senator CRAPO. Do you believe that we will ultimately recover all the TARP dollars?

Mr. BERNANKE. I won't speak about the auto industry loans or those sorts of things. If you look at the money that was put into financial institutions specifically, I think, overall, we are going to end up pretty close to break even, maybe somewhat in the red, but not too much. And considering what was achieved in terms of stabilizing the U.S. financial system and avoiding the collapse of our system, I think that would be a good outcome. So I do think that, unlike some of the scare stories about $700 billion being thrown away, the financial institutions collectively will, in the end, be something close to a break-even there.

Senator CRAPO. Well, thank you. For my last question, I would like to shift to derivatives, and I appreciate the fact that recently you got back to me with a progress report on our efforts to

strengthen the infrastructure for our over-the-counter derivatives markets. In that response, you stated that from the perspective of end users, there will always be occasions when the end users' risk management needs cannot be met by cleared OTC products or by exchange-traded products. Thus, an important issue is to preserve the ability of counterparties to contract customized deals while properly managing the risk of these deals. End users have not typically created the large exposures to counterparties that are the focus of efforts to reduce systemic risk through broader clearing.

The question I have is, do you believe that, again, as we try to structure how we are going to approach our financial regulatory system, that we can effectively avoid the AIG-type issues and the concerns that we need to deal with in that context from the legitimate need for end users to have the flexibility to hedge their unique business and risks through customized derivatives?

Mr. BERNANKE. I think we can. I think we do need some scope for customized derivatives for certain users. Those derivatives that can be standardized should be traded on exchanges, and I think that is the plan. But I would add that unlike AIG, which did not have significant oversight at all of their derivatives business, that we should be very clear that between the SEC, CFTC, and the bank regulators, that banks, for example, who create customized derivatives will also be carefully watched to make sure they have adequate capital and risk management for those positions so we don't get something like the AIG situation, where they had an enormous one-way bet with no capital behind it.

Senator CRAPO. Thank you.

Chairman DODD. Senator Crapo, thank you very much. Good questions.

I am going to turn to Senator Schumer, and just to notify the Committee, there is a vote that has started, and what I announced earlier, we will come back at 1 p.m. rather than having this back-and-forth. We have got a series of votes here, Mr. Chairman, and I don't want to just have it be so disjointed. So we will go to Senator Schumer for his line of questioning and then the Committee will reconvene at 1 p.m.

Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman, and thank you, Mr. Chairman.

First, I want to say to you that I sat in the room with many others, Senator Dodd and Senator Shelby, I believe, and some others in this room, when we were told about the imminent collapse of the financial system and panic was in the air. We have lots of problems. This economy is not moving well enough from my purposes, or, I think, anybody's here, but we are not in the Great Depression which we might have been.

And in a sense, you are a victim in this society when you solve a problem, you are better off than you avoid a problem, even though society is better off that the problem was avoided, and I think people forget how important that is. It is easy to criticize. It is easy to say it could have been done a different way. But at that moment, action was needed and needed quickly or we would have had financial collapse, and you did act quickly and I think, you know, that—well, I talked to Warren Buffet. He said the govern-

ment deserves a high grade for its efforts to prevent the collapse of the financial system and rescue the economy from imminent free fall, and you played a major role there, and I hope my colleagues will remember that.

My question is on—my first question is on something that I have been very critical of the Fed in the past, and that is consumer protection. As you know, I think the Fed dropped the ball on consumer protection issues. I support the creation Senator Dodd has proposed of a strong, independent Consumer Financial Protection Agency.

Now, every day, we find a new way—banks are in trouble. We know that. Many of them, their profits are being squeezed here and there and their reaction is to raise all kinds of fees and recoup on the backs of consumers. There has been a new report that has come out on ATM fees released by BankRate.com, and according to that report, the average ATM fee rose 12.6 percent in 2009 to $2.22. That is a heck of a lot. Plus, not only will the bank that owns the ATM charge you, your own bank now probably charges you a fee for withdrawing money at ATMs owned by other banks. The average cost of the fee for using someone else's ATM is $1.32. Over 70 percent of banks charge customers this fee. Together with massive increases in credit card interest rates and other fees, like these overdraft fees that we are seeing, consumers are bearing a disproportionate burden in maintaining the health of banks' balance sheets.

So I believe the Fed should conduct a thorough review of ATM fees to ensure that consumers are protected from excessive ATM fees, especially the double-whammy fee for using another bank's ATM. What is your opinion on this? You probably saw the study. And will the Fed agree to conduct its own study and get us some answers on it pretty quickly?

Mr. BERNANKE. Well, first, Senator, as you know, we have just put out some rules on overdraft protection in general as it applies to ATMs and debit cards. And it will require banks to get an opt-in from the consumer before they can charge them for an overdraft, and that will address one of those issues.

We will definitely take a look at ATM fees and just at least try to verify what is happening and what the patterns are and we will get back to you with that information.

Senator SCHUMER. Good, and could you just make some suggestions, at least, as to what should be done if you can't do them yourself?

Mr. BERNANKE. We will look at it and see what we learn.

Senator SCHUMER. OK. Do you—just from your preliminary look at the report, do you think what is happening in ATM fees is similar to what is happening with credit cards and others, that fees are going up at a much greater rate than they did in the past?

Mr. BERNANKE. I would like to get back to you on the numbers.

Senator SCHUMER. OK.

Mr. BERNANKE. I certainly find it plausible. I believe that the fees are going up. I think, in part, banks are trying to find ways to make revenue, basically——

Senator SCHUMER. You bet.

Mr. BERNANKE. ——but we will look at it.

Senator SCHUMER. OK. My second question relates to the next bubble. Senator Dodd talked about the international bubbles and what has happened in Dubai, but I would like to talk about the potential bubbles here in this country. This last crisis was a result of a massive bubble focused probably on real estate, and there has been a lot of attention lately on the Fed's zero interest rate policy and whether it is helping create new bubbles. The worry, of course, is is it going to be an instant replay, different actors, different script, same horrible outcome in terms of the horror movie we just went through.

Raising interest rates is one answer to deal with the bubble, but that is obviously tricky. I would be worried about raising interest rates because it would hurt getting people back to work, which should be our number one concern. So could you talk a little bit about what can be done to deal with these potential bubbles before they burst, given that you don't have the tool of interest rates as easily available because of the difficult economic situation, and then give us a little bit of your thinking on whether and when interest rates should be raised to deal with these potential bubbles.

Mr. BERNANKE. Well, ideally, the way we should deal with bubbles, at least the first line of defense, ought to be supervision and regulation. If we have appropriate risk controls that force banks not to pile into overcrowded positions, for example, or to take excessive risks, or if we have a Systemic Risk Council which looks at emerging asset price increases or concentrations of risk across the banking system, I think that is the first best way to try to address bubbles.

That is something, in my very first speech as a Governor in 2002, I said. You know, the first line of defense ought to be regulation and supervision, and that has the benefit that it can help protect the system even if you are not sure that the increase in asset prices is a bubble or not.

Unfortunately, we do not now have that system, and I, therefore, think that monetary policy has to pay some attention to this situation. We are looking at it. I have said in the past, and I continue to believe, that it is extraordinarily difficult to know in real time if an asset price is appropriate or not. But given that caveat, we are doing our best to try to look at the major credit and stock markets, use the valuation models we have, use the standard indicators that we have and try to look for misalignments.

Senator SCHUMER. Are there any other tools other than interest rates that might work?

Mr. BERNANKE. In some countries, they have had special measures, for example, where there have been house price increases, there have been things like mandatory increases in downpayments, things of that sort. So I suppose those are ideas that could address specific types of problems. But for a general bubble, I think basically that supervision and regulation of the financial system is the strongest, most effective approach and I do not rule out using monetary policy as necessary if that situation does become worrisome and threatening to our dual mandate, which is growth and inflation.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

I appreciate your indulgence, Chairman Bernanke, here in breaking this up a little bit, but I thought it maybe better served your interests and ours, as well, to have some continuity to it. So we will take a break, hope you get a bite to eat, and we will see you back here in about an hour.

The Committee will stand in recess until 1 p.m.

[Whereupon, at 12 p.m., the Committee recessed, to reconvene at 1 p.m., this same day.]

Senator JOHNSON [presiding]. This Committee will come to order.

Senator Corker.

Senator CORKER. Thank you, Mr. Chairman. I am getting my thoughts together. I apologize. I just came from another meeting.

Mr. Chairman, thank you for being here and for your service and for always being available at the other end of the phone when questions arise. I appreciate that very much.

I am going to spend most of my time today trying to understand more on a go-forward basis what needs to happen from a regulatory process. I know that many of us here on the Committee are trying to work through appropriate reg reform, and obviously, the Fed has been playing a big role in that.

Let me just start with the Reg W issue. Paul Volcker recently has been quoted as saying, you know, that banks have been engaged in risky behavior. We have had people in our offices saying that—and if Mr. Volcker is listening, this is not me saying it. I am just repeating it, OK?—that he is not really saying the way things are, let me put it that way. And yet we have looked back—you know, I know Senator Warner and I in particular have spent a lot of time on the resolution issue, and the problem that occurs with the resolution and what you were dealing with at the time a year ago was the fact that a commercial bank inside a highly complex bank holding company is very hard to sort of take out. And yet the 23A and B regulations, which basically say that a bank's deposit cannot be used—the depositors' money cannot be used to engage in other things with their affiliates that might pose risk, there have also been some statements made that maybe you loosened that activity over the last year or so, couple years, and the fact is that bank deposits have been used more aggressively with affiliates than they had in the past.

The reason it is important, it is important to know, number one; but it is also important as we look at resolution, if banks are doing this and they are highly involved with other entities, it is very difficult to unwind one of the organizations if, in fact, the bank's depositors' money has been used in other activities in the bank itself.

So that is a very long-winded question. If you could give a fairly short answer, since I just have 8 minutes, I would appreciate it.

Mr. BERNANKE. I will try. The 23A exemptions allow the holding company—typically what happens—to put assets down into the bank to be financed by deposits. We do not grant those very often. We generally consult with the FDIC to make sure they are comfortable. When that is done, it is done in a way that makes sure the bank is not taking additional risk, that it is whole. So it is not, I think, a general issue. It is something that we have done in some of the mergers and some of the things that have happened, conversion to bank holding company status, those sorts of things. But it

is not something that happens often. I do not think it is going to be generally an issue with resolution.

There are lots of ways, though, which holding companies and banks are intertwined. For example, they might share an IT system or——

Senator CORKER. IT, right.

Mr. BERNANKE. ——risk controls or all kinds of other things. And in that respect, both operationally, but also in some ways financially, there are linkages that make it more complicated.

The basic fact, which I am sure you appreciate—not everyone does—is that the FDIC law applies only to banks; whereas, a bank holding company does not have a resolution mechanism, and losing the bank holding company can be a very serious problem.

Senator CORKER. And I realize the management issue and the IT and, just look, I mean, the reason these organizations are put together is so they can work together in a more synergistic way. Let us face it. But should we draw a stiffer line, if you will, between those? And should there be any flexibility? Should we eliminate that so there is not either the perception or the substance behind the fact that some of those deposits may be used for more risky behavior than most people thought they otherwise would have been?

Mr. BERNANKE. No, I think we are in a reasonable place right now. Again, whenever assets are transferred down to the bank, there have to be guarantees, protections, backstops to make sure that the bank is not at risk of taking losses. And the purpose of those things is to segregate the bank for the purpose of protecting the FDIC's insurance fund, for example.

If we go forward and have a resolution regime that addresses the whole company, I think these issues are still there, but they are less of a concern because the whole company will be addressed.

Senator CORKER. You have talked a great deal about there is—well, you have talked a great deal about the Fed maintaining supervision over some of the larger entities in the country, and some people have put theories out that, you know, the Fed ought to look at the—ought to supervise the top 25 entities in America. You know, that has been a number that has been thrown out.

As we look back at Citi and the fact that Citi was under corrective action until 2003, and then the Fed basically lifted that, the Fed was watching Citi—I mean, that is like Prime A, you know, the prime example of what the Fed is supposed to show prudential regulation over. And yet Citi, let us face it, turned out by all counts to be an absolute disaster from the standpoint of the activities they got involved in. It was the primary type of institution that the Fed should be supervising. And I do not say this to beat a dead horse, but it does make one wonder. I know a lot of people talk about the Fed being the adult in the room and all those kind of things, but it does make one wonder, you know, why that happens to be a good idea. And I wonder if you might expand on that.

Mr. BERNANKE. Well, there are two separate issues. The first is the performance of the duties and how effective a particular supervisor is. And I talked earlier about some of the things that we have done in our self-assessments, what mistakes we have made and problems we have found and how we are fixing them, and we are

taking a lot of steps to try to strengthen our supervision and our regulation.

But, you know, there were problems throughout the entire regulatory system, and if you are going to preclude anyone from participating in future regulation because they made mistakes in the crisis, you are going to be cutting about most of the——

Senator CORKER. We wouldn't have any regulators.

Mr. BERNANKE. You wouldn't have any regulators left. That is right. So, really, one question is: Can the Fed fix the problems? I believe we have made a lot of progress, and I would be happy to talk to you offline in more detail or give you a summary now. There is a discussion in my testimony. You know, we have done a lot to strengthen the regulation, increase capital, increase liquidity, to improve risk management oversight—many of the issues in the company you mentioned, but other companies as well.

But then there is a second issue, which I call the structural issue. When you are setting up for the future a structure of how regulation should work, what is the role of the central bank? And the central bank was created to address financial instability, to stop panics. That followed the 1907 panic, was what caused the Fed to be set up in the first place. We have the lender of last resort facility. We have the breadth of expertise.

So I think, assuming that we and other regulators can correct the problems that we have discovered, the appropriate structure should be one where the Fed is involved because without being involved, we will not have the expertise, we will not have the information, we will not have the insight that will let us be effective in addressing systemic issues.

Senator CORKER. So I want to talk to you some more about that. My time is about to end. I know that you have stated you are going to quit buying the mortgage-backed securities that you are buying right now from Fannie and Freddie in March, and other institutions. There are a lot of people saying that when you do that, interest rates on home mortgages are going to go up a couple hundred basis points. And I think it would be really good for all of us to know whether you really are going to do that or not. I mean, I think it would be appropriate for—you have stated it is going to end in March. I think it would be appropriate for people to know so they can be making other plans, because I think it is going to have a huge impact on the market. I think a lot of people question whether that is within Section 14 of the Fed's charter in the first place, but I would love to have a response to that.

And then, second, if we could, since my time is out and I am kind of filibustering, one of the things that you and I have talked a great deal about is just the political involvement in monetary policy. And I am concerned about people like us getting involved in monetary policy. I have stated that all the way through, and I think most people in this Committee would be very concerned about us getting involved in monetary policy.

On the other hand, I wonder if it should go both ways, and what I mean by that is when the Bush administration, you know, touted this stimulus back in May of their last year, which most people saw on the surface was ridiculous—I mean, we are going to spread $160 billion around the country and drop it out of helicopters. I think

most people thought it was—I will not say "most people." A lot of people thought it was a pretty silly idea. And yet you championed that, and that affects people here because the Chairman of the Fed is thought to be a really intelligent, important person. And, of course, you are.

The same thing happened with this last stimulus, which in my opinion was absolutely not a stimulus. It is proven now it did not do what it was supposed to do. But, again, when you speak and say it ought to happen, people up here vote that way.

So I guess I would just ask, if we are not to be involved in monetary policy, should you be used as a tool by whether it is a Republican administration or a Democratic administration that caused an agenda to come forth that, you know, is really a political agenda, not something that is necessarily good for our country? And, Mr. Chairman, I thank you for the generosity of letting me go a little longer.

Mr. BERNANKE. May I just say quickly——

Senator CORKER. Well, I would like for you more than quickly to answer both.

Mr. BERNANKE. Both, all right. On the mortgage-backed securities, we have a longstanding authorization to do that. I do not think there is any legal issue. We have said that the current program is going to come to an end at the end of the first quarter. It is a monetary policy decision. The Committee will have to see how the economy is evolving and whether or not we need to do more. The several hundred basis points, there is a lot of uncertainty about exactly what the impact will be. I think that is very much at the high end of what estimates are, but we will have to see how that plays out.

On the fiscal part, I think you——

Senator CORKER. So people involved in home mortgages will just know when they know?

Mr. BERNANKE. Well, we do not know. We do not know exactly what the effect will be.

Senator CORKER. So saying it is going to end in March is just kind of like saying we are going to withdraw troops in Afghanistan in 18 months, just kind of saying it. I am just——

Mr. BERNANKE. Well, in order to try to mitigate the effects, we have been tapering it off very slowly, and so far we have not seen much effect, but we will see how it evolves, and the committee is prepared to respond, if necessary.

On the other thing, I think you are absolutely right. As a general matter, I have tried to stay out of fiscal policy, and I do not make specific recommendations. I did not make any recommendations about the size or composition or any of those things. But you are absolutely right, and I will continue my practice of leaving fiscal decisions to the Congress.

Senator JOHNSON. Senator Menendez.

Senator MENENDEZ. Well, thank you, Mr. Chairman.

Chairman Bernanke, I just want to start for purposes of memory, because we often seem to have short-term memory here, in November of 2008 and the time—and I think you referenced it to some degree in your opening statement. In November of 2008, after those Presidential elections, you and Secretary Paulson came before

Members of this Committee and basically said, you know, we have an emerging set of circumstances and we need you to act, to do so boldly; and in the absence of doing that, that we would have a global financial meltdown.

So I want to start there because it is the beginning of what has then transcended since then. Is that pretty much a fair statement?

Mr. BERNANKE. Yes, sir, except that it was October. It was early October.

Senator MENENDEZ. October, OK. And then the actions took place thereof, because I often get from my constituents back in New Jersey, you know, "Senator, when I make a mistake, I have to pay for it, and it seems when these financial institutions make a mistake, I have to pay for it, too."

And I think that the difficulty is creating the connection between why we acted based upon the expertise of yourself and others who said we needed to do so because, otherwise, there would be a global financial meltdown, and that obviously has real-life consequences to Main Street in New Jersey, or for that fact, across the country. Is that a fair statement?

Mr. BERNANKE. Of course.

Senator MENENDEZ. Now, which brings me to where we are today, and I want to get a sense from you: Do you believe that the American economy is recovering?

Mr. BERNANKE. It is beginning to grow again. We would like it to grow faster. We would like jobs to come back faster. But I do believe we avoided an even far worse situation by avoiding the collapse of the financial system, as you indicated.

Senator MENENDEZ. And to give us a sense, when we say we avoided—because, you know, I think Senator Bayh mentioned that, or maybe Senator Schumer or both, mentioned that sometimes when you avoid harm from happening, you get no credit for it. But give us a sense of what would have happened had we just said, you know, "Let the markets do it on their own. Let them figure it out."

Mr. BERNANKE. Well, my professional career before I came to the Fed was as a scholar, an academic studying financial crises and their effects on the economy, including the Great Depression. And there is a lot of evidence, not just in the United States but in many other countries, that when the financial system collapses or melts down, it has very, very serious effects on the broad economy. And I think just the fact that Lehman Brothers and the associated instability around that period contributed to a global recession is evidence for that point.

It is my belief that if we had not acted, if Congress had not supported our actions to stabilize the system, if we and our partners in other countries had not worked together in those weeks in October to prevent what in my view would have been a collapse, a meltdown of many of the major banks in the world, that we could very well be in a Depression-like situation with much higher unemployment than today, very deep decline in output, and no immediate prospects for a recovery, unlike the situation we have today where we do see the economy growing.

So I think the risks of allowing that meltdown were enormous, and the costs to the economy, to the taxpayer, to the average worker, to the average person of allowing the financial system to col-

lapse—the financial system is like the nervous system of the economy, and if it breaks down, you get much broader consequences.

So it has been a very hard message to explain, but it is extraordinarily important to understand that I did not intervene because I care about Wall Street. I am not a Wall Street person. I am an academic. I come from a small town. I did it because I knew from my studies that the collapse of the financial system would have extraordinarily bad consequences for Main Street. And that is why we did what we did, and I firmly believe we did the right thing.

Senator MENENDEZ. So now in December of 2009, I asked you whether the economy was recovering, and you answered, "It is growing." Growth does not necessarily mean recovery then.

Mr. BERNANKE. Well, it is technically a recovery in that it is growing and that we are no longer declining, but it is certainly not a satisfactory situation since we have a 10-percent unemployment rate.

Senator MENENDEZ. We agree on that. So what do you believe is the most significant threat to our economic expansion both in the short term and in the long term?

Mr. BERNANKE. Well, there are multiple concerns. Certainly one of them is that it still remains difficult to get credit, particularly for bank-dependent firms. That is preventing small businesses from hiring and from expanding.

The high unemployment rate is a major concern because we are seeing not just 10-percent unemployment, but we are seeing very long duration of unemployment. We are seeing a lot of people on part-time work or on short hours, and that has implications not just for the short term, but for the skills and labor market attachment of workers going forward. It is going to affect people for many, many years.

There are additional issues like our external trade deficit, the fiscal deficit, and so on that we do need to address. But in terms of the immediate recovery, as I talked about in a speech I gave in New York a couple of weeks ago, I think the two issues we need to watch most closely are the return, the healing of the credit system, particularly for smaller borrowers, and the labor market, which is, of course, still in great stress.

Senator MENENDEZ. And we seem not to have succeeded at dealing with the credit market in a way that meets some of our goals that are critical to also deal with our unemployment consequences.

You know, I look at where some of the major institutions are getting credit. They are getting credit, you know, easily two points lower than some strong regional entities, and that is probably what is keeping them largely afloat. But the question is, as you do that at the Fed, where is the movement here—the hammer, for lack of a better—you know, to get them to loosen up the credit? And what can the Fed do to move it in a direction that also is going to begin to make a real significant impact on unemployment, the two things that you say are critical?

Mr. BERNANKE. Well, on unemployment we have a range of policies, including low interest rates and mortgage-backed securities purchases and a variety of other things.

On credit, it is a difficult thing. I think it is a mistake to tell banks, "You must lend such-and-such amount," because we got into

trouble in the first place with bad loans. We want them to make good loans. We want to make loans to creditworthy borrowers. So the Fed and the other banking agencies have been working with the banks to try to make sure that they are not, either by examiners or on their own account, failing to make loans to creditworthy borrowers. So we have issued guidance about the importance of doing that. We have trained our examiners to look at both sides to make sure that banks are giving full weight to the importance of continuing relationships that they have with, for example, small business borrowers.

We have issued guidance with detailed examples for how to deal with a borrower who may be making payments, but whose collateral, which may be his business, has declined in value, that it still might be important to continue lending to that person or to that business.

And, in addition, we have been trying to strengthen what is called the shadow banking system through our program to increase securitization of small business loans, commercial real estate loans, and the like.

So we are addressing this. We did the stress tests to get banks to raise capital.

So we are working at this. We understand the critical, central importance of this. It is not going to be a quick improvement, but I do think we are seeing some improvement, and as the economy strengthens, there will be a mutually beneficial improvement in the economy and in the credit markets.

Senator MENENDEZ. Well, this is clearly the singular most important——

Mr. BERNANKE. I agree.

Senator MENENDEZ. I know there are many other issues that the Fed deals with, you know, but this is the singular most important issue that your chairmanship is going to be critical over in terms of helping us move this country forward in a way that its economy is recovering more robustly, that unemployment is being reduced, and that we give people back the dignity of work, which is ultimately the opportunity to sustain their hopes and dreams and aspirations. So I am going to be looking at what you are doing in that respect incredibly closely.

Mr. BERNANKE. Absolutely.

Senator MENENDEZ. And my time is up, but I do want to visit with you about the Consumer Financial Protection Agency. When you came to see me, we had some original conversations about that. But, you know, my one criticism—I think you have done a lot of hard work in difficult times, but my one criticism—which really precedes your time even, but continued during your time—is that the Fed had broad powers in consumer financial protection, and it just did not use it in a timely fashion. And so there are many of us who question that leaving that there is not necessarily in the best interests of the country.

So I will look forward to having a discussion with you on that.

Mr. BERNANKE. Senator, just quickly, I do not disagree with we were late in using those powers, but over the past 3 years or so under my chairmanship, we have actually been very active in a wide variety of areas of consumer protection.

Senator JOHNSON. Senator DeMint.

Senator DEMINT. Thank you Mr. Chairman, and thank you, Mr. Chairman, for being here today and for your service.

When Congress created the Federal Reserve, they created, arguably, the most powerful institution in the whole world. Our whole economy, all our prosperity, wealth, rest on the soundness of the dollar, as does much of the economic systems all around the world. So as we consider your renomination, it is important that we ask some difficult questions—not just of you, but to ourselves—because no one can say that there have not been major failures, and I think a lot of us have to admit that the Federal Government, the Federal Reserve, let down the American people and a lot of people have been hurt.

I will take exception to one of the arguments that I have heard today and I have heard often about what we heard last October and what actually happened. We were told if we did not appropriate nearly $1 trillion to buy toxic assets, the worldwide economic system was likely to collapse. We appropriated nearly $1 trillion, and we never bought one toxic asset, and the world economic system did not collapse.

Now, we can make a case and debate all we want about whether or not twisting banks' arms and forcing more money in the banking system actually helped us. We could talk about that all day. But the premise that we used to create this TARP program was never followed through on. It is difficult for me to find credibility in the arguments that we saved our economy.

But I would like to ask a few questions, Mr. Chairman, and I would appreciate short answers. I want to cover some territory today. But we do not know a lot about the operation of the Federal Reserve, and for that reason, I think the way to judge performance is to look at outcomes, particularly outcomes based on the goals that you have set for yourself.

In your confirmation hearing in 2005, you specifically listed four duties of the Federal Reserve, and I would just like to mention those and just ask you how you think we have done.

One of them was fostering the stability of the financial system and containing systemic risks that may arise in the financial markets. Has the Federal Reserve under your leadership accomplished that goal?

Mr. BERNANKE. No, but we also have lots of other co-conspirators in that problem.

Senator DEMINT. Another duty you listed, supervising and regulating the banking system to promote the safety and soundness of the Nation's banking system and financial system. Has the Federal Reserve under your leadership accomplished that goal?

Mr. BERNANKE. We found some mistakes, and we have tried to improve them.

Senator DEMINT. I appreciate your short answers.

Another duty you listed was conducting the Nation's monetary policy in pursuit of the statutory objective of maximum employment. Do you feel the Federal Reserve under your leadership has accomplished that goal?

Mr. BERNANKE. We have moved monetary policy as much as possible to try to support employment growth, but, obviously, a 10-percent unemployment rate is not very satisfactory.

Senator DEMINT. Again, I appreciate your answers.

For me, perhaps the biggest failure in the Federal Reserve in the political side here in Washington is that amid all of these failures, the politicians, the folks in the administration, and Federal Reserve have claimed credit for saving the system while blaming capitalism and unrestrained free markets for our problems. That has justified the positions that are now being taken here in Congress in many ways to come back and even extend the control, the intrusion of the Federal Government further into the private sector. I think you have been a big part of orchestrating that and shifting the blame onto the private sector. No one is arguing that there is not blame to go around everywhere. But the biggest failure I have seen is the failure for us to recognize the role that we played in the lack of our oversight of Fannie Mae, who created a lot of these toxic assets and sold them around the world; the loose monetary policy that created chronically low unemployment rates and high leverage across the economy. But not taking some of the blame and making sure the public is aware of that, we have undermined the system that made this country prosperous, and I think that is an egregious error.

I would like to just mention a few things. What you say, predictions you make are critically important because we act on them, the whole world acts on them. I would just like to mention a couple of these as we go along.

On March 28, 2007, when asked about the subprime market, you said, and I quote, "The impact of the broader economy on financial markets of the problems in the subprime market seems likely to be contained."

A little later, May 17, 2007, you said, "We do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system."

A little later, February 28, 2008, on the potential bank failures, I quote, "Among the largest banks, the capital ratios remain good, and I do not expect any serious problems of that sort among the large internationally active banks that make up a very substantial part of our banking system."

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

On July 16, 2008, right before our crash, speaking of Fannie Mae and Freddie Mac, you said, "They are adequately capitalized and in no danger of failing."

To a large degree, the oversight that we are responsible for here in this Congress, we did not accomplish because of assurances that we had gotten over the years from your predecessor and from yourself. And by doing that, I think we have egregiously failed the American system.

Let me mention a few things here as I run out of time. Capitalism depends on capital, and I would like to ask a couple of questions about the Federal Reserve and capital. Is the Federal Reserve an instrument of the Government?

Mr. BERNANKE. It is an agency of the Government, yes.

Senator DEMINT. Do you believe money is an instrument of Government to be manipulated as necessary to calibrate the collective economic behavior of the public with the perceived financial needs of Government?

Mr. BERNANKE. The monetary policy is intended to follow the mandate the Congress gave the Federal Reserve, which is to achieve maximum employment and price stability. That is what we try to achieve.

Senator DEMINT. Do you believe that employment should be a mission, a goal of the Federal Reserve?

Mr. BERNANKE. Yes, I think the Federal Reserve can assist keeping employment close to its maximum level through adroit policies.

Senator DEMINT. Should the Government or an agency established by the Government have the power to distort the purchasing power of money?

Mr. BERNANKE. The Federal Reserve is mandated to achieve price stability, and one thing you did not mention in your list was inflation. Inflation has been low, and in that respect, the purchasing power of the dollar has been good, has been stable.

Senator DEMINT. In a free market economy, you would think that the cost of capital would fluctuate based on supply and demand, yet a big part of the role of the Federal Reserve is to try to fix those interest rates. Is that a function that has been employed properly? And is that something that needs to be reconsidered?

Mr. BERNANKE. Well, we always need to improve our execution, but I think that, as evidenced by the fact that every major country in the world has a central bank and uses monetary policy, I think that is the system that we have determined is the most effective at this point.

Senator DEMINT. Again, I appreciate your testimony. I would again, as you and I have talked personally, ask you to consider the need to make the Federal Reserve more transparent. There is no reason that independence needs to mean secrecy. The confidence in the Federal Reserve, the mistrust around this country has reached new heights, and we need to do something to restore the faith that the American people have in their monetary system, their financial system, and that responsibility is at the Federal Reserve as well as in the Congress. But I would encourage you again to consider what type of openness or audit, as you and I have talked about, would be appropriate in order to reassure the American people that we are not looking at another Fannie Mae situation, that over years we were told not to worry, not to worry, everything is OK, and now we saw what it did. We cannot allow that to happen with the Federal Reserve.

Again, Mr. Chairman, thank you very much, and I yield back.

Mr. BERNANKE. May I quickly respond to that?

Senator DEMINT. Yes, sir.

Mr. BERNANKE. Senator, on Fannie and Freddie, the Federal Reserve had been raising concerns about Fannie and Freddie for many, many years. We were on the side of concerns about that.

In terms of transparency, I think the Congress should have access to all of our financial information, financial operations and the

like, and we have made every effort to do that, and whatever remains to be done, we want to work with you to do that. Our main concern is about the independence of monetary policy itself and not about any financial aspect. So we are very much committed to transparency in all financial aspects of the Federal Reserve.

Senator DEMINT. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Akaka.

Senator AKAKA. Thank you very much, Mr. Chairman.

Chairman Bernanke, I want to add my welcome to you and your family to the Committee today. I feel you have demonstrated tremendous skill in addressing the extraordinary economic crisis and challenges that we have.

As you know, I have always greatly appreciated your capacity and dedicated efforts to improve the financial literacy of students and consumers. The true costs of financial illiteracy have been made all too apparent by this financial crisis. One of the core causes of the crisis was that families were steered into mortgages with risks and costs they could not afford or even understand, and that has been already expressed. We share a firm commitment to trying to better educate, protect, and empower consumers.

I appreciated your advocacy and the efforts of the Federal Reserve to promote the use of financial institutions for lower-cost remittances. In Hawaii, we have many families that send portions of their wages to family members living in the Philippines or other countries. Unfortunately, too often, consumers fail to take advantage of the lower-cost remittance services found at banks and credit unions.

My question to you is, what must be done to, one, better inform consumers about costs associated with sending money, and two, to encourage mainstream financial institutions to provide low-cost remittances?

Mr. BERNANKE. Well, Senator, first, let me just agree with you wholeheartedly about financial literacy. The Federal Reserve has been committed to working on this for a long time, as you know, and, of course, the recent crisis illustrates abundantly how important it is that people understand the contracts, the financial instruments that they are taking on. So we will continue to work with that and we will continue to also try to provide consumer protections that provide the information, the disclosures, the protections that help people get into the right product, which is very important.

I agree with you about remittances. That has been an interest of mine for some time. The Federal Reserve has been working on that. We have worked, for example, with some other countries to try to reduce the cost of sending money to home countries. But I think one of the valuable lessons here is that many of the remittance services that people have are quite expensive and they may involve costs associated with exchange rates and the like.

We have encouraged institutions, where possible, to reach out, because if we can persuade immigrants to use mainstream financial institutions for remittances, they may become interested in having a checking account or a savings account or taking out a loan, if necessary. So it is a way of introducing people who may not be that familiar with the banking system into the mainstream

banking system and, in many cases, reducing the costs that they face dealing with payday lenders and the like. So we do encourage that, and I think I would encourage financial institutions to use that tool as a way of attracting new customers from immigrant communities.

Senator AKAKA. Chairman Bernanke, there are too many unbanked individuals that lack a formal relationship with a bank or credit union. As you mentioned, without access to mainstream financial institutions, working families miss out on opportunities for savings, borrowing, and low-cost remittances. I personally understand this issue because I grew up in an unbanked family. In addition to encouraging the use of banks and credit unions for low-cost remittances, can you tell me what else must be done to bank the unbanked?

Mr. BERNANKE. Well, the government can provide various incentives, encouragements, to banks to do what in many cases is really in their own interest, which is to try to reach out to these communities. For example, the Community Reinvestment Act, which gives credit to banks for providing services, including branches in low- to moderate-income communities, is one way to encourage banks to take those sort of actions. We encourage banks to have multilingual employees, again, to establish those relationships.

But I would hope that banks would see that expanding those services into immigrant areas, low- and moderate-income communities, is really a way of expanding their customer base and increasing the deposits and is really a profitable business strategy. So that, I think, fundamentally is the motivation for banks to go beyond the narrow groups that they are serving now and try to branch out more broadly.

Senator AKAKA. You did mention about predatory lenders. Working families are having trouble accessing affordable credit. Unfortunately, many working families, of course, turn to predatory payday lenders for small loans. My question is, what must be done to protect consumers from high-cost payday loans, and two, to encourage the development of affordable alternatives?

Mr. BERNANKE. Well, the Federal Reserve doesn't directly regulate payday lenders. I think that in most cases, they are regulated by States who set requirements in terms of the information they provide. It is very important for people to understand what the cost actually is. If you are paying a certain number of dollars until payday, you may not realize that as an interest rate, that may be many hundreds of a percent or more. So regulatory work at the State level or wherever the appropriate level is to make sure that customers understand the cost of the credit they are obtaining and learn about the alternatives, I think is a very positive direction.

And in general, as we were discussing earlier, to the extent that mainstream banks can come in and provide the alternatives and the competition to check cashing and payday lending and the like, the better the chance that families will have good access to credit and reasonable terms.

Senator AKAKA. Thank you very much for your responses. Thank you, Mr. Chairman.

Senator JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, very much for being here. The Fed's current policy of extremely low, near-zero interest rates is certainly helping banks recover in certain ways. I mean, they can use money to recapitalize through buying long-term government bonds. But at the same time, that scenario is discouraging, in many ways, getting credit out to businesses, to citizens who need it, to the recovery. What is your concern about that and how do you balance those objectives?

Mr. BERNANKE. Well, as I have discussed earlier in the testimony, we have seen a lot of improvement in the broad credit markets, in the corporate bond markets and the stock market and the like, which means that larger firms have pretty good access now to credit. But there is still a big problem for people who are bank-dependent, small businesses and consumers and the like. It is not an easy problem because we don't want to tell banks to make bad loans. We want them to make good loans and loans to creditworthy borrowers.

We have, however, done everything we can, or at least we are trying very hard to encourage banks to do that, in particular by telling our examiners, training our examiners to work with banks to take a balanced perspective. That is, we don't want you to make a risky, imprudent loan, but if you have a longstanding relationship with a customer who has been paying, if you have a creditworthy borrower, you should make the loan. It is good for you. It is good for the economy. It is good for the borrower.

So we are supporting that with our examination policy, with our guidance. We recently provided some commercial real estate guidance which gave examples for how, say, a small business who wants to borrow against their place of business, and the value of the store has gone down but they can still make the payments, why that should be considered still a good loan and why you should still make that loan.

On top of that, we have certainly pushed the banks to add capital. You know, since our stress test in the spring, there has been a very big increase in the amount of private capital raised by the banking system. And we have, as you know, increased support of their funding through the discount window and through our efforts to get the securitization market running again, in particular our program to help investors link up with small business lenders, credit card and other consumer-type loans.

So we are attacking this from a number of dimensions. We are not where we want to be, but we are seeing some improvement and expect things to get better as the economy improves.

Senator VITTER. Well, I guess my more focused question was, isn't having extremely near-zero interest rates, in fact, an impediment to banks putting more money out to small business and others?

Mr. BERNANKE. No, I don't think so. To the extent the banks use the money to buy Treasuries, it is because they don't see a good lending alternative. So we want them to look at the lending alternatives to put out the money. The lower interest rates stimulate the demand for credit. Part of the reason—not the entire reason, of course, but part of the reason—that bank credit is contracting is that the demand for automobiles and houses and furniture and

other things has fallen in the recession and lower interest rates make it more attractive for people to buy a car, for example, and that increases the demand for credit and brings people to the bank to take out a loan.

So the purpose of the low interest rates is to strengthen the economy, to support employment, and to get us going again. As the economy strengthens, that will improve the credit situation. It will make credit risk lower, and that should, in turn, make banks more willing to lend. So I do think it is constructive.

Senator VITTER. OK. We have talked about the following before, but as I have told you before, months ago, it seems to me, and it still seems to me, unfortunately, there is a huge disconnect between a lot of the discussions we have here and a lot of the discussions you have and others have at the Fed in terms of trying to, within strong safety and soundness parameters, trying to get credit out the door and what the regulators down on the ground and folks visiting particular institutions are doing in terms of really moving in exactly the opposite direction by being so cautious in reaction to what has happened in the last year that they are making it virtually impossible for community banks to loan new money.

Just my anecdotal experience is that that hasn't changed, hasn't gotten any better since we talked about it several months ago. What more can any of us here or the Fed do to bridge that divide?

Mr. BERNANKE. Well, we should provide you, Senator, with a description of all the various measures we are taking in terms of regular conference calls, meetings, manuals, instructions to the examiners about how they should be proceeding, and I think one useful step that we have taken, for example, in the latest commercial real estate guidance is to give lots of examples. Here is an example of what a loan might look like, and here are the things you should be looking at. It helps people concretely to think about how to deal with a loan that may not be perfect but still is worth making.

So we are making a very hard effort to do it. I am sure there is some slip between Washington and the grass roots, but we understand that issue and the Fed actually has, over a long period of time because of our macroeconomic responsibilities and our attention to the broad economy, has had a pretty good record, I believe. So I don't know which regulators your bankers are talking about. We have had a pretty good record of trying to balance the needs of the economy and the needs for safety and soundness.

Senator VITTER. Well, again, this is all anecdotal, but the experience in Louisiana, particularly in community banks, is that the regulators on the ground who are actually dealing bank by bank are giving almost all of the signals in the opposite direction and they are often reacting to whole categories of loans, like anything to do with real estate, and just saying, you know, your book is above the line we are drawing now, so don't consider anything new, without getting to the merits of the loan, even when their portfolio is solid and not falling apart. So I would just make that comment again in the same vein that we had that discussion several months ago.

Mr. BERNANKE. I appreciate that.

Senator VITTER. As I am sure you know, *The Wall Street Journal* has criticized you for being part of the mistake of too much liquid-

ity and credit around 2003 to 2005 and has doubted that you will have the ability or the discipline to rein that in at the appropriate time. How do you respond to that criticism, and what factors going forward will you be particularly focused on in terms of changing that monetary policy over time?

Mr. BERNANKE. Well, Senator, there are really two issues. Let me talk about first going forward. Clearly, we have put a lot of stimulus in the economy in order to try to get growth back and get jobs created and credit flowing. But we understand that there is another side to it and that includes making sure that we keep prices stable, that we don't have inflation issues, and even though ideally the financial regulatory system would be the first line of defense against bubbles or other misalignments in asset markets, given that we do not have currently a financial regulatory structure that is really designed to prevent those misalignments, I do think monetary policy has to pay some attention to those issues.

And as I mentioned earlier, we are following valuations using standard models and metrics to see if we see anything that is particularly out of line. It is very difficult to know if an asset price is appropriate or not, but we are factoring that into our discussion, as was mentioned in our last minutes, in fact.

On the retrospective issue, it remains controversial. You know, my own view is that the conventional wisdom in some quarters that Federal Reserve monetary policy in 2003 to 2005 was a principal or major source of the housing bubble, I just don't think the evidence is that clear. There are a lot of very good economists on the other side of that. One example is Robert Shiller, who—perhaps the maven of the housing bubble—in his view has said it had more to do with mortgage financing and psychology than it had to do with monetary policy.

It is very striking that if you look across countries, for example—and the IMF just did a study on this—there is no correlation between monetary policy during this period and housing prices. So, for example, Canada had similar monetary policy to the U.S. as did Germany via the ECB, but neither Canada nor Germany had a housing bubble, whereas the United Kingdom had somewhat tighter policy and they had a housing bubble. So the correlations are quite weak. Now, that is not to say that is not an interesting issue we should continue to pursue, but I just want to raise some doubt in your mind that this is an established fact.

But the Federal Reserve certainly has a responsibility to understand the role of monetary policy in bubbles and to think about how we can identify those, as difficult as it is, and to try and take that into consideration, where we can, in making monetary policy.

Senator VITTER. OK. In terms of regulatory reform, and in particular resolution authority that we are considering, if we have an appropriate, in your mind, resolution regime, new resolution regime otherwise, would you support taking away 13–3 and other type authority to send taxpayer dollars to specific firms?

Mr. BERNANKE. Yes, I would.

Senator VITTER. And would there be any subcategory of that sort of authority which would send—from either the Fed or other entities—to send dollars to individual firms that you think we should accept and retain?

Mr. BERNANKE. Well, currently, if the FDIC resolves a failing bank, there may be rare circumstances under which the Fed would assist by providing short-term liquidity to that bank as part of the resolution process. So it is conceivable, and I am not saying it has to be that way, but it is conceivable that in the resolution authority there might be provisions under certain circumstances where the Fed would lend on a short-term collateralized basis to the entity. But that is a decision for Congress to make. You want to figure out the best way to structure the resolution authority.

I think that if the resolution authority is there, though, to go back to your original question, the Fed does not want to be involved in bailouts. I mean, we got involved in them only because there was not a good legal structure for dealing with these firms, and in the future, we have no interest in doing that.

We think there may be some value in having lending programs that apply to the economy generally under emergency circumstances, but not to individual firms.

Senator VITTER. OK. Well, again, my concern, as I tried to say, is individual firms going——

Senator JOHNSON. Would the Senator leave the following questions to a second round?

Senator VITTER. Sure. Thank you.

Senator JOHNSON. Senator Tester.

Senator TESTER. Yes, thank you, Mr. Chairman, and I want to thank you for being here today, Chairman Bernanke. Over the next 4 years, if you are confirmed, you will play, and we have referenced it already, a key role in job creation in this country.

Last week, I spent 2 days visiting five of Montana's bigger cities—Kalispell, Missoula, Billings, Helena, Great Falls—to discuss the economy and jobs. I heard one message consistently in each town, and that is we need to allow our local banks the opportunity to lend, an issue that Senator Vitter and others have brought up.

At the same time, I am hearing that Fed regulators are sending mixed messages. From DC, it is to lend, but from the field offices, it is buildup capital, don't consider commercial loans. I have heard from several banks that claim the FDIC and Fed examiners are overzealous and overreaching and in some case reversing State regulatory exams demanding write-downs and reclassifications of loans and assets.

You have made claims here today and before that you are pushing banks to lend. The folks on the ground are seeing, for the most part, the exact opposite. I believe that Congressman Minnick and the House Financial Services Committee sent you a letter at the end of October talking about common sense regulation on the ground in these economic times. You have talked about conference calls. You have talked about meetings. You have talked about what you are doing.

I guess the question is, is there anything more you can do, because from what I am hearing, it is not working.

Mr. BERNANKE. Well, I appreciate the feedback, and all I can say is we will take another look at it and try to step it up further because it is important to have a balanced perspective.

Senator TESTER. But you do agree that these local banks play a critical role and the capital they provide play a critical role in job

creation, and if they are bound up and do not loan money because regulators are putting the boots to them, the economic recovery is going to be slow in coming?

Mr. BERNANKE. That is true, but we do have to make sure that they are making good loans. We don't want to go back into a situation where they are making bad loans and then it ends up costing money for the Deposit Insurance Fund. But subject to that, obviously, we want them to make good loans.

Senator TESTER. I would agree with that. I guess the real question then becomes, what is the definition of a good loan?

Mr. BERNANKE. One that gets paid back.

Senator TESTER. OK, and so what determines that?

Mr. BERNANKE. Well, a set of criteria about——

Senator TESTER. And have those criteria changed?

Mr. BERNANKE. The criteria haven't changed. What has changed is the economic environment. You have people whose business has deteriorated or whose asset values have declined and it makes them less creditworthy. But again, we have tried through our policies, to identify the key issue—the ability to repay—which may not be the same, for example, as the collateral value. So we want to identify criteria that will help banks make loans to people who will repay and can repay, but be careful obviously about not making loans that are not likely to be good.

Senator TESTER. There is also a perspective out there that the playing field is tilted to the big guys. Could you comment on that? I am talking about the big financial institutions, and that the little guys who really didn't create the problem are doing all the suffering and the big guys are back making incredible profits and that the playing field is tilted toward them. Could you talk about that for a second?

Mr. BERNANKE. I will. We have an enormous too big to fail problem in this country. All the problems that people are talking about, the bonuses, the unfair playing field, government backstops, moral hazard, all of that follows from too big to fail, and the best thing that we can do to solve that problem, to create market discipline for those big firms, to force them to compete on an even playing field, is through regulatory reform that will address too big to fail, and I think that basically has two components.

One component is tougher regulation for these large firms, higher capital requirements, tougher liquidity, supervision, and risk management requirements on the one hand, but on the other hand, going back to Senator Vitter's comments and others, a resolution regime that will allow the government in a situation of crisis to wind down, allow a firm to fail, and allow creditors to take losses without having all the collateral damage to the financial system and the economy that we saw last fall.

Senator TESTER. OK. And if you have already stated an answer to this question, I apologize, but I really don't know this. The Chairman of this Committee put out a regulatory reform bill. Does it adequately deal with the too big to fail issue?

Mr. BERNANKE. I believe it addresses the resolution issues. Senator Dodd knows that I disagree about the Federal Reserve's role on the regulatory side. We think we both have the appropriate ex-

pertise and the need to know, so to speak, that we should be involved in oversight of the banking system.

Senator TESTER. OK. So taking the turf issue out, if you can do that, because I know you are looking to be confirmed for this job, taking the turf issue off the table, does that bill adequately address the too big to fail?

Mr. BERNANKE. Well, it is not a turf issue, it is a fundamental issue about the soundness of the plan. But putting that aside, at least on one side, which is the resolution regime, I don't want to—let me be quite frank. I haven't read the latest version and I know right now we are in discussions and so on——

Senator TESTER. There is still work——

Mr. BERNANKE. ——but broadly speaking, it had the features that a firm would be able to be wound down, that losses could be imposed. If I understand that correctly, then that is where we should be heading, in that general direction.

Senator TESTER. OK. Well, there is some——

Chairman DODD [presiding]. I take that as a wild endorsement.

Senator TESTER. Yes, exactly.

[Laughter.]

Mr. BERNANKE. It is a strong endorsement, Senator.

Senator TESTER. I was trying to help you out, Mr. Chairman.

While some of the folks in Congress recommend using TARP funds to spur lending in local markets, Montana is only one of two States that receive no Capital Purchase Program funds. Our banks don't want TARP funds. So what other recommendations would you propose to spur some small business lending, rather than TARP?

Mr. BERNANKE. Well, I think we have to address your regulatory issue that you raised. We are trying to strengthen the secondary market so that banks that make a small business loan can then package it and sell it; we have made a lot of progress in restoring the secondary market for SBA loans and also for commercial real estate loans. Those are the main suggestions I have.

Senator TESTER. All right. I just need to know your thoughts on an idea that has been bounced around here a bit, was bounced around a little bit in Montana, the New Employee Tax Credit concept, providing business a credit if they bring on a new employee and keep them for 2 or 3 years or whatever that arbitrary figure might be. It has been done before. What is your perspective on it?

Mr. BERNANKE. Well, I don't think we have a clear answer to that question, unfortunately. The historical record is mixed. Some have been perceived as successful, some not so successful. So there is not a clear enough consensus that I would want to make a recommendation to you, particularly since I just promised Senator Corker I wasn't going to make fiscal policy recommendations.

Senator TESTER. But we are talking jobs.

Mr. BERNANKE. Yes, I know, and there are a lot of different ways to approach jobs and I am sure you have seen the list. I mentioned earlier Christina Romer's op-ed in *The Wall Street Journal* which listed the five or six items that people are looking at. I would have to say that some of the others she mentioned are more straight forward and we would have a better sense of what the effect would be, but the Jobs Tax Credit, one of the drawbacks is we don't have

a sense of how strong an effect that would have or how permanent the effect would be.

Senator TESTER. Regardless of how it is structured?

Mr. BERNANKE. Well, it would depend a lot on how it is structured and how it is publicized and to whom it applies and so on, and that is part of the reason I can't give you a clear answer.

Senator TESTER. OK. If we had a more concrete proposal, you could?

Mr. BERNANKE. We could help you analyze it. But again, I am reluctant to make a——

Senator TESTER. I understand.

Mr. BERNANKE. ——a clear recommendation.

Senator TESTER. Sounds good. Thank you very much.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very, very much.

Senator Johanns.

Senator JOHANNS. Mr. Chairman, thank you for being here. I will just show bias to start out. I have always believed that less government and lower taxes helps create jobs. But let me pursue something with you.

I think the biggest challenge that you face in your job is maybe not what you have been through, although that was significant, it is what you do from here, because at some point, there has to be a very artful exit strategy. You have done some things, or the Fed has done some things that have really, really been unprecedented. It has gotten a lot of debate, a lot of concern. Some have agreed with you. Some have vehemently disagreed with you. I think that is reflective of what has happened with the Committee today.

I would like you to just walk us through the things that the Fed has in place, everything from your policy with Treasuries to interest rates, and talk to us about the exit strategy, number one, and what timing—and I am not necessarily looking for, by June 1, we will do this. What I am looking for is what economic signals will cause you to reach a conclusion that we can pull back from this or we can do that? So talk to us a little bit about that.

Mr. BERNANKE. Certainly. Well, first, as you know, the Federal Reserve created a number of special programs to try to address problems in specific markets, like the commercial paper, the interbank market, the money market mutual funds, a variety of areas where there were stresses, we created special facilities and the like to try to reduce those stresses.

As things have improved, the demand for funding from these programs has dropped significantly. We are down now to about 15 percent of the peak in terms of the dollars outstanding through these various programs. So we have made a lot of progress just through the fact that demand has gone away as the markets have improved in reducing all these programs, and, we will be cutting back the size and closing them, first, as market conditions normalize, as they continue to do, and in particular, those programs are justified only under so-called unusual and exigent circumstances, and as markets normalize, from a legal perspective we will need to be thinking about closing them down, and we are moving in that direction. And, again, we have made a lot of progress in that direction at this point.

Beyond that, our major programs have been asset purchases. We had a Treasury purchase program which brought our holding of Treasury bonds about back to where it was before the crisis, so we really have not increased our holdings of Treasuries. But we have also had a very big program of purchasing Fannie Mae, Freddie Mac, and other GSE mortgage-backed securities. We have announced that the current program will be wound down, tapered off through the first quarter of next year, and that is currently on schedule.

So what we have is, if you will, a rolling exit process whereby the special programs are running off just because of lack of interest, and they will be shut down over time. We have bought a lot of Treasuries and MBS, though at this point we have announced tapering off of those programs.

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. And we can support that through a number of mechanisms that we have developed to reduce the size of the balance sheet and the amount of reserves in the system. And so we will do that gradually over time.

So from a technical perspective, we have plenty of clarity about how we can exit from all these programs and how we can tighten policy and how we can, you know, raise interest rates, remove the accommodation at the appropriate time so that we get a sustainable recovery without inflation.

Of course, as always, the communication, the timing, and so on is difficult. It always is, coming out of a recession. But it is not especially difficult in the sense that all these various programs and unusual steps we have taken we have good means now of reversing them and unwinding them as the time comes.

Senator JOHANNS. As we look out to just next year, let us say, the next 12 months, we already have unemployment that has now gone over 10 percent, probably—well, not probably. It is much higher than that if you count people who have just given up. That number is in the 17-, 17.5-percent range, from what I understand. We are a consumer-driven economy, so if you have got a whole bunch of consumers very much on the sidelines just trying to keep things together as best they can. You have got a whole bunch of other consumers worried about losing their jobs.

As you look out there over the next 12 months, what is your expectation when it comes to unemployment numbers? And is this going to get worse before it gets better, is kind of the bottom line of where I am headed with that question?

Mr. BERNANKE. Well, the unemployment rate is very high, and it is a tremendous problem, and it obviously means a lot of hardship for a lot of people and some very long-term scars in the labor market.

The rate at which the unemployment rate comes down is going to essentially depend on how fast the economy grows and then also how much confidence employers have to bring more workers on.

We have an employment number tomorrow. We will get a near-term reading of what is happening. I do not know what the number is, but most forecasts right now are still for job loss. But as the economy continues to grow, we should begin to turn that corner and start to see job creation. However, because we have people coming into the labor market all the time, you need to have a certain amount of growth just to absorb the new entrants into the labor market. So you probably need something like 2.5 percent growth in the economy just to absorb those new entrants and keep the unemployment rate more or less stable.

Right now, the FOMC expects growth next year to be fairly moderate, somewhere in the 3.5-percent range, and what that suggests is that over next year we will see the unemployment rate declining but, unfortunately, slower than we would like. It depends also in part, again, on employers. Employers have been very effective in increasing productivity and reducing the amount of labor that they need to produce output. Our sense is that they cannot keep up that kind of cost saving indefinitely. At some point, as the economy begins to expand, they will have to bring back some workers. But to the extent that cost savings and those kinds of labor reductions continue, that will be another drag.

So the bottom line is we do not really know—our forecasting is far from precise—but if, in fact, the economy grows at a moderate pace, as we expect, the unemployment rate should peak and then come down, but only slowly.

Senator JOHANNS. My last question. One of the things I hear as I talk to the business community, not only in my home State of Nebraska but those who come into my office, is they just feel there is a tremendous amount of uncertainty that is causing anxiety about decision making in terms of investment, capital expansion. Even when they see the business pick up, they are very, very reluctant to add people. And here is the uncertainty that they talk to me about. They talk to me about climate change legislation and the impact that that will have. They talk to me about card check and the impact that that would have on their business, the impact of regulatory reform, the impact of health care reform, and that has a real financial impact on them.

How big a problem is that in terms of our economy starting to find its equilibrium, stabilize itself, with all of those, you know, really exorbitant things going on out there impacting that psychology of the marketplace?

Mr. BERNANKE. Well, we have heard the same thing in our discussions. You know, the FOMC has Reserve Bank presidents from around the country, they talk to business people as well, and they bring that message to us, and they have heard a lot about concerns about uncertainty.

One place where it is particularly relevant to the Federal Reserve is as we think about financial regulatory reform and capital requirements and so on, one reason why banks may be a little bit reluctant to lend is that they do not know what the capital standard is going to be, they do not know what the regulatory standard is going to be, and that creates some uncertainty for them as well. So it is an issue.

I do not have any real way of measuring in percentage points how big an effect this is. It is certainly something we hear a lot. My guess is that it will not be in itself a reason that the economy cannot grow. But it does probably mean that firms will wait a bit longer to hire. Maybe they will start with temporary workers. Maybe they will start by bringing back part-time workers to work full-time. Maybe they will use some overtime.

So I do think it may contribute to some extent to the slowness at which firms make the commitment to make new capital investments and to bring workers back that they have let go.

Senator JOHANNS. Thank you, Mr. Chairman.

Chairman DODD. Senator, thank you very, very much.

Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and welcome, Mr. Chairman. Thank you for hanging in there with us today. I am a little under the weather.

One of the great benefits of being at the end of this horseshoe is that you get to hear everybody else's questions and your answers. One of the enormous frustrations to me over the last months and weeks—and I am sure it is frustrating to you, too—is to sit here and listen to Senator after Senator, myself included, talk about what we are hearing anecdotally on the ground about lending to small business, to hear the stories of small businesses that are maxing out their credit cards because they cannot get access to capital of the banks, to hear from community banks that they are unable to lend because they believe the examiners are not giving them the headroom they need to lend. And every time we have this conversation, you answer, wisely and well, which is you say we are doing training, we have guidelines, and, of course, we do not want people to lend poor loans, and no one here wants that either.

And I guess my question for you is: Is there a way we can move beyond this conversation to a place where we can actually acquire evidence of whether or not lending is going on in our communities? Is the tightness of the credit related to the fact that we do not have good credit risks? Or is it that we are overcautious? I mean, how will you evaluate that? How do you know that your training has worked? How do you know that your guidelines have worked? How do you know what is actually going on in the State of Colorado or the other States that are here? Because what I do not want to do is go through another hearing and another month and another week where we do not know what the evidence really is of what is going on on the ground.

Mr. BERNANKE. Well, it is intrinsically very difficult to have statistics on how many good loans were not made, because obviously if we knew which loans were good, we could just instruct the banks to make them, and it is their credit judgments which are so difficult.

What we do, one metric we have——

Senator BENNET. I might agree with you prospectively, but, I mean, even retroactively, if we could look at what has happened—your choice on the period of time—so that we could take the anecdotal evidence that we have and the efforts that you have made and try to see whether those efforts are successful or not. Because if it has not been successful, if people go to the trainings and then

come back and do not follow the guidelines that you have given them, or if we are being too conservative—and, believe me, I would not—I stipulate to the view that we should not do bad loans. How are we going to know that or not? And the reason it is so important to me is I do not see any way to get this unemployment rate down without having our small businesses have access to credit. And I think you have heard that universally today.

Mr. BERNANKE. I have heard it, and I will give it some more thought. I think one statistic that we have is we do survey the senior loan officers of a large number of banks on a quarterly basis, and we ask them a whole bunch of questions about demand for loans and what they are seeing and so on.

Senator BENNET. Right

Mr. BERNANKE. And one thing that has been very clear is that the tightness of lending standards imposed by the banks themselves are at record tight levels, so it is not just the regulators.

Senator BENNET. So here is what I—I mean, first of all, I for one would be very willing to work with you and your staff on this because we have got to move past this he said/she said aspect of what is going on. You know, you have the regulators or the examiners saying one thing is true. We have an observation like the one you just made about banks holding onto capital saying that that is the issue.

I just feel like we are being guided by sort of vague impressions of what might be going on out there when the people that actually cannot keep their doors open and feel that they are good credit and that they are able to pay cannot get access to credit. And they may be wrong. In other words, their credit may not be good, but I can tell you there is an avalanche of that feeling that is out there, and I would like to be in a better position to say here is what is really going on, or at least to be able to say, you know, the examiners and the banks and the people in Washington have somehow convened together to try to diagnose the issue so that a month from now we can say things are getting better, or we can say things are getting worse, or we have not moved off dead center. But we have no—the frustration is that we have no measuring stick at all, really, other than people's impressions.

Mr. BERNANKE. Other than surveys and data on the kinds of loans being made. The Fed staff did work——

Senator BENNET. But we would not run our business that way. I mean, it would not be just based on survey data. Survey data is useful, but it——

Mr. BERNANKE. I was going to add—I am sorry. I was going to add——

Senator BENNET. I apologize.

Mr. BERNANKE. The Fed staff did work with the Treasury trying to develop metrics for the TARP program to what extent did it lead to higher lending. And there was, I think, some progress made there. But your point is very well taken. I have heard this many times, as you can imagine, and I will take this back to our staff and see if we can figure out some more useful metrics or ways of thinking about this problem.

Senator BENNET. OK. I think, again, it is because of the consequence of my sitting here at the end that I can hear the same conversation over and over and over again. Other people may not.

Mr. BERNANKE. As you can imagine, I have heard it many times.

Senator BENNET. I know. And I just think it would be useful to everybody if we were able to agree upon a set of metrics going forward. And, again, I would offer to help.

You mentioned something early in your testimony this morning about the importance of withdrawing from this economy in a way that creates jobs. I may be putting language in your—I think I wrote it down. "In a manner that promotes job creation" is what you said, something like that. Could you talk a little bit about that?

Mr. BERNANKE. Withdrawing the policy accommodation you mean?

Senator BENNET. I just wanted to know what you—no. Withdraw your balance sheet from our economy.

Mr. BERNANKE. Right. So as part of the normalization of monetary policy, right now monetary policy is quite supportive of economic growth. We have near zero interest rates. We have a large balance sheet. We have a number of programs to try to keep down interest rates or to improve functioning in key credit markets.

As I was describing to Senator Johanns, we will have to unwind those programs, and we have a set of ways of doing that. But basically the trade-off is the same one that we usually face when we come out of a recession, which is that at a certain point we have to begin to scale back the amount of stimulus we are providing for the economy so that we do not overshoot and create inflation or other problems down the road. And that is a judgment call because monetary policy takes some time to work.

So all I was saying there was that we are going to have to find sort of the right moment, the right communication, so that we can begin the withdrawal of stimulus or continue—we have already really in some sense begun that process by reducing some of the size of our programs, for example—how to withdraw that stimulus in a way that will avoid any side effects like inflation or asset bubbles or any other problem, but at the same time be consistent with a sustainable and increasing expansion. That is the challenge that we always face at this stage.

Senator BENNET. OK. Thank you, Mr. Chairman. I appreciate it, as always.

Chairman DODD. Senator Bennet, thank you very, very much.

Senator Gregg.

Senator GREGG. Actually, I think Senator Hutchison was here earlier, came back, and——

Chairman DODD. I apologize. You are correct.

Senator Hutchison, I apologize to you. Senator Hutchison, my apologies.

Senator HUTCHISON. Thank you, Mr. Chairman, and thank you, Senator Gregg. I appreciate that note.

Thank you, Mr. Bernanke, for coming to be with us in what has obviously been a long hearing, and I appreciate that you are here.

During your appearance before the Committee in July, we spoke about the effect that the proposed health care reform would have

on our fiscal policy and the economy as a whole. At that time, you said that when considering health care reform, cost must be an issue, must be the issue.

The Democrats' proposal has now come to the floor, and we see that it has a $2.5 trillion price tag over the 10 years from when it starts in 2014 to 2023. Yet according to the CBO the huge Government takeover of health care is not going to lower health care costs, and, in fact, insurance premiums for every individual and family will go up, and I think if we are going to look at how we can change that cost curve, we need to have the ability to determine not only how to do it, but what is going to be the long-term effect of the $2.5 trillion price tag that is going to be on it on our long-term economic situation. And I would like to ask you what you think it will be.

Mr. BERNANKE. Well, Senator, as I said last time, I think the real issue is health care costs—not just the total bill in some sense, but what does it do to the industry, what does it do to the cost of care per person. And what we have seen over the last 30 years or so is that health care costs per person are rising about 2.5 percent a year faster than income, and that is not sustainable. Obviously, at some point health care would become the entire economy.

So what I consider to be the key issue, given that the Government has exposure to Medicaid, Medicare, and other costs, is finding ways perhaps not immediately but over a number of years to bring down the cost per person of health care.

I have not read the CBO study. I know enough to know that health care economists have differed quite a bit about implications of different proposals and different measures. So I am not going to weigh in with a number. I do not have a good number to give you, only to repeat what I have said before, which is that as part of this process, it is very, very important that we do our best not to reduce the quality of care or reduce coverage or to make health care worse. This is a very inefficient system, and there must be ways to reduce the cost of delivering the health care, and many ideas have been suggested, ranging from information technology to various incentive payments to experimental or evidence-based medicine.

I just want to reiterate that because it is critical that we get a stable and sustainable fiscal trajectory going forward, we do need to address this issue, and I do not think we can get a sustainable fiscal situation without addressing the issue. But, again, in terms of the specifics, there is a lot of disagreement about exactly how much effect on individual health care costs this bill will have. But I would just urge Congress to continue to look for savings, ways of reducing that cost.

Senator HUTCHISON. Well, if I understand, what you are saying is that you have not looked at the numbers yourself, but if it is, in fact, going to increase the costs of premiums to every family and the overall cost to every individual, every business, as well as to the Government, that would have a harmful effect on our economy long term?

Mr. BERNANKE. If that is the case, higher costs to the private sector increase the cost of doing business, reduce wages. Higher costs to the Government means a higher fiscal deficit, all else equal, and

that has potentially significant consequences for interest rates and for capital formation and for the health of the economy.

So, clearly, it is a very, very crucial issue that we try to address the cost issue in health care.

Senator HUTCHISON. Thank you. We share your concern.

Let me move to the financial regulatory policies that Chairman Dodd has put a bill forward. A bill has also come out of the House. And one of the issues is the too-big-to-fail issue, and I think every one of us is concerned about it. We have different approaches to that issue, but let me ask you this: In Chairman Dodd's proposal, there is a systematic risk resolution mechanism that would allocate the risk, attempts to allocate the risk, and it would exempt community banks at the $10 billion or below level.

I have concerns about using the asset test because at $10 billion you could include funds that are highly leveraged and inherently risky to our financial system. But you would also exclude asset-heavy mid-market community banks that pose no threat.

Do you have a recommendation, as we are working through this, for how you could measure a financial institution's risk so that we ensure that it is not a safe and sound community bank that is paying for the too-big-to-fail policy risk that it will not have a part in producing nor profiting from? Because I do not think any of us wants another taxpayer bailout. Many of us are very concerned about the one that is before us now and not being used the way we were told it would be used. But, second, I am very concerned about putting any more burden on our community banks, which are trying to lend and trying to have an impact for business that would give them liquidity. And so I want to protect those community banks from having to pay for the risk of too big to fail so that the taxpayer does not have to do it, nor do they.

What would you suggest is the best measure to determine who should pay for the risk so that taxpayers will not going forward?

Mr. BERNANKE. Well, a relatively simple thing to do—and this is just one suggestion—would be to exempt all insured deposits, that is, do not make people do a liability test, but excluding deposits for which the premiums are being paid to the FDIC, which seems fair. And beyond that, it would in practice exempt most community banks that have primarily deposit-based funding, and perhaps some additional exemption above that. So that would be one approach.

A more difficult approach would be to try to do the analogy to what the FDIC does now, which is to make the premiums risk-based in some way, have it depend on some estimate of how the firm would be affected if the financial crisis did hit the system, and that would depend on things like the riskiness of the positions that the bank takes, which affects the FDIC premium. It might be affected by its funding mix. It might be affected by the complexity of its operation and a variety of things.

As you can see by my answer, I think that would be a very complicated thing to do, so my first guess would be to try to find a formula that exempts deposit-funded or community-sized banks for the most part and it puts most of the weight on firms that do a lot of proprietary training and do a lot of riskier types of activities. Doing it based on uninsured deposits would be one first cut at that.

Senator HUTCHISON. My time is up, but I thank you very much.

Chairman DODD. Thank you, Senator, very much.

Let me turn to Senator Gregg.

Senator GREGG. Am I it?

Chairman DODD. Well, you may be. I think maybe my colleague from Alabama may have another question or two. Senator Merkley is coming back, as well, so you are not the last person.

Senator GREGG. Mr. Chairman, first, I want to say thank you, thank you on behalf of people who live on Main Street in New Hampshire. The simple fact is that if you hadn't been there and been willing to take extraordinary action last fall and into last winter and the early spring, along with Secretary Paulson and Secretary Geithner, this country would be in a catastrophic financial situation right now, and it is very likely we would be experiencing a depression or potentially a depression, but certainly a recession which would be radically more severe than what we have experienced, which has been bad and terrible for a lot of people.

The way I describe it is it is like people driving over a bridge that was about to fall down. They didn't know that there was somebody under there who fixed it so it didn't. They don't give you credit. But the fact is, you did take the action that was necessary and it was a very aggressive and creative action, as you have acknowledged. Over $2 trillion, it looks like to me, from your portfolio went into trying to make sure that our financial institutions remained liquid during this difficult time.

So I respect what you did. I obviously don't agree with 100 percent of it, would have done some things differently, but I didn't hold the magic wand, nor did any of us at this table, and I think the proof is in the pudding, which is that we are coming out of this recession and the world didn't devolve into chaos, fiscal chaos, which it might well have done had you not taken that type of initiative.

There are a lot of big issues now pending as a result of that as we try to reorder the way that we approach the structure of our financial institutions in this country, and what I think is critical, and I have said it before on this Committee, is that as we do that, we not undermine what is our great and unique strength as a nation, which is that we are able to create credit, we are able to create capital, and we are able to advance credit and capital to entrepreneurs in a manner that no other nation has ever done. And as a result, people who have ideas and they are willing to go out and take chances and create jobs can find the resources to do it.

And as we advance this effort in the area of financial regulation, we have got to be careful we don't create unintended consequences of limiting that advantage that we have against the rest of the world. The rest of the world has some advantages over us. That is one of our big advantages over them.

And so how the Fed is postured in this is critical, because you are at the epicenter of the structure of our financial institutions, of our credit institutions, and of our monetary policy, obviously. And thus, I am concerned, deeply concerned about this, I call it pandering populist movement out there to basically step onto monetary policy, have the political entities of this country step onto monetary policy.

You have already spoken out against it well and eloquently. I just want to second what you said. I know Secretary Summers did a study on this. You have obviously studied it as an economic historian. But I can't think of a nation where the value of its currency was turned over to or even marginally or significantly influenced or even marginally influenced by elected officials that that nation has prospered. Usually, that is an absolute recipe for inflation and an absolute recipe for other nations looking at the nation that allows its political process to set the value of its money as risky, if not detrimental. And we are too big and too important to the rest of the world to allow that to happen here.

And I understand it is an easy political vote. Go out and beat up on the Fed. You are that mysterious event. You could be in a Dan Brown novel, I guess. But the simple fact is that you are there because we recognized early as a Nation in this century—the last century—that it was important to keep monetary policy separate from fiscal policy, and monetary policy independent. So that is a long explanation of support for your position and unalterable opposition to stepping into this issue.

You are, as you said, audited in every area in a very open and aggressive way, and we have the access to those audits, everybody has the access to those audits except on the issue of monetary policy and that is the way it should be.

I want to get into this too big to fail issue, because I haven't figured out how we address this yet, but there is a proposal that came out of the House Banking Committee that said that healthy, well capitalized, vibrant, energized institutions which have no definable risk to them will be subject to the potential break-up, and that break-up will be determined by an independent group of politically appointed people, or maybe even Members of Congress, for all I know, under the structure, arbitrarily. I mean, that, to me, is a European model of governance that is very threatening because there, big is not necessarily bad. In fact, in many instances, it makes for a competitive advantage. If these institutions are solvent and they are structured well and they are competing, they give us an economic advantage.

It would be incredible industrial policy for a group of politicians to come in and say, well, you are too big, and we don't like you because you are too big, therefore, we are going to break you up. I mean, where does that stop? Does it stop with Wal-Mart because we don't like the fact that they aren't unionized? Does it stop with Coca-Cola because they produce a product that some people think adds to obesity? Does it stop obviously with Altera? I mean, where does that stop, when you get on that slippery slope of functioning, strong companies that are big, but represent no risk because they are functioning and they are strong?

So I guess I would ask you, obviously, too big to fail is a big issue for us and it has got to be addressed, but shouldn't that be addressed on the issue of the institution being a risk as versus the institution just plain being big?

Mr. BERNANKE. So my preferred approach to too big to fail, which I agree with you is perhaps the central issue in financial reform or certainly one of the very biggest ones, has two or two-and-a-half components, depending on how you count. One is to offset some of

the incentives to become too big to fail and to take into account the additional risks that a very large firm may pose to the system——

Senator GREGG. By raising their capital requirements over other——

Mr. BERNANKE. By raising capital requirements or making sure they are safe, making sure they have enough liquidity——

Senator GREGG. Which is a function of making them safe.

Mr. BERNANKE. So that is the regulatory approach, and I think that should be part of it.

The other part is to have market discipline, and the way to have market discipline is to have the ability to fail. We have talked about this several times today, but it is absolutely crucial that when people lend money to a large financial institution, that they are doing due diligence and looking at the riskiness and the activities and the profitability of that institution and not making their loan based on assumed government support of that institution. And so——

Senator GREGG. There is no implied guarantee that an entity can survive, that the stockholders are at risk, as are the——

Mr. BERNANKE. Under our current system, when we say that we are going to let these firms fail, it is not entirely credible because everybody sort of knows that if we come to a huge crisis and we are trying to protect the system, we might intervene, as we did. So we need to make it credible, and one way to make it credible is to have a set of rules and laws that allow us safely to let firms fail so that their failure doesn't affect the broad system and the broad economy. So those two items.

And on size, *et cetera,* I agree size is not a particularly good indicator of riskiness or even danger to the financial system. I think 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 under some circumstances.

But I think those are the elements that would solve the problem, particularly the first two, the tougher regulation and the resolution regime.

Senator GREGG. Well, I will take your comments, then, as saying that simply because a company is large is not a reason a group of politicians should step in and break it up.

Mr. BERNANKE. No, I think we should all recognize that size and complexity often have economic benefits and we should, as much as possible, let the market decide. And one of the many advantages of getting rid of too big to fail is that ability to obtain funding and sell shares, *et cetera,* depends not on the government's backstop, but on the economic value of the operation.

Senator GREGG. If I might be indulged for one more second, not to imply that the Chairman's proposal falls in that category of what I am concerned about. What I am concerned about is the Kanjorski, I think is his name, the language that came out of the House. How do you feel about this idea of requiring large institutions to have a living will? Does that create a—is that a situation where you have, almost by saying, well, you have got to have a living will, therefore you are maybe being given the imprimatur of too

big to fail, or does it actually give the opportunity to say that that is not the case?

Mr. BERNANKE. I think living wills, while they are not a panacea, can be a useful adjunct to supervision. What a living will does is essentially describe how the bank or financial institution would unwind itself. And the reason that can be important, as we found out with Lehman Brothers and others, is that in many cases for tax reasons or for international reasons, whatever, financial institutions are extremely complicated from a legal perspective and it is very, very difficult and complicated to unwind them when the time comes.

So it would be helpful, even in a planning sense, for us to understand how the firm is structured, what its legal connections are, and in situations where extraordinarily complex legal structures are there for tax avoidance or other less economic reasons, maybe there would be a case for looking for a simpler structure in some cases. But I think it would be a useful tool, not only in the actual crisis or in the actual wind-down, but in the process of understanding how the firm works and whether or not simplification in terms of its structure might be beneficial.

Senator GREGG. Thank you.

Chairman DODD. Thank you very much, and just for the purposes of the public, we are not talking about death panels here now in living wills.

[Laughter.]

Chairman DODD. That is a separate hearing. That is another committee that deals with those issues here.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you for your testimony, Chair Bernanke.

Several times today when you have been asked about too big to fail, you have emphasized the power to unwind the institution. You mentioned in passing in one of your replies the issue of risk that goes from one company to another, but I don't think you specifically talked about it in terms of the role of derivatives. There are folks who would say that derivatives are the issue in too big to fail because that is why we intervened. It is not to save this one financial institution, but because through derivatives, the consequences of their failure are transported to so many other financial institutions.

And so I was wondering if you could maybe elaborate on that piece of the puzzle, of the role of derivatives in too big to fail and how you think that we reduce that risk.

Mr. BERNANKE. I don't think that derivatives are by any means the only issue. One example would be that we have had very destructive financial crises in the 1930s and in other contexts where derivatives weren't really much of an issue at that point. But clearly in this crisis, they were a big issue, and one of the main problems was that they weren't appropriately overseen, which meant in many cases they were not protected by capital reserves. The classic case would be AIG, which had a lot of one-way bets, one-directional bets, but even though it was a kind of insurance they were selling, because it wasn't regulated, they didn't have reserves or capital be-

hind that, and then, of course, when the bet went wrong, then the company came under a lot of pressure.

One thing that the AIG example illustrates, by the way, is that derivatives have not only the risk associated with the outcome of the underlying security, but also counterparty risk, so that those people who were holding AIG insurance faced not only the possibility of loss because of the underlying, but also because of the possibility that AIG could not pay. So clearly, making derivatives safer, both in an operational sense, in the way they are traded, but also in terms of protecting against counterparty risk, is a very important part of this reform.

I agree with proposals that have been made that derivatives that can be standardized, and that is quite a few of them, and are accepted by central counterparties or exchanges or clearinghouses for clearing on those institutions should be traded on a central counterparty, which would be an organization which, by taking margin and holding capital, essentially ensures against counterparty risks, protects the participants against counterparty risks.

Also, by having trading on a clearinghouse, we will have a much more transparent situation. People will know what outstanding positions look like. There will be no problems, as we had with credit default swaps, with transactions which are not cleared in a timely way so there is confusion about who owes what to whom.

So I do think that strengthening the infrastructure generally—settlements, payments, clearing—but in particular, making sure derivatives are traded, where possible, on a central counterparty or on an exchange, is an important step to making the system stronger, and it ties into too big to fail in a couple of ways. One is if you get rid of the counterparty risk, you reduce the contagion. So in the case of AIG, if AIG had failed, the implications for the counterparties would have been less because the counterparty risk would have been eliminated.

And second, you should be regulating those derivatives to make sure that you don't have a situation where a company is essentially betting the bank, saying that if the coin comes up heads, then we make a lot of money. If the coin comes up tails, then the government bails us out. I mean, that is not a situation that we want to have.

So good regulation of derivatives positions, including uncustomized derivatives, would also be part of a new regime.

Senator MERKLEY. If I could summarize what you just said, you said you support moving to an exchange, and as you put it, for all the derivatives that could be standardized. Of course, we have the challenge of deciding to what degree derivatives can be standardized. We have a lot of end users who are also very resistant to the idea of going to an exchange because they feel that the margin costs would impede their ability to hedge, and that might be an argument that is coming forward regardless of the ability to standardize. Any thoughts about that issue?

Mr. BERNANKE. Well, I think the case for exceptions is not the margin costs. So that is an appropriate cost of just protecting against the counterparty risk. The case for not putting everything on the exchange is that some risks are not hedgeable through

standard derivatives. It could be that I, as a municipality, want to hedge against some complicated set of events that might occur and there is no way that a derivative can be written that would be standardizable that would meet my needs. So there are going to be circumstances where derivatives are not customizable and they are still providing a useful hedging service.

There are a couple of practical issues that come up there. I think one of them is what exemptions do you give on the end user side, and I think the main goal there is to avoid getting around the regulations through indirect means of setting up these deals. For legitimate end users who are nonfinancial companies who need to hedge some specific risks, we ought to try to make it possible for them to do that.

But on the other side, if they are transacting, for example, with a bank or a dealer, the bank or the dealer should face regulations or capital requirements both to make sure that they are safe in the positions that they are taking, but also to internalize the cost, the potential cost to the system. There is a risk associated with these derivatives not traded on central counterparties. If the bank knows that it has to hold a certain amount of capital against its nonstandardized positions, that will increase its effective cost of offering those positions and that will, in some sense, balance the scales so there is not an artificial incentive to create noncustomized derivatives.

So it is a balancing act, but we do want to leave some space for derivatives that are specialized for individual needs.

Senator MERKLEY. So the challenge of drawing that line between what is customized and providing that opportunity, if you will, to address it, also, then, the challenge that I think this is—I think this is what you are saying, but I will just repeat it and make sure I understand—is that you want to have appropriate boundaries on that to prevent that exception from being something that the entire derivative market is driven through.

Mr. BERNANKE. That is right.

Senator MERKLEY. And then were you saying that there need to be fees based on OTC derivatives as part of that inherent risk to the system?

Mr. BERNANKE. Well, not necessarily fees, but to the extent that you have nonstandardized OTC derivatives, there should be sufficient capital behind them and sufficient oversight of their positions so that, A, the institution is not being put into mortal danger by its positions that it has taken, and B, the extra capital is, in fact, a kind of cost, and that would tend to even the playing field between customized and noncustomized derivatives.

Senator MERKLEY. Mr. Chair, can I put in one more question here?

Chairman DODD. Yes, quickly. We have got a vote here coming up.

Senator MERKLEY. A quick question, then. You referred earlier to the fact that you didn't feel in the AIG situation that you all had much leverage in terms of asking institutions to take a haircut. It is a little hard for ordinary Americans and some of us, myself included, to get my hands around that, because if the risk is that folks might have a tremendous loss, it seems like they would be

ready to come to the table and say, we will mitigate that by taking some share. But let us just say that in that crisis, that moment, the need to move fast, that wasn't possible. Are there things that we should do in structuring this bill that in the future, when that situation arises that gives the sort of leverage that would make sense to enable the Fed to drive a better deal, if you will?

Mr. BERNANKE. Absolutely. My earlier response, I didn't want to convey that we didn't want to get the haircut. We really did and we tried. The problem under the existing system is that the only way to get the haircut is to have a credible threat that, well, if you don't take the haircut, we are going to go bankrupt and you are going to lose everything. But, of course, since we had intervened to prevent AIG from going bankrupt and everybody knew that the collapse of AIG would have catastrophic implications for the financial system, it just wasn't credible that we would let that happen and so we didn't have the leverage.

So it was a bad outcome, absolutely, I agree, but we really didn't have much choice given the legal structure we were in. By all means, the reform ought to fix that, and in particular, when the government comes in, the Treasury, the FDIC comes in to unwind a systemically critical financial firm, it should be using a special bankruptcy procedure, not the usual one, a special procedure which allows the government to, under perhaps some specified rules in advance, to take haircuts, not to protect the equity holders, the subordinated debt holders, for example, at the same time that you are still having a safe wind-down.

So I think if you structure this resolution authority, one of the many benefits of it will be that the government will be able to put the cost on the creditors. It will be able to renegotiate contracts, including bonuses and things of that sort. Those are all the things we needed, but we didn't have in the current system.

Senator MERKLEY. Thank you. Thank you very much.

Chairman DODD. Thank you very much.

We are going to briefly turn to my colleague from Alabama and then have brief closing remarks. But then Senator Corker wants to come back and he has a question or two for you, as well, Mr. Chairman.

Senator SHELBY. Thank you, Mr. Chairman. I will try to be brief, Mr. Chairman.

Chairman Bernanke, I believe that the last few years have provided us with ample evidence to conclude that the current regulatory structure that we have, one in which the Fed serves as the preeminent regulatory body, requires considerable restructuring. In fact, I believe the American people realize that. I also believe, too, that the Fed's monetary policy independence is crucial and it must be preserved. Very important to the central bank.

Fortunately, the regulatory reform process gives us here, I think, a chance to develop a better, more accountable regulatory structure and enhance the real and perceived independence of the Federal Reserve as a monetary policy setting entity. Very important.

But to achieve these ends, I think the Fed will have to give up some of the regulatory authority, as Senator Dodd has proposed. I would hope that you, as the Chairman, in the interest of achieving better regulation and better monetary policy and independence of

the Fed, would put the monetary policy ahead of your interest, of the Fed's interest, in protecting turf.

Mr. Chairman, I do have, and this is just a short letter and I want to share it and I would like it to be made part of the record.

Chairman DODD. Without objection.

Senator SHELBY. This is a letter in *The Washington Post* today, and some of you have probably read it, but it was written by Vincent Reinhart. He is a resident scholar at the American Enterprise Institute and it has to do with the proposals Chairman Dodd has made.

It says, "Regarding Federal Reserve Chairman Ben Bernanke's November 29 Sunday Opinion commentary, 'The Right Reform for the Fed,'" that you wrote, "As a result of legislative convenience, bureaucratic imperative and historical happenstance, a variety of responsibilities have accreted to the Fed over the years. In addition to conducting monetary policy, the Fed also distributes currency, runs the system through which banks transfer funds, supervises financial holding companies and some banks, and writes rules to protect consumers in financial transactions. Mr. Bernanke argues that preserving this melange is not only efficient but crucial to protecting the Fed's independence.

"Apparently," the letter goes on, "the argument runs, there are hidden synergies that make expertise in examining banks and writing consumer protection regulations useful in setting monetary policy. In fact, collective diverse responsibilities in one institution fundamentally violates the principle of comparative advantage, akin to asking a plumber to check the wiring in your basement."

"There is an easily verifiable test," he writes. "The arm of the Fed that sets monetary policy, the Federal Open Market Committee, has scrupulously kept transcripts of its meetings over the decades," and this man writing this says, "I should know, I was the FOMC Secretary for a time." And then, "After a lag of 5 years, this record is released to the public. If the FOMC made materially better decisions because of the Fed's role in supervision, there should be instances of informed discussion of the linkages. Anyone making the case for beneficial spillover should be asked to produce numerous relevant excerpts from that historical resource. I don't think they will be able to do so."

He writes further, "The biggest threat to the Fed's independence is doubt about its competence. The more the Congress expects the Fed to do, the more likely will such doubts blemish its reputation."

I ask that this letter be put in the record.

Chairman DODD. Without objection, it will be included.

Mr. Chairman, Senator Corker will come over and close up here, but let me—first of all, I want to thank Senator Shelby for his comments about the effort we are making, and I want to thank you, as well, and your staff. You have been tremendously helpful already and very constructive.

I was one of those people in that room on the night of September 18 when you and Hank Paulson came into the room, and there are a lot of people going back, and I will go to my grave believing that what you did—what we did—over that 2-week period, sort of the economic equivalence almost of 9/11 in ways as you described it that evening in a very straightforward, monotone voice—I will

never forget your words—will go down as the right thing to have done. And he is not here now, but Judd Gregg, Bob Corker, Jack Reed, Chuck Schumer, on this side, anyway, we met along with some others and worked with you and others in putting that proposal together. You deserve, in my view, a great deal of credit for moving that forward and then the creative ideas that kept us out of the difficulty. Proving a negative is always hard, and obviously we don't ever want to be in a situation to have to prove that. But nevertheless, I think we did by the actions that were taken.

I also want to underscore something Judd said about the idea of having something big is bad. I think that is a bad idea and we don't include that. I think the idea that you have described in how you require capital standards and so forth to make sure that you don't have an institution be at risk makes a lot of sense, as well.

And the door is open here. Look, we are very much in the process. This is a dynamic process we are engaged in. I strongly support your confirmation. And as I said at the outset, I believe you are the right person at the right time to do this job. But I want you to know the door is open as we are trying to evaluate how best to do this.

I think all of us here very much appreciate this is a unique moment we are getting. There have been many others before us who have talked about doing this, but there was never the will to do it. If there is any silver lining in what we have been through, and the fact that we had 52 hearings this year on this subject alone in this Committee, it is because we are in this moment. If we wait too long, the moment passes. And people will say, well, look, things are going well. Why bother? If we had acted too early, we might have overreacted, in my view, and that would have been bad, as well.

So we are right in this kind of sweet spot in which I think we have a chance, and I believe there is a common determination by virtually everybody on this Committee, Democrat and Republican, not seeing this ideologically, but what works, what doesn't, what is right, what is wrong, and we invite you and your staff and others to be at that table with us as we go through this, not to suggest that we are going to agree on everything, but I want you to know that door is open.

Senator SHELBY. Mr. Chairman, could I say one thing?

Chairman DODD. Yes, sir.

Senator SHELBY. I agree with Senator Dodd. I don't think big is necessarily bad.

Chairman DODD. No.

Senator SHELBY. But I do believe big is bad when it has an implicit——

Chairman DODD. I agree.

Senator SHELBY. ——response out there with the marketplace that the government is backing it.

Chairman DODD. I agree with that.

Senator SHELBY. That is bad, Mr. Chairman.

Mr. BERNANKE. I agree, as well.

Chairman DODD. We all agree on that.

Senator Corker, you are——

Senator CORKER. Thank you.

Chairman DODD. I am going to go over and vote. You are in charge.

Senator CORKER. When you come back, you will never know what may have happened to this place.

[Laughter.]

Senator CORKER. But I will try to behave like a gentleman, sir.

Chairman DODD. Thank you, Mr. Chairman.

Mr. BERNANKE. Thank you.

Senator CORKER [presiding]. Mr. Chairman, I thank you for being with us so long, and I think you know that I was happy that the administration decided to renominate you. And I think you knew coming into these confirmations, unless something really strange happened, that I was going to support you, and I am. OK?

I am becoming slightly frustrated, though, and I know that you are probably going to be confirmed, and I do not know when that is going to happen. You know, it may be held off until after reg reform occurs, as I mentioned to you the other day on the phone. It may happen before. You are the Fed Chairman regardless. I mean, I think you are the Fed Chairman until another Fed Chairman is nominated and approved, and I think that is the case. Your staff is nodding no, but that is debatable, I guess.

But I have worked very closely with you over the last year, which I appreciate, or year and a half. And we have talked about a lot of things important to our country. And what I have appreciated about you is I absolutely do not believe you have a political cell in your body, as I have said publicly many times, and I really believe you wake up every day trying to do what you think is best for our country.

But I am concerned—and I am becoming sort of frustrated with it—that the activity—I mean, you have worked very closely with both administrations. This is not partisan. I think much of that has hurt your credibility some. And just as you mentioned, as we talked earlier in our last exchange, on the fiscal side I do think that you end up getting used as a tool for administrations to advance policies that they think is good, it is outside the monetary policy issue. And I just would caution you, I think that hurts you. OK?

The Bush, the stimulus was ridiculous. I mean, it was silly. It was sophomoric, and it had no effect, and you supported it. And when you support it, I mean, what happens on the Senate floor when Ben Bernanke says that he supports something, because of the respect not only of you but the position, that has an effect. Same thing with the Obama stimulus, which, you know, regardless of what people say, it did not accomplish what they said it would do, and I think it was certainly less than a stimulus. And we can debate that. It does not really matter. That is not what matters. What matters to me is that you weighed in, and when you weigh in on something, it is like it gets the Moody's rating—not that Moody's rating matters much anymore. But that is what it does.

I think the same thing is happening right now in financial regulation. And as I said way back when, long before this, 6 to 8 months ago, at maybe the last Humphrey Hawkins meeting, I think to the extent that the Fed continues to thrust itself in the middle of things, you know, being the systemic regulator, which,

again, we are going to have another systemic risk, we are going to have another failure, we are going to have—I do not care who the Fed Chairman is. I do not care what kind of reg bill we pass. It is going to happen. And it just seems to me that the more you thrust yourself in the middle of those things that are outside of monetary policy and outside of being lender of last resort, the more you do things to damage the institution.

And I say that because I respect the institution, and just like Judd Gregg said and just like I think I said in my comments, I do not want us involve in monetary policy. I think that would be a disaster not only for our country, but for every country that does business with us, which is every country.

So I am becoming—you know, I know you are lobbying us heavily right now as far as what the Fed role should be in regulation. And on a private basis, I want to hear that. I mean, just a minute ago, I know that you alluded to Chairman Dodd's bill, and I have to tell you—and everyone on his staff knows this—I very much appreciate what he is doing to try to work out a bipartisan bill, and I think we are going to do that. At least I am going to keep saying I think we are going to do that until I think we are not, OK? But just like, for instance, saying a minute ago that you think this bill absolutely solves too big to fail. Well, at least that is what was reported to me, and I——

Mr. BERNANKE. No, I——

Senator CORKER. Please clarify that, because as much as I respect him, I think there are some frailties in the legislation.

Mr. BERNANKE. I only talked about some general elements. I certainly did not endorse the bill.

Senator CORKER. Good. I got an e-mail in another meeting, and I am glad—well, I just think that you are highly respected, the position is highly respected. I think the more the Fed throws itself in the middle of things that are outside the categories that it is charged to do, the chances are—maybe not you but the next person down the road—the Fed's independence ends up being undermined. And there is no question to me that the efforts by Congressman Paul and others to do the things that are occurring right now, I know his longer-term goal is—I understand he is a gold standard person. I understand there are other goals behind that. But I do think that much of what has happened recently and the hyperactivity of some of 13.3 issues, with Maiden Lane and AIG, I mean, you know, that is kind of questions. It ended up sort of being equity, and I do not mean that, again, to poke jabs, but that type of activity ends up hurting the Fed, an institution that, like Judd Gregg and others, I respect, you I respect. And I guess over the last 45 days or so, I have become very nervous about that activity. And I just want to tell you that. And I am nervous about us and what we might do, but I am also beginning to be nervous about the powers that you at the Fed want to take on, that Treasury is encouraging you to take on, and I just wondered if you might respond to that knowing that I am somebody who, unless the sky falls in, I am going to support your nomination. And I respect your abilities and intellect, and I appreciate what you have tried to do on behalf of our country. But I am concerned about what that is actually doing to the Fed itself.

I do not now if you are understanding. I do not know if I am expressing myself well.

Mr. BERNANKE. You expressed yourself well, Senator. I would like to respond briefly, if I could. First of all, I thank you for the conversations we have had. It has been very good to work with you.

First, your point on fiscal policy, I have tried to stay out of fiscal policy. I will be more vigilant in the future. I think there is an appropriate division of labor: Congress and the administration, fiscal policy; Federal Reserve, monetary policy. And I will try to do that, although I should say that I think there are some broad general issues like the deficit, for example, where the Federal Reserve Chairman does have some responsibility to speak up, and I think I will have to continue to do that.

Senator CORKER. And I am speaking more to specific policy proposals.

Mr. BERNANKE. Right.

Senator CORKER. And I think——

Mr. BERNANKE. Well, even in the cases you cite, I never said anything more than maybe it is time to think about this general thing. I never endorsed any particular plan. I never endorsed any components of it or any size or anything like that. But I take your point.

Second, some of the steps we have taken, like the AIG episode, for example, obviously have hurt the Fed a lot politically. We know that. And I think that should just be proof that we did it for the good of the country. We did not do it for ourselves, because it obviously has hurt the Federal Reserve in the public's view. We did it because we felt that there was no other way to avoid what a number of your colleagues have called the risk of a catastrophic collapse of the financial system. And so we did what we did knowing it would be politically unpopular, knowing it would bring down problems for the Federal Reserve, but because we did not have an alternative. And one of the things we are hoping, of course, that the Congress will come up with will be some framework that will allow this to be done in a more orderly way and will leave the Federal Reserve completely out of it. And we would like to be left out of it.

On financial stability, I would like to differ just a little bit, which is that the Federal Reserve actually was founded in 1913 for financial stability purposes, not monetary policy, and it has been a big part of financial stability for 100 years almost. We have not been lobbying. What we have been doing, if anything, is trying to provide advice and our reasoned views on the subject. And what some might think of as turf in my view is an important component of thinking about how a successful financial stability program ought to be structured.

So given that that is very much in our domain, I do not want to use undue influence, but to the extent that we have arguments and positions to take, I only ask you to believe that we do it based on what our view is of the appropriate public policy and not because of turf. And you will notice that we have not used the same kind of energy on some other aspects, that this has been the thing which we view as critical, and I actually do believe that if the Federal Reserve is completely eliminated from financial stability pol-

icy, it will have very negative consequences at some time in the future when neither you nor I may be here.

So I hope you will understand that on that particular issue we do feel we have a stake and an expertise and that we are trying just to get the right policy.

Senator CORKER. Well, I appreciate that, and I also apologize for being given some information about the hearing a minute ago that apparently was off base, and certainly I am very glad you cleared that up. And I would just echo the same thing that Chairman Dodd just said, and that is, I think that we, all of us here, just are trying to get it right, and I think it is really hard. I think the resolution piece and the too-big-to-fail piece is the most important. If we do nothing else over the course of the next several months but solve that, I think it is the most important thing, and in my opinion, if we only did that, that would be fine.

I hope that you will, you know, continue to talk with us in our offices, both privately and in any other setting, to help us work through this. And my comments today, again, are not in any way to—they are just to say that, look, my antenna right now makes me feel nervous about the hyperactivity and the unintended consequences of what could happen down the road. I mean, you responded aggressively during this last cycle, and as has been said, you know, you are being criticized for responding aggressively. And I think if we allow the Fed's role in our financial system to become something far greater than it should be—there is an appropriate level, I understand—but far greater than it should be, we are going to set ourselves up to do some ultimate longer-term damage to our country.

Anyway, thank you for letting me talk with you. I know all of us could Monday morning quarterback the many zillion calls that you have had to make over the last year or so, and with little information and little time. I respect you for what you are doing. I thank you for coming and being so patient with us today, and I do look forward to over the next couple months with Chairman Dodd's staff and Ranking Member Shelby's staff and all of us working together to try to get it right, and I thank you.

Mr. BERNANKE. Thank you.

[Whereupon, at 3:13 p.m., the hearing was adjourned.]

[Prepared statements, biographical sketch of nominee, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR TIM JOHNSON

Thank you Chairman Dodd and Ranking Member Shelby for holding the nomination hearing for Ben Bernanke to serve another term as Chairman of the Federal Reserve Board of Governors. This will be one of the most important nomination hearings the Banking Committee will hold all year, as the Administration and Congress continue to look for ways to restore our Nation's financial stability, promote economic recovery, and work on legislation to ensure that another economic crisis like the one we faced last year never happens again.

While there has certainly been criticism of the Federal Reserve for not doing enough to protect consumers and for the unprecedented actions it took during the financial crisis, there is also consensus that Mr. Bernanke kept our Nation out of a Depression and has kept inflation in check. As our Nation recovers, and faces additional challenges in the months ahead, there is no doubt that having one of the world's foremost experts on the Great Depression at the helm of the Federal Reserve is a benefit to our Nation as a whole.

As it is the Fed's independence and its ability to carry out day-to-day decisions about monetary policy without the intrusion of Congress that strengthens the Fed's credibility in the eyes of the private sector and allows it to follow policies that maximize price stability and economic stability, I do question what other responsibilities the Fed should have. Should the Fed supervise the biggest banks? Were the stress tests effective? Has the Fed constrained excessive risk-taking in the financial sector? Has the Fed done enough since the crisis to improve its oversight of bank holding companies and to be able to predict and prevent the next crisis? Does the Fed have too much power and responsibility and should Congress designate some of the Fed's obligations to other agencies? These are all questions that this Committee must consider in the coming weeks with regulatory reform legislation. Finding the right answers to these questions is important to our Nation's economic stability.

All this said, the Fed has economic and financial expertise that is unrivaled, and I believe that Mr. Bernanke has rightly been renominated for this post. I look forward to the opportunity to hear Mr. Bernanke's testimony, and to hear his responses to my questions and my colleagues' questions.

PREPARED STATEMENT OF BEN S. BERNANKE

TO BE CHAIRMAN,

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,

DECEMBER 3, 2009

Chairman Dodd, Senator Shelby, and Members of the Committee, I thank you for the opportunity to appear before you today. I would also like to express my gratitude to President Obama for nominating me to a second term as Chairman of the Board of Governors of the Federal Reserve System and for his support for a strong and independent Federal Reserve. Finally, I thank my colleagues throughout the Federal Reserve System for the remarkable resourcefulness, dedication, and stamina they have demonstrated over the past 2 years under extremely trying conditions. They have never lost sight of the importance of the work of the Federal Reserve for the economic well-being of all Americans.

Over the past 2 years, our Nation, indeed the world, has endured the most severe financial crisis since the Great Depression, a crisis which in turn triggered a sharp contraction in global economic activity. Today, most indicators suggest that financial markets are stabilizing and that the economy is emerging from the recession. Yet our task is far from complete. Far too many Americans are without jobs, and unemployment could remain high for some time even if, as we anticipate, moderate economic growth continues. The Federal Reserve remains committed to its mission to help restore prosperity and to stimulate job creation while preserving price stability. If I am confirmed, I will work to the utmost of my abilities in the pursuit of those objectives.

As severe as the effects of the crisis have been, however, the outcome could have been markedly worse without the strong actions taken by the Congress, the Treasury Department, the Federal Reserve, the Federal Deposit Insurance Corporation, and other authorities both here and abroad. For our part, the Federal Reserve cut interest rates early and aggressively, reducing our target for the Federal funds rate to nearly zero. We played a central role in efforts to quell the financial turmoil, for example, through our joint efforts with other agencies and foreign authorities to avert a collapse of the global banking system last fall; by ensuring financial institu-

tions adequate access to short-term funding when private funding sources dried up; and through our leadership of the comprehensive assessment of large U.S. banks conducted this past spring, an exercise that significantly increased public confidence in the banking system. We also created targeted lending programs that have helped to restart the flow of credit in a number of critical markets, including the commercial paper market and the market for securities backed by loans to households and small businesses. Indeed, we estimate that one of the targeted programs—the Term Asset-Backed Securities Loan Facility—has thus far helped finance 3.3 million loans to households (excluding credit card accounts), more than 100 million credit card accounts, 480,000 loans to small businesses, and 100,000 loans to larger businesses. And our purchases of longer-term securities have provided support to private credit markets and helped to reduce longer-term interest rates, such as mortgage rates. Taken together, the Federal Reserve's actions have contributed substantially to the significant improvement in financial conditions and to what now appear to be the beginnings of a turnaround in both the U.S. and foreign economies.

Having acted promptly and forcefully to confront the financial crisis and its economic consequences, we are also keenly aware that, to ensure longer-term economic stability, we must be prepared to withdraw the extraordinary policy support in a smooth and timely way as markets and the economy recover. We are confident that we have the necessary tools to do so. However, as is always the case, even when the monetary policy tools employed are conventional, determining the appropriate time and pace for the withdrawal of stimulus will require careful analysis and judgment. My colleagues on the Federal Open Market Committee and I are committed to implementing our exit strategy in a manner that both supports job creation and fosters continued price stability.

A financial crisis of the severity we have experienced must prompt financial institutions and regulators alike to undertake unsparing self-assessments of their past performance. At the Federal Reserve, we have been actively engaged in identifying and implementing improvements in our regulation and supervision of financial firms. In the realm of consumer protection, during the past 3 years, we have comprehensively overhauled regulations aimed at ensuring fair treatment of mortgage borrowers and credit card users, among numerous other initiatives. To promote safety and soundness, we continue to work with other domestic and foreign supervisors to require stronger capital, liquidity, and risk management at banking organizations, while also taking steps to ensure that compensation packages do not provide incentives for excessive risk-taking and an undue focus on short-term results. Drawing on our experience in leading the recent comprehensive assessment of 19 of the largest U.S. banks, we are expanding and improving our cross-firm, or horizontal, reviews of large institutions, which will afford us greater insight into industry practices and possible emerging risks. To complement on-site supervisory reviews, we are also creating an enhanced quantitative surveillance program that will make use of the skills not only of supervisors, but also of economists, specialists in financial markets, and other experts within the Federal Reserve. We are requiring large firms to provide supervisors with more detailed and timely information on risk positions, operating performance, and other key indicators, and we are strengthening consolidated supervision to better capture the firmwide risks faced by complex organizations. In sum, heeding the lessons of the crisis, we are committed to taking a more proactive and comprehensive approach to oversight to ensure that emerging problems are identified early and met with prompt and effective supervisory responses.

We also have renewed and strengthened our longstanding commitment to transparency and accountability. In the making of monetary policy, the Federal Reserve is highly transparent, providing detailed minutes 3 weeks after each policy meeting, quarterly economic projections, regular testimonies to the Congress, and much other information. Our financial statements are public and audited by an outside accounting firm, we publish our balance sheet weekly, and we provide extensive information through monthly reports and on our Web site on all the temporary lending facilities developed during the crisis, including the collateral that we take. Further, our financial activities are subject to review by an independent inspector general. And the Congress, through the Government Accountability Office, can and does audit all parts of operations, except for monetary policy and related areas explicitly exempted by a 1978 provision passed by the Congress. The Congress created that exemption to protect monetary policy from short-term political pressures and thereby to support our ability to effectively pursue our mandated objectives of maximum employment and price stability.

In navigating through the crisis, the Federal Reserve has been greatly aided by the regional structure established by the Congress when it created the Federal Reserve in 1913. The more than 270 business people, bankers, nonprofit executives,

academics, and community, agricultural, and labor leaders who serve on the boards of the 12 Reserve Banks and their 24 Branches provide valuable insights into current economic and financial conditions that statistics cannot. Thus, the structure of the Federal Reserve ensures that our policymaking is informed not just by a Washington perspective, or a Wall Street perspective, but also a Main Street perspective.

If confirmed, I look forward to working closely with this Committee and the Congress to achieve fundamental reform of our system of financial regulation and stronger, more effective supervision. It would be a tragedy if, after all the hardships that Americans have endured during the past 2 years, our Nation failed to take the steps necessary to prevent a recurrence of a crisis of the magnitude we have recently confronted. And, as we move forward, we must take care that the Federal Reserve remains effective and independent, with the capacity to foster financial stability and to support a return to prosperity and economic opportunity in a context of price stability.

Thank you again for the opportunity to appear before you today. I would be happy to respond to your questions.

STATEMENT FOR COMPLETION BY PRESIDENTIAL NOMINEES

Name:	**Bernanke**	**Ben**	**Shalom**
	(Last)	(First)	(Other)

Position to which nominated: **Chairman, Board of Governors of the Federal Reserve System**

Date of nomination:

Date of birth: **13** (Day) **12** (Month) **1953** (Year)   **Place of birth:** **Augusta, Georgia**

Marital Status: Married   **Full name of spouse:** **Anna Friedmann Bernanke**

Name and ages of children:

Joel Asher Bernanke, age 26

Alyssa Gail Bernanke, age 23

Education:

Institution	Dates attended	Degrees received	Dates of degrees
Harvard University	1971-75	B.A.	1975
Massachusetts Institute of Technology	1975-79	Ph.D.	1979

Honors and awards: List below all scholarships, fellowships, honorary degrees, military medals, honorary society memberships and any other special recognitions for outstanding service or achievement.

Fellow, American Academy of Arts and Sciences, 2001-present.
Guggenheim Fellowship, 1999-2000.
Fellow, Econometric Society, 1992-present.
Alfred P. Sloan Research Fellow, 1983-84.
Hoover Institution National Fellow, 1982-83.
National Science Foundation Graduate Fellow, 1975.
Allyn Young Prize (for best Harvard undergraduate economics thesis), 1975.
John H. Williams Prize (for outstanding senior in the Harvard Economics Department), 1975.
Phi Beta Kappa, 1975.

Memberships: List below all memberships and offices held in professional, fraternal, business, scholarly, civic, charitable and other organizations.

Organization	Office held (if any)	Dates
American Economic Association	Member	1979-2002
	Editor, American Economic Review	2001-2004
Econometric Society	Fellow	1992-present
American Academy of Arts and Sciences	Fellow	2001-present
National Bureau of Economic Research		
	Research Associate	1980-2002
	Director, Program in Monetary Economics	2001-2002
	Coeditor, Macroeconomics Annual	2001-2002
	Member, Business Cycle Dating Committee	2001-2002
Montgomery (NJ) Board of Education	elected member	1994-2000

Employment record: List below all positions held since college, including the title or description of job, name of employment, location of work, and inclusive dates of employment.

Chairman, Board of Governors, Federal Reserve System, February 2006-present.

Chairman, Council of Economic Advisers, June 2005-January 2006.

Member, Board of Governors, Federal Reserve System, August 2002-June 2005.

Howard Harrison and Gabrielle Snyder Beck Professor of Economics and Public Affairs, Princeton University, 1996-2005. Department Chair, 1996-2002. Class of 1926 Professor of Economics and Public Affairs, Princeton University, 1994-1996. Professor of Economics and Public Affairs, Princeton University, 1985-1994.

Associate Professor of Economics, Graduate School of Business, Stanford University, 1983-1985.

Assistant Professor of Economics, Graduate School of Business, Stanford University, 1979-1983.

Morgenstern Visiting Professor, Department of Economics, New York University, Fall 1993.

Visiting Professor, Department of Economics, M.I.T., Fall 1983; academic year, 1989-90.

Teaching Fellow, M.I.T., 1978-79.

Government experience: List any experience in or direct association with Federal, State, or local governments, including any advisory, consultative, honorary or other part time service or positions.

Chairman, Board of Governors, Federal Reserve System, February 2006-present.

Chairman, Council of Economic Advisers, June 2005-January 2006.

Member, Board of Governors of the Federal Reserve, Aug 2002-June 2005.

Member, Montgomery Township (NJ) Board of Education, 1994-2000.

Visiting Scholar, Federal Reserve System - Philadelphia (1987-89). Boston (1989-90), New York (1990-91, 1994-96).

Member, Academic Advisory Panel, Federal Reserve Bank of New York, 1990-2002.

Member, U.S.-Israel Joint Economic Development Group (U.S. State Department), 1997-2002.

U.S. Census Advisory Board, 1986-89.

Published Writings: List the titles, publishers and dates of books, articles, reports or other published materials you have written.

Publications: Articles

"Measuring the Effects of Monetary Policy: A Factor-Augmented Vector Autoregression (FAVAR) Approach." Quarterly Journal of Economics, February 2005, pp. 387-422. With Jean Boivin and Piotr Eliasz.

"Monetary Policy Near the Zero Bound: An Empirical Analysis." Brookings Papers on Economic Activity, 2004:2, pp. 1-100. With Vincent Reinhart and Brian Sack.

"Why Does Monetary Policy Affect the Stock Market?". Journal of Finance, June 2005, vol. 60, no. 3, pp. 1221-57. With Kenneth Kuttner.

"Monetary Policy in a Low-Interest-Rate Environment," American Economic Review, Papers and Proceedings, May 2004, vol. 94, no. 2, pp. 85-90. With Vincent Reinhart.

"Monetary Policy in a Data-Rich Environment", Journal of Monetary Economics, April 2003, vol. 50, no. 3, pp. 525-46. With Jean Boivin.

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"The Financial Accelerator in a Quantitative Business Cycle Framework." With Mark Gertler and Simon Gilchrist. In John Taylor and Michael Woodford, eds., Handbook of Macroeconomics, Amsterdam: North Holland, 2000, chapter 21.

"The Liquidity Effect and Long-Run Neutrality", in Charles Plosser and Allan Meltzer, eds., Carnegie-Rochester Conference Series on Public Policy, 1999, vol. 49, no. 1, pp. 149-94. With Ilian Mihov.

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"Inflation Targets and Monetary Policy", Journal of Money, Credit, and Banking, November 1997, vol. 29, no. 4(2), pp. 653-84. With Michael Woodford.

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"Procyclical Labor Productivity and Competing Theories of the Business Cycle: Some Evidence from U.S. Interwar Manufacturing Industries", Journal of Political Economy, June 1991, vol. 99, no. 3, pp. 438-59. With Martin Parkinson.

"On the Predictive Power of Interest Rates and Interest Rate Spreads", New England Economic Review, Federal Reserve Bank of Boston, November-December 1990, pp. 51-68.

"The Gold Standard, Deflation, and Financial Crisis in the Great Depression: An International Comparison", in R. Glenn Hubbard, ed., Financial Markets and Financial Crises, Chicago: University of Chicago Press for NBER, 1991. With Harold James.

"U.S. Corporate Leverage: Developments in 1987 and 1988", Brookings Papers on Economic Activity, 1990:1, pp. 255-78. With John Y. Campbell and Toni M. Whited.

"Clearing and Settlement During the Crash", Review of Financial Studies, 1990, vol. 3, no. 1, pp. 133-51.

"Financial Fragility and Economic Performance", Quarterly Journal of Economics, February 1990, vol. 105, no. 1, pp. 87-114. With Mark Gertler.

"Unemployment, Inflation, and Wages in the American Depression: Are There Lessons for Europe?", American Economic Review, Papers and Proceedings, May 1989, vol. 79, no. 2, pp. 210-214. With Martin Parkinson.

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"Is There a Corporate Debt Crisis?", Brookings Papers on Economic Activity, 1988:2, pp. 83-125. With John Campbell.

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Publications: Expositional Pieces, Comments, Reviews

"The U.S. Current Account and the Dollar: Comment." Brookings Papers on Economic Activity, 2005:2.

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"Oil Shocks and Aggregate Macroeconomic Behavior: The Role of Monetary Policy: Reply." Journal of Money, Credit, and Banking, April 2004, Vol. 36, No. 2, pp. 287-91.

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"A Crash Course for Central Bankers", Foreign Policy, September-October 2000, p. 49.

"Comment on Rosengreen, Peek, and Tootell", in Frederic Mishkin, ed., Prudential Supervision: What Works and What Doesn't, University of Chicago Press for NBER, 2001, pp. 293-297.

"Comment on DeLong, 'America's Historical Experience with Low Inflation'", Journal of Money Credit and Banking, November 2000, Part 2, pp. 994-997.

"Missing the Mark: The Truth About Inflation Targeting", Foreign Affairs, September/October 1999, 158-161. With Thomas Laubach, Frederic S. Mishkin, and Adam S. Posen.

"Unanticipated Money Growth and the Business Cycle Reconsidered: Comment", Journal of Money, Credit, and Banking, November 1997, vol. 29, no. 4(2), pp. 649-52.

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"What Does Monetary Policy Do?: Comment", Brookings Papers on Economic Activity, 1996:2, pp. 69-73.

"What Do We Know About How Monetary Policy Affects the Economy?", Federal Reserve Bank of St. Louis Review, May/June 1995, vol. 77, no. 3, pp. 127-130.

"Historical Perspectives on the Monetary Transmission Mechanism: Comment", in N. Gregory Mankiw, ed., Monetary Policy, Chicago: University of Chicago Press, 1994.

"How Important is the Credit Channel in the Transmission of Monetary Policy?: A Comment", Carnegie-Rochester Conference Series on Public Policy, December 1993, vol. 39, pp. 47-52.

"The World on a Cross of Gold: A Review of Golden Fetters: The Gold Standard and the Great Depression, 1918-1939", Journal of Monetary Economics, April 1993, vol. 31, no. 2, pp. 251-267.

"Why Does the Paper-Bill Spread Predict Real Economic Activity? Comment", in James H. Stock and Mark W. Watson, eds., Business Cycles, Indicators, and Forecasting, Chicago: University of Chicago Press, 1993.

"The Cycle Before New-Classical Economics: Comment", in The Business Cycle: Theories and Evidence, Michael Belongia and Michelle Garfinkel, eds., Boston: Kluwer Academic Publishers, 1992.

"The Bank Credit Crunch", in Federal Reserve Bank of Chicago, Credit, Markets in Transition, Proceedings of the 28th Annual Conference on Bank Structure and Competition, 1992.

"Recent Trends in Corporate Leverage: Causes and Consequences", in Edward I. Altman, ed., The High-Yield Debt Market: Investment Performance and Economic Impact, Dow-Jones Irwin, 1990. With John Y. Campbell.

"'Regulation of Debt and Equity', by Kopcke and Rosengren: Comment", in Richard W. Kopcke and Eric S. Rosengren, eds., Are the Distinctions Between Debt and Equity Disappearing?, Federal Reserve Bank of Boston, October 1989.

"Comments on Corporate Debt", in Federal Reserve Bank of Chicago, Banking System Risk: Charting a New Course, Proceedings of the 25th Annual Conference on Bank Structure and Competition, 1989.

"Is There Too Much Corporate Debt?", Business Review, Federal Reserve Bank of Philadelphia, September-October 1989, pp. 3-13.

"Monetary Policy Transmission: Through Money or Credit?", Business Review, Federal Reserve Bank of Philadelphia, November-December 1988, pp. 3-11.

"'Crazy Explanations of the Productivity Slowdown', by Paul Romer: Comment", NBER Macroeconomics Annual, 1987.

"Review of: The Great Depression, 1929-1938, by Christian Saint-Etienne", Journal of Political Economy, August 1985, vol. 93, no. 4, pp. 831-35.

"Review of: Financial Crises, C. P. Kindleberger and J. P. Laffargue, eds.", Journal of Economic Literature, June 1983, vol. 21, no. 2, pp. 574-75.

"Rates of Return by Industrial Sector in the United States, 1948-1976: Discussion", American Economic Review, Papers and Proceedings, May 1980, vol. 70, no. 2, pp. 338-339. With J.I. Bulow.

"Review of: Factors in Business Investment, by Robert Eisner", Journal of Political Economy, August 1980, vol. 88, no. 3, pp. 811-813.

Publications: Books, Edited Volumes

NBER Macroeconomics Annual, Cambridge MA: MIT Press
Vol. 10, 1995.
Vol. 11, 1996.
Vol. 12, 1997.
Vol. 13, 1998.
Vol. 14, 1999.
Co-editor (with Julio J. Rotemberg).

Vol. 15, 2000.
Vol. 16, 2001.
Co-editor (with Kenneth Rogoff).

The Inflation-Targeting Debate. Co-editor (with Michael Woodford). Chicago: University of Chicago Press for NBER, 2005.

Inflation Targeting: Lessons from the International Experience. 1998. Princeton: Princeton University Press. With Thomas Laubach, Frederic Mishkin, and Adam Posen. Paperback, 2000.

Essays on the Great Depression. 2000. Princeton: Princeton University Press. Paperback, 2001.

Textbooks: Macroeconomics (with Andrew Abel). 6 editions. Pearson, 2008.
Principles of Economics (with Robert Frank). 4 editions. McGraw-Hill, 2008.

Political Affiliations and activities: List memberships and offices held in and services rendered to all political parties or election committees during the last 10 years.

None.

Political Contributions: Itemize all political contributions of $500 or more to any individual, campaign organization, political party, political action committee or similar entity during the last eight years and identify specific amounts, dates, and names of recipients.

None.

Qualifications: State fully your qualifications to serve in the position to which you have been named. (attach sheet)

I obtained a B.A. in economics summa cum laude at Harvard in 1975 and a Ph.D. in economics at M.I.T. in 1979. I was employed as a professor of economics at the Stanford Graduate School of Business (1979-85) and at Princeton University (joint appointment in the economics department and the in the Woodrow Wilson School of Public and International Affairs, 1985-2002), where I also served as department chair (1996-2002). I was the founding Director of the Bendheim Center for Finance at Princeton University, which houses research activities in finance as well as graduate and undergraduate educational programs.

I have published extensively on a broad range of economic topics (see above), with a particular focus on monetary policy, macroeconomics, and finance. Recognitions of my research accomplishments include numerous prizes and awards (see above). My research is widely cited and has been influential in policy analysis in central banks around the world. In 2001 I was named by the American Economic Association to serve as editor of the AEA's flagship research journal, the American Economic Review. I served as the Director of Monetary Economics and Member of the Business Cycle Dating Committee at the National Bureau of Economic Research, a nonprofit/nonpartisan organization that promotes economic research. I am the founding editor of the International Journal of Central Banking, a collaborative effort of the Federal Reserve and the other G-10 central banks. I have trained many graduate students in monetary economics and macroeconomics, including many currently working as economists in the Federal Reserve System or in other policy positions, both here and abroad.

As an academic I interacted regularly with the Federal Reserve System (including both regional Reserve Banks and the Board of Governors) as a visiting scholar or outside policy adviser. I have also visited and advised foreign central banks, including the European Central Bank when it was in its founding stage.

In 2002 I was nominated by President Bush and confirmed by the Senate to a partial term as a member of the Board of Governors of the Federal Reserve. I was nominated and confirmed to a full term in 2003. In 2005 I was nominated by the President and confirmed by the Senate to serve as the Chairman of the President's Council of Economic Advisers. In the fall of 2005 I was nominated by the President and confirmed by the Senate to become Chairman and Member of the Board of Governors of the Federal Reserve System. I have served as Chairman of the Board of Governors and Chairman of the Federal Open Market Committee since February 2006.

Future employment relationships:

1. Indicate whether you will sever all connections with your present employer, business firm, association or organization if you are confirmed by the Senate.

I would continue to be employed by the Board of Governors of the Federal Reserve System.

2. As far as can be foreseen, state whether you have any plans after completing government service to resume employment, affiliation or practice with your previous employer, business firm, association or organization.

I do not.

3. Has anybody made you a commitment to a job after you leave government?

No.

4. Do you expect to serve the full term for which you have been appointed?

Yes.

Potential conflicts of interest:

1. Describe any financial arrangements or deferred compensation agreements or other continuing dealings with business associates, clients or customers who will be affected by policies which you will influence in the position to which you have been nominated.

None.

2. List any investments, obligations, liabilities, or other relationships which might involve potential conflicts of interest with the position to which you have been nominated.

None.

3. Describe any business relationship, dealing or financial transaction (other than tax paying) which you have had during the last 10 years with the Federal Government, whether for yourself, on behalf of a client, or acting as an agent, that might in any way constitute or result in a possible conflict of interest with the position to which you have been nominated.

None.

4. List any lobbying activity during the past ten years in which you have engaged in for the purpose of directly or indirectly influencing the passage, defeat or modification of any legislation at the national level of government or affecting the administration and execution of national law or public policy.

None.

5. Explain how you will resolve any conflict of interest that may be disclosed by your responses to the items above.

Not applicable.

Civil, criminal and investigatory actions:

1. Give the full derails of any civil or criminal proceeding in which you were a defendant or any inquiry or investigation by a Federal, State, or local agency in which you were the subject of the inquiry or investigation.

None.

2. Give the full details of any proceeding, inquiry or investigation by any professional association including any bar association in which you were the subject of the proceeding, inquiry or investigation.

None.

2. List sources, amounts and dates of all anticipated receipts from deferred income arrangements, stock options, uncompleted contracts and other future benefits which you expect to derive from previous business relationships, professional services and firm memberships or from former employers, clients, and customers.

NONE

The undersigned certifies that the information contained herein is true and correct.

Signed: ______________________________ Date: 9-25-09

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM BEN S. BERNANKE

Q.1. With respect to the failure of Lehman Brothers, you stated in a speech delivered on August 21 of this year that: "As the Federal Reserve cannot make an unsecured loan, and as the government as a whole lacked appropriate resolution authority or the ability to inject capital, the firm's failure was, unfortunately, unavoidable." However, in the case of American International Group (AIG), it was judged that the firm had assets that were adequate to secure an $85 billion line of credit. Would the Chairman provide any documents prepared by the Fed detailing or analyzing the adequacy of collateral in the case of Lehman Brothers and in the case of AIG?

A.1. We are working with your staff and Committee staff to respond to requests for documents, which include information related to valuations of the assets that are collateral for the extensions of credit to AIG or related to AIG assets.

Q.2. Former New York Insurance Commissioner Eric Dinallo has testified that "the crisis for AIG did not come from its State regulated insurance companies." Does the Federal Reserve agree?

A.2. Many factors contributed to the imminent liquidity crisis that faced AIG in the fall of 2008. Among these factors were limitations on the authority of the State insurance commissioners to monitor and regulate significant risks that were taken by AIG (the parent holding company) and its unregulated subsidiaries, in particular AIG Financial Products. These risks imperiled the entire organization and, because of the scope, size, and interconnectedness of AIG, the financial system. A disorderly failure of AIG clearly would have placed additional pressures on, and magnified the risks facing, AIG's insurance subsidiaries, as well as financial markets and financial institutions generally. The resulting uncertainty could have led to a run by policyholders and creditors on the insurance industry as a whole.

Q.3. Former New York Insurance Commissioner Eric Dinallo has testified that "AIG life insurance companies would not have been insolvent" because of losses related to AIG's securities lending program. Does the Federal Reserve agree?

A.3. As the functional regulator of the New York-domiciled insurance subsidiaries of AIG, former Commissioner Dinallo would have been in the best position to determine whether the losses incurred as a result of AIG's securities lending program would have caused the New York-domiciled insurance subsidiaries to be insolvent under State insurance law and regulations. However, the securities lending program did create risks for the AIG organization and increased the liquidity pressures on AIG for the reasons noted above and in my previous testimonies. In addition, AIG's insurance subsidiaries had substantial derivatives exposures to AIG Financial Products and were interconnected with the parent company and its unregulated affiliates in a variety of operational and other ways. The failure of AIG during the period of severe financial and economic stress in the autumn of 2008 would have had severe consequences on AIG's insurance subsidiaries and the financial system.

Q.4. It is often mentioned that large systemically important firms should face higher capital, liquidity, or other requirements to reflect risks that they pose to the system. How exactly could the systemic risks be measured and the special requirements be tailored to effectively internalize systemic externalities that might arise from such firms? If it had the authority, would the Federal Reserve impose any special systemic-risk-based requirements on any institution that it oversees today?

A.4. One of the clear lessons of the crisis is that the capital, liquidity and risk-management requirements for large, interconnected firms need to be strengthened both to improve the safety and soundness of the individual institutions and to reflect the risks that these organizations pose to the financial system as a whole. As I have noted in speeches and testimonies, we are in the process of strengthening the prudential standards for the large financial institutions we supervise, working in collaboration with relevant domestic and foreign supervisors, and of adjusting our supervisory practices to take greater account of macroprudential considerations. The best methods of measurement and implementation of standards based on the systemic importance of organizations are still being worked out, and will likely require that regulators collect additional data from firms, but the need for heightened standards for systemically important institutions remains clear.

Q.5. In September 2008, the Treasury created a new "supplemental financing account," which, at its inception, held $500 billion obtained by the Treasury from selling a special issue of Treasury bills to the public. What was the reason for this large injection of funds by the Treasury into the Federal Reserve? Did the Federal Reserve ask the Treasury to establish a new supplemental financing account?

A.5. In September 2008, the Federal Reserve requested that the Treasury establish a Supplementary Financing Program (SFP) to help the Federal Reserve manage the balance sheet effects of the credit and liquidity initiatives that the Federal Reserve had undertaken to address severe strains in financial markets. Specifically, the SFP has facilitated the Federal Reserve's implementation of monetary policy by enhancing its control over the supply of bank reserves.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR JOHNSON FROM BEN S. BERNANKE

Q.1. Section 109 of the recently enacted "Credit Card Accountability Responsibility and Disclosure Act of 2009" rightly requires card issuers to consider the ability of a consumer to make required payments on an account before opening the account or increasing an existing line of credit. Recently, the Fed released its proposed regulations to implement Section 109. Can you describe the process undergone by the Board in writing the proposed regulations to implement Section 109? What considerations were made when the Board decided to further define the "the ability of a consumer to make required payments"? Can you please describe the benefits associated with consideration of income instead of consideration of

“ability to pay”? Can you also describe to the Committee the benefits associated with the consideration of a consumer’s income or assets in connection with a credit card loan and compare them to the potential operational and other costs associated with such a requirement, such as reduced credit availability? Do you think your rule for Section 109 appropriately weighs the costs and benefits of this change?

A.1. Our implementation of the Credit Card Accountability, Responsibility and Disclosure Act of 2009 (“CARD Act”) followed the process used by the Board in other rulemakings. After reviewing the statutory language and legislative history of the Act, including Section 109, we conducted outreach meetings with both industry representatives and consumer groups to inform our judgments about the best way to implement the statute. We also drew on our recent experience in developing mortgage regulations that require creditors to consider consumers’ ability to make the scheduled loan payments. We are currently in the process of considering the comments received on the proposed rules in order to develop final rules.

Section 109 requires card issuers to consider a consumer’s ability to make the required payments under the terms of the account before opening the account or increasing an existing credit limit. Under the Board’s proposal, a card issuer must, at a minimum, consider the consumer’s ability to make the required minimum periodic payments after reviewing the consumer’s income or assets as well as the consumer’s current obligations. The proposed rules specify, however, that card issuers may also consider other factors traditionally used by the industry in determining creditworthiness, such as the consumer’s payment history, credit report, or credit score. These additional factors provide creditors with useful information about a consumer’s past propensity to pay. As we develop the final rule, the Board will carefully consider the public comments and weigh the operational and other burdens created by the rule against the potential benefits to consumers.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BAYH FROM BEN S. BERNANKE

Q.1. The United States Mint recently issued a report that concluded that its State Quarters Program—honoring each State with a quarter bearing symbols emblematic of that State on its reverse side—had realized $6.3 billion dollars in profit to the government from seigniorage. [Seigniorage occurs when coins are taken out of circulation by collectors and the government realizes the difference between the coin’s face value and the per unit production cost—a profit of more than 23 cents per quarter.]

This profit was realized because the Federal Reserve provided adequate supplies of each new quarter to its member banks so that the public could easily obtain and collect those coins. Because of diminished demand during the recession, the Fed has reduced the volume of their purchases from the Mint. But, more importantly, the Fed has also refused to make coins available by design. In other words, they will not allow member banks to order specific coins (such as the Guam quarter) to make them available to their

customers. This combination of policies has greatly reduced the availability of individual coins to the collecting public.

A new series honoring the Nation's national parks will begin in 2010. If the Federal Reserve continues its policies, it will reduce the availability of these new quarters to everyday collectors. This in turn will jeopardize the potential profit to the government, resulting in nowhere near the $6.3 billion generated for the Treasury by its predecessor, the State quarter.

While it is the U.S. Treasury that reaps the benefits of seigniorage, not the Federal Reserve, the Fed is in a position to greatly improve the profit that can be realized by the government for the new national parks quarters to be released in 2010. Would the Fed consider making each of these coins available by design for an initial period after their release? In this way, the public would have the ability to obtain and collect these coins from circulation, providing much greater distribution than will be achieved by the Mint alone.

A.1. The Federal Reserve has supported the previous commemorative circulating coin programs that Congress has created and will support future programs, including the new national parks quarters program that begins next year. The method of providing such support, however, requires a careful balancing of costs and benefits, with a focus on inventory management. At present, the Reserve Banks have sufficient inventories of quarters to meet banking industry demand for about 3 years. Because of these inventory levels, which are very high by historical standards, the Reserve Banks will likely not be ordering large quantities of each of the new quarter designs. That said, as was done with the Westward Journey nickel series, the Abraham Lincoln Bicentennial pennies, and the State Quarters program, the Reserve Banks will override their normal first-in first-out process, and will provide to depository institutions new-design quarters until those supplies are exhausted before fulfilling remaining demand using other available inventory.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM BEN S. BERNANKE

Q.1. The measures you have taken to put the financial system back on track have left a handful of banks larger than they were prior to the crisis, and those banks are still unwilling to lend money, and apparently still engaging in some of the same risky investing behavior that led to the mess we're in. If they were too big to fail this time around, they will be even bigger in the event of a future calamity. The current situation only encourages reckless speculation by the major banks who have been assured that they will never be held accountable for their actions. What will you do to reduce the incentives of these banks to engage in reckless behavior if they think taxpayers will always bail them out?

A.1. The belief by market participants that some firms may be too big to fail has many undesirable effects. A critical first step to counteracting the moral hazard problem to which you refer is to ensure that all systemically important institutions are subject to effective consolidated supervision. Second, a more macroprudential approach needs to be incorporated into the existing framework for supervision and regulation. A macroprudential approach would

consider the interdependencies among firms and markets that could threaten the financial system and the real economy. Such an approach would lead to strengthened capital, liquidity, and risk-management requirements for systemically important firms. Another important step to counteracting moral hazard is to create a resolution process that would allow the government to wind down in an orderly way a systemically important firm the disorderly failure of which would impose substantial costs. Importantly, the process should allow the government to impose "haircuts" on certain creditors and shareholders of such firms.

Q.2. Banking supervision, consumer protection, and monetary policy are all very different jobs. There is a real danger that all of these important functions could detract from one another if they are all given to the Fed. Given the Fed's many significant monetary policy responsibilities, can the Fed really take on significant responsibilities in other areas as well, such as supervision of all systemically significant institutions, even those that are not banks? Or more consumer protection authority than it has now?

A.2. Many independent agencies within the U.S. government have two or more missions or goals. The Federal Reserve believes that it can effectively conduct monetary policy, macroprudential regulation, and consumer protection and, indeed, that there are valuable synergies among these responsibilities.

The conduct of monetary policy and macroprudential regulation share important similarities. Both are addressed at conditions in the overall economy and financial system. Partly for this reason, the two endeavors overlap in terms of relevant data and analytical techniques, as well as the necessary staff expertise. Over the past 2 years, 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. Conversely, the Federal Reserve economists primarily employed to support monetary policy contributed importantly to the success of the Supervisory Capital Assessment Program. The Federal Reserve also views consumer protection as complementary to, rather than in conflict with, its other central bank responsibilities, such as prudential supervision and fostering financial stability. For example, sound underwriting benefits consumers as well as lenders, and strong consumer protections can add certainty to the markets and reduce risks to financial institutions.

Q.3. The Fed has not succeeded on many consumer protection fronts, most notably in failing to regulate mortgages. Since 1994, the Fed has had the power—indeed the duty—under the Home Ownership and Equity Protection Act to prohibit loans that are "unfair, deceptive," or "otherwise not in the interest of the borrower." This sweeping power could have curtailed many of the abusive and predatory mortgage lending tactics that triggered a massive wave of foreclosures on subprime and Alt-A mortgages, but it was not invoked until 2008, long after the foreclosure crisis became apparent.

When did you first encourage the Board of Governors to invoke this law?

Has the Board of Governors conducted any assessment of its failure to invoke the law before it did?

Why should we believe that the Fed will exhibit a better track record on consumer protection than it has in the past? Shouldn't we give those responsibilities to an independent Consumer Financial Protection Agency that is focused on protecting American consumers as its primary mission?

In the wake of the Fed's failure to act in this crucial area, why has the Fed remained neutral when it comes to the creation of a Consumer Financial Protection Agency?

A.3. In the past several years, the Board has taken several actions under the Home Ownership and Equity Protection Act (HOEPA) to respond to various consumer protection concerns that have arisen in the mortgage marketplace since HOEPA was enacted in 1994.

The Federal Reserve initially published rules to implement HOEPA in 1995. In response to the increase in the number of subprime loans, the Board held a series of public hearings in 2000, focused on the abusive lending practices occurring at that time and the need for additional rules. The information surfaced at those hearings formed the basis for the revision to the HOEPA rules issued by the Board in December 2001, which strengthened consumer protection, applied HOEPA's protections to a larger number of high-cost loans, and addressed practices occurring in the market place at that time.

The 2001 rules also strengthened HOEPA's prohibition on unaffordable lending by requiring that creditors generally document and verify consumers' ability to repay a high-cost HOEPA loan. In addition, the Board used the rulemaking authority in HOEPA to prohibit practices that are unfair, deceptive, or associated with abusive lending. Specifically, to address concerns about "loan flipping," the Board prohibited HOEPA lenders from refinancing one high-cost loan with another high-cost loan within the first year unless the refinancing is in the borrower's interest. The 2001 final rules also addressed other issues, such as concerns about costly credit insurance.

During the summer of 2006, shortly after I became Chairman, the Board conducted a series of public hearings to gather information about new lending practices that had emerged as the subprime market continued to grow. In response, in 2007, the Board and other Federal financial regulatory agencies published interagency guidance addressing certain risks and emerging issues relating to subprime mortgage lending practices, particularly adjustable-rate mortgages. The agencies recognized that issuing guidance was the swiftest way to respond to these concerns. Also in 2007, the Board held another hearing to consider ways in which the Board might use its HOEPA rulemaking authority to further curb abuses in the home mortgage market, including the subprime sector. This became the basis for the new HOEPA rules that the Board proposed in December 2007 and finalized in July 2008.

While we should have taken some actions sooner, I believe that the Federal Reserve has shown that it can write strong, effective consumer regulations, as we have done for both credit cards and mortgages. In addition, we recently announced an examination program for nonbank subsidiaries of bank holding companies. We are

strongly committed to the importance of consumer protection in maintaining financial stability and restoring consumer confidence.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MERKLEY FROM BEN S. BERNANKE

Q.1. *Regulatory Approach*—When people think of the Federal Reserve, they usually think of monetary policy. But under the system we have today, the Fed holds a central position in our bank regulatory system and is being asked by the Administration and the House of Representatives to hold a larger position. The Federal Reserve made a series of decisions that led directly to this crisis, including:

- Refusing to provide basic consumer protections on mortgages;
- Fighting regulation of the over-the-counter derivatives market;
- Permitting regulated banks to use off-balance sheet vehicles to hold large amounts of assets;
- Permitting overreliance on short-term funding market ("repo");
- Driving the development of risk-based capital, first Basel I which was too reliant on rating agencies and then Basel II, which the SEC applied to the investment banks and outsourced to the banks the evaluation of their own capital adequacy; and
- Permitting the rise of unregulated highly complex securitization—CDOs and CDO squareds—which when combined with Basel I, were used by banks to game regulatory capital.

Certainly not all of these were your decisions, but you were on the Board for a substantial period of the time while these decisions were made and in 2006, just before this very crisis, you spoke on record in favor of many of these regulatory approaches. Has your regulatory philosophy fundamentally changed because of this crisis, and if so, how?

A.1. The crisis has reinforced some elements of my regulatory philosophy and changed others. I have long believed that, because of their access to the safety net, bank holding companies are not subject to effective market discipline and therefore need robust consolidated supervision. The financial crisis has demonstrated that, because they may be perceived as too big to fail, very large complex nonbank financial institutions must also be subject to robust consolidated supervision. Furthermore, the crisis has made clear to me that consolidated supervision needs to take into account macroprudential as well as microprudential considerations. Finally, the crisis has convinced me that we must take steps to enhance market discipline on large banks and nonbank financial institutions. The critical step in that regard is to create authority for resolving such firms that carries with it a credible threat that their creditors will bear significant losses in the event the firm becomes insolvent.

Q.2. *Systemic Risk—Proprietary Trading*—Even as this economic crisis only begins to abate, I am particularly concerned that certain large banks engage in a substantial amount of proprietary trading

even though they are guaranteed by the Federal safety net. Even though banks are making billions trading on own accounts, it only takes a day or two of large losses to cause a failure. Moreover, I continue to hear about serious conflicts of interest between banks as client-oriented broker-dealers and hedge fund-like principal investors.

I am pleased that Chairman Dodd's discussion draft includes a vigorous GAO study on this issue, but we need to get ahead of the curve. What is to prevent another Long-Term Capital Management or Barings, where a large bank's trading positions get it jammed by an unexpected turn in the market?

A.2. "Proprietary trading" or a banking organization's active trading and position taking in financial instruments for its own account occurs in several forms. In the normal course of making markets to meet customers' needs for financial assets and liabilities, banking organizations must maintain inventories of securities that may or may not be hedged. As a result, a certain amount of inventory position taking is inherent in the investment banking and market-making business. Banks may also take positions above the levels required for market-making activity with the hope of generating additional income. When such positions occur within the same accounts used for customer accommodation, it can be difficult to segment the positions taken for market-making purposes from those taken for other purposes. More explicitly, proprietary trading can also occur when banks employ multiple desks of traders devoted solely to position taking for the bank's own account. Both types of trading operations, market making and proprietary position taking are subject to conflicts of interest requirements dictated by regulation and supervisory guidance, as well as by industry adopted sound practices.

Customer accommodation and proprietary trading operations at banking organizations are also subject to requirements on the adequacy of their internal risk management processes including the need for board of directors and senior management oversight of established risk tolerances, limits on risk taking, risk measurement systems and various types of internal controls. Banks are expected to employ multiple measures and limits on the risk exposures of their trading operations and are encouraged to avoid over-reliance on any single measure or limit. Minimum capital requirements and other regulatory constraints are also important safeguards in controlling the potential impacts of losses in proprietary risk taking, as is the market discipline that arises from appropriate disclosure of the scale of proprietary trading at banking organizations.

The recent crisis has surfaced a number of areas for improvement, and both international and U.S. supervisors are moving forward to address these issues. For example, the Basel Committee on Bank Supervision (BCBS) has released international standards for stress testing all of a bank's material risk exposures. The BCBS has also substantively revised the risk management and capital standards applied to banks' trading activities and will shortly propose new global standards for bank liquidity management that should significantly affect the scope and size of banks' proprietary risk taking.

Q.3. *Consumer Protection: Interest Rates and State Usury Laws*—One of the defining features of our financial system in recent decades has been the spread of financial products that carry extraordinarily high interest rates.

I grew up in a working class family—my dad was a millwright. My parents and our neighbors worked hard to send their kids to good schools and to own their own homes, and it angers me when I see schemes and scams that seem almost exclusively geared towards unfairly stripping money out of the pockets of working families. When I was Speaker in the Oregon legislature, we capped the interest that payday lenders could charge—but we couldn't act in other areas because we were told its Federal regulation that we couldn't touch.

It's widely known that just in the payday lending industry, 75 percent of customers are repeat customers—they come in again and again because they are trapped in a cycle of high-interest debt that they simply cannot escape from. I am hopeful that we will see the creation of a strong Consumer Financial Protection Agency to police some of these products, but none of the proposals give the agency the power to set a national usury rate, nor does there seem to be much interest in giving States the power to set the usury rate for lending from national banks.

Would you agree that interest rates on some financial products, such as payday loans and even some credit cards, are simply too high? Why not let States determine the highest rate of interest for consumers in their State, and if the citizens of a State wish to adopt policies that restrict their own credit, let that be the decision of that State?

A.3. The maximum interest rate that a national bank can charge is generally the highest rate allowed by the laws of the State where the bank is located. This is dictated by the National Bank Act, and the Supreme Court has held that a national bank may charge the rate allowed by its home State to customers in other States. However, if the Congress determined that national banks should follow the laws of each State when doing business in that State, it could amend the National Bank Act.

On the one hand, States often are good laboratories for new consumer protections to address troublesome products and practices. In fact, the Federal Reserve looked at State predatory lending laws in developing our HOEPA rules. States can also address concerns that are regional in nature. On the other hand, there is some benefit and efficiency to a national standard, as long as that standard is strong enough to adequately protect consumers.

With respect to payday loans, they do appear to be a very expensive form of credit, and some States have legislated in this area by adopting restrictions for such loans. The Federal Reserve encourages mainstream banks to reach out to unbanked consumers, especially in low- and moderate-income neighborhoods, to offer them more cost-effective products; and we support financial literacy programs to help consumers make better choices.

Q.4. *Trade and Monetary Policy*—For a long time, I've been concerned about the regulatory arbitrage inherent in international trade between countries with sound labor and environmental laws

and those without, and how that affects our employment situation. More recently, I've also become concerned about how international trade imbalances affect our monetary policy.

Failures in consumer protection turned the housing bubble into a foreclosure and financial crisis, but as you have noted, the existence of the housing bubble itself comes from the global savings glut, mostly emanating from trade imbalances coming from Asia. The challenge is that traditional monetary tools might not even address problems emanating from trade imbalances.

Are you concerned about the monetary policy implications of global trade imbalances, and if so, what monetary tools do you have to deal with the imbalance going forward? Do you also think that we should reduce regulatory arbitrage in trade by requiring our trade agreements include stronger provisions to raise global labor and environmental rules?

A.4. Policymakers should be concerned about the potential implications of global imbalances for the sustainability of economic growth as well as the stability of the financial system. Countries with large current account surpluses should reduce the gap between saving and investment by strengthening domestic demand and reducing their dependence on external demand. The United States, which runs sizeable current account deficits, should increase national savings, importantly by committing to reduce Federal budget deficits over time and establishing a sustainable trajectory for the public debt.

The goal of monetary policy in the United States, as mandated by Congress, is to pursue maximum sustainable employment and stable prices. Global imbalances affect the formation of monetary policy insofar as they have implications for financial markets, economic activity, employment, and inflation. However, 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 G20 and other international organizations in a cooperative effort to devise strategies for dealing with these issues.

Whether labor and environmental standards should be required in trade agreements is a matter of public policy to be determined by the Executive and Legislative branches. Clearly, policymakers should resist both unfair trade practices and protectionist measures. We must also find ways to assuage the pain of dislocation that trade may bring to some households, firms, and communities. But at the same time, we must not lose sight of the fact that our participation in a free and open international trading system allows us to enjoy both a more productive economy and higher living standards.

Q.5. *Federal Reserve Transparency*—Many of my constituents are deeply angry with the way this financial crisis has unfolded. $30 billion in direct asset purchases were provided so JPMorgan could

acquire Bear Stearns. $300 billion in loan guarantees were provided to Citibank, and of course $80 billion in direct lending was provided to rescue AIG. And that is just from the Fed alone—not even counting TARP. All the while, banks have reduced lending and foreclosed on peoples' homes.

While the Federal Reserve's actions kept the banking system from collapse, many people are deeply concerned that the Fed could deploy this amount money without any checks and balances and without any oversight. I recognize that GAO review of monetary policy would be unwise, but when the Fed is engaged in propping up failed institutions, that is not monetary policy: that's a bailout and should be subject to robust audit.

For a democratic citizenry to have trust in its government, transparency is absolutely essential. You have stated your willingness to work with us, and I appreciate the receptivity that you have shown to my staff as we have worked on these issues. Are you ready to accept a robust audit of the Fed's actions relating to emergency bailouts, even as we acknowledge that legitimate monetary policy should remain independent?

A.5. I agree that, in a democracy, any significant degree of independence by a government agency must be accompanied by substantial accountability and transparency. Federal Reserve policymakers are highly accountable and answerable to the government of the United States and to the American people. As you know, the financial statements of the Federal Reserve System (including the Reserve Banks) are audited on an annual basis by an independent public accounting firm and these audited statements are provided to the Congress and made publicly available. In addition, the Federal Reserve provides the Congress and the public substantial information concerning our actions and operations, including the actions we have taken during the crisis to protect the stability of the financial system and promote the flow of credit. For example, Federal Reserve officials regularly testify before Congress and we publish a detailed balance sheet on a weekly basis. We also provide Congress and the public detailed monthly reports on our liquidity programs that detail, among other things, the number and distribution of borrowers under each facility; the value, type, and quality of the collateral that secures advances under each facility, including the loans to prevent the disorderly failure of Bear Stearns and AIG; and trends in borrowing under the facilities. Moreover, the GAO already has full authority to audit the credit facilities the Federal Reserve provided to "single and specific" companies under the authority provided by section 13(3) of the Federal Reserve Act. These facilities include the loans provided to, or created for, AIG, Bear Stearns, and Citigroup under section 13(3).

We believe permitting the GAO to review the operational integrity of the broadly available credit facilities established under section 13(3) could provide Congress and the public additional comfort regarding the manner in which the Federal Reserve is exercising its responsibilities and protecting the taxpayer in its operation of these facilities without endangering our ability to independently determine and implement monetary policy. A review of the operational integrity of these facilities could be structured so as not to involve a review of the monetary policy aspects of the facility, such

as the decision to begin or end the facility or the choices made regarding, the structure, scope, design, or terms of the facility. We remain willing to work with you and other members of Congress to implement and perfect such an approach. As you recognize, in doing so it is vitally important that the independence of monetary policy be preserved. Actions that are viewed as weakening monetary policy independence likely would increase inflation fears and market interest rates and, ultimately, damage economic stability and job creation.

Q.6. *Federal Reserve Governance*—Although Chairman Dodd's legislations strips the Federal Reserve System of its role as a banking regulator, the Administration and the House have increased the responsibility of the Fed for oversight of bank holding companies and other systemically significant firms. While the Board of Governors in Washington is ultimately responsible for this supervision, the day-to-day supervision is conducted by the Reserve Banks under the direction of each Reserve Bank president. Although the selection of each Reserve Bank's president is overseen by the Board of Governors, the boards of directors of the Reserve Banks, which are dominated by the member banks, play critical roles and effectively have veto power to prevent a regulator they see as too tough. If the Federal Reserve does maintain its regulatory authority, do you think it is time to change Reserve Bank governance or regulatory oversight structure so that the bankers do not have any say over who their primary regulator is?

A.6. Under the policies of the Board and the Reserve Banks, the boards of directors of the Reserve Banks play no role in the supervision or regulation of banking organizations by the Federal Reserve and do not have a veto over any supervisory or regulatory policy. Supervisory and regulatory policy, directions, and decisions are vested in the Board of Governors of the Federal Reserve System, all the members of which are appointed by the President of the United States and confirmed by the U.S. Senate. The Board of Governors has and retains full and unfettered authority to remove any officer of a Reserve Bank, including the president of a Reserve Bank and any examiner or supervisor employed by the Reserve Bank, that does not abide by and fully implement the policies, directions, or decisions of the Board of Governors regarding supervision and regulation of banking organizations.

The structure of the Federal Reserve, which the Congress enacted, has worked well for nearly 100 years and has added great strength to the Federal Reserve System. It allows the Federal Reserve Board to meet its responsibilities for supervising and regulating a diverse group of banking organizations throughout the United States. At the same time, it allows the Federal Reserve System to benefit from contacts in numerous local communities throughout the United States in collecting information related to monetary policy. This access to a broad array of community and business contacts throughout the United States adds real "Main Street" anecdotes and information to the economic statistics collected nationally.

Q.7. *Mortgage-Backed Securities Purchases*—One of the more creative applications of monetary policy in this crisis is the Federal

Reserve's purchases of agency mortgage-backed securities. By directly purchasing mortgage backed securities, the Fed has supported the availability of credit in the housing market. Only a few weeks ago, the Fed's purchases of these agency MBS topped $1 trillion, and the program was announced to remain in effect through March. Moreover, TALF, which supports the private label securitization markets, has been extended through June of 2010.

When will the housing and other securitization markets be strong enough to operate on their own? What risk is the Fed taking on in these purchases? Is this an appropriate type of monetary policy action over the long term, one that you expect to use again?

A.7. Financial market functioning has, in general, improved substantially since the spring of this year. For example, spreads between yields on private debt securities and Treasury debt have returned toward more normal levels at both short and long maturities even as corporate bond issuance this year has exceeded last year's issuance. In private-label securitization markets, issuance of shorter-term asset-backed securities backed by consumer and small business loans has increased: Some of those issues were supported by TALF; others were not. Recently, the TALF financed the first new commercial mortgage-backed security (CMBS) since 2008; other CMBS have since come to market without TALF support. While usage of the TALF has continued to expand at a modest rate, usage of the Federal Reserve's other credit and liquidity facilities has declined rapidly as market functioning improved.

In light of the ongoing improvement in financial market functioning, usage of the Federal Reserve's liquidity facilities has declined dramatically, and a number of these facilities are scheduled to close early next year. We also anticipate ending the current program of MBS purchases at the end of the first quarter. The Board and the FOMC will of course continue to evaluate the evolving economic outlook and conditions in financial markets and are prepared to extend some or all of its programs if that proves necessary.

With respect to risks the Federal Reserve has taken on, we have, as noted in the question, purchased agency-guaranteed MBS. Because of the agency guarantee, the Federal Reserve has no exposure to credit losses stemming from defaults on the underlying mortgages. However, the fair market value of MBS can and does vary in response to movements in longer-term interest rates.

Finally, the Federal Reserve believes that the TALF, other liquidity and credit facilities, and large-scale asset purchases were appropriate steps in light of the severe financial dysfunction and contracting economic activity, as well as the fact that the Federal Reserve had taken the Federal funds rate essentially as low as possible. In general, these steps would be neither necessary nor appropriate in more normal times, and I certainly hope conditions will not warrant using them again.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM BEN S. BERNANKE

Q.1. Please provide:

a. Unreleased transcripts of all FOMC 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 FOMC, 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.

A.1. 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 5 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 Web site, 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 Web site: *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 Web site: *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 Web site: *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 Web site: *http://www.federalreserve.gov/monetarypolicy/files/fomcminutes20091104.pdf*);
- Semiannual Monetary Policy Report and Testimony (See July 2009 Report, attached as Ex. 1, tab E) (also available on our public Web site: *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 Web site: *http://www.federalreserve.gov/boarddocs/rptcongress/annual08/pdf/audits.pdf*); and
- Voluminous information on policy actions available on our public Web site: *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:

- Thirteen 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 nonmonetary policy, which total 33 to date—24 completed and 9 in process (reports of the audits are available on GAO's Web site: *http://www.gao.gov/docsearch/repandtest.html*).

Q.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?

A.2. 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 Fed-

eral Reserve to establish the Term Auction Facility and other programs to more directly address liquidity pressures.

Q.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.

A.3. 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 Web site.

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

A.4. No one has requested any commitments from me in connection with my renomination, nor have I made any commitments other than what I said in my statement before the Senate Banking Committee that, if reappointed, 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.

Q.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?

A.5. 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.

Q.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?

A.6. 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.

Q.7. Paul Krugman recently wrote about the problem policymakers will face in the future because of the public'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?

A.7. 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.

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

A.8. 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.

Q.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 U.S. 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?

A.9. 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.

Q.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?

A.10. 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 2 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 2 years in this regard.

Q.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?

A.11. 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.

Q.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?

A.12. 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.

Q.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?

A.13. 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 G20 and other international organizations in a cooperative effort to devise strategies for dealing with these issues.

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

A.14. 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 nonregulated 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.

Q.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.

A.15. 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 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.

Q.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?

A.16. No. The revolving credit facility established for AIG in September 2008 was and is fully secured by assets of AIG and its primary nonregulated 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.

Q.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?

[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.

A.17. 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.

Q.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?

A.18. 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.

Q.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?

A.19. 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.

Q.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?

A.20. 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 for-

ward 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.

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

A.21. 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.

Q.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?

A.22. 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.

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

A.23. 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.

Q.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?

A.24. 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.

Q.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.

A.25. 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 de-

pended 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.

Q.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?

A.26. 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 1½ 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.

Q.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?

A.27. 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.

Q.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 fullfaith-and-credit obligations of the United States.

A.28. 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 C.F.R. 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.

Q.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 Senator 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?

A.29. 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 author-

ity 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.

Q.30. In response to a question posed by Senator 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?

A.30. 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.

Q.31. In response to a question posed by Senator 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?

A.31. 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.

Q.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?

A.32. 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.

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

A.33. 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.

Q.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?

A.34. 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.

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

A.35. 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. Broadbased caps applied without such analysis potentially could limit the banking system's ability to support economic activity.

Q.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?

A.36. 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.

Q.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 percent of deposits in this country?

A.37. 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.

Q.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 percent, 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?

A.38. 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.

Q.39. In his questioning at your hearing, Senator 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?

A.39. 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.

Q.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?

A.40. 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 2 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.

Q.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?

A.41. 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 macroprudential supervision and new resolution authority over systemically important financial firms. These reforms would mitigate moral hazard and I strongly support them.

Q.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?

A.42. 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.

Q.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?

A.43. 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 in-

herently 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.

Q.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?

A.44. 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.

Q.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?

A.45. 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 meas-

ures 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 trade-off 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.

Q.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?

A.46. 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.

Q.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?

A.47. 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.

Q.48. Why does the Fed insist on waiting 5 years before it releases transcripts of FOMC meetings to the public?

A.48. The effectiveness of monetary policy deliberations is facilitated by the policy of maintaining the confidentiality of FOMC meeting transcripts for 5 years, so that participants can have a candid and free exchange of views about alternative policy approaches. It is noteworthy that the 5-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.

Q.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?

A.49. 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.

Q.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?

A.50. 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.

Q.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?

A.51. 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.

Q.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?

A.52. 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 nonperforming 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 2 years

under more-adverse-than-expected economic assumptions, and because it ensured consistency across institutions.

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

A.53. 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.

Q.54. What was your rationale for letting Lehman fail?

A.54. 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.

Q.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?

A.55. 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.

Q.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?

A.56. 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.

Q.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?

A.57. 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.

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

A.58. 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.

Q.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?

A.59. 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.

Q.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 percent. 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?

A.60. 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.

Q.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?

A.61. 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.

Q.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?

A.62. 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.

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

A.63. 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.

Q.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?

A.64. 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.

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

A.65. 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.

Q.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?

A.66. 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 expecta-

tion 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 noncore 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.

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

A.67. 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.

Q.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 U.K. and the U.S.) 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?

A.68. 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.

Q.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?

A.69. 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.

Q.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?

A.70. 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 pre-

vailing. 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 nonbanking 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.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR VITTER FROM BEN S. BERNANKE

Q.1. The current policy of the Federal Reserve is keeping interest rates near zero. This is allowing banks to earn a lot of money by buying long term government bonds and using that money to recapitalize the banks—which is a good thing—but, if the Federal Reserve continues this policy for an extended time, why would banks lend to consumers when even the least risky consumer is far riskier than buying U.S. Treasuries? Doesn't this Federal Reserve policy discourage the lending Washington policy makers say they're trying to promote?

A.1. In response to the sharp decline in economic activity late last year, the FOMC lowered its target for the Federal funds rate to a range of 0 to ¼ percent. This action, along with the Federal Reserve's other policy initiatives, was taken to foster the Federal Reserve's dual objectives of maximum employment and stable prices. As is usually the case, long-term interest rates did not decline by as much as short-term rates in response to the cuts in the funds rate. However, the relatively high interest rates on longer-term securities do not provide banks or other investors with an easy and low-risk source of profits, because investments in such securities involve a significant degree of interest rate risk; therefore, relatively high longer-term yields are unlikely to be an important reason for the current reluctance of banks to lend. Instead, that reluctance appears to be due more to the banks' concerns about the economic outlook, credit risks associated with that outlook, and to some extent, to the banks' own capital positions. The contraction in bank loans outstanding is also attributable in part to low demand for bank credit, which in turn is also largely a result of the economic downturn and concerns about the outlook. As part of our effort to support appropriate bank lending, the Federal Reserve and the other Federal banking agencies issued regulatory guidance in November 2008 to encourage banks to meet the needs of their cred-

itworthy customers. We have also encouraged banks to raise private capital to support more lending. In particular, the Federal Reserve led the Supervisory Capital Assessment Program (or "stress test") of the largest bank holding companies last spring; the results of the stress test increased confidence in the banking system and helped many banks raise private capital and repay TARP funds. We have also eased lending conditions by providing banks with ample short-term funding and by helping to revive securitization markets. We expect that, as economic activity picks up, the demand for loans should increase, credit conditions are likely to ease, and banks will likely step up their crucial intermediation activities.

Q.2. In July, as part of your last appearance before this Committee, you were asked if you plan to hold the Treasury and GSE securities on your books until maturity. You responded, "the evolution of the economy, the financial system, and inflation pressures remain subject to considerable uncertainty. Reflecting this uncertainty, the way in which various monetary policy tools will be used in the future by the Federal Reserve has not yet been determined. In particular, the Federal Reserve has not developed specific plans for its holdings of Treasury and GSE securities." Basically, you had no plan to unwind this swollen portion of the Fed balance sheet. Do you have a plan yet, Mr. Chairman?

A.2. Broadly, our plan is to manage the System's portfolio of securities over time in a way that fosters the achievement of the Federal Reserve's statutory objectives of maximum employment and stable prices. As with other aspects of the conduct of monetary policy, the way in which the System's portfolio evolves will be determined by the emerging outlook for the economy, inflation, and financial markets. For example, it is possible that the Federal Reserve's holdings of Treasury and GSE securities will decline gradually, reflecting prepayments and maturing issues. In this case, the payment of interest on reserves along with reserve management tools may prove adequate for the implementation of appropriate policy adjustments. Depending on how economic and financial conditions evolve, however, the FOMC could determine that a more rapid reduction in the size of the portfolio would be desirable and so choose to sell some of the securities. That judgment would involve weighing many factors including the implications that such actions would have for long-term interest rates, including mortgage rates, and the related effects on economic growth, inflation, and financial markets.

Q.3. Over the last year, the Federal Reserve has introduced $1 trillion into the banking system. The Federal Reserve continues to expand its purchases of mortgage backed securities. Chairman Bernanke, in past testimony before this Committee you have said that part of the plan to rein in this excess liquidity is to pay banks interest on reserves. What rate of interest will you have to pay in order to accomplish this and what will that do to the economy?

A.3. The Federal Reserve is well positioned to remove the current extraordinary degree of monetary policy accommodation at the appropriate time. The Federal Open Market Committee (FOMC) sets a target level of the Federal funds rate that it believes will best foster the Federal Reserve's statutory objectives of maximum employment and price stability in view of its outlook for economic activity

and inflation. The current and expected future values of the Federal funds rate influence longer-term interest rates and other asset prices. And those changes in turn affect household and business spending decisions. Currently, the FOMC has expressed its target for the Federal funds rate as a range from 0 to ¼ percent. The interest rate paid on reserves helps to keep the Federal funds rate close to the target set by the FOMC because banks will not ordinarily lend to one another in the Federal funds market at rates below what they can earn on balances maintained at the Federal Reserve. The interest rate paid on bank reserves will be set over time at a level that is consistent with, and in practice very close to, the FOMC's target Federal funds rate. As required by law, the interest rate paid on reserves must not exceed the general level of short-term interest rates.

Q.4. On Monday, the Dubai government said that it would not guarantee the debts of state-owned Dubai World. A senior finance official said, "Creditors need to take part of the responsibility for their decision to lend to the companies. They think Dubai World is part of the government, which is not correct." Dubai world has since offered to restructure $26 billion in debts. As a result, no great crisis has erupted in the markets. What lesson have you drawn from this?

A.4. The announcement by Dubai World that it would seek to restructure a portion of its debt payments caught many investors by surprise. Because the company is wholly owned by the government of Dubai, some investors had believed that the government would back its debt. While this news initially had some negative impact on global financial markets, those markets have recovered as market participants came to perceive that the losses associated with the restructuring likely would be contained. However, Dubai World's announcement has seriously affected the terms and availability of credit for the government and corporations in Dubai: Interest rates on debt issued by both the government and government-affiliated corporations have increased sharply, credit ratings of many of those corporations have been downgraded, and their ability to raise new funds has been seriously impaired. These developments reinforce the lesson that lenders will charge steep premiums if they have concerns that borrowers will fail to fully repay their investments.

Q.5. Tuesday, a *New York Times* report highlighted the fact that on December 14, 2008, well after receiving an injection of TARP money from the taxpayer, Citi announced $8 billion of financing for public sector entities in Dubai. Chairman Bernanke, did you know that Citi made this investment with the help of taxpayer funds? What scrutiny did the Federal Reserve give this transaction given the fact that Citi was forced to take tens of billions of dollars of TARP funds?

A.5. With the exception of mergers and acquisitions, the Federal Reserve does not pre-approve individual transactions of the financial institutions we supervise. We also note that cash in an institution is fungible, so it would not be accurate to state that TARP funds were used for this or any other individual investment. In many large deals like this one, the lead bank arranges the deal and

then syndicates it to other investors, oftentimes removing a large share of the risk from its balance sheet.

Q.6. More than a year after the Federal Reserve bailed out the failing insurance giant; taxpayers deserve to know what the exit strategy is. Just this week the Federal Reserve Bank of New York bought two life insurance companies from AIG in exchange for reducing the debt the company owes the Fed by $25 billion. It seems like a positive step, but owning two life insurance companies is hardly an exit from the morass of AIG. Will taxpayers get their money back from AIG and how much can they reasonably expect to get back?

A.6. 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 loans were 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.

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.

The loans made to Maiden Lane II LLC (ML II) and Maiden Lane III LLC (ML III), which are two special purpose vehicles formed to help stabilize AIG, will be repaid with the proceeds from the liquidation and disposition of the portfolio holdings of these two entities. If the portfolio holdings were liquidated today, based on fair value, the Federal Reserve would recover fully on its loan to ML III and incur a modest loss on its loan to ML II. However, the loans to ML II and ML III are not structured or designed for the immediate sale of collateral assets. Instead, the loans are designed to allow the sale of the collateral over a longer period that allows for the recovery of markets and the intrinsic asset values. In addition, AIG has a $1 billion subordinated position in ML II and a $5 billion subordinated position in ML III. These subordinated positions are available to absorb first any loss that ultimately is incurred by ML II or ML III, respectively. On this basis, the Board does not anticipate that the loans to ML II or ML III will result in the realization of any losses to the Federal Reserve or the taxpayers.

Each of these matters is described more fully in the monthly reports filed with Congress by the Federal Reserve under section 129 of the Emergency Economic Stabilization Act of 2008, and can be found on the Board's Web site.

Q.7. Mr. Chairman, as I'm sure you know by now, the recent report issued by the Special Inspector General of the Troubled Asset Relief Program on payments made to AIG counterparties says that "the Federal Reserve Bank New York's negotiating strategy to pursue concessions from counterparties offered little opportunity for success, even in light of the willingness of one counterparty to agree to concessions." How involved were you in the decision made by the Federal Reserve Board of New York to pay these counterparties at par?

A.7. 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 Federal Reserve Bank of New York (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 would prevent 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.

The episode starkly illustrates the need for a special resolution regime for failing, systemically critical companies that will allow the government to protect the financial system while still being able to obtain concessions from shareholders, creditors, counterparties, and management. As I said at my hearing: "We do not want any more AIGs. We do not want any more Lehman Brothers. We

want a well established, well stated, identified, worked out system that can be used to wind down these companies, allow them to fail, let the creditors take losses, let counterparties, like the AIG counterparties, take losses, but without completely destabilizing the whole economy, as can happen."

Q.8. In your last appearance before this Committee, Mr. Chairman, you and I talked about the proposal for GAO audits of the Federal Reserve. As you know, I support full, delayed audits of the Federal Reserve. The argument you and others make in opposition to these audits is that they would compromise the ability of the Federal Reserve to make monetary policy independently. Yet, you now support audits of emergency, 13(3) facilities even though you said that, "because supporting economic growth when the economy has been adversely affected by various types of shocks is a key function of monetary policy, all of the facilities that are available to multiple institutions can be considered part of the Federal Reserve's monetary policy response to the crisis." How is it that you feel that some GAO audits of monetary policy are ok and others are not?

A.8. We have indicated our willingness to work with the Congress to enhance the review of the operational integrity of the temporary market credit facilities that we established under section 13(3) in a way that would not endanger our ability to independently determine and implement monetary policy. A review of the operational integrity of these facilities could be structured so as not to involve a review of the monetary policy aspects of the facility, such as the decision to begin or end the facility or the choices made regarding the structure, scope, design, or terms of the facility. The GAO already has the authority to conduct reviews of Federal Reserve lending under section 13(3) to single and specific entities, such as Bear Stearns, AIG, Citigroup and Bank of America Corporation, and we have been working with GAO to facilitate their audit of these facilities.

We continue to be very concerned, however, about the proposals that would broadly authorize GAO to audit the Federal Reserve's monetary policy and discount window decision making and implementation. As you know, the Federal Reserve is already fully subject to audit by the GAO in virtually all of its other areas of responsibilities. The limited exceptions for monetary policy and discount window operations were adopted to ensure that the Federal Reserve could, in the words of the Senate committee report at the time, "independently conduct the Nation's monetary policy."

Monetary policy independence enables policymakers to look beyond the short term as they weigh the effects of their monetary policy actions on price stability and employment and reinforces public confidence that monetary policy will be guided solely by the objectives laid out in the Federal Reserve Act and not by political concerns. Financial markets likely would see a GAO audit or the threat of a GAO audit of monetary policy as an attempt by Congress to intrude on the Federal Reserve's monetary policy judgments and to try to influence subsequent monetary policy decisions. Households, businesses, and financial market participants would understandably be uncertain about the implications of the GAO's findings for future decisions of the FOMC, thereby increasing mar-

ket volatility and weakening the ability of monetary policy actions to achieve their desired effects. Actions that are viewed as weakening monetary policy independence likely would increase inflation fears and market interest rates and, ultimately, damage economic stability and job creation. Thus, maintaining an independent monetary policy is important not because it benefits the Federal Reserve, but because of the important public advantages it provides households, families, small and large businesses and the Nation as a whole.

The Federal Reserve is highly transparent and is committed to providing Congress and the public with the information it needs to oversee the activities and decisions of the Federal Reserve without undermining our ability to effectively fulfill our monetary policy and other responsibilities. For example, the Federal Reserve is already subject to a full audit of its financial statements by an independent public accounting firm. These audited financial statements are published annually and reported to Congress. In addition, the Federal Reserve publishes a detailed balance sheet on a weekly basis—unique among central banks—showing all of its assets and liabilities as well as changes in entries on its financial statements from the previous week. This allows Congress and the public full access to information on the assets and liabilities incurred by the Federal Reserve on a regular and consistent basis. We also make substantial, detailed information available on our Web site and in regular public reports regarding the programs, credit facilities and monetary policy decisions of the Federal Reserve.

Q.9. Mr. Chairman, in the House Financial Services Committee's consideration of the systemic regulation bill, it narrowly adopted an amendment that requires a 20 percent haircut for all secured creditors in the case of an institution identified as systemically important. The sponsors stated that the intent was to prevent secured lenders from requiring additional collateral as the institution failed. Also the FDIC, who supports, the amendment argues it would incentivize secured lenders to review secured borrowers more closely. It appears to me that the proposal would significantly increase cost of secured borrowing and be potentially disruptive of a number of secured lending markets such as the repurchase agreements, advances from the Federal Home Loan Banks, and possibly some of the Fed's own activities. Also, it is my understanding that secured creditors spend significant resources today assessing the creditworthiness of the borrowers as well as the value of the pledged collateral. Have you had a chance to review the proposal and form an opinion on the impact it has on the institutions and the market?

A.9. Based on an initial review of the proposal, the Federal Reserve has concerns regarding the destabilizing effect the proposal could have on financial markets and institutions. If implemented, the proposal could make liquidity crises more frequent, more rapid, and more severe. It could create incentives for secured creditors of a systemically important institution to "rush to the exits" at early signs of financial difficulties, shutting the institution off from useful sources of liquidity and perhaps turning temporary financial problems into terminal ones. Moreover, introducing change into the

secured financing markets should be done with great care and consideration of potential ramifications. The Federal Reserve relies upon deep and liquid secured financing markets in its implementation of monetary policy. Policymakers should carefully evaluate the implications of any proposal to change established market practices on market functioning and potentially on the conduct of monetary policy.

Q.10. Can you cite an example of when in its history the Federal Reserve was early about doing something on a looming banking crisis?

A.10. In the period leading up to the crisis, the Federal Reserve and other U.S. banking supervisors took several important steps to improve the safety and soundness of banking organizations and the resilience of the financial system. For example, following the September 11, 2001, terrorist attacks, we took steps to improve clearing and settlement processes, business continuity for critical financial market activities, and compliance with Bank Secrecy Act, anti-money laundering, and sanctions requirements. Other areas of focus pertained to credit card subprime lending, the growth in leveraged lending, credit risk management practices for home equity lending, counterparty credit risk related to hedge funds, and effective accounting controls after the fall of Enron. These are examples in which the Federal Reserve took aggressive action with a number of financial institutions, demonstrating that effective supervision can bring about material improvements in risk management and compliance practices at supervised institutions.

In addition, the Federal Reserve, working with the other U.S. banking agencies, issued several pieces of supervisory guidance before the onset of the recent crisis—taking action on nontraditional mortgages, commercial real estate, home equity lending, complex structured financial transactions, and subprime lending—to highlight emerging risks and point bankers to prudential risk management practices they should follow. Moreover, we identified a number of potential issues and concerns and communicated those concerns to the industry through the guidance and through our supervisory activities.

Q.11. Chairman Bernanke, what share of the blame does the Federal Reserve bear for the catastrophe of last year?

A.11. As I stated in a speech on October 23, entitled, “Financial Regulation and Supervision after the Crisis: The Role of the Federal Reserve,” this crisis was an extraordinarily complex event with multiple causes. Weaknesses in the risk-management practices of many financial firms, together with insufficient buffers on capital and liquidity, were clearly an important factor in the crisis. Unfortunately, regulators and supervisors did not identify and remedy many of those weaknesses in a timely way. All financial regulators, including of course the Federal Reserve, must take a hard look at the experience of the past 2 years, correct identified shortcomings, and improve future performance. Over the past several months, the Federal Reserve has taken several significant steps to strengthen its regulatory and supervisory framework.

Q.12. Chairman Bernanke, what was the biggest mistake you made over the last year?

A.12. It is an extraordinary privilege to work at the Federal Reserve. I work with some of the most talented individuals one would find in either the private or public sector. Although I try to take every opportunity to thank my colleagues, given the extraordinary challenges they have confronted the past few years, I am sure I could have said it more often.

As I testified before the Committee, a financial crisis of the severity we have experienced must prompt financial institutions and regulators alike to undertake unsparing self-assessments of their past performance. Clearly, financial regulators, including the Federal Reserve, did not do enough to prevent excessive risk-taking in our financial system. At the Federal Reserve, we have been actively engaged in identifying and implementing improvements in our regulation and supervision of financial firms. In the realm of consumer protection, during the past 3 years, we have comprehensively overhauled regulations aimed at ensuring fair treatment of mortgage borrowers and credit card users, among numerous other initiatives. To promote safety and soundness, we continue to work with other domestic and foreign supervisors to require stronger capital, liquidity, and risk management at banking organizations, while also taking steps to ensure that compensation packages do not provide incentives for excessive risk-taking and an undue focus on short-term results. Drawing on our experience in leading the recent comprehensive assessment of 19 of the largest U.S. banks, we are expanding and improving our cross-firm, or horizontal, reviews of large institutions, which will afford us greater insight into industry practices and possible emerging risks. To complement on-site supervisory reviews, we are also creating an enhanced quantitative surveillance program that will make use of the skills not only of supervisors, but also of economists, specialists in financial markets, and other experts within the Federal Reserve. We are requiring large firms to provide supervisors with more detailed and timely information on risk positions, operating performance, and other key indicators, and we are strengthening consolidated supervision to better capture the firmwide risks faced by complex organizations. In sum, heeding the lessons of the crisis, we are committed to taking a more proactive and comprehensive approach to oversight to ensure that emerging problems are identified early and met with prompt and effective supervisory responses.

Q.13. Given the benefit of hindsight, would you still bail out Bear Stearns in the way that you did last year? What would you do differently?

A.13. At the time of the near collapse of the investment bank Bear Stearns, Federal Reserve lending under section 13(3) of the Federal Reserve Act was the only tool available to the U.S. Government to prevent the disorderly collapse of the company. A disorderly failure of Bear Stearns in early 2008 could have had seriously adverse effects on financial markets and financial institutions, effects that—as later demonstrated in the case of Lehman Brothers—could have been extremely difficult to contain. The adverse effects would not have been confined to the financial system but would have been

felt broadly in the real economy through their effects on asset values and credit availability. In light of these facts, I believe the Federal Reserve, with the full support of the Treasury Department, acted appropriately in providing secured loans to facilitate the acquisition of Bear Stearns by JPMorgan Chase.

The events associated with Bear Stearns clearly highlight the need for strong, consolidated supervision of all systemically important firms—not just those that own a bank. They also demonstrate the need for a resolution regime that would allow the orderly wind down or restructuring of a financial firm the disorderly failure of which would otherwise threaten financial stability and the economy.

Q.14. On November 24, 2009, Reuters reported that the U.S. Federal Reserve asked banks that were part of its so-called "stress tests" to submit plans to repay government money lent to them under the Trouble Asset Relief Program (TARP).

Without going into specifics on individual financial institutions or naming names, do you foresee any financial institutions that will have trouble repaying their TARP money? How will you handle companies that face challenges in repaying taxpayer money?

A.14. With respect to the firms that participated in the "stress test," 18 of the 19 had TARP preferred stock. Of those 18 firms, 10 have now fully redeemed their TARP capital. Each of those firms issued significant common equity in connection with the TARP redemption. The Federal Reserve and other supervisors are in discussions with the remaining 8 SCAP firms that have outstanding TARP capital in order to facilitate reduced reliance on TARP capital, while ensuring they can maintain capital levels consistent with supervisory expectations after any proposed redemption.

Among the many companies that received TARP Capital Purchase Program investments, which include firms not subject to SCAP, it is likely that some will have trouble repaying their TARP funds. Indeed, some institutions that received TARP investments have since reported significant financial deterioration and have already deferred payment of interest/dividends on their TARP securities in order to preserve capital. The banking agencies will address companies that face challenges in repaying TARP investments in the same manner that they address other companies facing capital constraints. To the extent that the repayment of TARP instruments or payment of dividends on the TARP funds would raise questions about the adequacy of capital at an insured depository or its consolidated parent company, the banking agencies may object to the payout and require the institution to retain the investment in order to preserve its resources and meet obligations to insured depositors.

Q.15. On December 3, 2009, *The Wall Street Journal* reported that the Bank of America is set to repay its TARP funds. Given that news, along with the Federal Reserve's request that financial institutions submit plans for repayment and the critical role that you played lobbying Congress for the creation of TARP I am interested in your opinion on the need to continue the program. As you know the authority to purchase new troubled assets under TARP expires

on December 31, 2009, but that it can be extended for almost another year. Do you believe that the stability of our Nation's financial system necessitates an extension of this bailout program?

A.15. The TARP program has contributed significantly to the improved conditions in financial markets. By providing capital to be invested in numerous financial institutions and establishing programs to restore the flow of credit, TARP has been a key stabilizing factor for the financial system. But more progress is needed. Far too many Americans are without jobs, and unemployment could remain high for some time even if, as we anticipate, moderate economic growth continues. Small businesses continue to face challenging credit conditions although, as I noted in my testimony before the Banking Committee, the Term Asset-Backed Securities Loan Facility has made an important contribution by helping to finance some 480,000 loans to small businesses. More broadly, the financial system has not yet fully recovered and remains vulnerable to unexpected shocks in the near future. Indeed many of the favorable indications in financial markets remain linked to the presence of TARP and other government initiatives, including the extraordinary actions taken by the Federal Reserve under its monetary policy and financial stability authorities that I outlined in my testimony. In his recent letter to the Congress about the extension of the TARP, Secretary Geithner struck a reasonable balance in stating his intention to dedicate most of the remaining TARP funds to deficit reduction while maintaining for a period the capacity to respond should financial conditions unexpectedly worsen.

Q.16.a. *The Wall Street Journal* reported on some questions that different economists felt that you should answer. Let me borrow from some of those and I will credit them with their questions accordingly:

Anil Kashyap, University of Chicago Booth Graduate School of Business: With the unemployment rate hovering around 10 percent, the public seems outraged at the combination of three things: (a) substantial TARP support to keep some firms alive, (b) allowing these firms to pay back the TARP money quickly, (c) no constraints on pay or other behavior once the money was repaid. Was it a mistake to allow (b) and/or (c)?

A.16.a. TARP capital purchase program investments were always intended to be limited in duration. Indeed, the step-up in the dividend rate over time and the reduction in TARP warrants following certain private equity raises were designed to encourage TARP recipients to replace TARP funds with private equity as soon as practical. As market conditions have improved, some institutions have been able to access new sources of capital sooner than was originally anticipated and have demonstrated through stress testing that they possess resources sufficient to maintain sound capital positions over future quarters. In light of their ability to raise private capital and meet other supervisory expectations, some companies have been allowed to repay or replace their TARP obligations. No targeted constraints have been placed on companies that have repaid TARP investments. However, these companies remain subject to the full range of supervisory requirements and rules. The Federal Reserve has taken steps to address compensation practices

across all firms that we supervise, not just TARP recipients. Moreover, in response to the recent crisis, supervisors have undertaken a comprehensive review of prudential standards that will likely result in more stringent requirements for capital, liquidity, and risk management for all financial institutions, including those that participated in the TARP programs.

Q.16.b. Mark Thoma, University of Oregon and blogger: What is the single, most important cause of the crisis and what is being done to prevent its reoccurrence? The proposed regulatory structure seems to take as given that large, potentially systemically important firms will exist, hence, the call for ready, on the shelf plans for the dissolution of such firms and for the authority to dissolve them. Why are large firms necessary? Would breaking them up reduce risk?

A.16.b. 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, triggered by the end of the housing expansion in the United States and other countries. Financial institutions have been adversely affected by the financial crisis itself, as well as by the ensuing economic downturn.

This crisis did not begin with depositor runs on banks, but with investor runs on firms that financed their holdings of securities in the wholesale money markets. Much of this occurred outside of the supervisory framework currently established. An effective agenda for containing systemic risk thus requires elimination of gaps in the regulatory structure, a focus on macroprudential risks, and adjustments by all our financial regulatory agencies.

Supervisors in the United States and abroad are now actively reviewing prudential standards and supervisory approaches to incorporate the lessons of the crisis. For our part, the Federal Reserve is participating in a range of joint efforts to ensure that large, systemically critical financial institutions hold more and higher-quality capital, improve their risk-management practices, have more robust liquidity management, employ compensation structures that provide appropriate performance and risk-taking incentives, and deal fairly with consumers. On the supervisory front, we are taking steps to strengthen oversight and enforcement, particularly at the firm-wide level, and we are augmenting our traditional microprudential, or firm-specific, methods of oversight with a more macroprudential, or system-wide, approach that should help us better anticipate and mitigate broader threats to financial stability.

Although regulators can do a great deal on their own to improve financial regulation and oversight, the Congress also must act to address the extremely serious problem posed by firms perceived as "too big to fail." Legislative action is needed to create new mechanisms for oversight of the financial system as a whole. Two important elements would be to subject all systemically important financial firms to effective consolidated supervision and to establish procedures for winding down a failing, systemically critical institution to avoid seriously damaging the financial system and the economy.

Some observers have suggested that existing large firms should be split up into smaller, not-too-big-to-fail entities in order to reduce risk. While this idea may be worth considering, policymakers

should also consider that size may, in some cases, confer genuine economic benefits. For example, large firms may be better able to meet the needs of global customers. Moreover, size alone is not a sufficient indicator of systemic risk and, as history shows, smaller firms can also be involved in systemic crises. Two other important indicators of systemic risk, aside from size, are the degree to which a firm is interconnected with other financial firms and markets, and the degree to which a firm provides critical financial services. An alternative to limiting size in order to reduce risk would be to implement a more effective system of macroprudential regulation. One hallmark of such a system would be comprehensive and vigorous consolidated supervision of all systemically important financial firms. Under such a system, supervisors could, for example, prohibit firms from engaging in certain activities when those firms lack the managerial capacity and risk controls to engage in such activities safely. Congress has an important role to play in the creation of a more robust system of financial regulation, by establishing a process that would allow a failing, systemically important nonbank financial institution to be wound down in an orderly fashion, without jeopardizing financial stability. Such a resolution process would be the logical complement to the process already available to the FDIC for the resolution of banks.

Q.16.c. Simon Johnson, Massachusetts Institute of Technology and blogger: Andrew Haldane, head of financial stability at the Bank of England, argues that the relationship between the banking system and the government (in the U.K. and the U.S.) 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 macro economy over time. What can be done to break this loop?

A.16.c. 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. A new regulatory structure should 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.

Q.16.d. Brad Delong, University of California at Berkeley and blogger: Why haven't you adopted a 3 percent per year inflation target?

A.16.d. The public's understanding of the Federal Reserve's commitment to price stability helps to anchor inflation expectations and enhances the effectiveness of monetary policy, thereby contributing to stability in both prices and economic activity. Indeed, the longer-run inflation expectations of households and businesses have remained very stable over recent years. The Federal Reserve has not followed the suggestion of some that it pursue a monetary policy strategy aimed at pushing up longer-run inflation expectations. In theory, such an approach could reduce real interest rates and so stimulate spending and output. However, that theoretical argument ignores the risk that such a policy could cause the public to lose confidence in the central bank's willingness to resist further upward shifts in inflation, and so undermine the effectiveness of monetary policy going forward. The anchoring of inflation expectations is a hard-won success that has been achieved over the course of three decades, and this stability cannot be taken for granted. Therefore, the Federal Reserve's policy actions as well as its communications have been aimed at keeping inflation expectations firmly anchored.

Q.17. The Obama administration uses a phrase that, before the beginning of the year, I was not all that familiar with. They talk about jobs that are "created or saved." As an economist, can you define what a "saved" job is? How would one measure how many jobs are being saved? Do you know of any economist or Federal agency that measures the number of jobs saved (if they do, please provide some detail as to when they decided to track that number and how they define it and measure it)?

A.17. The Council of Economic Advisers has been compiling the Administration's estimates of jobs created or saved, and can provide you with the details of their methodology. In general, the challenge in estimating jobs created or saved is the need to try to estimate how employment would have evolved in the absence of the policy being considered.

Q.18. Section 109 of the recently enacted "Credit Card Accountability, Responsibility and Disclosure Act of 2009" (P.L. 111-24) requires card issuers to consider the ability of a consumer to make required payments on an account before opening the account or increasing an existing line of credit. The provision in Section 109 results from an amendment that was proposed to the underlying legislation. The original amendment would have required card issuers to consider income and similar metrics when evaluating an applicant's or cardholder's ability to make payments on a credit card account. Such specificity was deleted in the amendment that was ultimately adopted as part of the Credit CARD Act. Furthermore, again unlike in the mortgage context, obtaining income and asset information can be very difficult in the context of a credit card relationship, especially in connection with credit line increases and credit obtained at the point of sale.

Could you explain why the Board's proposed regulations to implement Section 109 reinserted the notion that card issuers must consider income or assets despite what appeared to be clear indications that Congress did not believe it was necessary?

Can you please provide the Committee any and all information the Board considered when it determined that the consideration of income/assets would result in a statistically significant improvement in the underwriting of credit card loans? If you do not have any such information, or if the Board cannot conclude that the consideration of income/assets results in a statistically significant underwriting improvement, please indicate such.

Please quantify for the Committee the benefits associated with the consideration of a consumer's income or assets in connection with a credit card loan and compare them to the operational and other costs associated with such a requirement. Please include, in particular, costs such as systems changes, reduced credit availability at the point of sale, the adverse selection of relying on consumers to request credit line increases, and consumer dissatisfaction that would result.

Assume a credit card issuer obtains income information from an applicant, and obtains information from a consumer report about the consumer's credit obligations. Would you please provide examples of what a card issuer should do with this information, and statistical (or other) evidence of how such information would demonstrably improve upon other underwriting mechanisms?

A.18. Our implementation of the Credit Card Accountability, Responsibility and Disclosure Act of 2009 ("Card Act") has followed the process used by the Board in other rulemakings. After reviewing the statutory language and legislative history of the Act, including Section 109, we conducted outreach meetings with both industry representatives (including retailers) and consumer groups to inform our judgments about the best way to implement the statute. We also drew on our recent experience in developing mortgage regulations that require creditors to consider consumers' ability to make the scheduled loan payments.

Section 109 requires card issuers to consider a consumer's ability to make the required payments under the terms of the account before opening the account or increasing an existing credit limit. Under the Board's proposal, a card issuer must, at a minimum, consider the consumer's ability to make the required minimum periodic payments after reviewing the consumer's income or assets as well as the consumer's current obligations. The proposed rules specify, however, that card issuers may also consider other factors traditionally used by the industry in determining creditworthiness, such as the consumer's payment history, credit report, or credit score. These additional factors provide creditors with useful information about a consumer's past propensity to pay.

The Board's publication of the proposed rules did not reflect a final determination regarding the appropriate method for ensuring that a card issuer considers a consumer's ability to make the required payments. Instead, the Board provided the public with an opportunity to comment on the advantages and disadvantages of the proposed rules. The comments we received raised many of the same issues you have raised. In particular, comments from card issuers and retailers generally stated that there are significant operational and other costs associated with collecting and considering information about a consumer's income or assets. However, comments from consumer groups supported consideration of income

or asset information and urged the Board to go further by requiring that this information be verified through documentation or other means. The Board is currently in the process of considering these and other issues raised by the public comments in order to develop a final rule.

Q.19. At your hearing you said that the Federal Reserve did not see any asset bubbles in the U.S. Why don't you consider what is occurring in the gold market to be a bubble? Or, should we see it as a forward indicator of increasing inflation?

A.19. Gold is used for a wide range of purposes, including as an investment, a reserve asset, or in the production of jewelry and other products. Accordingly, it is often unclear whether movements in gold prices owe to changes in supply or demand, and whether those movements are consistent with fundamentals or might indicate a bubble. However, the recent rise in gold prices has not been much out of line with the increases in other commodities, suggesting that increases in gold prices might well be consistent with fundamentals, perhaps reflecting the global economic recovery. Gold prices may also reflect general economic uncertainty. As measures of U.S. expected inflation drawn from inflation-protected bond yields and from surveys of consumers and professional forecasters have remained well contained, it seems unlikely that higher gold prices signal higher inflation expectations.

Q.20. Are you concerned that Congress with various fiscal policies and the Federal Reserve with its various monetary policies, low Federal funds rate and purchasing mortgage backed securities and Treasuries, will re-inflate the housing bubble with even more liability for the taxpayer given the increase in federally guaranteed mortgages?

A.20. Of course, the Federal Reserve needs to be alert to the full range of potential consequences of our policies, and we will continue to carefully monitor conditions in housing markets. That said, however, the prospect of a re-ignited housing bubble does not seem likely in the period ahead. The demand for housing appears to be strengthening gradually, supported by a variety of factors including low mortgage interest rates for the most creditworthy borrowers, home prices that have fallen considerably from their peaks, and various government tax and credit initiatives. But by no means does this gradual improvement signal an overheating in housing markets. Nationally, house prices have declined 30 percent from their peak. Futures markets foresee only tepid increases over the next year; similarly, respondents to the Reuters University of Michigan survey of consumers expect at best sluggish appreciation. Home sales are still at comparatively low levels, and credit availability remains difficult for many borrowers, far different from the situation prior to the financial crisis. In addition, mortgage markets now operate under revised Federal Reserve regulations restricting certain unfair, abusive, or deceptive lending activities that contributed to the earlier excesses in the housing market. Finally, the large number offoreclosures that are likely to come on the market represents a significant potential source of downward pressure on house prices that may linger for some time.

Q.21. Mr. Chairman, as you know the FHA is insuring somewhere between 30 to 40 percent of the new home loans made in the country at the same time that its loan reserves are below 2 percent and there is a real threat that the FHA runs out of money and has to come to Congress or the Treasury for an appropriation.

What are the long term consequences of a mortgage market so heavily reliant on a guarantee by the Federal government?

How do we transition back to a market without such a heavy reliance on the taxpayer?

As a banking regulator, what views do you and the Federal Reserve have about the safety and soundness of loans made by banks with only a 3.5 percent downpayment? Should Congress be concerned that they are more risky than a loan made with a 10 or 20 percent downpayment?

A.21. The FHA is currently serving an important role in supporting housing demand because it is the main source of finance for homebuyers with less than 20 percent downpayments. According to data from the National Association of Realtors, the typical first-time homebuyer over the past few years has had a down payment of less than 10 percent of the purchase price of the home. In addition, the FHA provides an outlet for borrowers seeking to refinance out of loans held in subprime or alt-A mortgage-backed securities who have seen their initial equity cushions decrease.

As house prices stabilize over the next couple of years, outsized losses at mortgage insurance companies and banks—the traditional alternatives to FHA loans—should diminish. Once the effects of the extraordinary credit boom and bust of this decade start to wane, private lenders will again likely find it profitable to enter the market for higher LTV loans and the mortgage market should return to its traditional structure, where the FHA plays an important, but limited, role.

Higher LTV loans, including FHA loans, are obviously more exposed to house price movements than loans where the borrower has made a large downpayment. As a result, it is particularly important that all lenders underwrite higher LTV loans with particular caution; for example, by carefully verifying the borrower's ability to repay and history of meeting credit obligations. (For banks, these risk mitigants, and other items, were contained in supervisory letters SR 06-15 and 07-12.)

As always, banks, the FHA, the GSEs, and other institutions participating in the mortgage market should seek to accurately measure and appropriately price the risks they accept when making loans. For the FHA, the prudent underwriting of mortgages may also entail the development of new mortgage products and greater expenditures on technology and software resources that would allow it to better measure and manage its credit risk exposure. Otherwise, it may suffer from adverse selection as other lenders come back into the mortgage market.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

[FROM THE WASHINGTON POST, THURSDAY, DECEMBER 3, 2009—LETTER TO THE EDITOR, P. A32]

The Right Role for the Fed

Regarding Federal Reserve Chairman Ben Bernanke's Nov. 29 Sunday Opinion commentary, "The Right Reform for the Fed":

As a result of legislative convenience, bureaucratic imperative and historical happenstance, a variety of responsibilities have accreted to the Fed over the years. In addition to conducting monetary policy, the Fed also distributes currency, runs the system through which banks transfer funds, supervises financial holding companies and some banks, and writes rules to protect consumers in financial transactions. Mr. Bernanke argues that preserving this melange is not only efficient but crucial to protecting the Fed's independence.

Apparently, the argument runs, there are hidden synergies that make expertise in examining banks and writing consumer protection regulations useful in setting monetary policy. In fact, collecting diverse responsibilities in one institution fundamentally violates the principle of comparative advantage, akin to asking a plumber to check the wiring in your basement.

There is an easily verifiable test. The arm of the Fed that sets monetary policy, the Federal Open Market Committee (FOMC), has scrupulously kept transcripts of its meetings over the decades. (I should know, as I was the FOMC secretary for a time.) After a lag of 5 years, this record is released to the public. If the FOMC made materially better decisions because of the Fed's role in supervision, there should be instances of informed discussion of the linkages. Anyone making the case for beneficial spillovers should be asked to produce numerous relevant excerpts from that historical resource. I don't think they will be able to do so.

The biggest threat to the Fed's independence is doubt about its competence. The more the Congress expects the Fed to do, the more likely will such doubts blemish its reputation.

VINCENT REINHART,
Resident scholar at the American Enterprise Institute.