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

BEN S. BERNANKE
CHAIRMAN

January 5, 2011

The Honorable Bernard Sanders
United States Senate
Washington, D.C. 20510

Dear Senator:

I am responding to your letter of December 6, 2010, in which you asked several questions about the information released by the Federal Reserve on December 1, 2010, regarding the usage of Federal Reserve credit and liquidity facilities. That release provided detailed information on credit and other transactions conducted to stabilize markets during the recent financial crisis, restore the flow of credit to American families and businesses, and support economic recovery and job creation in the aftermath of the crisis.

In your first question, you asked how the Federal Reserve managed the conflicts of interest arising for senior executives of corporations that borrowed from the Federal Reserve and also served on the boards of directors of Federal Reserve Banks.

The Federal Reserve, with input from a wide range of financial institutions and other market participants, developed a series of emergency lending facilities to address the financial crisis that emerged in the summer of 2007. Federal Reserve Bank directors had no involvement in a Reserve Bank's decision to make credit available under any of these emergency lending facilities. These facilities were all approved by the Board of Governors and were not subject to approval or review by the Reserve Bank boards of directors. Only borrowers that met the strict and transparent eligibility requirements for each particular emergency lending facility were able to participate in the facility.

Reserve Bank directors are explicitly included among the officials subject to the federal conflict of interest statute. 12 U.S.C. § 208. This statute imposes criminal penalties on Reserve Bank directors who participate personally and substantially as a director in any particular matter that, to the director's knowledge, will affect the director's financial or business interests or those of his immediate family. Reserve Banks routinely provide their new directors with specific training on the federal conflicts of interest statute. Reserve Bank corporate secretaries have the expertise to respond to inquiries by directors regarding possible conflicts of interest in order to assist them in complying with the statute.

Importantly, Federal Reserve System policies also prevent a Reserve Bank director from influencing business matters involving firms owned by the director or with which the director is affiliated, thereby limiting actual or potential conflicts of interest that could arise from either affiliation or stock ownership. Reserve Bank directors are not involved, for example, in matters related to the supervision of particular banks or bank holding companies. While they do vote on recommendations to the Board regarding the level of the discount rate, directors are not involved in any aspect of decisions regarding discount window lending to any financial institution. Moreover, Reserve Bank directors played no role in either approving the establishment of the emergency facilities or authorizing the specific transactions undertaken pursuant to those facilities. The Board of Governors of the Federal Reserve, not the Reserve Banks, approved the establishment of each of the emergency facilities.

Each emergency facility had objective and well-documented eligibility requirements established by the Board of Governors, which are publicly available on the Federal Reserve's websites. Only those institutions that met the eligibility requirements for a particular program were able to participate in that program, and the Reserve Banks administering the programs had no discretion to waive or ease eligibility requirements in particular cases. An institution that was eligible to participate could do so if it chose without the need for "influence," while an institution that was not eligible would not have been able to participate without regard to any efforts at influence.

The Federal Reserve is working with the Government Accountability Office (GAO) on an audit mandated by the Dodd-Frank legislation that requires the GAO to identify changes to selection procedures for Federal Reserve Bank directors or other aspects of Federal Reserve Bank governance to eliminate actual or potential conflicts of interest in bank supervision. Another GAO report mandated by Dodd-Frank requires the GAO to assess whether there were conflicts of interest with respect to the manner in which various emergency lending programs were established or operated.

In your second question, you asked how much money the Federal Reserve lent to each of the material investors in the Term Asset-Backed Securities Loan Facility (TALF) and how much each one profited or lost as a result of participating in the TALF. The amount lent to each TALF borrower can readily be determined using the information provided on the Federal Reserve Board's website as part of the December 1, 2010, release. The published information includes the borrower for each TALF loan, the U.S. city and state in which the borrower was located, the terms of the loan, and collateral information.

Each TALF loan had a single borrower, which was required to be a U.S. company. The website also reports information on individuals or entities, if any, that are understood by the Federal Reserve to have held a "material" investment in a TALF borrower, defined as a 10 percent or greater interest in the TALF borrower. Information on material investors was collected by the TALF agents or, in some cases, provided directly to the Federal Reserve Bank of New York by the TALF borrower, as part of the TALF due diligence program.[1] Some TALF borrowers had one or more material investors, while others had none. The Federal Reserve Bank of New York made loans to the TALF borrowers, not to the material investors in the TALF borrowers. The Federal Reserve does not know the amounts earned by the material investors.

It is also important to note that TALF was a broad market support program that benefited U.S. consumers and businesses. The TALF was introduced, in cooperation with the Treasury, to encourage the issuance of asset-backed securities (ABS) backed by new loans to U.S. consumers and businesses. ABS are a common instrument used to finance a variety of consumer and business credit, including small business loans, auto loans, student loans, and credit card loans. ABS markets became severely disrupted during the financial crisis in 2008, drastically reducing the supply of credit to consumers and businesses. By restarting the ABS market, the TALF supported nearly 2 million auto loans and over 1 million student loans to residents of the United States, nearly 900,000 loans to small U.S. businesses, 150,000 other U.S. business loans, and hundreds of millions of U.S. credit card loans.

The TALF worked by providing loans to ABS investors to finance part of their purchases of eligible ABS. The ABS investors provided the rest of the financing and so had their own capital at risk. The program was designed to encourage very broad participation; any U.S. company could potentially borrow from the facility. The broader the participation, the greater was the resulting flow of credit to U.S. consumers and small businesses. Nearly 200 different borrowers participated in the TALF, including traditional asset managers, pension funds, hedge funds, and banks, as well as many smaller companies.

The TALF loan rates were set at levels well above those that had prevailed under normal market conditions. As a consequence, even though no TALF loans have come due according to their stated maturity dates, about two-thirds of the loans by dollar amount have been repaid early, likely as borrowers replaced the TALF financing with cheaper market financing or sold the securities financed by the TALF loans. All remaining TALF loans are current in their payments of principal and interest and all remain well collateralized.

In your third question, you asked why the Federal Reserve extended TALF loans to material investors located in the Cayman Islands. As I noted in the response to your second question, the Federal Reserve did not lend to the material investors. Although some of the individuals or entities that reportedly had material investments in TALF borrowers were based abroad, the Federal Reserve only extended loans through the

[1] Because of the large number of participants, TALF borrowers interacted with the Federal Reserve through "TALF agents," consisting of the primary dealers and other broker dealers selected to help the program reach as diverse a set of borrowers as possible.

TALF to U.S. companies. Moreover, the program was designed to increase the flow of credit to U.S. consumers and businesses of all sizes. It accomplished that objective by requiring that all or substantially all loans backing TALF-eligible ABS be to U.S. residents or U.S. businesses; similarly, all or substantially all of the mortgages backing TALF-eligible commercial mortgage backed securities (CMBS) had to be secured by U.S. properties.

In your third question you also asked, more broadly, if the Federal Reserve lent under its emergency facilities to entities located in the Cayman Islands or other tax havens. As noted above, the Federal Reserve lent only to U.S. companies (including, in some cases, U.S. branches and agencies of foreign banks) under the credit facilities established under its emergency authority, including the TALF.

In your fourth question, you asked why the Federal Reserve lent to a U.S. branch of a foreign bank through the Term Auction Facility (TAF). Section 19 of the Federal Reserve Act as amended by the Monetary Control Act of 1980 requires the Federal Reserve to provide most U.S. branches and agencies of foreign banks with access to Federal Reserve credit on the same terms that it is provided to U.S. depository institutions. Bank funding markets, especially term funding markets, came under severe pressure during the financial crisis. To address these funding pressures, the Federal Reserve first took steps to increase the amount of liquidity available to financial institutions through the discount window. However, many banks were reluctant to borrow at the discount window out of fear that their borrowing would become known and would erroneously be taken as a sign of financial weakness. To meet the demands for term funding more directly, the Federal Reserve established the Term Auction Facility in December 2007.

Under the TAF, the Federal Reserve auctioned discount window loans to depository institutions (U.S. commercial banks, savings institutions, and credit unions, as well as U.S. branches and agencies of foreign banks) that were eligible for primary credit. All depository institutions that maintain deposits subject to reserve requirements are eligible to borrow from the Federal Reserve's discount window. TAF lending helped ease conditions in the term dollar funding markets used by depository institutions. Increasing the liquidity of depository institutions promoted increased lending to U.S. businesses and households. U.S. branches and agencies of foreign banks are important providers of credit to U.S. businesses.

In your fourth question, you also asked why the Federal Reserve lent to the central banks of South Korea and Mexico. The Federal Reserve did not extend credit to the central banks of South Korea or Mexico. The Federal Reserve established temporary central bank liquidity swap lines with a number of foreign central banks. Foreign central banks then drew on those lines to provide dollar liquidity to institutions in their jurisdictions. As a part of that program, the Federal Reserve swapped U.S. dollars with the central banks of South Korea and Mexico for an equivalent amount of foreign currency at market rates. The maximum amount of dollar liquidity provided to the Bank of Korea (the central bank of South Korea) at any point in time during the operation of the swap lines was $16.35 billion; the maximum amount of dollar liquidity provided to the Bank of Mexico (the central bank of Mexico) at any point in time was $3.22 billion.

These dollar liquidity swaps were conducted for the same reasons that dollar liquidity was provided to other central banks via the swap lines. Because of the role that the U.S. dollar plays in global financial markets, beginning in the second half of 2007, severe strains in dollar funding markets overseas disrupted financial conditions in the United States. The central bank liquidity swap lines were designed to address these strains and counter pressures that had developed in U.S. dollar financing markets in those countries. By relieving these pressures, the swap lines helped stabilize U.S. dollar funding markets both abroad and at home.

In your fourth and fifth questions, you asked why the Commercial Paper Funding Facility (CPFF), which was established by the Federal Reserve, purchased the commercial paper (CP) of a number of firms with non-U.S. parents. The CPFF bought only commercial paper issued by entities organized under the laws of the United States, including in some cases U.S. firms with foreign parents, or U.S. branches of foreign banks. The commercial paper market is a critical source of financing for U.S. businesses and financial intermediaries. Liquidity conditions in the commercial paper market had deteriorated sharply in the fall of 2008, reducing the availability of credit to U.S. businesses and households. The CPFF increased the liquidity of the CP market by providing greater assurance to investors in CP that firms would be able to roll over their maturing commercial paper. For the CPFF to be effective in improving the liquidity of the U.S. commercial paper market, it had to provide a liquidity backstop to a substantial portion of the market. The CP that was bought paid interest rates that were significantly above market rates in more normal times and participants in the program were required to pay a material fee. Each emergency lending facility, including the CPFF, had objective and well-documented eligibility requirements, which are publicly available on our website. Since the U.S. companies with foreign owners you listed qualified for the program and paid the appropriate fee, the CPFF bought their commercial paper. The entire CP purchased by the CPFF was repaid, with interest.

You also asked in your fifth question why the Federal Reserve accepted ABS backed by loans to U.S. households and businesses to purchase automobiles manufactured by foreign companies as collateral for the TALF. As I noted above, the TALF was designed to increase the availability of credit for U.S. households and businesses including, importantly, loans to purchase automobiles. All TALF-eligible auto ABS had to be backed entirely or almost entirely by loans to U.S. households and businesses. This helped U.S. consumers and the U.S. economy. I would note, also, that a much larger volume of TALF-eligible ABS was issued by the financing arms of U.S. auto manufacturers and retailers, including Ford, Chrysler, General Motors (through Ally Bank), and Harley Davidson.

Lastly, in your sixth question you urged the Federal Reserve to include on our website information on individual items of collateral pledged to back certain loans. Loans provided under some of the Federal Reserve's liquidity programs (such as the TALF) were closely tied to specific items of collateral, and the Federal Reserve had little or no recourse beyond these specific pieces of collateral in the event of default. In most cases, the assets were generated or acquired by the borrower with the view of participating in the Federal Reserve facility. In this way, the facility restarted markets that were frozen. For all of these programs, the Federal Reserve provided detailed information on all the individual assets that were pledged as collateral. For other lending programs, our loans were not tied to any particular piece of collateral, and the Federal Reserve had recourse to the borrower in the event of default--that is, the Federal Reserve was relying on all of the resources of the borrower, not just the general collateral pledged, for repayment of the loan. In these cases, the assets posted as collateral for the loan were not generated for the purpose of borrowing from the Federal Reserve and, instead, generally represented assets generated by the normal business activities of the borrower. For example, a bank would pledge a sizable portion of the mortgages, auto loans and other consumer loans it generated in the ordinary course of its business as collateral for loans from the TAF. For these programs, the Federal Reserve provided considerable information on the aggregate amount of collateral pledged along with a breakdown of the collateral by type and by credit rating. This information provides the public with a very clear view of the nature of the assets that were accepted as collateral and the risk embedded in that collateral and complies fully with the disclosure requirements of the Dodd-Frank Act.

As you know, the Dodd-Frank Act requires the Government Accountability Office to conduct a financial audit of all of the Federal Reserve's emergency lending programs, including an assessment of the effectiveness of the security and collateral policies established for each facility in mitigating risk to the relevant Federal Reserve Bank and thus to taxpayers. The Federal Reserve is working closely with the GAO and will provide any information on collateral that the audit team deems necessary for its review.

As you point out, the Federal Reserve released information on over 21,000 transactions on December 1, 2010. In addition, we have been providing on our website an ongoing basis on extensive information about the emergency credit facilities the Federal Reserve established in response to the financial crisis. My staff is available to help navigate the information, if that would be useful to you or your staff.

I hope this information is helpful. Please let me know if I can be of further assistance.

Sincerely,