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TESTIMONY

Actions by the New York Fed in Response to Liquidity Pressures in Financial Markets

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Good morning, Chairman Dodd, Ranking Member Shelby, and other members of the Committee. Thank you for giving me the opportunity to appear before you today. I am here to outline the actions by the Federal Reserve Bank of New York in response to present challenges in financial markets, including those in relation to the proposed merger of Bear Stearns and JPMorgan Chase.

On the evening of Thursday, March 13, 2008, I took part in a conference call with representatives from the Securities and Exchange Commission, the Board of Governors of the Federal Reserve and the Treasury Department. On that call, the SEC staff informed us that Bear Stearns' funding resources were inadequate to meet its obligations and that the firm had concluded that it would have to file for bankruptcy protection the next morning. The SEC said it concurred in that judgment, and it would spend the evening discussing with Bear what kind of bankruptcy filing was appropriate.

The conference call that evening took place against the backdrop of an extraordinarily challenging period in the U.S. financial system. This context was critical to the decisions we made over the next several days. And I think it's important to start with an explanation of the broad risks to the economy posed by the crisis now working through the financial system.

The intensity of the crisis we now face in U.S. and global financial markets is a function of the size and character of the financial boom that preceded it. This was a period of rapid financial innovation—particularly in credit risk transfer instruments such as credit derivatives and securitized and structured products. There was considerable growth in leverage, greater reliance on ratings on structured credit products and a marked deterioration in underwriting standards.

The innovation in financial products was accompanied by a dramatic increase in the amount of financial intermediation occurring outside the core banking system. The importance of securities broker-dealers, hedge funds, and mutual funds in the financial system rose steadily. Off-balance-sheet vehicles of various forms proliferated, and increased concentrations of longer-dated assets were held in funding vehicles with substantial liquidity risk.

The deterioration in the U.S. housing market late in the summer of 2007 precipitated a sharp rise in uncertainty about the value of securitized or structured assets. Demand for these assets contracted dramatically and the securitization market for mortgages and other credit assets stopped working. This, in turn, increased funding pressures for a diverse mix of financial institutions. Uncertainty about the magnitude and the level of losses for financial institutions fueled concern about credit risk in exposure to those institutions.

Part of the dynamic at work was that banks were forced to provide financing for—or take over—the assets in a range of structured investment vehicles and conduits financed by asset-backed commercial paper. As some investors attempted to liquidate their holdings of these assets, many of the