

**Conference Call of the Federal Open Market Committee on
February 7, 2009**

A joint conference call of the Federal Open Market Committee and Board of Governors of the Federal Reserve System was held on Friday, February 7, 2009, at 10:00 a.m. Those present were the following:

Mr. Bernanke, Chairman
Mr. Dudley, Vice Chairman
Ms. Duke
Mr. Evans
Mr. Kohn
Mr. Lacker
Mr. Lockhart
Mr. Tarullo
Mr. Warsh
Ms. Yellen

Mr. Bullard, Ms. Cumming, Mr. Hoenig, Ms. Pianalto, and Mr. Rosengren, Alternate Members of the Federal Open Market Committee

Messrs. Fisher, Plosser, and Stern, Presidents of the Federal Reserve Banks of Dallas, Philadelphia, and Minneapolis, respectively

Mr. Madigan, Secretary and Economist
Ms. Danker, Deputy Secretary
Mr. Luecke, Assistant Secretary
Mr. Skidmore, Assistant Secretary
Ms. Smith, Assistant Secretary
Mr. Alvarez, General Counsel
Mr. Baxter, Deputy General Counsel
Mr. Sheets, Economist
Mr. Stockton, Economist

Messrs. Clouse, Connors, Kamin, Slifman, Sullivan, Weinberg, Wilcox, and Williams, Associate Economists

Ms. Mosser, Temporary Manager, System Open Market Account

Ms. Johnson, Secretary of the Board, Office of the Secretary, Board of Governors

Mr. Frierson, Deputy Secretary of the Board, Office of the Secretary, Board of Governors

Ms. Bailey, Deputy Director, Division of Banking Supervision and Regulation, Board of Governors; Mr. English, Deputy Director, Division of Monetary Affairs, Board of Governors

Mr. Blanchard, Assistant to the Board, Office of Board Members, Board of Governors

Ms. Liang, Associate Director, Division of Research and Statistics, Board of Governors;
Mr. Nelson, Associate Director, Division of Monetary Affairs, Board of Governors

Ms. Beattie, Assistant to the Secretary, Office of the Secretary, Board of Governors

Mr. Williams, Records Management Analyst, Division of Monetary Affairs, Board of
Governors

Mr. Barron, First Vice President, Federal Reserve Bank of Atlanta

Mr. Fuhrer, Ms. George, and Mr. Rosenblum, Executive Vice Presidents, Federal
Reserve Banks of Boston, Kansas City, and Dallas, respectively

Messrs. Rasche and Schweitzer, Senior Vice Presidents, Federal Reserve Banks of St.
Louis and Cleveland, respectively

**Transcript of the Federal Open Market Committee Conference Call on
February 7, 2009**

CHAIRMAN BERNANKE. A good Saturday morning to everybody. Thank you for joining this meeting. This is going to be a joint FOMC–Board meeting because, although I do not anticipate we will be taking any formal action today, I do want to give everyone the opportunity to express views and to discuss policy issues. With that said, I need a motion to close the meeting.

MR. KOHN. So moved.

CHAIRMAN BERNANKE. Without objection. The Board is in session as well as the FOMC. Let me just welcome Governor Tarullo, who is joining us in his first meeting. He has been here working for about a week and is already contributing to discussions at the Board. The purpose of the meeting today is for me to discuss with you the Treasury’s proposed financial stabilization plan and, in particular, the Fed’s proposed role in that overall structure. This is a “close hold.” There have been a number of leaks, as often happens, which is very counterproductive; but I think the Fed has done well, and I would not like those leaks to come from the Fed. So I appreciate your keeping your confidence close.

We have been discussing, and by “we” I mean primarily the Treasury, the Federal Reserve, the FDIC, and the OCC, the last week or so—with a lot of staff work before that—a plan that Secretary Geithner will propose on Monday at 12:30 in a speech at the Treasury. They have been very wide-ranging discussions, and, frankly, there was little in the way of resolution or focus until very recently—only in the last 24 hours or so have we begun to see where Secretary Geithner wants to take the plan; in fact, we got a very substantial revision of the document this morning at 9:15, so you can see this is very much a work in progress.

But given the schedule for Secretary Geithner to announce the plan on Monday, I thought this was an opportune point for us to review the plan and the Fed's potential role. As you'll see when I go through the plan with you, the details are fairly lacking. There is an overall structure. That, in part, is on purpose. The political strategy is to provide an overall structure with some detail, but not a great deal of detail, with the idea that the public discussion and the congressional discussion will create some buy-in on the political side. It's like selling a car: Only when the customer is sold on the leather seats do you actually reveal the price. So the strategy, again, is to provide the framework to get the Congress involved within certain parameters, and then, only when there is some consensus on how the plan will work and what the key elements will be, to negotiate whether additional funding beyond \$350 billion is necessary.

But I think there are some advantages to that from a political point of view. I will say that both I and the staff—Bill Dudley and others—are somewhat concerned, at least given the way things stand now, about the market reaction. First, the lack of details will create some uncertainty and concern, particularly because there's not a great deal said about the “problem children,” the BAC and Citi. Secondly, I think the markets will be disappointed in the following sense: As I will describe, this is a real truth-telling kind of plan. It's fundamentalist. It's not about giving the banks a break. It's not about using accounting principles to give them back-door capital. It's very much market-oriented and “tough love.” And I think we all will like that. I like that. But the banks' shareholders aren't going to be thrilled about it.

As I will explain—and I'll go through this whole thing in detail in just a minute—the Fed's role in the bank stabilization plan per se is minimal. We may be called upon to do some transition or bridge-financing of parts of the aggregator bank concept to a more permanent, non-Fed financing, but we're not involved in any wraps or anything like that, so in the broad

elements of the bank stabilization plan, we are pretty much on the sidelines. Where we are part of the overall stabilization plan is in a proposed expansion of the TALF to include additional types of ABS. An important element of that would be that the Treasury will be proposing legislative action to ensure that we can sterilize the effects of any expansion of our balance sheet on bank reserves; and that would be, I think, a condition for us to fully meet the size of the expansion that they want. I'll come back to that in detail, but that, essentially, is where the Fed's role is visualized.

Let me go ahead now and go through the plan. I'll talk about the overall plan. I'll talk about the Fed's role. I'll give you some reasons why I think the Fed's role is appropriate for the economy and advances our own narrow institutional interests. Then we will take all the comments and questions that you would like to make. Again, because this is a meeting, voicing your views is certainly appropriate.

The first element of the stabilization plan is summarized as enhanced transparency about asset valuations and capital needs. So there's a principle here that I believe to be very important: The more disclosure and clarity there is, the less uncertainty there is and the better the chance that we'll come to some kind of stability.

One part of this first element will be a coordinated supervisory scrub of at least the top 20 banks or so to ensure that we understand how they are valuing their assets. We want to find some consistency in their marks, we want to find consistency in their provisioning, and we want to go beyond provisioning, which is focused on one-year losses, to look at expected losses beyond one year. So we're going to do a tough scrub of the balance sheets. We're going to require enhanced disclosure so that there will be as much information as possible, with as much consistency as possible, about the balance sheets of the banks.

Another part of this element is that this is going to be a forward-looking exercise. In particular, the standard Basel II regulatory capital standards are to some extent going to be subsumed in the following sense: There will be either explicitly or implicitly an analysis of bank balance sheets based not only on the current expectations or current modal forecasts, but on a stress scenario as well. And the presumption is that banks will have enough capital that they will be able to meet regulatory standards even in the stress scenario; that means there will be some presumption of a capital buffer—not a permanent increase in capital standards, but rather a temporary increase in capital required that could be run down over time in order to meet the standards even in a period of extreme stress.

The language of the presentation will be something along the lines that we want to be sure that our most important and largest banks, at least, and all of those banks are going to be resilient, even in the case of a very bad macroeconomic outcome. A forward-looking approach gets around the accounting issues about reserving versus marking to market, and we'll be very aggressive in terms of trying to get a proactive capital injection. They'll use this scenario to size the capital needs of particularly the top 20-25 banks, and, moreover, we will be looking not strictly at Basel II standards, as I said, but also at market-relevant standards, like TCE to total assets, as well as the Basel risk-weighted asset standards. So Step 1 is a scrub for consistency and an evaluation of the ability of banks to meet capital standards even in a bad scenario in the future.

The second element of the bank program is a capital facility. Of course, the first line of defense, to the extent that banks can, is accessing private capital markets, and they'll be strongly encouraged to do so. Obviously, that is very difficult except for a very few banks, so there will be a backup U.S. government capital facility. What appears to be now the most likely form of

capital is a convertible preferred instrument, which could be put in as preferred but converted to common as needed to meet the “well-capitalized” standard of 3 percent of risk-weighted assets for common equity.

I think about this as like an initial margin versus a maintenance margin. The initial margin you can think of as being 4 percent, either common or convertible preferred, which would be enough common or implicit common to meet the bad scenario. That’s the initial margin. The maintenance margin, though, is 3 percent common. Going forward, as the amount of common slips below 3 percent, then the banks will be forced to convert their preferred stock into common stock to maintain that common ratio of at least 3 percent; 3 and 4 percent are not the exact numbers—these numbers will be calibrated by these exercises looking at the scenarios. Again, this is focused primarily on the largest institutions, the top 22 or so, which are the ones above \$100 billion, but all banks would be eligible to take this common should they so desire. Again, the purpose is to capitalize banks in a forward-looking way so that they are able to withstand severe scenarios, and to focus more on common. I should add that I believe that the assumption is that even the existing preferred—the preferred that was injected under the first TARP round—would be changed to convertible, so that the initial TARP could be converted into common as needed.

We discussed at great length methods of taking bad assets off of bank balance sheets or insuring them. There are a lot of problems with these. There’s a sense that we need to do that but a lot of concern, in particular, about how to price, because too low a price will not attract any interest and too high a price will be a subsidy from the taxpayer. There was also a general preference—putting aside the accounting issues and so on, which are very important—for an aggregator bank, which takes assets off the balance sheets, as opposed to a ring fence or a

guarantee, which provides downside risk protection but doesn't clean the assets off of the bank's balance sheet.

So the current plan is to have an aggregator bank with initial capacity up to about \$500 billion, which is low—potentially it's expandable. The way it would be run would be as a public-private partnership. I'm speaking roughly—I don't have all the exact details—but the basic idea would be that there would be bidding by the private sector for the right to participate. The bids would reflect the amount of capital that the private sector agents were willing to contribute. The instrument that would be created would be a bank that would have both public and private capital. Regarding the funding, as I said, the Fed might place some initial bridge-financing to get the thing up and going initially, but in very short order the idea is that the funding would be through FDIC-insured liabilities, so the Fed would not be involved in any sustained way in this organization.

The government would give the bank instructions about broad asset classes to purchase, and there's some debate about this. There was some discussion about whether the asset purchases had to come from banks or not, or were just general. I think right now we're leaning towards restricting it to assets that are on bank balance sheets. But the asset price and purchase decisions would be made by the private sector with the profit motive guiding them; and the idea would be that this would avoid concerns about overpayment and would be an effective mechanism for price revelation and price discovery in these markets. So the third element would be the aggregator bank. Again, I think that will be viewed as very small, and banks will be disappointed about the pricing mechanism, which will not be some kind of subsidy to them; but it does have the advantage of being a market-based, truth-telling type of mechanism.

The fourth element is an extension of the FDIC program—the temporary liquidity guarantee program. The current plan is to extend it from July to October, a three-month extension, and perhaps to expand the cap, as well. The FDIC is also very eager to introduce a “covered bond”-type program, which would allow banks to finance for up to ten years on a heavily collateralized basis along the lines that we see in Europe, for example; and those covered bonds would be FDIC-guaranteed as well.

This capital process is going to end up with substantial government minority shares, at the least, in many large banks and majority shares in a few. So a very difficult and important question is: How are we going to manage that? We don't want to do it in a way that destroys the company, or destroys the franchise value, but, at the same time, we have to accept the reality of government ownership. The proposal from the Treasury is to set up an independent body called a Government Investment Board, the fifth element in the plan. The Government Investment Board would control all the shares, including not only the preferred but also the common shares that are invested in the banks and manage them from a wealth-maximization point of view. It also would be involved in setting guidelines, perhaps according to the share of ownership, for bank dividend policy, compensation policy, governance, and so on. So you can imagine the situation—in particular for a couple of banks we have in mind—where the government would have majority ownership: The bank would become subject to tough dividend and compensation restrictions, and the Government Investment Board, together with the supervisory authorities, would direct the bank in terms of issues like changing management, changing business plans, and so on. It would not be the government running the bank, but, in cases where the government has a high ownership share, it would assert those rights in the way that a supervisory authority

would. There will be an explicit objective to return ownership to the private sector as soon as possible, consistent with maintaining financial stability.

Sixth and finally, on the bank conditions, the President has already indicated some stronger conditions on lending and executive compensation. For lending there would be—and I will just quote the language—“banks would indicate a commitment to increase lending above a baseline, consistent with safety and soundness.” They would provide detailed information about their lending on a monthly basis, as well as a “qualitative description of the lending environment.” So this is an attempt to finesse the difficulties of measuring lending against an unknown baseline, but there will be some reporting requirements that will try to satisfy the political need to say the banks are making efforts to lend. This is obviously a very difficult issue and one in which the supervisors will have to play a role, because we’ll have to help mediate issues about when banks should be lending more and when we think that doing so is not consistent with safety and soundness. As already indicated, there will be stronger executive compensation restrictions. They are contemplating a dividend holiday—restricting dividends at all participants to one cent, at least for 2009. Finally, there would continue to be a distinction between banks voluntarily participating and those that are required to participate or are receiving exceptional support, in which case the dividend and compensation and other restrictions would be correspondingly tougher.

So that’s the broad nature of the plan. It’s got forward-looking capital. It’s got convertible capital. It’s got a Government Investment Board to manage that common stock. It’s got conditions on the banks. It has a private-public aggregator bank.

As I said, I think that will be somewhat disappointing to the market, and I hope that the Treasury will at least clarify in greater detail something about how to deal with the banks that

will almost immediately become government majority-owned. But there are still 48 hours to go, and, given the past experience, that's enough time for at least four major changes in the program.

Now to the Federal Reserve role. The Federal Reserve's principal role in this will be an expansion of the TALF, the asset-backed securities loan facility. There will be a joint announcement of an agreement between the Treasury and the Fed to expand the TALF from its current planned level of \$200 billion to potentially as high as \$1 trillion. The expansion will take place over time—based on learning, based on Fed management—but I think it will be made explicit, as we've already done, that we will be considering, besides the assets we are already looking at, ABS that include CMBS and private-label RMBS, which would include prime jumbo mortgages.

The initial plan for this expansion had the Fed program taking legacy assets. We have pushed back against that very hard, and we have gotten agreement that, as with the current TALF, the expanded TALF would take only newly securitized and newly rated ABS, not legacy assets. So we will not be involved in the aggregator bank or in the toxic asset removal process. I will note, just for clarity, that not all the assets themselves will be new; for example, in the case of commercial real estate, some of the underlying assets are existing buildings. But the securitizations and the ratings will be fresh; so that will reduce our risk, and, of course, the risk also is reduced substantially by the Treasury element.

Legally, in order for the TARP scoring to work in a favorable way, this has to be a Federal Reserve facility. So it will be a Federal Reserve facility. We will be the lead agency. We will be in charge of developing the program. We will have final say on the decisions with respect to the assets to be taken, the rate of expansion, the scale of expansion, and so on. I think

this is very important, and it will be clear that the Fed is autonomous and controlling its own balance sheet.

Finally, as I already mentioned, as part of this, very importantly, and as an explicit part of the announcements that Tim Geithner will make on Monday, the Treasury will propose to the Congress legislative changes that will allow the Fed to sterilize the implications of all of our lending, not just the TALF lending, on bank reserves and the money supply. So if that is done, that will be a major gain for us in terms of our concerns about macroeconomic stability.

I'm going to give you an opportunity in just a few minutes to comment and ask questions, but let me just say that this has gone through a lot of discussion and negotiation, and I can personally argue that I think that where the TALF and the Fed's role is now is good for the economy and is good for the Fed. On the economy, clearly, any understanding of what's happening in financial markets and the banking system has to recognize that one of the big problems is the shutdown of the securitization markets. Getting the banks lending again is all well and good, but there are limits to that. There needs to be additional lending capacity. We need to get the securitization markets going again. We are facing some very specific issues that were discussed at the FOMC meeting, like the upcoming crunch in commercial real estate finance. I think that this TALF program—although, again, we want to reserve the right to see how it works and to make changes and so on—is addressing a very important problem. And at this point, it would be doing so in a very broad-based way, because it will be covering a whole range of different kinds of assets; and the notion that we're somehow focusing on very narrow sets of assets would not be legitimate. I think this is good for the economy. I think it will be an important complement and perhaps one of the most powerful elements of this plan. And as we think about ways to use our balance sheet to stimulate the economy and ease financial

conditions, I think this is a very promising direction, consistent with stabilization of the banking system more broadly.

Looking at this from the Fed's perspective, just to reiterate, I think this is good for our institutional objectives. First of all, it respects Fed autonomy. This is a joint project. As I indicated, the Fed will take the lead in decisions about expansion and assets. We will not be taking legacy assets, and we will not be participating in wraps or running an aggregator bank. Those were some of the objectives, in terms of things that we wanted to stay away from, that I talked about at the last meeting, and we will not be involved in them.

Secondly, I think this overall is a very good step in the direction of protecting our balance sheet. For one thing, there is the Treasury's contribution: Our analysis of the first \$200 billion of the TALF suggests that the \$20 billion and 10 percent capital from the Treasury provide extremely good protection against any credit risk, so that we see very, very little risk of any credit losses to the Fed. For another thing, from a liquidity perspective, there is the very important step for the Treasury to support legislation to help us drain excess reserves.

There have been various discussions about the need for congressional approval, input, and so on. That will come, beginning with my testimony on Tuesday, which is on our use of our 13(3) authorities and a discussion of our role in bank rescues, et cetera, and in which I will, among other things, be saying that if there's a good resolution regime in place, we will be very comfortable with an accord that takes us out of that business. But more broadly, this whole plan will be presented to the Congress, including the TALF. We will get their feedback and their views, and in particular, they will have to take positive action on the reserve-draining mechanism for us to be able to undertake the TALF on the scale that has been described.

So I think this is positive. It moves us in the direction of the objectives I set forth at the FOMC meeting about where we want to go in terms of an accord. And I would add that, in working closely with the Treasury on these important matters and developing a good relationship, I think we increase the odds of getting cooperation in other areas we're concerned about, including removal of the SPVs from our balance sheet. And let me just say, on a very preliminary and close-hold basis, that I have also had some rather encouraging discussions with both the Treasury and the Congress on an inflation objective, and I think that also would be something I would want to preserve as we develop a good relationship with the Treasury.

I've spoken for quite a while. Let me stop now, and the rest of the meeting will just be your questions and your comments. Does anyone have any comments or question, Board or Presidents? I see President Lockhart.

MR. LOCKHART. Thank you, Mr. Chairman. Can you elaborate on how the sterilization is likely to be done? Will there be an expansion of the SFP or will we be issuing our own bills?

CHAIRMAN BERNANKE. The language on Monday would be that the Treasury will be pushing legislation to achieve this objective—it will not specify. I believe their preference would be to do it through the financing bills, but there will be two important improvements over the existing program. One is that it will be explicitly outside the debt limit; so there would be no constraints from the debt limit in terms of their ability to help us sterilize the balance sheet. Secondly, there would have to be a clear understanding that this was at the discretion of the Fed and not the Treasury; that is, the Treasury could not withhold a reasonable request from the Fed to provide those bills. President Fisher.

MR. FISHER. Thank you, Mr. Chairman, and thank you for the briefing. On the expansion of the TALF, is there a first-loss guarantee from the Treasury as we had before under the \$200 billion—the \$20 billion for the \$200 billion?

CHAIRMAN BERNANKE. Well, staff members have worked through the details for the first \$200 billion very carefully. They have developed haircuts for the various types of assets based on generous allowances for risk of loss. And then, of course, we have the \$20 billion of capital. The result that has been presented to me is that, for midrange haircuts—which are more generous than what the market is offering now but would be punitive under normal times—we see the risks to the Federal Reserve from the credit as being extraordinarily low.

Going forward, we would have the same process. The Treasury would provide capital. The haircuts would be set by some systematic process. I don't absolutely guarantee that the capital ratio would be 10 to 1, but whatever ratio it is would be set based on the presumption that with virtual certainty there would be no losses to the Federal Reserve.

MR. FISHER. So it's a moving thing. In other words, we don't know whatever first-loss guarantee we might require? That's an open door for us? Or you do not think it is going to be necessary?

VICE CHAIRMAN DUDLEY. There will be Treasury capital. The question is just, how much.

CHAIRMAN BERNANKE. There will definitely be Treasury capital. Will it be 10 to 1? You know, there are a number of parameters: There's the size of the haircut, there's the variability in the loss rates and the different assets that we consider, and then there's the capital. We can trade off among those things. Suppose we learn, for example, in the first round that the haircuts we're providing are in some sense too generous and that we get tremendous demand for

this lending. Then in the second round we could consider some tradeoff between bigger haircuts and lower capital. But in any case, it would be thoroughly vetted by the Board staff and the New York Fed and others to give us comfort that the risk of loss to the Federal Reserve is extremely low. In fact, under the current parameters, the risk of loss to the Treasury appears to be quite low; and there's \$20 billion ahead of us. So the basic principle—that there will be enough capital and sufficiently large haircuts to essentially eliminate any realistic risk of credit loss—will be preserved.

MR. FISHER. Mr. Chairman, I just have two other questions—these are data point questions. Internally, what kind of leverage do we expect to see realized on that \$1 trillion? That is, how much do we think the financial community will leverage that facility?

CHAIRMAN BERNANKE. Do you want to help, Bill?

VICE CHAIRMAN DUDLEY. Well, the haircuts on the existing program are slightly below 10 percent on average for the consumer asset-backed securities. So the leverage there is roughly 11 to 1. Obviously, as the Chairman said, we're going to have to go through the same analysis that we did for consumer asset-backed; we have to do it for other asset classes to determine what is an appropriate haircut given the expected loss experience of commercial real estate, of private-label RMBS, and so on, under these scenarios. So I think we can't say for sure exactly what the leverage ratio is going to be. As the Chairman said, we have choices on haircuts, we have choices on rates, we have choices on how much capital the Treasury supplies to backstop the facility—all those parameters can be adjusted. But I think, as a rule of thumb, we started down the TALF path for consumer asset-backed securities thinking that they were going to be roughly 10 percent. That's where we ended up. So it's probably going to be

something on the same order of magnitude. But the analysis is going to have to drive that process. I would hesitate to commit to a number before the staff has a chance to do that analysis.

MR. FISHER. One last question, Mr. Chairman. You mentioned, after spelling this out a bit before, that we would provide some bridge-financing for the aggregator bank. What's the order of magnitude and what's the dynamic of that bridge-financing that we contemplate presently?

CHAIRMAN BERNANKE. Well, it may or may not be needed. The maximum scale of the bank is \$500 billion at initial stages. It is a bank, and I assume it will be structured as a bank and, therefore, be eligible for normal discount window collateral-based lending. I think the notion is that in the very short run there may be some timing differences between the purchases being made by the asset managers and the acquisition of the financing. So there might be short periods of mismatch where Fed financing would allow the thing to operate.

I view this as being very short-term, well-collateralized, normal bank lending, and it should have no implications, I think, for our balance sheet or our monetary policy, because it will be a matter of weeks or a month or two at the most, I would imagine, and may not be necessary at all; but it's just a backstop as the thing gets running. We have a good bit of confidence that we can find long-term financing mechanisms other than the Fed, including even the possibility, for example, that the assets that are purchased might be paid for with guaranteed liabilities of the aggregator bank. So I don't view this as really a problem that any of us should be particularly concerned about, and it will not invoke any special authority. It will not invoke 13(3) or anything like that.

MR. FISHER. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. President Hoenig.

MR. HOENIG. Yes, Mr. Chairman. Thank you for the briefing. I have a couple of questions. When we do this scrubbing of these banks, is the source of the capital the remaining part of TARP, or is there additional funding anticipated for this?

CHAIRMAN BERNANKE. So this is a very, very close hold. Our very rough estimates suggest that it's conceivable, particularly given the assumption that the TARP I preferred stock could be converted to common, that we could actually manage this whole thing, including the expansion of the TALF, et cetera, and including \$50 billion plus for foreclosures within the existing authority, within the remaining \$350 billion (I should also mention I was at the White House last night discussing foreclosures, and that will be part of the program, perhaps later this week). That being said, it's not certain, and that's why, for better or worse, the Treasury's strategy is to unveil a program and approach, to be a little coy about cost, to see what they get in terms of political and industry reactions, with the idea that if the program itself gains some support, it will be easier at that point to say, "Well, here's what we need to fund it." But I don't know whether that's going to succeed. They're going to ask Tim that question, but I'm sure he'll try to dodge it. But the hope is, and I think there is some chance, that we're not talking about a massive increase in the TARP.

Part of this, of course, is a bit of an end run around the TARP's original scoring—which is irrational scoring and had TARP being charged for the total value of any amount of assets purchased or insured—by using the TALF and by using the aggregator bank with public capital but private FDIC-insured financing and private capital. The capacity of those instruments to buy assets is a multiple of what the TARP contribution is, which makes good sense both politically and economically, I think.

Because of those types of things, it does seem that somewhere around what we have might be adequate; but, on the other hand, it needs to be clear to the banks that we're not going to go out there and say, "Well, you need so much capital, but—sorry, we ran out." Also, there's always the risk of other emergencies. So we have to have some confidence that there will be enough capital to meet whatever the size that the scrub suggests.

MR. HOENIG. If you encounter a bank—one of the largest 22 and beyond—that is insolvent, then would we basically use the FDIC's resolution process to go in and recapitalize and create a bad bank for that institution at that time and have to be 100 percent owner of that and then move forward from there? Is that the plan?

CHAIRMAN BERNANKE. The plan is not as explicit as I would like. Maybe there's some constructive ambiguity going on. Yes, if a bank is insolvent, then presumably what will happen is that we'll use a systemic risk exception. The FDIC will seize the bank. It will zero out the shareholders. It will make whole all of the major debt holders—following, again, the systemic risk exception which allows for non-least-cost resolution—and it will liquidate the bank. So that's certainly one possibility. It's a more complex situation, though, particularly at the two biggest problem banks, because, even though their asset losses might exceed their capital, they do have franchise values; and it's a bit of a judgment call as to whether the economic interest is in liquidating them or in trying to preserve them, or at least parts of them. So that's a decision that, presumably, this investment board is going to have to make. But, yes, the FDIC will definitely be prepared to do either open bank or closed bank assistance if the bank is ruled insolvent.

MR. HOENIG. I ask that question because, if we can clarify that, then you would have, I think, a greater certainty in the sense of: Yes, we are going to take it over, and yes, we are going

to run it and then reprivatize it. And that takes uncertainty out of it if the banks are, in fact, insolvent. And if they are not insolvent, then you're going to take ownership up to whatever it requires to bring their capital ratios up, and you're going to take a managing role and reprivatize them, so that they are systematically administered all the way through.

You also mentioned in your comments that all banks can seek this capital, and I don't know what that means exactly going forward. In other words, if, after the 22, you go into these other banks, those with less than \$100 billion and they weren't insolvent, but they were undercapitalized—we have a ton of commercial real estate ahead of us—would the FDIC, I guess, be in a position to add capital and then these banks would become part of this Government Investment Board oversight as well?

CHAIRMAN BERNANKE. For banks beyond the 22, my understanding would be that—just because of lack of resources—they're not going to go through the same scrub with the same forward-looking buffer requirement. They will instead go through the usual supervisory process. Presumably they have less or no systemic consequences. So they will be where they are now, basically. They may be helped or not by the asset purchases going on, but they will have access, obviously, to the aggregator bank, and they'll have access to the capital should they choose to take it. But they will be in a different place. Bill.

VICE CHAIRMAN DUDLEY. Just one thing that I think is different for the smaller banks relative to the larger banks is that a much greater proportion of their capital structure is in tangible common equity, and, if you remember, the stress test is going to be applied probably against this tangible common equity standard. For most small banks, they're probably going to have quite a bit of room on that metric. And as the Chairman said, it's just not practical in a two-

month window to scrub 8,000 banks. So you're really relying on the fact that most of these small banks are better capitalized on the metric that you really care about.

MR. HOENIG. Not to disagree with you, Bill, but most of these 8,000 banks are being prioritized now and are being scrubbed across the country. So I think this issue is coming forward, and it will be focused on commercial real estate. I can assure you of that. I have another question.

CHAIRMAN BERNANKE. Deborah Bailey wants to add to the answer.

MS. BAILEY. One thing that I just wanted to make sure we understand is that the test on insolvency is different from having a buffer. For the large institutions, you would only get to the point of insolvency if, in fact, you looked at their expected losses for the first year and you got a reserve need that was so big that it actually made the institution insolvent. What was outlined here is the amount of capital a bank would need as a buffer to get beyond that one-year time frame, whether it is two years or three years. You would not use that calculation to make a determination of insolvency. So I just want to make sure that you understand, in looking at even the largest two that we're talking about, the insolvency decision is made the same way as always. If you have no capital or you've gone below 2 percent (for prompt corrective action), then we would do, obviously, what we would do in the normal course for large banks, or any bank. But that's not what we are talking about here in terms of capital buffer.

MR. HOENIG. Well, Deborah, I'm not sure I understand your answer, because if you have an institution and you do the exam and it has X number of assets in difficulty, which brings its capital down to, say, 3 percent, they would then choose to apply for capital under this program, and then what would you do? Would you acknowledge their request and provide them that capital, or would you say no because—whatever the reason?

MS. BAILEY. We would acknowledge that request and give them the capital. I was responding to your question on insolvency for the large banks, and I just wanted to make sure you understood that.

MR. HOENIG. I appreciate that. I have two more questions. In terms of the TALF—just to clarify and maybe take some of my confusion away—in this morning’s paper there was discussion about the TALF encompassing our willingness, as these new asset-backed securities are developed, to actually work through hedge funds, and you had mentioned possibly confining this to commercial banks or broadening it. Can you clarify that for me, so that I understand whom we would be working through as the counterparty on this, as we engage in the TALF?

CHAIRMAN BERNANKE. The way this works is that the asset-backed securities are originated typically by banks; incidentally, it would be those banks that are creating the ABS that are subject to the TARP restrictions on compensation and so on. But we are not buying the ABS. What we are doing is lending to investors who, in turn, want to buy the ABS. Those investors could be hedge funds, or they could be other kinds of investors; but the counterparty is not really that important, because this is a nonrecourse loan. So the loan, in any event, is based on the collateral and the haircut.

From a political point of view, we’ve developed some talking points on this. Governor Tarullo raised this question, as well. We do restrict the counterparties to U.S. institutions, so foreign institutions are not eligible. I should say that going forward, although initially we are going to be taking them “first come, first serve,” if there is strong demand, then we are prepared either to adjust the terms to reduce the attractiveness or to go explicitly to some kind of auction mechanism. So one way or another, there will not be excess returns being earned by anybody, because if there are excess returns, they will be competed away through the auction process or

whatever mechanism we use to allocate these funds. But our direct counterparties will be nonbanks—the investors who buy the ABS—but it's a nonrecourse loan, so the fact that we don't supervise them is really not very relevant.

MR. HOENIG. One last question about the Government Investment Board, which has the oversight role. If we had enough ownership, would they select an individual to sit on the boards of directors of these institutions, or would that be determined separately from the Government Investment Board in terms of the government's ownership and representation?

CHAIRMAN BERNANKE. My understanding is the Government Investment Board is an attempt—whether it will be successful or not is debatable—to insulate a bit the running of the business from the political process, to have some kind of business-oriented oversight. In fact, for banks that are in trouble and have substantial government ownership, there will really be two complementary enforcement mechanisms. One is the supervisory mechanism, and the other will be this oversight board, which will be essentially voting the government's stock. I assume that those two mechanisms would collaborate. For troubled banks, the supervisors might demand a change in the board of directors and a change in management, and they probably would get agreement from the Government Investment Board. The oversight board can do what it wants, basically. It might just demand a change in the management and change in the board of directors, or it might decide that it wants to put its own hand-picked people on the board of directors. But, again, the hope is that this will be a step removed from direct government decisions about loans, for example, and will simply be an attempt to get the business in as good a shape as possible either to sell it off or, at some point, to dismember it.

MR. HOENIG. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. President Evans.

MR. EVANS. Thank you, Mr. Chairman. First, I'd like to say that relative to the fears for our balance sheet that I expressed ten days ago, I've heard a lot of things that have made me feel much better about this. So I think you've done a great job.

On the TALF, you mentioned that our goal could expand to \$1 trillion. Is that going to be our decision, or is that going to be part of the Treasury announcement? And I guess that interacts with the capital cushion, the haircuts, and how much we're going to lever. So any light you could shed on that would be helpful.

In looking at the term sheets on the TALF yesterday, somebody pointed out to me that the haircuts for some loans seemed to be lower than what is charged at the discount window. But maybe those aren't apples-to-apples comparisons? It seems that it's more generous—lower for the TALF—as I understand it.

VICE CHAIRMAN DUDLEY. They are borrowing at a higher rate, though—LIBOR plus 100 basis points.

MR. NELSON. And they're triple-A ABS.

MR. EVANS. Okay. So at the discount window they're not rated. So there's more uncertainty.

CHAIRMAN BERNANKE. Also, these are only new assets and not legacy assets. So that reduces the uncertainty as well.

MR. NELSON. It could be that they were looking at haircuts for the asset type that was backing them.

MR. EVANS. It's just that, as you look at the table, it does get your attention. So maybe an additional FAQ on that would be helpful.

CHAIRMAN BERNANKE. If there are questions related to the announcement yesterday, Bill Nelson and many others here can address those. Don't hesitate to put those in. On the \$1 trillion, I think the announcement will be something like "up to \$1 trillion," and depending on what we learn, et cetera. So I think the headline number will be out there, but certainly we have to be comfortable with the structure of the program, its utility, the applicability of 13(3)—that is, are conditions still warranting that kind of activity—the credit protection, et cetera. So there's no commitment here. There's no way that they could force us or otherwise claim that we had committed to \$1 trillion. But I do think, given the fact that our balance sheet has actually shrunk recently, that this commitment plus the GSE purchases puts us in a range which is very substantially supportive but is manageable from a monetary policy point of view. I should never, ever, ever make promises or say "never," because I've been wrong every time as the economy has deteriorated, but I'm hopeful that this would be the last key initiative—but, who knows?

MR. EVANS. So on the TALF expansion, I can guess that my colleagues and everyone here have gotten a lot of phone calls and correspondence from people who were outside of the asset classes that have access to it, and as you expand it, I assume that this is only going to grow. So I wonder, will there be discussions, or could we at least have some guidance as to what the selection process is? And then finally, on the bank preferred stock from TARP I—I'm just not familiar enough with this—what is the bank reaction to this going to be when we now come at them and say that, "oh, this is going to be convertible into common stock"?

CHAIRMAN BERNANKE. I think they'll like that.

MR. EVANS. Will they be happy about that? I have talked to a lot of bankers who say, "Look, I didn't really need this, but it seemed like a good signal at the time."

CHAIRMAN BERNANKE. First of all, it's at their option. They don't have to do it.

VICE CHAIRMAN DUDLEY. It will be converted if they absolutely need it.

CHAIRMAN BERNANKE. They only do it if they need it. Of course, that will depend both on their need for capital and on the price, and I don't know what the strike price is. I don't know how that's set up—that's another piece of important information. The downside, of course, is, if you're converting huge amounts of capital into common, you have to deal with the control issue.

VICE CHAIRMAN DUDLEY. They won't like that event of the conversion, but that event would be precipitated by the fact that they had very bad performance and they needed the common equity. So it's sort of a good news–bad news kind of paradigm.

On your TALF asset question, I think that we're going to try to have the Treasury not be definitive about what assets are included or not included in the expanded TALF. To give a “for example:” We're pretty comfortable, I think, with our analysis that CMBS and private-label RMBS should be included. But whether it goes beyond that, I think, is really in the “to be determined” category, and I think we are going to try to make sure that the Treasury announcement doesn't commit us to things beyond CMBS and private-label RMBS. That's certainly our intention.

MR. NELSON. Just to say definitively, if I could, the haircuts on triple-A ABS charged at the discount window are all smaller than the ones charged by the TALF.

MR. EVANS. I thought that autos were higher.

MR. NELSON. There is no distinction among the discount window haircuts. So you might be thinking of auto loans as opposed to triple-A ABS that are backed by auto loans.

MR. EVANS. Yes, I was. That's why I said it might not be apples to apples.

CHAIRMAN BERNANKE. Thank you. Okay, Charlie?

MR. EVANS. Yes. Thank you.

CHAIRMAN BERNANKE. All right. President Stern.

MR. STERN. My questions have been addressed. Thank you.

CHAIRMAN BERNANKE. Okay. Governor Duke.

MS. DUKE. Mr. Chairman, let me make sure I understand on the TALF. Is this going to be contingent on the ability to sterilize the expansion of the TALF?

CHAIRMAN BERNANKE. Well, mostly. If the legislation giving the ability to sterilize is not passed, then we're back to where we were last week, which is that we have to make judgments about how much expansion of what programs we're comfortable with, based on our assessment of the duration of those commitments and on the presumed effectiveness of things like interest on reserves and so on. But I think clearly there's a tit for tat, in that there is no commitment on our part to do \$1 trillion. I mean, we may nonetheless make the decision to do something. I think we need to make judgments as a Committee about what we're comfortable with in terms of ultimately unwinding and sterilizing those impacts.

I would guess that, without the legislation, the \$1 trillion would probably be quite uncomfortable for us, because, assuming that the new ABS is done on the same terms as the initial, it's a three-year commitment with some tail potentially after that if they put assets to us. That's worrisome in terms of the size and duration of the balance sheet. So I wouldn't say that we wouldn't go beyond \$200 billion, necessarily, but I think the chance that we would go even substantially towards \$1 trillion would be quite unlikely.

MS. DUKE. Okay, and then a second question. I worry that this announcement might have actually the opposite effect on the banks. Do we have any contingency plan if this doesn't

go well and there start being runs on uninsured liabilities at the banks? Do we have any contingency plan for what we'll do then?

CHAIRMAN BERNANKE. I think we have had various strategies in the past, including injection of capital and so on, and I guess under the current situation, they'd be prepared to inject common. It would be the first time they've done that. I will raise this with Tim Geithner, but there's been no discussion in our group. Deborah has a comment.

MS. BAILEY. I don't have a good response to your question, but there is a separate group working on what steps we might take if, for example, there's vulnerability, particularly around some of the larger banks, before this program can even get up and running, or if there's another Friday night phone call. There is an interagency group that is not only working through the steps and clearly thinking about the capital and the wraps that we have done before, but that is also considering what other actions might need to be taken. There's also a separate subgroup of people who are thinking about the legal changes that need to be made in the regulatory structure to be able to deal with a failure of a large, systemically important financial holding company; now we would have to deal with it through something like bankruptcy, which is not acceptable. So we're laying out all of those steps—what we've done before, what other things we can do. The FDIC is involved in it. We're trying to quickly put down on a couple of sheets of paper all of those things.

MS. DUKE. I can foresee a circumstance where this is interpreted as a change in the regulatory requirements for capital, a judgment that the values in the bank's equity are not there, a judgment that there is a plan to go in and close large numbers of banks, and I can see it being a particular vulnerability for those that are large but not as large—for instance, anything smaller than WaMu. And I can see those banks having a very violent reaction or their counterparties

having a violent reaction, something that would force us into action in a large number of good-sized banks. I just think we ought to think about what we would do in that case.

MS. BAILEY. We have run screens, too, just to see which banks might on “day one” have a capital bogey that would not necessarily meet that tangible common equity threshold, to see which ones the market might pick on right away—that are vulnerable—and there are probably about four of them. So we’ve tried to go through and look at those particular firms.

MS. DUKE. We might think it’s four of them, but the markets might think it’s a lot more than four of them. That would be one concern here. The second concern I would have is that given the experience with the TARP capital and in many cases the buyer’s remorse of having taken that capital, I can see a scenario where the banks would immediately start to dump assets and sell business lines in order to fortress up their liquidity as well as create additional capital in ways that don’t involve the government. And I think those outcomes would be very different than what we expect to happen or what we would like to have happen here.

MS. BAILEY. I’ll add one other thing to that point: It hasn’t been decided yet. As the Chairman said, a lot of the details are still being worked out. But there is a concern around banks retooling their balance sheets, shutting down on lending, or shrinking their balance sheets to make some particular capital ratio bogey. We’re trying to figure out ways to get around that. For example, last night there was a lot of discussion about having a dollar amount of capital to focus on as opposed to a capital ratio—so we’re trying to see if we can work through some process where banks don’t shrink their balance sheets just to get to a certain capital ratio. People are working on all of that now, and we’re all concerned about the same thing.

MS. DUKE. Yes. The experience of the messaging in the last round is not encouraging.

CHAIRMAN BERNANKE. We agree with that concern very much, and we're going to raise this again with Tim. I guess there are always these short-run versus long-run concerns. I think, on the other hand, we do not want to commit to maintaining the existence of every current bank that is operating, and, as I said, one thing I like about this in principle, although the communication is a huge problem, is that it is very market-based and very "tough love." The hope is to come out the other side with a banking system which is plausibly well-capitalized and can inspire investor confidence. But the transition could be very tricky, and we need to think very hard about contingency plans and about our communications.

Vice Chairman, you have a two-hander?

VICE CHAIRMAN DUDLEY. Yes, and I think that Governor Duke raises some very important points, which is why I was here until late in the night last night, to try to improve the messaging.

I think there's another issue, too, which is that there are firms that can be resolved pretty easily within the existing bank resolution framework, and there's one particular firm that can't; we are working on how to handle the one particular firm that can't, but it's very, very difficult, given the existing tools.

CHAIRMAN BERNANKE. President Fisher had a two-handed intervention.

MR. FISHER. Mr. Chairman, I just wanted to underscore the questions that Governor Duke has asked, because of the cumulative process here under the previous administration. I'm not attacking that administration, but the way things were announced and delivered by the Secretary of the Treasury and the whole process made for really a "ready, fire, aim" approach. And I'm very uncomfortable. I understand the pressure that everybody's under and that Secretary Geithner is under, but the vagueness here, which you mentioned at the beginning, will

in my opinion just feed upon what was almost a spastic methodology (that's a gross word, but, in effect, that's what it was), because we've gone through this process before. So, in a sense, the markets are conditioned to worry whenever something is announced, and I do think we all should be—you should be, the Board should be, and the FOMC should be—prepared for a harsh negative reaction. The lack of specificity here is what they've seen before, and I realize that that's, in some people's minds, politically wise—to see what the reaction is—but we plant the seeds for a very harsh reaction by being vague. And I just wanted to add my concern to Governor Duke's. At least we should be prepared for a very harsh reaction. My response to this is, it's just one more uncertain step being taken. I know how hard we're working on this, and I know how much thought has gone into that. So we're learning at every step. But be prepared for a negative reaction that could be quite harsh, and at least we ought to have that in our contingency planning. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Governor Warsh, you had a two-hander, but also a regular question?

MR. WARSH. Thank you, Mr. Chairman. Let me just echo the comment you made at the outset, which I think Governor Duke and others have made. It will sound in the spirit of piling on, because this is obviously an incredibly tough situation and we're all doing our very best. I think in terms of market expectations that you and, I think, Bill referenced—these expectations have been raised about what is going to be announced on Monday. My sense is that this program is both more and less than they're expecting: More in that it is broader and more comprehensive; less in that it's less clear what this is going to mean in effect and with respect to timing. So I'd say that while the questions are being asked about how this works in practice, we are likely to have markets test that weakness, test that ambiguity, and I suspect they will do that

in this upcoming week, particularly with respect to some of our most systemically important institutions. So I think for them this will be exceptionally problematic. I hope that this is better received than my instincts and the instincts of some others on this call suggest, but I do think that we need to be as prepared as we can be to respond to these questions.

With respect to how the Congress might react, I think that's an additional difficulty. In some ways, I think this proposal is encouraging the Congress to engage in these discussions, engage on lending, engage on capital, which, again, I think will add uncertainty to markets over the course of the next several trading days.

A couple of other concerns along those lines: While these questions are being raised, it will be more difficult, not less, for capital markets to get traction separate and apart from financial institution weakness, so I think that some of the improvements that we've seen from some of the facilities that have been announced and implemented in New York by Bill and his colleagues might be under increased difficulty during this period. And then finally, just as a note of caution, I think even apart from those institutions that are going to have the biggest questions with respect to control and creeping nationalization and the intent of the U.S. government, I think there will be implications for the healthier ones who are their competitors, implications for their business model and their deposit base, which we're going to be put in the position of having to address.

So I wish I had easy answers to it, but my sense would be that, in the course of the discussions with Treasury between now and Monday morning, there are really two ways to go. One is to go narrower at the first and be more specific about particular programs and set expectations about when they will announce the rest. The other is to try to put some time parameters around when they're going to answer questions subsequently—so that we don't just

have a series of leaks and bleeding information that finds its way into the newspapers. I think the Fed has been remarkably quiet and confidential during this. My sense is Treasury has, as well. But, if the last week is any indication, the sort of false starts and messages that come from this process are going to create difficulties. So let me stop there, but just raise my concerns there as well.

CHAIRMAN BERNANKE. We hear that. President Pianalto had a two-hander.

MS. PIANALTO. I have a couple of concerns similar to those Governor Duke raised. I have been hearing directly from some of the banks in my District. Two of them I believe are among the four that Deborah said we are watching closely. They have been hit hard in the past week in terms of stock prices because of concerns that they are not going to be able to take advantage of some of the programs that you've laid out. Now, one of the things that they raised is that markets are speculating that their financial conditions are so bad that they wouldn't be able to participate in these programs. What I like about what you laid out in the scrubbing of these institutions is that they are going to be treated equally—because some of them are saying that some regulators are being a little less stringent, so there is not equal regulation or supervision of these institutions. I think emphasizing in the communication that they are going to be scrubbed and treated consistently might be helpful, because, especially for a couple of institutions, the markets are judging that their financial condition is different than might otherwise be perceived.

The other issue that they raised and you didn't mention as part of this package is the short-selling provision. Again, this is important to them because some of these institutions' stocks are getting hit extremely hard, because of some assumptions that are being made. So

perhaps the ban on short-selling during this period of uncertainty is an option and something we should consider again.

CHAIRMAN BERNANKE. The SEC has not been involved in this discussion. I haven't heard any plans to do that, but it's an idea. Governor Duke had a two-handed intervention.

MS. DUKE. One other follow-up on the scrubbing process: I think there's a risk that this gets interpreted as an admission of regulatory failure, as if we have not already supervised them adequately and have let them report assets at the wrong values. That further erodes the credibility of both the supervisors as well as the financials of banks that are doing fine. And I would worry that we would get caught up in a conversation about whether or not the supervisory process had done its job, rather than being able to convey the message that we're looking at a more stressed scenario than would be required by regular accounting.

CHAIRMAN BERNANKE. So the language in the document as it currently stands: "In conjunction with the review of the capital planning process, supervisors are undertaking a coordinated review of banks' reserving and valuation to ensure consistency and appropriateness across banks. Supervisors will also work with institutions to increase the transparency by enhancing each firm's public disclosure of exposures, non-performing assets, and reserves, as well as firms' internal assessments of expected credit losses."

So I think the emphasis is a bit more on consistency, but the point you raise is one that has been mentioned and was noted on the communication issue.

MS. DUKE. President Pianalto is assuming that this means that the others will do the job as well as we did. You may have all of the supervisory agencies thinking that this means that everybody else will do things as well as they did and the general public thinking that nobody had done the job properly before this.

CHAIRMAN BERNANKE. Any other two-handers? [No response.] Okay. So back to the normal cycle here. President Plosser.

MR. PLOSSER. Thank you, Mr. Chairman. I think this last round of discussion about communication is really critical, and I share some of the concerns that have been raised. The other point Governor Duke raised that I think is important is the relationship between the proposals for sterilization and the increase in the size of the TALF. And I like the proposal you made, Mr. Chairman. I think it's a great step forward. But I'm anticipating that we'll have to hang tough on that—that there might be a lot of pushback from the Congress saying, “You don't need to do this. Just do the TALF and increase it to \$1 trillion anyway. We don't need to provide you with the sterilization capabilities.” And I think we have to be pretty tough in trying to ensure that we have that flexibility. I think it's an important step.

The other thing is the Government Investment Board you talked about. Will they have oversight over all banks who accept capital from the TARP, either old or new? Or will it be partitioned by some sort of size—just the top 22? And, therefore, are they the ones that will be imposing these conditions you spoke of—the commitments to lend, the executive compensation issues that would have some stronger conditions, and the dividend restrictions? Is that going to be managed through this oversight board, or is that something separate? And whom will that apply to? Again, just the ones that have accepted capital, or everyone? I don't know if there's any clarification on this.

Back to the communication—about the \$1 trillion headline number. I think it's going to be viewed by many people as a target. And we're going to have to work hard not to have it interpreted that way.

My last question is about the aggregator bank. Having a good bank–bad bank model is obviously not something new. There are a number of banks in history who have created good bank–bad banks internally where they actually split a bank into two and gave shareholders and debt holders shares in both banks. I’m wondering about a way of minimizing public commitment of capital for the bad bank, and I’d just like to hear a little more discussion about how the public-private relationship in this bad bank might look. Anything more expansive you can offer on that I’d appreciate. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. So, just to reiterate, the \$1 trillion is contingent on liquidity support, in the sense that we will have to take into account the availability of the sterilization facility in thinking about what we can do. And we all understand and take very seriously our responsibility to be able to unwind the programs in a timely way.

The language on the “independent”—it says here—Government Investment Board is a little vague. It says, “The Board will oversee the management of our investments in financial institutions,” which I guess means from an asset management point of view. “The Board will establish guidelines for and monitor our investment interests in financial institutions on questions of voting rights, dividend policy, compensation issues, and governance. But it will also ensure compliance with conditions associated with USG investment, and will ensure transparency.”

It sounds to me as if it’s going to serve, to some extent, as a board that votes the government’s interest. And I assume that common will have different interest than preferred. But I am sure there will be general terms for accepting the money that are in the legislation or in the policy stated by the Treasury regarding executive compensation and so on. Those will be universally applied. The board will just make sure that they’re applied. But the board will have the authority to go further, depending, for example, on the state of the bank.

On the aggregator bank, we looked at a huge number of different models. I think if we had done the entirely public-controlled one, which, I should say, our staff generally tended to prefer to the public-private partnership, the argument would have been to create silos in the aggregator bank, one for each bank that participates, and then to pay for the assets acquired, in part with shares in those silo banks—sort of a first-loss position. That was the leading public alternative.

The problem was that it's not just an economic issue, but the Treasury feels very politically vulnerable to the charge that we are negotiating high prices and giving a back-door subsidy to the banks. Although our staff felt that we could do reverse auctions for broad classes of assets, the Treasury remained concerned, for example, about individual loans and other very idiosyncratic types of assets. I think there is still some willingness to consider perhaps a combination of public and private acquisition, but they felt that having the private acquisition would look better in terms of ensuring that good prices were being obtained.

Once you have private acquisition, however, then you have to give the private investment managers scope to buy whatever they want from any bank. In fact, the initial idea was not even having to buy from banks, in which case it's no longer a question of a bank saying, "Well, here's the share of stuff we want to put into our bad bank." It really depends on what they can sell to the private investment manager. So the good bank-bad bank structure in each bank fits less comfortably, less easily, with this private-public arrangement.

In terms of the details, there are not very many. Again, I've got this draft, and everything is time dated, because it's a moving target. It says, "The Treasury will invest capital alongside private investors for the purchase of up to \$500 billion in legacy assets from regulated financial institutions. Purchases through the investment portfolio will be guided by appropriate risk and

return objectives.” And there will be definitions of which classes are eligible; it refers to a competitive bidding process or private sector process. Financing will be provided by the government “with the degree of leverage guided by requirements consistent with a triple-A rating from an NRSRO.” So I think that means also that they’re taking some steps to make sure there’s not a subsidy in the pricing mechanism or in the terms on which you finance the aggregator bank either. But we’ll see. Vice Chairman.

VICE CHAIRMAN DUDLEY. I think the key question about this aggregator bank is: Given these private sector investors who are going to have to be compensated for the risks that they’re taking, will the bank pay prices high enough to incentivize banks to actually sell assets to the aggregator bank? I think at this stage we don’t really know the answer to that. I don’t think at this point we can really say how well or how badly it will work in practice.

CHAIRMAN BERNANKE. The theory is that the reason there’s such a huge bid-asked spread between what the banks are willing to accept and what the investors are willing to pay is that there’s this huge liquidity premium, basically because investors don’t have long-term financing. So we are going to give them long-term financing. That ought to make them willing to see through the liquidity premium. That certainly will bring them closer together. If they’re still not willing to sell, then it suggests that there’s some informational difference—or something—that goes beyond the liquidity premium. So at least it does address that important part of the bid-asked spread. Two-hander from President Plosser.

MR. PLOSSER. Thank you, Mr. Chairman. I appreciate the answers. But in some sense, won’t the scrubbing exercise, at least for many of these banks, help drive them to make perhaps different decisions about those assets that they’re willing to sell and what they’re willing to sell them for?

CHAIRMAN BERNANKE. I think that's right. For example, consider an asset that is carried on the banking book at 90 and for which the bank has reserved only for the next year. If the government says, "We're going to take seriously that your expected losses after the first year are 20, and we're going to make you put in capital to match that 20," then maybe it makes more sense to sell at 75, right? So, there should be some impact from that. But it all depends on the execution as well as the concept. Governor Kohn.

MR. KOHN. Thank you, Mr. Chairman. Some of my questions were the ones that Governor Duke was raising. The capital piece of this seems to be very critical. In some sense we backed away from the huge aggregator bank or the ring fencing in favor of just putting more capital in there, and I guess we're sort of forcing the banks to come to us for capital with the scrubbing process.

All of that makes sense to me—with a few questions. It does strike me that this is a new requirement. Now, I know, as Deborah has taught me, that we have Tier 1 capital requirements, and they're supposed to be dominated by common, and we've kind of slipped from that. But it does sound like we are putting in place a new capital requirement, and there are all the pro-cyclical problems with that. Especially if we go to a dollar level of capital, we haven't had those kinds of requirements before. We haven't ever told a bank that it can't sell pieces of the bank to meet our requirements.

I think there will be huge resistance to this by the banking sector. Now, maybe part of this will depend on the terms on which the new capital comes in. One prominent banker yesterday said he wouldn't take any new capital. He may not have any choice. But I think there's going to be a lot of resistance to the capital. I feel bad, because I don't have a solution to any of these problems. I'm just pointing out my concerns.

CHAIRMAN BERNANKE. We're going into the period of the financial crisis where the government is going to begin to dictate capital requirements, so a lot of people are going to be facing that. In principle, our existing requirements require holding capital against expected losses beyond the reservable period. So this is not a departure in principle. It's just something that hasn't been effectively executed in the context of a rapidly declining economy.

MS. BAILEY. And I think getting to the 3 percent bogey gets to the predominant figure. That doesn't change the well-capitalized requirement of 6 percent. So we were trying really hard not to come up with a new capital standard in that sense.

MR. KOHN. But we are using the stress scenario.

MS. BAILEY. Right, but only for the buffer.

MR. KOHN. But then we're making that buffer a requirement—sort of. I think it's the right thing to create a safer banking system, one that's robust to the stress scenario. But it's going to be very difficult.

MS. BAILEY. I think there will be some differences. We're trying not to do just a fixed percent. That's why we're looking at it institution by institution and working with the examiners who have some insights on the quality of different portfolios in order to get to a buffer. I agree with the Chairman. The buffer was always supposed to be there. It's the environment we're now requiring it in that's very different.

VICE CHAIRMAN DUDLEY. I think the expectation, too, is that this number is not going to be stated. In order to minimize the idea that there is this new requirement, there's not going to be a number out there that they actually have to go to. What we have here is a fundamental tension between individual institutions who want to hold only enough capital for the good states of the world, and us, who want them to hold enough capital for the bad states of the

world, to make the bad states less likely. And that fundamental tension has existed throughout the last year and a half. The buffer is designed to cut through that dilemma a little bit by forcing them to hold enough capital that they can withstand a bad state of the world, which will then make the bad state of the world less likely. I think that's the intent. But they're not going to like it. I think that's fair.

CHAIRMAN BERNANKE. So the current document says that the capital is going to be "sized on the basis of the capital planning process, undertaken in conjunction with the firm's supervisor. The capital buffer established under this program does not represent a new capital standard, and it is not expected to be maintained on an ongoing basis. Instead, the buffer is available to help absorb larger-than-expected future losses and to support lending to creditworthy borrowers." Governor Duke.

MS. DUKE. The capital that we normally want them to hold is private capital. Now we not only want them to hold that, but we want them to hold ours, because ours is the only capital that they can get.

MR. WILCOX. This will be structured with pretty strong incentives to try to get them to buy us out of the position, precisely on that consideration.

MR. KOHN. In terms of the market reaction, my expectation—and I defer to Bill—would be that reaction in the equity market will be extremely negative, but not necessarily in the liquidity market. We've seen such things before. We used to have a dynamic between the CDS spreads and the equity market and liquidity, and we've broken that with the TLGP, the Fed facilities, and things like that. So I don't see any reason for liquidity to slip, except perhaps for those marginal institutions that Betsy referred to—the ones where no one knows whether they're in the "too big to fail" category or not—and the others that Kevin was talking about, the ones

right at the top that seem to be slipping. In those cases, I wouldn't expect a run as much as the "slow bleed," because who knows what's going to happen, and business will go away. But I think it's important that the TLGP has been extended, and it would be good to put whatever emphasis we can put on that to protect liquidity. I think the aggregator bank is important, because that is an offset. And even if it doesn't pay above market in some sense, I think it will help—just like our buying MBS. I'm impressed with the effect our purchase of MBS and support of commercial paper has had; just putting a bid in those markets has helped. So the bigger the aggregator bank can be and the stronger the TLGP is, I think, the more they will be able to provide a little bit of protection against the downside risk in the capital.

Finally, on the TALF—this is not a question, but a view—I think it's so important to get these securitization markets working. We've spent a lot of time talking about the capital constraints on the banks; that's not going to go away any time soon. If we want credit flowing to households and businesses, a lot of it has to flow through the securitization market. The TALF is there to encourage the demand for securitized assets. We don't know whether it will work. A lot of smart people think it will work, and our fingers are crossed. But we also have the opportunity to rejigger it and try and make it work, if it doesn't work the first time. I do think the sterilization part is important. But I think it's also very important to get that market going. We ought to cooperate as best we can in getting that happening.

CHAIRMAN BERNANKE. Governor Duke.

MS. DUKE. I would just challenge the assumption that the equity prices don't matter, because when the vast majority of the public sees those stock prices going down, particularly to the very low levels that they've reached recently, that triggers some concern about the institution.

They don't have anything else to look at—the only thing they can see is what's happening to the stock prices, and that's how they judge.

CHAIRMAN BERNANKE. I'm taking some notes on what everyone is saying, and I want to say that many of the views I've heard are consistent with what I and some of the staff believe. We will communicate this to the Treasury Secretary. But if anybody, including presidents, wants to communicate specific points or specific concerns to me, do it via Michelle, if you'd like. I will aggregate them into an e-mail or into a memo and send it to him saying, "This is the sense of the FOMC; here are some issues that were raised," and just make sure, at least, that he is aware of some of these concerns. President Lacker.

MR. LACKER. That would be an aggregator memo? [Laughter]

CHAIRMAN BERNANKE. Yes. But with separate—

VICE CHAIRMAN DUDLEY. Separate silos for each Bank?

CHAIRMAN BERNANKE. Yes.

MR. LACKER. I have a couple of questions. First is about this last discussion. Maybe there's something else going on here, but the sense you get is that the inability of banks to raise private equity has to do with two things: One is that the probability distribution around their losses is wide enough that there's a substantial chance that, absent government intervention, some losses would be absorbed by debt holders, so new equity would, to some extent, subsidize current debt holders; the second is the prospect for future government capital injections that are dilutive. It strikes me that it's going to be unlikely for banks to raise private equity until those two sources of concern for potential equity investors are removed.

The aggregator bank and some of the other programs can reduce that uncertainty—that debt overhang problem. Of course, if the banks had enough capital, there wouldn't be a debt

overhang problem. But if there is one now, they're not going to be able to raise private equity to get to a point where their equity cushion is big enough to reduce that debt overhang problem. So I'm not sure it's going to be likely they are going to have any success in raising private capital under this plan. And on this question, Governor Kohn said something—and if this was in your presentation, Mr. Chairman, I missed it—about them not being able to sell assets to raise their capital ratio. Is that a provision of what is proposed?

CHAIRMAN BERNANKE. Deborah talked about an alternative discussion about setting capital in terms of quantities instead of ratios, but that's not something that, as far as I know, is in the plan at this juncture. I think there will be some deleveraging that will go on. The hope would be that the aggregator bank, et cetera, would be a safety valve for that.

MR. LACKER. Governor Kohn said something about a restriction on them not selling assets. I didn't quite understand that.

MR. KOHN. Deborah had noted that that was a concern—that they would meet the requirement by selling assets; and one way of trying to mitigate that was to set the capital requirement in terms of an amount, so selling assets wouldn't necessarily help you meet the new requirement.

MS. BAILEY. It is a big concern that banks could try to meet the new requirement in a variety of ways, including selling their assets. On the other hand, there are good examples where you do want them to deleverage and sell the assets. But the problem in terms of getting things moving again is, if they just shut down, don't lend at all, totally strip their balance sheet, it somewhat defeats the purpose. So people are brainstorming about other ways to do this without leading to shrinkage of the balance sheet to meet some ratio number.

CHAIRMAN BERNANKE. So, President Lacker, I don't think that's in the current version of the plan. I guess you could call it a benefit that the concern that the aggregator bank wouldn't have any business gives an additional reason for banks to offload assets to the aggregator bank.

MR. LACKER. I took the broad lesson of the RTC, Japan, and Sweden to be that selling assets has some benefits as well as some potential problems, so I wasn't quite sure what the attitude was about that.

I'm a little puzzled about the incentives in the aggregator bank. You talked about the private profit motive and paying fundamental values for things. Yet they're going to have this huge government guarantee in their liabilities, and I'm not quite sure how we ought to view the incentives of the private equity holders who would control that. It's not clear to me that they're going to be managing it from a socially optimal point of view.

CHAIRMAN BERNANKE. The argument is analogous to the TALF in a way. As I was saying before, the idea is that there's lots of money on the sidelines willing to buy these troubled assets. The rate of expected return is now very high, because of liquidity and risk premia. But what's preventing the purchases is lack of long-term reliable financing. The bank would make that financing available but not at concessional rates; also—and this may not be fully market-based—it would provide a little bit of downside tail risk, because there'd be some government capital involved. But, of course, on the other hand, you'd have to share the returns with the government based on their capital contribution.

The idea is that you give these investors some long-term financing, so they don't have to worry so much about the short-term holding risks and liquidity risks, and, therefore, they would be able to buy more and offer better prices than they're able to now without that support. So

that's the logic of it. And because they share in the profits, they have no incentive whatsoever to overpay for whatever assets they acquire. They'll pay as little as they can, and so arguably we can tell the public that they're getting the benefits of aggressive market-based pricing.

MR. LACKER. That argument depends on the financing rate being a true rate, and the financing rate they could get now in the market being some distorted rate, I guess. If that's not true, then we're subsidizing their financing, and they ought to be willing to pay more.

CHAIRMAN BERNANKE. That's right, but also, there's going to be competition among the potential investors for this license, and that will bid away some of the rents, I think.

MR. LACKER. Yes, but the value of those rents will be contingent on their ability to pursue whatever strategy they want when they control it. So that doesn't mitigate the effect on what they're willing to pay for things. In fact, it requires them to overpay if warranted by the financing arrangement.

CHAIRMAN BERNANKE. Again, this is as much about optics as it is about economics. They want to be able to portray a market-based system that is not suffering from serious adverse selection and overpayment issues.

MR. LACKER. I have two questions about the TALF. One is that I think it would be a good thing if our best estimates are that the probability that the Federal Reserve bears a loss is virtually negligible. There have been analyses like that in the private sector that haven't come true in the past. We're all tied together in the Reserve Banks in terms of these losses, and our boards of directors are expressing an increasingly avid interest in the nature of the risks we're exposed to on our balance sheets. And here we're taking the Fed System's balance sheet from \$1.7 trillion or something up to \$2.7 trillion—this is a fairly notable increase. I think it would be useful for us to have access, at a fairly detailed level, to this analysis of the potential losses to the

Federal Reserve that might be involved in the TALF—what kind of analytics determine the parameters, and how they were set, and why we have confidence that the probability of losses is fairly minimal. I'd be interested in knowing if you could assure us we'd get access to that from whoever is doing the analysis within the System.

CHAIRMAN BERNANKE. How about a presentation at the next FOMC? Would that be acceptable?

MR. LACKER. Do you mean just a verbal presentation?

CHAIRMAN BERNANKE. No, with documents and details. We can send you analysis, if you'd like. But you might prefer to have a discussion and a verbal presentation as well.

VICE CHAIRMAN DUDLEY. It's not the most straightforward thing to work your way through, and I think we can share a lot of material on that. But if I could address the risk of the TALF for just a second, I'd mention four points. One, it's a triple-A-rated security, so it's already at the upper part of the capital structure. Two, there's a haircut that the investor takes above and beyond that triple-A-rated security. Three, there's a spread in terms of the interest margin that's earned. And then, four, there's the Treasury capital between us and loss.

So a lot of things have to happen to get to the Fed actually losing money here. And under most scenarios, the Treasury doesn't lose money. The Treasury makes money on an expected value basis under reasonably stressful scenarios. We can share that stuff with you. But I think it's important to recognize that these are new securitizations, so they're newly underwritten, and a lot of things have to happen before they get to us.

MR. LACKER. Yes. I understand the details of the program. I understand all of the buffers there are between us and some losses. But in the past, people said the triple-A tranches of RMBS CDOs were virtually risk-free, and now they're selling for below 50 cents on the

dollar. I know your folks are more expert in this than the rating agencies. It's just that we want some comfort, and we want to be able to vouch to our boards of directors, who still have the standard fiduciary responsibilities—even though the Treasury is obviously bearing the loss at the end of the day—that we understand the risks that are being run and that we're comfortable telling them that we understand the risks are low. So it will be good to get that analysis from you in New York.

The second question I have about the TALF has to do with the role that hedge funds are going to play. We've seen over the last couple of weeks a tremendous amount of political noise about executive compensation at the entities that have received TARP capital injections. I wonder what our political vulnerability might be here to questions from the Congress or concerns raised in the public about the compensation practices or other practices of entities that are getting credit from the Federal Reserve on terms that arguably aren't available in the market, so they are presumptively somewhat advantageous, and the loans are certainly governmental funds. Is there some risk to us that we'd be caught up in complaints about compensation practices and lavish expenditures at hedge funds?

CHAIRMAN BERNANKE. That's a good question. I don't have a really satisfactory answer. On the one hand, we have had legal consultations, which persuaded us and the Treasury that, as far as meeting the letter of the law of the TARP is concerned, it's sufficient to impose those compensation and other restrictions on the issuers of the ABS as opposed to the investors who are buying it. But, of course, you're right—there's always political risk there. The other point is the communication issue, and we've made some efforts to set up some talking points to explain what this does and why it's important. Michelle, can you send the Presidents a list of our

talking points about why this is a benefit for the general public? But you raise a good point—it's a risk. President Evans just wants to interject.

MR. EVANS. Will the investors in the aggregator bank be subject to any executive compensation regulations?

CHAIRMAN BERNANKE. That's a similar question—and I assume not. President Lacker.

MR. LACKER. I don't want to shut off the discussion on this point, if there's more. But, if not, this is my third and final question. It's a comment in addition to a question, and it has to do with where we're going to come out in the end—a year or two from now—with regard to an accord on credit policy. I understand that this is an intermediate step, and that you envision further discussions down the road towards a more complete or comprehensive understanding with the Treasury about credit policy. My concern here is that I think that there are a range of possible strategies, and I worry about whether the steps we're taking now compromise where we might ultimately want to go. I understand the provision of credit by the Federal Reserve in exceptionally exigent circumstances, where there's enormous time pressure—we get a call on a Friday night, and convening the Congress on a Saturday afternoon doesn't really seem feasible. That's fine with me—that ought to be a Federal Reserve function.

But for programs that take three months to implement, arguably it would be feasible—perhaps not politically feasible, I'll admit that, and that's a separate question—but as a matter of mechanics and parliamentary process, it would have been feasible to ask the Congress to approve the authority of the Treasury to implement the TALF program. And it occurs to me that drawing a bright line at what is, in terms of timing, feasible for the Congress to authorize the Treasury to implement seems like a logical approach that has a lot of attractive properties for us.

I'm concerned that we're going down a path that's taking us in a different direction, and we might compromise something that might be more workable and more beneficial, and we're doing it without a real discussion of where we want to head more broadly with regard to an accord on Treasury policy. As you describe it, part of the understanding with the Treasury now is that they would accompany us to the Congress in an appeal for a mechanism of one of two varieties for us to be able to sterilize our lending: One would be the idea of us issuing non-monetary liabilities; the other would be for the Treasury to issue debt and deposit with us under the current program.

The concern I have about the latter is what the nature of our understanding would be with the Treasury about who controls those issues. We ask, and they agree to say yes, usually, under reasonable circumstances. There's always the possibility that they will retain some implicit leverage over us that would constrain our independence going forward. On the other hand, having the ability to control our own issues of non-monetary liabilities seems really attractive.

But, again, I worry about bargaining power; in an event, knowing that we have that capability, the Treasury and the FDIC would, I think, retain the ability to stare us down and essentially say, "Well, you have the ability to issue non-monetary liabilities that don't count against the federal debt limit, so you do it." I think that's exactly the dynamic that emerged in the case of Citi and Bank of America, where there was nothing mechanically or legally that would have restricted the Treasury and the FDIC from taking all of the risk, and for us to bear none of the tail risk. But knowing that we had this tricky little mechanism for dressing up a guarantee as a loan, they prevailed upon us to participate and participate fairly substantially. So I worry that setting up an ability for us to issue non-monetary liabilities that are the functional equivalent of Treasury bills and are outside of the appropriations process and don't count against

the debt limit would give both the Congress and the administration an avenue, a target, a mechanism that would make it irresistible for them to come to us to finance things that they didn't want to go to the Congress to finance.

In my mind, the discussion about the accord needs to be about where it's appropriate for government lending to be done. You all know I've raised objections about our lending programs, but this is apart from the advisability of any one program. It's about the Congress and the appropriate constraints on circumventing the appropriations process, and it's about our independence.

I worry that we're going down a path where, as I said, we're going to be vulnerable to complaints about our inability or our unwillingness to constrain executive compensation or the lavish expenditures that entities that are going to be benefiting from our programs might make. We're going down a path where people like Elizabeth Warren are going to be writing reports—or could be writing reports—about what we do. I think that's a very uncomfortable situation to be in, and I'd like us to think clearly about whether that's what we're headed towards or whether this compromise is headed towards something that leaves us with a much broader and firmer measure of independence. So I just wonder what thoughts you've given to that kind of question, Mr. Chairman, and the extent to which you view representations we've made in these discussions as compromising alternative strategies about a credit accord.

CHAIRMAN BERNANKE. Let me respond very quickly. Of course, I've thought about this a great deal and tried to trade off various concerns. I think we're going to make progress towards an accord. I think we're on a path in that direction. In particular, we now have two "asks" in front of the Congress. One—which we will press very hard for as part of regulatory reform—will be for a strong resolution regime for non-depository institutions. If done properly,

that will eliminate the most vexatious and difficult and painful part of the 13(3) authority, which we used in the Sunday night massacres. So that's very important.

The second is this sterilization ask. I think that will also give us a great deal more independence in the sense that we'll be able to separate whatever decisions we make on our balance sheet from our monetary policy decisions. And just so you know, certainly part of the deal with the Treasury is that, if they get a supplementary financing authority, it's the Fed that will have the right to call for the use of those bills—it will not be at the Treasury's discretion.

As to your perspective on the Congress and the amount of time available—putting aside politically feasible, I don't think it's technically feasible for the Congress. Look at their inability to function on even relatively straightforward economic measures. These things we're doing, such as the TALF, they're very complex, they've been based on elaborate analysis of market and financial conditions, they have a lot of subtleties as far as legal issues, et cetera. There's just no way that the Congress can do that. They can't do that. They created the Fed. They gave us 13(3) authority. We are making a judgment. And I just want to say, in all of these discussions, we have to remember every minute that there were 600,000 jobs lost in January. This is an enormously serious economic situation, and it requires unusual responses.

We believe that the Congress doesn't have the capacity to come up with something like the TALF, that it is going to be constructive, and that it's very important in the context of the current economic crisis. And the Congress has every ability to shut it down—they have every ability. We're going to go to the Congress. I'm going to testify on 13(3) authorities on Tuesday. The Treasury plan is going to make the sterilization part of the explicit legislative ask. All they have to do is not accept that. That will limit us very substantially. So I think that we are comfortably within our rights, within the law, and within reason to take these actions,

understanding that we are not in normal times—we are in what you could very well call war time, and war time sometimes creates unusual necessities.

As I said, I think we are on the right path towards an accord, one that will take us out of the business of Sunday rescues, one that will give us flexibility on monetary policy separate from lending. I think ultimately we will have some more clarity, at least with the Treasury, regarding what conditions and terms under which we should get involved in any such lending program. I think reasonable people can disagree about whether, for example, our swaps activities and some of the other things we've done are within the purview of the central bank in a financial crisis. I would argue that they are. But that's something to be negotiated, and the current Treasury is, I think, very open to those negotiations.

I think the political risk is overstated. It's possible that we may come up against this concern that you raised about restrictions on compensation of the hedge funds. In that case, they will probably shut down the program, and that's yet another way in which the Congress can shut it down if they want to. But, even though we're in the middle of the deepest part of the crisis, I get very few letters from the Congress saying "we need to protect this or that sector," and the ones that I get are very perfunctory; and we reply saying, "Well, we are doing X," and they never come back. I just don't feel the pressure. I think the pressure would come if the Fed stood by and let the economy fall into the abyss, which is a very real possibility. So I think we're trying to balance these concerns in a reasonable way. My expectation is that we're moving in the right direction in terms of getting an accord, and I believe that, given what I feel is actually a relative lack of pressure to make unusual lending in the current circumstances, when things return to normal, we should be able to draw lines and, indeed, as part of the process of financial reregulation and so on, should be able to clarify these things much better. So I'm less concerned

than you are, and I understand that there are judgments that have to be made about this. But, remember, as I said—600,000 jobs. If we can do something about that in ways that have limited and manageable risk to us, I think we need to take that into account. President Fisher, did you have a comment?

MR. FISHER. You've covered some of this in your response, Mr. Chairman. Obviously, we need to be aware that a CDS market will build around Federal Reserve bills. There are perception issues here, and I'm sure that you've taken that into account, and the New York Desk has taken that into account, in at least developing our thoughts on Federal Reserve bills and this non-monetary paper that we're going to issue. That market will be discounting us in some way, shape, or form, and we'll just have to monitor that as we go through time.

I wanted to shift the subject only slightly, because one of the concerns I have, which I sent a note around about, is with regard to Treasury issuance. From what I've heard in this discussion, it's not clear what new issuance will take place, because there's so much lack of definition. But somebody used the number \$500 billion before in terms of the aggregator bank or the public-private partnership, and a portion of that will be Treasury. I'd just ask if we have an updated sense of how much net new issuance is likely to take place under the \$790 billion stimulus package and with the addition of new Treasury commitments, so that we have a sense of the impact that's likely to occur on the yield curve. Do we have a more refined sense of that presently? Maybe Bill has an answer.

CHAIRMAN BERNANKE. I don't have the number.

VICE CHAIRMAN DUDLEY. I don't have the number off the top of my head. The number is going up, clearly. It's a couple of trillion dollars, I think.

CHAIRMAN BERNANKE. There are a couple of different numbers that are relevant. One is gross issuance, which, of course, includes replacement of—

MR. FISHER. This is net new issuance.

CHAIRMAN BERNANKE. Net new issuance. But there again, there should be some distinction between the TARP issuance, which is asset acquisition, and the other issuance. But I don't know the number. We don't have anyone here who knows the number, but we can clearly look into it.

MR. FISHER. We have talked about numbers here—we decided at the last meeting not to be precise. But in our discussions with the Treasury and so on, there's no implicit or explicit understanding on their part that we will intervene to a specific degree on the longer end of the curve in the Treasury market—is that correct or incorrect,?

CHAIRMAN BERNANKE. They've never raised that with me at all. No, there is no understanding.

MR. FISHER. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. Vice Chairman.

VICE CHAIRMAN DUDLEY. I think your summary of the program was very precise, exactly as I understand the program myself as of late last evening. I think that we have to recognize, though, that Mr. Geithner still has 48 hours, and the program could change in the meantime. So if the program turns out to be somewhat different than the Chairman describes, that's not the Chairman's doing, that's the Treasury Secretary's doing. It could be a little bit different at the end of the day than what we have right now, so don't criticize the Chairman if the program morphs a little bit in the final 48 hours. I don't think it's going to change, though, to a great degree. I think that the one area of the program that really needs to be nailed down is the

FDIC guarantee program—exactly how they're going to extend that, whether they're going to modify the cap, and whether the covered bonds are being included. I think that most of the work, though, on the program now is really on the message. And I think that our general view of what we saw yesterday was it was a bit scary, it wasn't particularly confidence-building, and it wasn't very clear.

We have a number of people at the New York Fed that are helping with the process, and we're trying to do three things: Make it less scary; make it clear that this capital-raising exercise is designed to instill confidence in the banking system by ensuring that the banks have enough capital to withstand the stress scenario, above and beyond what we expect to happen; and, as a consequence of that, make investors look at the program as confidence-building rather than confidence-draining. I think the disappointment for a lot of people that have been working on this exercise is that the program is not as clear and definitive as we would like. But we're going to try to make the message as clear and as definitive as we can within the confines of the program.

As far as the TALF is concerned, I think that people are going to be a little bit confused about how the TALF fits into this program, because they're waiting for an announcement on Monday about the banking system, and the TALF isn't really about the banking system per se. It's really about expanding the capacity of the private sector balance sheet to take the pressure off the banking system, basically to help market functioning improve and ease financial conditions. So there may be a little bit of confusion with people wondering, well, is this TALF going to take bad assets off bank balance sheets? I don't think the TALF is really being built with that in mind. It's possible some assets could come off the bank balance sheets as a consequence, but we're going to need to be clear that the TALF is really not a bank rescue

vehicle. It's really more about improving financial conditions in the general economy. Thank you.

CHAIRMAN BERNANKE. President Bullard.

MR. BULLARD. Thank you, Mr. Chairman. I just wanted to make one comment about our boards of directors who are concerned about losses in the Federal Reserve System. They're just trying to be good business people. They hear a lot of things, and I think what they're hearing mostly is actual reported losses on the Bear Stearns portfolio, which has already been marked down, and they're worried about our arrangements at AIG and Bank of America and Citi. So that's what I think is going on. I think the clearer we can be about the fact that we're watching it and that we have it under control, the better from that perspective.

I just wanted to circle back. Generally speaking, this is, as we expected, a comprehensive plan. It has many moving parts, and many of them seem very reasonable to me. I think the biggest issue that has been brought up today is really this communication issue. Our near-term concern would be that we really get a bad reaction and create more difficulty this week. So I don't know if we can think a little bit more about things we could do to mitigate that. I know that it's up to the Treasury Secretary to decide how he wants to make the announcement. I think there's a lot of political pressure to make a big splash, but maybe making a big splash isn't necessarily the right way to get this to sail off in a smooth direction.

One thing on Vice Chairman Dudley's comment that TALF is not really about the banking system—you could pull that out and announce it at some other time when perhaps it could be better explained and better absorbed. It's going to be in with a lot of other provisions, so the impact might get lost and people might be confused about what it is. I'm just suggesting possibly there's another time we could announce that.

The other thought is about the scrubbing provision that—at least as I interpreted Governor Duke’s comments—might cause a very nasty reaction out there. Maybe that could be soft-pedaled or done in a way that says that we’re just thinking about this. The intention of that would be to mitigate some of the potential for a very nasty downturn that might exacerbate the situation and make it much worse. The signaling effects during this financial crisis have been astounding, absolutely astounding. And I think we do need to be very aware of that. It seems to me that’s our near-term challenge for this discussion. Thank you, Mr. Chairman.

CHAIRMAN BERNANKE. Thank you. You should tell your board that, in every one of the cases where we have taken risks, including the wraps for Bank of America and Citi, we have a letter from the Treasury saying that it’s understood that this is a responsibility of the U.S. government, and that any losses would come out of seignorage. We haven’t worked out how that would be done exactly, but the long-term impact on the Federal Reserve’s capital should be nil based on those representations.

MR. BULLARD. I understand, and I think my board appreciates that. But they also start to ask questions, because the numbers get so large that you start talking about more than we send back to the Treasury in a typical year. And the crisis seems to be going in unpredictable ways, so I think they’re just trying to be prudent business people on this question. As long as we have good risk-management in place, I think it would be fine—they’d just like to see reassurance on that.

CHAIRMAN BERNANKE. I appreciate that. And I guess I would add that seignorage obviously is adjusted over a period of years. We haven’t done a recent calculation. Perhaps it would be in our interest to do so. But I think we’re probably in the black on balance, because those are the only losses. Everywhere else the lending programs are providing us with some

additional interest income. So I think our net seignorage is probably positive. The Vice Chairman is nodding his head.

VICE CHAIRMAN DUDLEY. At this point in time.

CHAIRMAN BERNANKE. At this point in time, anyway. So I think overall that we're doing pretty well in terms of the financial implications for the Federal Reserve and for the government. Governor Duke.

MS. DUKE. Yes, Mr. Chairman. We talk about the analysis that we've done in terms of the TALF, and we're really establishing the capital that we think we need to hold on these assets, and it's presumably based on a loss estimate—not on any estimate of potential market value loss, but of credit loss.

The first question is: Are those being done on a stress scenario in the same way that we would apply it to the bank capital needs? And my second question is: From an actual and a communication standpoint, when we go in to scrub the banks, might we be looking to scrub the banks particularly from a credit loss standpoint, not necessarily from a market loss standpoint? Based on an estimate of their credit losses, some assets may actually be, in this analysis, worth more than they're marked on the balance sheet today, and others would be worth less. Or are we planning to go in there and focus on the worst of both possible worlds, both market value losses as well as credit losses?

CHAIRMAN BERNANKE. On the second question, I think the idea is just to make sure that everybody is using comparable standards, but not to change the rules. The rules would be what they are for mark-to-market and for banking book assets. So on the mark-to-market side, you'd be looking to see what the methodologies are and so on, and on the banking book side, you'd be looking to see whether reserving is taking place in an appropriate way and whether the

estimates of the credit losses are reasonable. In a sense, it is the worst of both worlds, I guess, but it's within the context of the existing accounting structure for banks.

Vice Chairman, do you want to respond to the first question?

VICE CHAIRMAN DUDLEY. Yes. On the first question, I think the stress testing is far beyond any other stress test any financial institution has ever had. I think it's one out of 100 years, and then stressed versus that.

MR. NELSON. The haircuts are set at 3 percentage points plus four times the estimated losses in a one-out-of-100-years scenario. But those are credit losses, not market losses.

VICE CHAIRMAN DUDLEY. It is a very high stress scenario. And if you want to give some numbers, it might be useful.

MR. NELSON. To provide some numbers—and I think these numbers are included in the memo that was circulated to the FOMC—our expected losses are \$500 million.

VICE CHAIRMAN DUDLEY. Not ours. Isn't that the whole loss?

MR. NELSON. That's the expected losses for the whole program.

VICE CHAIRMAN DUDLEY. Including for the Treasury.

MR. NELSON. The stress losses in a one-in-100-years scenario are \$2.4 billion. So that's to be compared with \$6 billion from the interest spread—that's just the spread over LIBOR or over the swap rate. So, even under the stress scenario, we anticipate that no one would lose money. Treasury would make money. And then, even if those were to be exceeded, we'd still have the \$20 billion Treasury cushion.

VICE CHAIRMAN DUDLEY. The Treasury could legitimately argue that they're putting up too much TARP capital relative to their risk.

MR. NELSON. It is probably important to add that it is very difficult to know what losses will be under these circumstances. We have very little to go by to judge what the future is going to be like. The future is pretty uncertain territory right now, but those are our best judgments.

CHAIRMAN BERNANKE. President Hoenig.

MR. HOENIG. Thank you, Mr. Chairman. Just a comment, and I'll try to keep it brief, because I know you've been very generous with your time here, but I have to tell you my thoughts as I look at what we're trying to do and the strategy. The U.S. economy over the last decade has leveraged up incredibly. The numbers are dramatic—a doubling of our leverage in the financial sector. Right now we're going through the deleveraging process. And as the leveraging went up, there was enormous misallocation of resources. So those resources are now shifting back and forth, and there is going to be pain with that—I don't think we can avoid that. The deleveraging process requires us to acknowledge hundreds of billions of dollars of loss. The loss is there—we can't avoid it—and the need to recapitalize by significant amounts is a fiscal action that we have to take.

What we're trying to do, if I understand today's meeting and other meetings, is to try to temporize the adjustment process—to give us time, or give the Congress time, or give someone time—so that a fiscal stimulus package can help make up the difference, or something like that.

It worries me, though, that we're doing it through the TALF, because it does further misallocate resources, although I know we're trying to make it as broad as possible. I am confident that we have a major commercial real estate problem coming, and that will bring us—again—losses that have to be taken and will put us in the position of having to figure out how we're going to temporize and lend, and that may in fact further distort things. So if we can

develop ways that would minimize our involvement, rather than continuing to accelerate it up to \$1 trillion, I think we would be well served in the long run, because the loss is there, and the adjustment is going to have to take place. And if we distort, I think we will only prolong, in the end, some very harsh realities that lie ahead. That's my concern, and I know you realize that, but I just have to voice it at this point. Thank you.

CHAIRMAN BERNANKE. I understand that concern. You often hear people say, "Well, we need people to save more. Why are we taking fiscal policy actions to try to get them to spend more? Isn't that inconsistent?"

I would say it's not inconsistent, because in the short term—I'm adopting a New Keynesian framework here—sharp adjustments in aggregate demand not only move us towards the long-term desired adjustment, but they also can create excess capacity (loss of use of resources) over and above the natural adjustment process that we need in the long run. So there is a case—for example, when there is a movement from low saving to high saving—for trying to provide mechanisms to maintain something close to full employment as you make that transition.

By the same token, we need to go from high leverage to low leverage. That process is happening. The losses are occurring. One thing I like about this bank program is that it's very honest. I think it's a very truth-telling program. It's not trying to hide things. But the deleveraging process has a side effect, which is to bring down aggregate demand and to create enormous excess capacity in the economy, which, I think, is partially wasted. Therefore, there is a social gain involved not in trying to stop this adjustment, or reverse it, but rather in trying to allow the economy to adapt to it in a more gradual way.

And I'm not particularly persuaded that we are misallocating credit, because I think the credit markets are just not working very well. There are all kinds of informational and capital

and other issues which are preventing the markets from working in anything remotely like a good way. We are trying to use the tools we have to mitigate the implications for the broader economy, not because we're trying to affect credit allocation per se, but because we're interested in the effect on overall demand and the economy. You mentioned CRE [commercial real estate], and, by the way, that's likely to be a thing that we would try to address in the TALF context.

So I understand all of the complexities here, and crises are a time when you have to examine orthodoxies and try to think about the complexity of the world. And we're making all kinds of tradeoffs. But I think we're better off trying to get to where we need to be in a more gradual and buffered way than allowing the system to go through a violent, wrenching process, which could very easily get us trapped in some Japanese-style situation where the usual dynamic mechanisms for adjustment are strongly attenuated and it takes a very long time. So I understand what you're saying, but I don't think there's a contradiction between trying to achieve a rationalization of leverage and consumption in the long run and trying in the intermediate term to mitigate the effects of that on aggregate demand and on the broad economy. I think it is a consistent intellectual position. You may not agree with it, but I think it's not inconsistent.

MR. HOENIG. Thank you.

CHAIRMAN BERNANKE. Other questions or comments? President Lacker.

MR. LACKER. I thought the conventional wisdom about Japan is that it was government action to delay adjustment that led to their stagnation.

CHAIRMAN BERNANKE. I disagree with that. I think that what happened was that they were very slow in adjusting to the financial crisis in the banking system. I don't know what you're referring to, frankly.

VICE CHAIRMAN DUDLEY. I think the zombie issue.

MR. LACKER. Yes, zombie banks, zombie borrowers that weren't foreclosed on, an inability to free up resources and pry them out of the hands of bankrupt firms and move them to new productive uses.

CHAIRMAN BERNANKE. Well, that wasn't government action, that was government inaction. It took a tough guy like Takenaka to confront the banks and force them to write down their positions and to recognize their losses—which is what I think is the positive virtue of the Geithner approach—which was the first step to recovery. People say, "Well, fiscal policy was insufficient." Well, maybe so, but there weren't a whole lot of intrinsic dynamics in that economy to restore full employment absent government policy, either. I view Japan as being a case of mostly insufficient action rather than excessive or incorrect action. But we don't want to debate that I think in any detail today.

MR. LACKER. I know, this could be a long debate. The scrubbing of the balance sheets is a very strong element in this plan, and I think that it's well worthwhile. And I think it's really clever to get around these accrual accounting problems rather than address them head-on. I think it makes a lot of sense to go in and run a shadow regulatory regime around what those assets are really worth.

CHAIRMAN BERNANKE. Okay. Other comments? President Fisher.

MR. FISHER. May I just take this opportunity to welcome Governor Tarullo on board and give him an option to leave if he decides to do so. [Laughter]

MR. TARULLO. Thank you, Richard.

CHAIRMAN BERNANKE. I'd like to point out Governor Tarullo has a 14-year term.
[Laughter]

MS. DUKE. Sentence? [Laughter]

CHAIRMAN BERNANKE. A term, not a sentence. Thank you, everybody.

END OF MEETING