S. HRG. 110–974

TURMOIL IN U.S. CREDIT MARKETS: EXAMINING THE RECENT ACTIONS OF FEDERAL FINANCIAL REGULATORS

HEARING

BEFORE THE

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

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

ON

EXAMINING THE RECENT ACTIONS OF FEDERAL FINANCIAL REGULATORS

THURSDAY, APRIL 3, 2008

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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U.S. GOVERNMENT PRINTING OFFICE

50–394 WASHINGTON : 2010

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

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C O N T E N T S

THURSDAY, APRIL 3, 2008

WITNESSES

TURMOIL IN U.S. CREDIT MARKETS: EXAMINING THE RECENT ACTIONS OF FEDERAL FINANCIAL REGULATORS

THURSDAY, APRIL 3, 2008

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

The Committee met at 10:10 a.m., in room SD–G50, Dirksen Senate Office Building, Senator Christopher J. Dodd (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN CHRISTOPHER J. DODD

Chairman DODD. Good morning. The Committee will please come to order.

Again, let me thank all of our witnesses and my colleagues and those of you gathered here this morning. We are not in our traditional hearing room, and the size of the crowd in the room is evidence of the reason why. So we thank all of you this morning to participate one way or another in this gathering.

Today the Committee will carefully consider recent actions taken by our Federal financial regulators in response to the ongoing turmoil in our markets and our economy. Much of our focus today will center on the period of 96 hours, mostly over the weekend of March 15th and 16th. During this momentous 4-day period, the Federal Reserve, the Federal Reserve Bank of New York, and the Treasury Department took dramatic and unprecedented action to stabilize our markets to infuse them with liquidity and to prevent additional financial firms from being swept under the riptide of panic that threatened to have taken hold of our markets.

Among those actions was the decision by these entities to support the acquisition of Bear Stearns by JPMorgan Chase. As part of the acquisition, the Federal Reserve Bank of New York, with the support and approval of the Federal Reserve Board of Governors and the Treasury Department, committed some $30 billion in taxpayer money to help facilitate the sale of the distressed company to JPMorgan Chase. And as part of its broader efforts to provide stability to the markets, the Fed's Board of Governors made a historic decision to allow primary dealers, firms which include investment banks, to access billions of dollars of liquidity on a daily basis.

The stunning fall of Bear Stearns, a Wall Street giant and America's fifth largest investment bank, was matched only by the swift and sweeping response to its collapse put together by the New York Fed and the Federal Reserve Board of Governors, which, with the support of the Treasury, exercised powers in some instances that had not been used since the Great Depression, and in others were unprecedented in nature.

There can be no doubt that these actions taken in order to calm financial markets that appeared to be teetering on the brink of panic have set off a firestorm of debate. They also raise a number of important questions that warrant our consideration. Was this a justified rescue to prevent a systemic collapse of financial markets or a $30 billion taxpayer bailout, as some have called it, for a Wall Street firm while people on Main Street struggle to pay their mortgages?

What was the role of the Federal Reserve, the Treasury, the New York Fed, and the SEC in helping to facilitate a range and set the terms, including the price of the original and amended merger agreement between JPMorgan Chase and Bear Stearns?

While hindsight is invariably 20/20, it bears asking if Bear Stearns would have survived if the Fed had opened the discount window to investment banks earlier. And what led to the sudden reversal on a policy that the Vice Chairman of the Fed had openly rejected in response to a question that I asked him before this very Committee only 2 weeks earlier?

What was the role of the SEC, the primary regulator of Bear Stearns, during this critical 96 hours and in the weeks of market turmoil leading up to that weekend of merger negotiations? And why were they seemingly unaware of the potential for market rumors to cause investors to suddenly stop doing business with Bear Stearns until it was too late.

These questions, the series of events leading up to Bear Stearns' rescue, the response by financial regulators, and the implications of those actions will be discussed and debated for years to come. It would be an overstatement to suggest that what occurred during those fatal 96 hours may have fundamentally altered our financial market landscape and our system of financial market regulation.

Given these considerations and the highly unusual and unprecedented actions taken by the Federal Reserve Board of Governors, the Federal Reserve Bank of New York, and the support of the Department of the Treasury, I believe it is appropriate, indeed essential, that this Committee, the Banking Committee, exercise its oversight and investigatory functions to examine the authority, economic justification, and the public policy implications of these extraordinary recent actions by our Nation's Federal financial regulators.

As such, the Committee has convened today's hearing, the first congressional analysis with all relevant parties to this issue, to hear the testimony of the public and private principals involved in this unprecedented series of events, and to provide Committee Members and the American taxpayer with a full, public, and thoughtful airing of these issues and their implications. With $30 billion on the line, the public deserves, of course, nothing less.

I want to thank all of the witnesses and my Committee Members as well for their participation here this morning. We look forward to the testimony of our witnesses.

Let me just say as well here that I want the witnesses to know, and others, that as a bottom-line consideration, I happen to believe that this was the right decision, considering everything that was on the table in the closing hours on that Sunday; that the alternative—and I do not think this is hyperbole—could have been devastating, both at home and around the world, for that matter. So I do not question that ultimate decision, but I think it is appropriate that we look at the rationale leading up to it, why decisions were made and not made earlier and later during the process, what was a part of that negotiation. Were there alternatives? Is this a model for the future? If so, what are the implications? What did the taxpayer get back from the $30 billion that we are putting on the line, or the $29 billion here?

Those are the kinds of questions I think all of us are interested in pursuing, and many, many more. But on the bottom-line issue, at least to this Member, I think fundamentally the decision was the right one in the final analysis. But I think it is appropriate we look at what else went on here to determine the wisdom of this step and what the implications are.

With that, let me turn to my colleague from Alabama, Senator Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you for calling today's hearing.

The collapse of Bear Stearns and the unprecedented regulatory response led by the Federal Reserve call for a thorough examination of this Committee, so I commend you, Mr. Chairman, for bringing this Committee together today.

In deciding to commit $29 billion to help finance JPMorgan Chase's takeover of Bear Stearns, the Fed has set a new precedent on the type of response that the Federal Government may provide during financial panics. It may be that the Fed's actions were warranted by the unique financial conditions prevailing in our markets. However, such policy decisions must be fully considered by this Committee. After all, the ultimate responsibility for financial regulations rests with this Committee and the Congress.

In examining the events of the past few weeks, we must certainly be mindful that regulators and market participants had to make prompt decisions using available tools in the midst of a financial storm. This will not be the last time that we face financial upheavals in our history. However, I think it would be unwise if we did not take this opportunity this morning to thoroughly examine what transpired, including how Bear Stearns was regulated, what caused its collapse, whether any other institutions face similar risk, and if there are any shortcomings in our regulatory structure.

Two aspects of the Fed's response deserve particular attention.

First, for the first time since the Great Depression, the Fed has funded a bailout of an investment bank. Previously, assistance by the Fed had been extended to only FDIC-insured depository institutions. But by extending the Federal safety net to an institution not supported by an explicit Federal guarantee, the Fed's actions may create expectations that any major financial institution experiencing difficulties might be eligible for a Federal bailout. I think we must guard against creating a moral hazard that encourages firms to take excessive risks based on the expectations that they will reap all the profits while the Federal Government stands ready to cover any losses if they fail.

A second point of concern is the legal authority for the Fed's actions. The financial assistance extended by the Federal Reserve was provided under the Federal Reserve's emergency lending authority, which allows the Fed to lend to any entity, not just banks, in, and I quote, "unusual and exigent circumstances" with the approval of five members of the Board of Governors. This unilateral regulatory authority is in sharp contrast to the regulatory scheme set forth under FDICIA for bank failures involving systemic risks, which includes roles for the FDIC, the Fed, the Treasury Secretary, and the President of the United States.

The Fed's recent actions may have been warranted. Nonetheless, the Committee here today needs to address whether the Fed or any set of policymakers should have such broad emergency authority going forward. And if the evolution of our markets leads to the Federal safety net being extended to non-banks, attention should be given here, I believe, to ensure that the proper decisionmaking process is here and safeguards are in place.

I look forward to exploring these and other issues with our witnesses today, and I appreciate again, Mr. Chairman, you calling the hearing.

Chairman DODD. Thank you very much, Senator Shelby.

Let me just say for the purposes of the Committee Members, as you know, we have also got a major bill on the floor dealing with the housing issue, so this is going to create somewhat of an awkward moment or two here and there as we go back and forth. What I would like to do, if I could at the outset—and we want to get to our witnesses, but I also know that all of my colleagues have some feelings about this matter, and so I am going to take a step here and ask any Member that would like to make an opening brief comment on this matter to be able to do so before we get to our witnesses. And then we will hear from the witnesses themselves and set up a question period as well.

But let me ask if anyone would like to be heard. I will begin with Senator Johnson, if he has any brief comments. Or anyone else who would like to be heard at the outset here, I would like to give you that opportunity to be heard. Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Chairman Dodd, for holding this hearing today.

There appears to be little consensus on the effects of the recent Fed action in the purchase of Bear Stearns. There has been criticism voiced from a large network of people. I have received letters from my constituents with concerns that it is a bailout of the big bank that creates a moral hazard. Others wonder if it is appropriate to offer help to Wall Street firms while insisting on market discipline for troubled homeowners.

There has also been applause for the situation from some quarters. The U.S. markets responded favorably. Other investment banks poised to be in trouble saw their stock rise. Foreign governments applauded this as a positive move for global markets, and other analysts suggested that the Fed actions averted what could very well have been a modern-day run on the bank.

The reality of the situation is probably somewhere near the middle.

I thank you, Chairman Dodd, and I submit my whole statement for the record.

Chairman DODD. All statements, by the way, of Members and any supporting data and information they would like to have included will be included in the record during the entire hearing.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I agree with the position you and the Ranking Member have taken. The only thing I would quibble with in your statement is when you said, "Hindsight is always 20/20." At this point hindsight has not yet reached that level of accuracy because we are viewing these events through the lenses of previously strongly held ideological positions. And it is important for us to have this hearing so that we can perhaps move away from some of those strongly held ideological positions and find out what really happened.

So I endorse what you have had to say and thank you for calling the hearing.

Chairman DODD. I will so modify my opening statement to reduce the 20/20.

Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you very much, Mr. Chairman, and the dramatic intervention by the Federal Reserve with regard to Bear Stearns raises significant questions.

What are the consequences of this implicit guarantee on these institutions by the Federal Reserve and financial markets? What regulatory authority should be exercised over these institutions? What are the steps being taken to minimize taxpayer exposure? And what are the steps being taken to ensure that there is improved risk management both by the financial institutions and regulators alike going forward?

I think all of these questions begin with a careful analysis of what has happened, a sober and highly detailed analysis of the actions of the agency, not just their authorities, but also how they implemented their authorities, how they cooperated and communicated with other regulatory agencies. It is not finger pointing. It is the kind of after-action report that is owed to the American public since you are using their resources to stabilize this market.

We have, I think, an obligation to encourage you—in fact, more than encourage you—to conduct this sober, no-holds-barred analysis of what happened, because the bottom line is to prevent a repetition and to strengthen our markets. I think the greatest competitive factor in our financial markets is the confidence that Americans and the world have that these markets are well regulated and transparent. And if there is any question about the regulatory sufficiency or transparency, that makes us less competitive in the marketplace, and it does not help us, it does not help the taxpayers that are supporting these efforts.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator Reed.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Thank you, Mr. Chairman. I am anxious to hear from the witnesses and get into the question period.

Chairman DODD. Thank you.

Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you for holding this hearing, Mr. Chairman. I appreciate it. You can see by the fact that this room is full that the economy has moved front and center when even the behind-the-scenes moves of regulators and institutions gets the attention it does.

My questions fall into three areas: the before, the after, and the who. I think everyone agrees that the Fed had no choice and the actions had to be done. But the question is first the before. How long before this happened should the regulators have known what happened? Bear Stearns had trouble. Two of their hedge funds went under due to mortgages in the summer. Where were the regulators? Was someone asleep at the switch, or is it that our regulatory structure does not work? The SEC has jurisdiction over Bear Stearns, but mainly looks at investor protection and disclosure. The Fed has responsibility for safety and soundness of the system, but no jurisdiction over investment banks. I think that things fall between the cracks.

The after: What are we going to do now? How are we guarding against the future Bear Stearns? And what rules are set in place so that things are done in a fair way? The response to Bear Stearns was necessary but ad hoc. If the Fed is going to be a stabilizer of last resort, it would be best if the stabilizing efforts were by the book instead of on the fly.

And, finally, the who: Everyone agrees that Bear Stearns was staring into the abyss. What about homeowners who are also staring into the abyss? It is true that a large institution creates systemic risk problems. An individual homeowner does not. As an aggregate, homeowners certainly do. Thousands and thousands and thousands of foreclosures create as much systemic risk as one investment bank. And I worry that as quickly as the Federal Government moved to save Bear Stearns from complete failure, it has moved at a snail's pace, if at all, to save homeowners from foreclosures where the same types of moral hazard like as not existed.

So I thank you for this hearing, Mr. Chairman. It is necessary. It is the beginning of a long road we have to face so that our system of regulation catches up to the financial system that is on the ground today.

Chairman DODD. Thank you, Senator Schumer.

Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman. I will be brief.

First of all, I want to know, the first question: How big do you have to be to be too big to fail? That is the question I ask first.

I am very troubled by the failure of Bear Stearns, and I do not like the idea of the Fed getting involved in a bailout of that company. But before making a final judgment, I want to hear from our witnesses why they thought it was necessary to stop the invisible hand of the market from delivering discipline. That is socialism. At least that is what I was taught. And I would imagine everybody at that table was taught the same thing. It must not happen again.

I am also troubled that the regulators who were supposed to be watching the types of mortgages being written did not do their job. Neither did the regulators who were supposed to make sure one firm did not become exposed to too much risk.

Other questions need to be asked. Does anyone else think they will get Fed intervention if they get into trouble? Who let our financial system become so fragile that one failure jeopardizes the health of the entire system?

I am sure many other questions will come up as well. I look forward to the hearing and will follow up during the questioning.

Chairman DODD. Thank you, Senator Bunning.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thank you, Mr. Chairman. Mr. Chairman, thanks for pulling this together. I just want to say—just start off by thanking you and Senator Shelby for the leadership you have provided in recent days and weeks to try to make sure that our action here in the U.S. Senate matches the action on the part of the Federal Reserve and on the part of the Treasury and others to try to restore confidence in our markets, to restore liquidity as well.

We will be taking up when we leave here today—the Chairman and Senator Shelby will be leading a debate, accepting amendments, debating amendments, as to what our responsibilities are to follow up on the actions that you take. And I agree with Senator Dodd. At the end of the day, I think, Chairman Bernanke, what the Fed has done will probably pass muster, and we will end up thanking you for that.

I am going to ask you, when it comes time for me to ask questions, I am going to be asking you to give us your advice, your informed advice on the package that we are about to consider, that we are going to debate. And we are taking on ourselves the ability to criticize or comment on what you have done, and I would welcome you to do the same in terms of what we expect to do later today and maybe through tomorrow and next week.

The other questions I am going to ask—and a bunch of my colleagues have already indicated, telegraphed their pictures, I will telegraph mine as well, in terms of looking and reflecting on the steps you have taken. But among the questions I want to ask, Chairman Bernanke, are: Why did the Fed take the action that you have done? How did the Fed actually intervene? Just sort of give us a glimpse behind the curtain as to how you actually intervened. What are the probable repercussions of the action? What are the possible repercussions if you had not chosen to act? Could this intervention be seen as a model of what to do or not to do in the future? And if it is maybe the latter, what steps should be taken to reduce the likelihood that similar interventions will not be needed in the future?

Those are the kinds of questions that I will be throwing your way, but one of the first questions I will ask is: What advice would you have for us as we take up our legislative actions on the floor?

Thank you very much, Mr. Chairman.

Chairman DODD. Thank you very much.

Senator Dole.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Mr. Chairman. I am also anxious to hear from the witnesses and get into the question period.

Chairman DODD. Thank you very much.

Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman. I appreciate you calling this hearing, and certainly no one questions the necessity of having acted to stop the Bear Stearns crisis. We can only imagine what would have happened to our broader economy at the end of the day. But the catch about this deal is that much of it is riding on faith, as I see it, and our faith cannot be blind, which means it is time to pull back the curtains and examine the details.

If we do not learn from the chain of events that led to Bear's demise, then we are doomed to see a repeat in the future. I hope the answers we will hear today will provide insight into some key questions, including how we ended up blindsided by the sudden tanking of a firm as large as this one on Wall Street; how the specifics of this unprecedented deal were hammered out. What are the consequences of sticking taxpayers with a $29 billion loan that could fail? And, last, how do we continue to look at struggling homeowners in the eye when we pull out all the stops to help a sinking ship on Wall Street but homeowners are still adrift at sea, drowning in foreclosure?

The Bear Stearns crisis reared its head, and it was solved in a matter of days. The foreclosure crisis has been going on for a year with no end in sight. And both pose, I think, significant if not equal threats to our economy.

So I look forward to getting to the bottom of exactly how the decision to rescue Bear Stearns came about and why their crisis is so different from the crisis still raging in neighborhoods across the country.

Thank you.

Chairman DODD. Thank you very much.

Senator Martinez.

Senator MARTINEZ. I will pass.

Chairman DODD. You pass on that.

Senator Tester.

STATEMENT OF SENATOR JON TESTER

Senator TESTER. Thank you, Mr. Chairman. Welcome, Committee Members. You have got a lot of questions to answer, and I appreciate you being here. This is a big issue.

You know, I had a hearing the day after this merger was announced. I had a forum on financial investments. The first question from the crowd did not go to the experts. It went to me. And the question was: "Why $30 billion? Why was it invested? I am homeowner. I am in trouble. How come nobody steps up to the plate to help me?" Many of the same questions that were asked here.

I guess if I was to add to this list of questions, Have we set precedents? Is this going to be the policy from now on? Is this the direction we are headed, and is the right direction to be heading in?

With that, Mr. Chairman, I just want to thank you for the hearing, and I do have many questions, more than that, when my time comes.

Thank you.

Chairman DODD. Thank you, Senator, very much.

Senator Corker.

STATEMENT OF SENATOR BOB CORKER

Senator CORKER. Mr. Chairman, I do not have an opening statement, and I hope that—you all have shown tremendous leadership, especially over the last few days. I hope we can move toward the leader and the Ranking Member only making opening comments in the future somehow so we could get to the witnesses, but I have been greatly illuminated and look forward to certainly hearing our witnesses.

Chairman DODD. We are glad you have a chair at the table and not in the closet back there as well.

[Laughter.]

Chairman DODD. We have all been in that seat at one point or another.

Senator Bayh.

Senator BAYH. I will wait.

Chairman DODD. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman. I will be brief as well. I believe that the Members of the panel who have spoken already have already raised a number of critical issues. I think there is one more that we need to pay attention to as we look at this situation.

The Congress is—or the Senate literally today is looking at issues relating to the housing market and the mortgage industry, and we are going to today in this hearing be looking very closely at what happened with the Bear Stearns situation and how the Fed and the Treasury and the SEC responded there.

I think as we look at these issues and as the hearing moves forward, we also need to look at our competitiveness, frankly, in capital markets and whether we need to look at an entirely new restructuring of how we regulate our financial markets in this country. This issue has also been raised recently by Secretary Paulson, and many others have raised it before he did.

So I believe that what we are looking at in today's hearing clearly brings forward the question of how is our regulatory structure in the United States set up and how should it be set up as we look forward to moving into this next century, and how can we make ourselves as competitive as possible in today's global economy.

With that, Mr. Chairman, I will stop.

Chairman DODD. Thank you. Thank you very much, Senator. And, again, I want to thank our witnesses for being here. We have, of course, the Chairman of the Federal Reserve Ben Bernanke; the Honorable Christopher Cox, the Chairman of the Securities and Exchange Commission; the Honorable Robert Steel, who is the Under Secretary for Domestic Finance at Treasury; and Tim Geithner, who is the President of the Federal Reserve Bank of New York. And we thank all four of you once again for being here.

Chairman Bernanke, you have spent quite a bit of time in Congress these last few days. I suggested in private before the hearing that we might find an office up here for the Chairman, he has been here so often over the last number of days.

We are grateful to you, all of you, for being here, as well as our other witnesses who are here in the second panel. We will begin with you, Mr. Chairman, and I would like you to take 5 or 6 minutes. I do not want to hold you to any specific time, but if you would try and keep it in that framework. And also any other information you think that would be valuable for the Committee to have, we will, of course, agree to accept that testimony, as well as the documentation.

With that, welcome to the Committee.

STATEMENT OF BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Mr. Chairman, I do want to thank you for this hearing, which I think is absolutely appropriate and necessary, and we welcome your oversight.

Chairman Dodd——

Senator BUNNING. Mr. Chairman, would you pull that mike closer? Thank you.

Mr. BERNANKE. How is that?

Senator BUNNING. That is great.

Mr. BERNANKE. Chairman Dodd, Senator Shelby, and other Members of the Committee, I appreciate this opportunity to discuss the economic and financial context and the actions the Federal Reserve has taken to stabilize financial markets and the economy.

Although the situation has recently improved somewhat, financial markets remain under considerable stress. Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and increased the amount of collateral they required to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices. Credit availability has also been restricted because some large financial institutions, including some commercial and investment banks and the government-sponsored enterprises, have reported substantial losses and writedowns, reducing the capital they have to support new lending. Some key securitization markets, including those for nonconforming mortgages, continue to function poorly, if at all.

These developments in financial markets—which themselves reflect, in part, greater concerns about housing and the economic outlook more generally—have weighed on real economic activity. Notably, in the housing market, sales of both new and existing homes have generally continued weak, partly as a result of the reduced availability of mortgage credit, and home prices have continued to fall. Private payroll employment fell substantially in February, after 2 months of smaller job losses, with job cuts in construction and closely related industries accounting for a significant share of the decline. But the demand for labor has also moderated recently in other industries. Overall, the near-term economic outlook has weakened relative to the projections released by the Federal Open Market Committee at the end of January. Inflation has also been a source of concern. We expect inflation to moderate in coming quarters, but it will be necessary to continue to monitor inflation developments carefully.

Well-functioning financial markets are essential for the efficacy of monetary policy and, indeed, for economic growth and stability. Consistent with its role as the Nation's central bank, the Federal Reserve has taken a number of steps in recent weeks to improve market liquidity and market functioning. These actions include reducing the cost and increasing the allowable term of discount window credit to commercial banks; increasing the size of our Term Auction Facility, through which credit is auctioned to depository institutions; initiating a Term Securities Lending Facility, which allows primary dealers to swap less liquid mortgage backed securities for more liquid Treasury securities; and creating the Primary Dealer Credit Facility, which is similar to the discount window but accessible to primary dealers. Although these facilities operate through depository institutions and primary dealers, they are designed to support the broader financial markets and the economy by facilitating the provision of liquidity by those institutions to their customers and counterparties. With respect to monetary policy, at its March meeting the FOMC reduced its target for the Federal funds rate by 75 basis points to 2¼ percent.

It was in this context of intensifying financial and economic strains that, on March 13th, Bear Stearns advised the Federal Reserve and other Government agencies that its liquidity position had significantly deteriorated and that it would have to file for bankruptcy the next day unless alternative sources of funds became available.

This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, and very importantly, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.

To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JPMorgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

The purpose of our action, as with our other recent actions—including our provision of liquidity to financial firms and our reductions in the federal funds rate target—was, as best as possible, to improve the functioning of financial markets and to limit any adverse effects of financial turmoil on the broader economy. We will remain focused on those objectives.

Clearly, the U.S. economy is going through a very difficult period. But among the great strengths of our economy is its ability to adapt and to respond to diverse challenges. Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year. I remain confident in our economy's long-term prospects.

Thank you, and I would be pleased to take your questions.

Chairman DODD. Thank you very much.

Chairman Cox.

STATEMENT OF CHRISTOPHER COX, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

Mr. COX. Thank you, Chairman Dodd, Senator Shelby, and members of the Committee, for inviting me to testify today on behalf of the Securities and Exchange Commission about recent events in the financial markets, and in particular the merger agreement between JPMorgan and Bear Stearns.

The recent actions by the Federal Reserve, as Chairman Bernanke has just described, are unprecedented and of unquestioned significance. They include not only the extension of guarantees and credit in connection with JPMorgan's acquisition of Bear Stearns, but also the opening of the discount window to every one of the major investment banks.

What happened to Bear Stearns during the week of March 10th was likewise unprecedented. For the first time, a major investment bank that was well-capitalized and apparently fully liquid experienced a crisis of confidence that denied it not only unsecured financing, but even short-term secured financing. And even when the collateral consisted of Treasuries and agency securities which had a market value in excess of the funds to be borrowed.

Counterparties would not provide securities lending services and clearing services. Prime brokerage clients moved their cash balances elsewhere. These decisions, in turn, influenced others to also reduce their exposure to Bear.

Over the weekend of March 15th and 16th, Bear Stearns faced a choice between filing for bankruptcy on Monday morning, or concluding an acquisition agreement with a larger partner.

In the cauldron of these events, the actions that the Federal Reserve took—in particular extending access to the discount window, not only to Bear Stearns but to the other major investment banks—were addressed to preventing future occurrences of the run-on-the-bank phenomenon that Bear endured. It remains, however, for regulators and Congress to consider what other steps, if any, are necessary to harmonize this significant new safeguard with other aspects of the existing legislative and regulatory structure.

The SEC, of course, does not have the function of extending credit or liquidity facilities to investment banks or to any regulated entity. Instead, through our consolidated supervised entities program, the Commission exercises oversight of the financial and operational condition of Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley at both the holding company and the regulated entity levels. Our oversight of the CSEs includes monitoring for firm-wide financial and other risks that might threaten the regulated entities within the CSEs, especially the U.S. regulated broker-dealers and their customers.

In particular, the SEC requires that firms maintain an overall Basel capital ratio at the consolidated holding company level of not less than the Federal Reserve's 10 percent well-capitalized standard for bank holding companies.

At all times during the week of March 10th through 17th, up to and including the time of its agreement to be acquired by JPMorgan, Bear Stearns had a capital cushion well above what is required to meet the Basel standards. Specifically, even at the time of its sale, Bear Stearns' consolidated capital and its broker-dealers' net capital exceeded relevant supervisory standards.

Even prior to the experience with Bear Stearns, the SEC's supervision of investment bank holding companies has always recognized that capital is not synonymous with liquidity. A firm can be highly capitalized while also having liquidity problems. So in addition to a healthy capital cushion, the firm needs sufficient liquid assets in the form of cash and high quality instruments such as U.S. Treasury securities that can be used as collateral for loans in times of stress.

For this reason, the CSE requirements are designed to ensure that an investment bank holding company can meet all of its cash needs even in the face of a complete cutoff of unsecured financing that lasts for a full year. In these ways, the CSE supervisory model has focused on the importance of both capital and liquidity.

What neither the CSE regulatory approach, nor any existing regulatory model, has taken into account is the possibility that secured funding, even if it is backed by high quality collateral such as U.S. Treasury and Agency securities, could become unavailable. The existing models for both commercial and investment banks are premised on the expectancy that secured financing would be available in any market environment, albeit perhaps on less favorable terms than normal.

For this reason, the inability of Bear Stearns to borrow against even high quality collateral on March 13th and 14th was an unprecedented occurrence. And that is what has prompted the Fed's action to open the discount window to investment banks.

Beyond this obviously powerful step that the Fed has taken, the Bear Stearns' experience has challenged the measurement of liquidity in every regulatory approach, not only here in the United States but around the world. It was in this connection that I conveyed to the Basel Committee my strong support for extending their capital adequacy standards to deal with liquidity risk of the kind that materialized for Bear Stearns.

The Fed's other important decision, to provide funding to Bear Stearns through JPMorgan, was made because—as you have heard Chairman Bernanke testify—Bear's extensive participation in a range of critical markets meant that a chaotic unwinding of its positions not only could have cast doubt on the stability of thousands of the firm's counterparties, but also created additional pressures well beyond the financial system through the real economy. These are considerations of systemic risk that extend far beyond the SEC's mandate to protect investors, ensure orderly securities markets, and promote capital formation through such means as the CSE program.

But it is important to observe nonetheless that the SEC's statutory and regulatory framework, including not only our broker-dealer net capital regime but also the protection provided to investors through SIPC, and the requirement that SEC-regulated broker-dealers segregate customer funds and fully paid securities from those of the firm, worked in this case to achieve the purpose for which it was designed.

Despite the run on the bank to which Bear Stearns was subjected, its customers were fully protected. At no time during the week of March 10th through 17th, up to and including the date of the agreement with JPMorgan, were any of Bear Stearns' broker-dealer customers at risk of losing their cash or their securities.

The question has been asked what might have happened if, notwithstanding the Fed's action, the transaction with JPMorgan had not been agreed to before Monday, March 17th? Unfortunately, unlike a laboratory in which conditions can be held constant and variables changed while the experiment is repeated, in the social science of the market the selection of one course of action forever forecloses all other approaches that might have been taken.

But there is one thing we know to a certainty. With or without JPMorgan's acquisition of Bear and with or without a bankruptcy, Bear Stearns' customers are and would have been fully protected from any loss of cash or securities.

Beyond demonstrating the importance of short-term liquidity in the form of available sources of secured funding, the Bear Stearns' experience has highlighted the statutory supervisory gap in this area. In 1991, when Congress enacted the Federal Deposit Insurance Improvement Act, it recognized the importance of having a framework for considering the resolution of financial difficulties experienced by commercial banks, but not unfortunately by investment banks.

FDICIA, together with the Federal Deposit Insurance Act, reflect Congress' conviction that it is best not to improvise the principles that will guide Federal intervention in financial institutions. That is a point that is equally valid not only for depository institutions but other systemically important institutions, as well.

Now, as always, the SEC is working closely with our regulatory counterparts to ensure that our regulatory actions contribute to orderly and liquid markets. These recent events have amply demonstrated that the SEC's mission to protect investors, maintain orderly markets, and promote capital formation is more important now than ever it has been.

Thank you again, Mr. Chairman, for the opportunity to discuss these important issues and I look forward to taking your questions.

Chairman DODD. Thank you very much, Chairman Cox.

Secretary Steel.

STATEMENT OF ROBERT STEEL, UNDER SECRETARY OF TREASURY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY

Mr. STEEL. Thank you. Chairman Dodd, Ranking Member Shelby, members of the Committee, good morning. I very much appreciate the opportunity to appear before you today to represent Secretary Paulson and the United States Treasury Department, and to join the independent regulators leading the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, the Federal Reserve Bank of New York. As you know, Secretary Paulson is on a long-scheduled trip to China today.

You invited Treasury here today to discuss the ongoing challenges in our credit markets, and specifically, the agreement between JPMorgan Chase and Company and the Bear Stearns Companies, Inc.

The Treasury Department continues to closely monitor the global capital markets and the past several months have presented to us many important issues and situations to evaluate and to address. As Secretary Paulson stated earlier this week, a strong financial system is vitally important, not only for Wall Street, not only for the bankers, but for all Americans. When our markets work, people throughout our economy benefit. Americans seeking to buy a car, a home, families borrowing to pay for college, innovators borrowing on the strength of a good idea for a new product or technology, and business financing investments that create new jobs. When our financial system is under stress, all Americans bear the consequences.

Mr. Chairman, as you have appropriately noted in your letter to Secretary Paulson, "It is important to maintain liquidity, stability, and investor confidence in the markets."

The recent events in the credit and mortgage markets are of considerable interest to this Committee, other Members of Congress, and most importantly, all of the citizens of this country. For several months, our financial markets have gone through a period of turbulence followed by periods of improvement. A great deal of deleveraging is occurring, which has created liquidity challenges for financial institutions and thereby compromised our credit markets' ability to be an engine of economic growth.

It took a long time to build up the excesses in our markets and we are now working through all of the varied consequences. Market participants are adjusting, making disclosures, raising capital, and repricing assets. We have continued to engage with our fellow regulators and market participants so that collectively we work through these challenges to limit the spillover effects to our economy and make our markets even stronger in the future.

During times of market stress, certain issues may hold the potential to spill over to the broader markets and cause harm to the American economy. This was the case, in our view, with the events surrounding the funding capability of Bear Stearns between March 13th, 2008 and March 24th. The funding condition of Bear Stearns had deteriorated rapidly and by March 13th, 2008 had reached such a critical stage that the company would have faced a bankruptcy filing on March 14th, 2008 absent an extraordinary infusion of liquidity.

During this period, regulators were continually communicating with one another, working collaboratively, and keeping each other apprised of the changing circumstances. The focus was not on the specific institution but on the more important strategic concern of the implications of a bankruptcy. The failure of a firm at that time that was so connected to so many corners of our markets would have caused financial disruptions beyond Wall Street.

We weighed the multiple risks, such as the potential disruption to counterparties, other financial institutions, the markets, and the market infrastructure. These risks warranted a careful review and thorough considerations of potential implications and responses.

Our role at the Treasury Department was to support the independent regulators and their efforts with private parties as credit markets were operating under considerable stress and we believed that certain prudent actions could help to mitigate systemic risk, enhance liquidity, facilitate more orderly markets, and minimize the risk to the taxpayers.

The Treasury Department supports the actions taken by the Federal Reserve Bank of New York and the Federal Reserve. We believe the agreements reached were necessary and appropriate to maintain stability in our financial system during this critical time.

Obviously, each independent regulator had to make its own individual assessment and determination as to what actions it would or would not take. While the Treasury Department was not a party to any agreements, we have a great deal of respect for the leadership of each regulator and appreciate their efforts during this extraordinary time.

Upon assessing the Bear Stearns situation, the Federal Reserve decided to take the very important and consequential action of authorizing the Federal Reserve Bank of New York to institute a temporary program for providing liquidity to primary dealers. Recent market turmoil has required the Federal reserve to adjust some of the mechanisms by which it provides liquidity to the financial system. Its response, in the face of new challenges, deserves praise.

At the Treasury Department, we will continue to monitor market developments. We remain focused on the issues surrounding recent developments, including the important responsibility of safeguarding Government funds.

Recent events underscore the need for strong market discipline, prudent regulatory policies, and robust risk management. The Treasury Department and our colleagues, comprising the President's Working Group on Financial Markets, are addressing the current and strategic challenges and doing all that we can to ensure high quality, competitive, and orderly capital markets. We seek to strengthen market discipline, mitigate systemic risk, enhance investor confidence and market stability, as well as facilitate stable economic growth.

Thank you, and I look forward to your questions, sir.

Chairman DODD. Thank you very much, Mr. Secretary.

Chairman Geithner.

STATEMENT OF TIMOTHY F. GEITHNER, PRESIDENT, FEDERAL RESERVE BANK OF NEW YORK

Mr. GEITHNER. Thank you, Mr. Chairman, Senator Shelby, members of the Committee. Thanks for giving me the chance to be here today.

These are exceptional times. We have taken some very consequential actions. They deserve and require very careful analysis and reflection and oversight. And you are right to begin that process now.

I have submitted a very extensive written testimony describing in detail the events that began that evening of, I think, March 13th. But I just want to limit my opening remarks to three things.

One is I want to explain why we did what we did. I want to talk a little bit about the policy challenges ahead and continuing risks to the economy in this financial crisis. And I want to set out some broad objectives for how we think about the future.

Three weeks ago, on March 13th, we learned from the SEC that Bear Stearns was facing imminent bankruptcy. This presented us with some extraordinarily difficult policy judgments. Bear Stearns occupies, occupied, a central position in the very complex and intricate relationships that characterize our financial system. And as important as that, it reached the brink of insolvency at an exceptionally fragile time in global financial markets.

In our judgment, an abrupt and disorderly unwinding of Bear Stearns would have posed systemic risks to the financial system and magnified the downside risk to economic growth in the United States. A failure to act would have added to the risk that Americans would face lower incomes, lower home values, higher borrowing costs for housing, education, other living expenses, lower retirement savings, and rising unemployment.

We acted to avert that risk in the classic tradition of lenders of last resort, with the authority provided by the Congress. We chose the best option available in the unique circumstances that prevailed at that time.

The Federal Reserve has to strike a very careful balance between actions to contain risk to the broader economy and actions that might amplify the risk of future financial crises by insulating investors from the consequences of imprudence.

In this context, though, let me just emphasize two things. A failure to act would have imposed significant damage on those households, on those companies, on those financial institutions that had been comparatively prudent. And in this particular case, no owner or executive or director of a financial institution can look at the outcome for Bear Stearns and choose to see their firm managed in such a way as to court a similar fate.

The financial arrangement we reached to help avert defaults was authorized by the Chairman of the Board of Governors, and supported by the Secretary of the Treasury. It is very carefully designed to provide a number of important protections to reduce the risk of any loss. First, our loans are backed by a substantial pool of collateral that will be professionally managed. Second, JPMorgan Chase agreed to absorb the first $1 billion of any loss that might occur in connection with this arrangement. And third, our long-term horizon for holding the collateral will enable assets to be managed in an orderly fashion to minimize the risk of any loss and minimize any disruption to markets.

The risk in this arrangement—and there are risks in this arrangement—are modest in comparison to the substantial losses to the economy that could have accompanied Bear's insolvency.

I believe the actions taken by the Federal Reserve on a number of fronts in recent months have reduced some of the risks to the economy that is inherent in this adjustment underway in financial markets. By reducing the probability of a systemic financial crisis, the actions taken by the Fed on and after March 14th have helped avert substantial damage to the economy and they have brought a measure of tentative calm to global financial markets.

Relative to the conditions that existed on March 14th, risk premiums have narrowed, foreign exchange markets are somewhat more stable, energy and commodity prices are somewhat lower, perceptions of risk in the financial system have somewhat diminished, and the flight to quality is less pronounced.

Nevertheless, and I want to emphasize nevertheless, liquidity conditions in markets are still substantially impaired and the process of deleveraging remains underway. Financial market participants are still extraordinarily cautious about assuming risk. And this will intensify, continue to intensify, the headwinds facing the U.S. in the global economy.

The causes of this crisis took a long time to build up and they will take some time to work through. And in this context, it is important to underscore the fact that policymakers and financial market participants are going to need to continue to act proactively, with actions that are proportionate to the challenges ahead.

Let me just highlight three important areas for continued focus on the policy front. First, it is very important that financial institutions continue to improve the quality of disclosure. And even the strongest institutions face compelling incentives to raise new equity capital so that they can take advantage of the opportunities ahead.

Second, alongside the broad policy actions, both monetary policy and fiscal policy, that are already in place to contain the downside risk to the economy, it is very important to strengthen the capacity of the major government sponsored enterprises, the Federal Home Loan Bank system, the Federal Housing Administration, so that they can provide finance to the mortgage market and help reduce the risk of avoidable foreclosures.

Third, the Federal Reserve, working closely with other major central banks, will continue to provide liquidity to markets to help facilitate the process of financial repair.

Looking forward, and it is important to look forward, even as we work to contain the risks in this financial crisis, we need to begin to design a comprehensive set of reforms to the financial system. In addition to the very important objective of putting in place a stronger set of protections for consumers, the overwhelming imperative of reform must be to put in place a stronger framework for financial stability, both in the United States and, I think, globally.

And our objective should be to create a system that preserves the unique strength of our markets in providing individuals and companies with innovative ways to access capital and credit, but with a greater capacity to withstand stress. And this is going to require significant changes to regulatory policy and to the regulatory framework. And I think the focus has to be on changing the incentives all financial market participants face in managing risk and exposure to adverse outcomes.

In my view, and this is my personal view, there are a set of important objectives and principles that should guide this effort. I am just going to list five quickly, before I conclude.

First, we need to ensure there is a stronger set of shock absorbers in terms of capital and liquidity in those institutions, both banks and a limited number of the largest investment banks, institutions that are critical to market functioning. And they need to be under a stronger form of consolidated supervision than exists today.

Second, we need to streamline and simplify our excessively complex and segmented regulatory framework to reduce the opportunity it creates for regulatory arbitrage, not just in the mortgage market but more broadly.

Third, we need to make the financial infrastructure more robust, particularly in the derivatives and repo markets, so that the system can better withstand the effects of default by a major participant.

Fourth, we need to redesign the set of liquidity facilities that we maintain in normal times—we, at the Federal Reserve, maintain in normal times—and in extremis, both in the United States and across the other major central banks. And these changes, as many of you have recognized, need to come with a stronger set of requirements for the management of liquidity risk by financial institutions that have access to central bank liquidity.

And fifth, we need to make sure that the Federal Reserve has the mix of authority and responsibility that is necessary to enable it to respond with adequate speed and force to systemic risk to financial stability.

Our system has many strengths, but to be direct about it, I think we have suffered a very damaging blow to confidence and the credibility of our financial system. One of the great strengths of our system, though, is the speed with which we adapt to change.

My colleagues at the Federal Reserve and I look forward to working with this Committee, with the Congress, and with the executive branch to try to think through the very important task of how to put in place a stronger system for the future.

I just want to express, in closing, my admiration and appreciation to the officers and staff of the Federal Reserve Bank of New York and the Federal Reserve system. They have performed with great skill and care under extreme pressure.

I also want to thank Chairman Bernanke, Secretary Paulson, Chairman Cox, and Bob Steel, among many other colleagues in the Fed and the supervisory community for really exceptional leadership in a difficult time.

Thanks again for giving me the chance to appear today.

Chairman DODD. Thank you very much, President Geithner.

Just a couple of quick points, if I can.

First of all, I just want to express once again to the witnesses, I realize this was an extraordinary case in calling this hearing, but with the exception of one witness we got statements very late last evening. Again, I want to make this appeal to people. You have got to let us know—my colleagues here want to be able to read these statements, they want to develop questions. We need to get these statements in a more timely fashion under the rules of the Committee.

I would be remiss if I did not bring it up again. I do not want to keep repeating it every hearing we go. So again, I understand the timing of this Committee may have put some additional pressures and I know others of you had to testify in other hearings prior to this. But I want to make that case.

Second, what I would like to do here, why don't I try 7 minutes. That is not a lot of time, but there are a lot of members here and I want to make sure everybody gets a chance to raise questions. I am not going to bang down the gavel at seven, but try and keep that in mind as you develop your questions on the Committee.

I will begin, if I can, with a question for the Federal regulators here. I guess going back, I was thinking this morning, there was the question raised by Howard Baker years ago, what did you know, and when did you know it? The kind of a question that comes to mind when you look at this situation, talking about the 96 hours. And what did our regulators know and when did you know it, in terms of our response to the situation with Bear Stearns.

Specifically, there have been some reports in the press about the details of this negotiation. The Wall Street Journal reported, and I quote them, it says "This was no normal negotiation. Instead of two parties, there were three, the third being the Federal Government. It is unclear what the explicit requests were made by the Fed or the Treasury."

So I will begin with you, Chairman Bernanke, and also ask Secretary Steel what, if any, interjections were there over stock price of Bear Stearns? Specifically again, there are just reports, and I want to share them with you, that they would make an offer. That JPMorgan Chase would make an offer of $4 a share. Subsequently it was conveyed to JPMorgan Chase by someone in the Federal Government that the offer sounded too high in terms of rewarding Bear Stearns' stockholders, given the taxpayer funding that was involved.

Therefore, were you or any of your agencies aware at any point that there was an offer of $4 a share made from JPMorgan Chase? And second, did you or anyone in your agency provide feedback to JPMorgan or Bear Stearns on the value of that offer, in particular? And then last, given the specifics of the situation, depending upon your answer, do you think it would be improper or is it improper for any high-ranking Government official to have given advice to the CEOs of companies regarding what the appropriate stock price should be in circumstances like this?

Mr. BERNANKE. Mr. Chairman, the Federal Reserve's interest in this negotiation was that Bear Stearns be assumed by a strong firm so that its obligations would be met. I would emphasize, in fact, that we were very careful to make sure that there were multiple opportunities for different firms to talk to Bear Stearns over that short period of time.

We had no interest or no concern about the stock price that was evaluated. That was a secondary issue, as far as we were concerned. We wanted to see Bear Stearns' liabilities assumed in some way.

Chairman DODD. So there was no interjection on the part of the Fed at all in this area?

Mr. BERNANKE. Not to my knowledge.

Chairman DODD. Secretary Steel.

Mr. STEEL. Well sir, the Secretary of the Treasury and other members of Treasury were active participants during this 96 hours, as you describe. There were lots of discussions back and forth. Also, in any combination of this type, there are multiple terms and conditions.

I think the perspective of Treasury was really twofold. One, was the idea that Chairman Bernanke suggested, that a combination into safe hands would be constructive for the overall marketplace. And No. 2, since there were Federal funds or the Government's money involved, that that be taken into account, and Secretary Paulson offered perspective on that.

There was a view that the price should not be very high or should be toward the low end and that it should be, given the Government's involvement, that was the perspective.

But regards to the specifics, the actual deal was negotiated or the transaction was negotiated between the Federal Reserve Bank of New York and the two parties.

Chairman DODD. President Geithner, can you shed any light on this at all, on these rumors that are going around about Federal agencies recommending a lower price rather than one that was being offered?

Mr. GEITHNER. Let me just echo what the Chairman and Bob Steel said. Two objectives, very important for us. One was there be an agreement reached that would avert the risk of default because of the consequences for the economy as a whole.

The second was that the outcome, to the extent possible, not add to the inherent moral hazard risk in this kind of intervention.

From my perspective, the outcome reached that evening and the subsequent agreement reached a week later, are fully consistent with those two objectives.

Would there have been some outcomes that would have been not consistent with other objectives? Possibly, but we were not presented with those outcomes.

Chairman DODD. The point I want to get at here is whether or not our Federal agencies at all, including Treasury in this case here, Secretary Steel, where one offer was made and the Treasury recommended a lower—that a lower price be offered. Was there any such intervention directly by the Treasury?

Mr. STEEL. I cannot confirm that, sir. Secretary Paulson and Treasury were active participants. But in the end, the actual offer made and accepted was between the Federal Reserve Bank of New York and the participants. As I said, there was a perspective, as President Geithner suggested, that the outcome, with all the different terms and conditions, would be consistent with communicating and making clear moral hazard to the least degree possible. And I think that is consistent with how President Geithner and I describe it.

Chairman DODD. I understand the motivation behind it. The question is whether—I guess I maybe should ask the first question. What would be your reaction to the question, generally speaking, as to the propriety in this sort of circumstance of the Treasury intervening with a specific request that a certain price be offered where this kind of a transaction is going forward?

Mr. STEEL. I think that the Treasury was actively involved and provided a perspective. The final terms and conditions were settled by the Federal Reserve Bank of New York. It was our perspective, as I said, that moral hazard wanted to be protected as much as possible. And so therefore a lower price was more appropriate. And there were lots of terms and conditions.

The appropriateness, from my perspective, is that when there is Federal money involved, as originally $30 billion and then $29 billion, then there is a point of view that should be offered to the principals, which in this case the Federal Reserve Bank of New York, as to our perspective.

Chairman DODD. Well, all right. Let me move on. I do not want to dwell on it, but that is a question I am sure others may pursue as well because it is a matter of concern.

I want to go back to the issue of the discount window, if I could, Mr. Chairman, with you. As I mentioned in my opening statement, in a hearing before this Committee a week or two earlier than the events of March 13th and 14th, we had in fact a panel of regulators before us. And I raised the issue as to whether or not opening up the discount window to broker-dealers would be a—how wise that would be. It was not just the Vice Chairman of the Fed but, in fact, every regulator at the panel that day rejected the idea. Obviously, people changed their minds, apparently, over the next 10 days or 12 days.

The question I have for you is, one, what happened in that 10 days that caused the Fed to change its mind? Second, if you had changed your mind, why didn't you change your mind on Thursday night instead of Sunday night? And if you had changed your mind on Thursday night instead of Sunday night, could Bear Stearns have been saved, since Bear Stearns was not insolvent, it was a liquidity issue. And if opening up that discount window would have provided additional liquidity, could all of this been avoided?

Mr. BERNANKE. Mr. Chairman, it was a very substantial step to do what we did, to open up the discount window. And we did not take it lightly, as Vice Chairman Kohn indicated. We had, in fact, earlier that week, on the Tuesday we had instituted the Term Securities Lending Facility which was, in fact, open to primary dealers. It was a source of liquidity and did provide reassurance. The market responded very well to that. But it was not available during that week.

It was precisely the set of conditions that we saw during the week and that led to the Bear Stearns' situation that caused us to reconsider our previously held position that it would take a very high bar to open up the discount window. We made the decision to do so on Sunday. At the time we did it, we did not know whether the Bear Stearns' deal would be consummated or not and we wanted to be prepared, in case it was not consummated, that we would need to have this facility in order to protect what we imagined would be pressure on the other dealers subsequently to that.

Whether opening it up earlier would have helped or not is very difficult to say. Perhaps President Geithner can add to this, but Bear Stearns was losing customers and counterparties very quickly. They were downgraded on Friday. We did lend them money, of course, to keep them into the weekend. But it is not at all obvious to me that it would have been sufficient to prevent their bankruptcy.

Chairman DODD. Before I turn to President Geithner on this question, I want to ask you as well, as you pointed out and others have, we are in the midst of considering legislation on the floor dealing with the housing issue. And I have raised this issue. Obviously, there are some serious regulatory questions being raised now as a result of opening up the discount window and expanding that opportunity.

Do you feel you have enough statutory authority to impose regulations on broker-dealers? Or do you need additional authority that we ought to be providing you? And since we are on the floor dealing with a related matter, it seems to me it is an important question to get to Senator Shelby and I and others who would be interested in knowing whether or not we ought to respond, rather than leaving this door open potentially with exposure that could cost us dearly.

Mr. BERNANKE. Mr. Chairman, for now we are working very effectively with the SEC and with the firms. We have the information we need. We believe that the lending we are doing to the primary dealers is being done safely and soundly, so there is not an immediate emergency there.

However, since our lending authority is only for emergencies, we will have to take this window back. We will have to close it when conditions normalize. So questions that Congress will want to consider over time: Should we make this a regular facility in the future? If so, presumably we will want to think through the prudential regulation of the investment banks to make sure that they are indeed safe and sound, adequately safe and sound to receive this particular privilege. And we would also need to think, I believe, about—the question was raised about FDICIA. Do we need additional thinking on the appropriate set of circumstances, the appropriate sequencing under which an investment bank in trouble would be reorganized, assisted, and so on?

So I think there are some very weighty issues, but let me just emphasize for the time being that we are effectively lending to investment banks. We are working very closely and carefully with the SEC and with the firms, and we do not feel that we are in any way lending improperly or unsafely at this point.

Chairman DODD. Let me ask the rest of you here the earlier question I asked about whether or not, had this Sunday night decision been made on Thursday or earlier—and others had raised it earlier. This was not some new idea. People had been talking about it, and it had been pretty widely rejected by the regulatory community at large. But, President Geithner, what is your reaction to that? What do you think might have happened on Thursday night had the decision been made to open that up? Would Bear Stearns have been in a different position?

Mr. GEITHNER. Very hard to know. Let me just make two points.

In some sense, we had—you can think about that question by thinking about what actually happened on Friday. So Friday morning, we took the exceptional step with extreme reluctance, with the support of the Board of Governors and the Treasury, to structure a way to get them to the weekend so that we could buy some time to explore whether there was a possible solution that would have them acquired and guaranteed.

Chairman DODD. Let me ask you something quickly on that point. I have read the written statement of Alan Schwartz. I am under the impression he thought that he got 28 days, not a day or 2 days.

Mr. GEITHNER. Well, if you look carefully at the statement that was made, the language said "up to 28 days." But I think I can answer your question if you will let me just continue this one thing.

So we took that extraordinary step to buy time to get to the weekend, and as you can hear from Alan later on, you can see—if you ask about the details of what happened over the course of that day, you can see a little bit about the scale of the loss of confidence, because the dynamics that Chairman Cox described accelerated over the course of the day. And the number of customers and counterparties that sought to withdraw funds, the actions by rating agencies on some Bear paper, accelerated that dynamic, despite the access to liquidity and despite the hope that that might buy some time. So I think that does raise a lot of questions about whether this very exceptional, temporary, carefully designed access to liquidity we provided would have been sufficient.

One other point. The way the Federal Reserve Act is designed and the way we think about the discount window for banks is we only allow sound institutions to borrow against collateral in that context. And I can only speak personally for this, but I would think—I would have been very uncomfortable lending to Bear given what we knew at that time if you could walk back the clock and think about what had happened if that facility had been in place before.

But, again, as everybody has emphasized, both these facilities—the one the Chairman described was announced that Tuesday, and the subsequent facility announced Sunday night—these were exceptionally consequential acts, taken with extreme reluctance and care, because of the substantial consequences it would have for moral hazard in the financial system going forward. And I do not believe it would have been appropriate for us to take that action Sunday night if we had not been faced with the dynamics that were precipitated by and accelerated by the looming prospect of a Bear default.

Chairman DODD. I have gone over my time, and I apologize to my colleagues.

Senator Shelby.

Senator SHELBY. Thank you, Chairman Dodd.

Chairman Cox, the Securities and Exchange Commission is the primary regulator of Bear Stearns. Under the Commission's Consolidated Supervised Entities Program, which you mentioned, the SEC oversees certain investment banks, including Bear Stearns, at the holding company level, focusing on the financial condition of the entire company. Some people think that the SEC missed the boat here, was asleep. You mentioned earlier the difference between capital and liquidity, which is a big thing.

When did the SEC first discover that Bear Stearns was experiencing severe liquidity problems? And after learning of Bear Stearns' problems, what steps did the Securities and Exchange Commission take to address the situation? And did you work with the Federal Reserve or anybody else in doing this? And what impact did those actions or inactions by the SEC have on protecting investors?

We all know that we had some warning about Bear Stearns earlier as far as capital. There are some other firms that got some capital problems and are out seeking capital to shore themselves up. But let's go back to the SEC. Where was the SEC on this? And were they on your kind of watchlist, if you want to call it that? And if not, why not?

Mr. COX. They were, going back to the summer of 2007, because of the troubles of their two hedge funds. And while some thought back in the summer of 2007 that because they did not, those hedge funds, pose direct risk to the holding company—they were separate—that that should not be of material importance to an analysis of the Bear Stearns holding company. The fact that for practical or commercial reasons Bear decided to support one of those funds caused us to take a view that we had to look at even outside the holding company at Bear. The SEC at that time began to monitor both capital and liquidity at Bear on a daily basis.

Fast forward to January of this year. As of January 31st, the capital and liquidity at Bear were still above regulatory thresholds and adequate for those purposes. The liquidity pool was $8.4 billion——

Senator SHELBY. Is that the last time you examined them?

Mr. COX. No, this is now—I am speaking——

Senator SHELBY. January 31st.

Mr. COX. January 31st, $8.4 billion on that date. The liquidity pool grew from January 31st to the first week in March to $21 billion. So substantial additional liquidity was being added, in part because of the pressure that the SEC as their supervisor was placing on them.

In 1 day—take us now to this week of March 10th. In 1 day, Thursday, March 13th, liquidity at Bear Stearns fell from $12.4 billion to $2 billion——

Senator SHELBY. Why?

Mr. COX [continuing]. And that is because of what we have heard discussed here this morning: the complete evaporation of confidence, the refusal of counterparties to deal with Bear.

Senator SHELBY. Was there kind of a run on the place or refusal to do business or what?

Mr. COX. Even though we are not accustomed to using that term in the investment banking sphere—that is a well-known notion with depository institutions—the analogy is nearly complete.

Now, to go to the rest of your question, our coordination with the New York Federal Reserve, that was regular and increasing since August of 2007 in the form of visits to their offices in New York, regular conference calls, many e-mails and so on. During that time we also worked together on a major project led by the New York Fed, the paper produced under the auspices of the senior supervisor group addressed to these issues.

The week of Monday, March 10th, the SEC and the New York Fed spoke by phone numerous times. Beginning on Monday, the Fed provided us with extremely helpful information regarding market rumors that they were hearing from a variety of market sources. We shared with them what we were hearing and provided information on Bear Stearns' operations and their finances. We met in their offices in New York on Wednesday and discussed Bear Stearns as well as the situation of other banks and securities firms. That, of course, takes us to the 96-hour period that everyone has already focused on.

Senator SHELBY. Is there a gap in the regulation process here between, say, the Federal Reserve's interest here, the SEC's mandate, and so forth? Is there a gap there that something fell through the cracks? Or is it just something that is just already so fast, like the liquidity was gone?

Mr. COX. Well, I think the speed with which this happened is truly the distinguishing feature. But there are significant differences between the charter and the mission of the SEC, on the one hand, and the Fed on the other.

Senator SHELBY. Absolutely.

Mr. COX. It is very important—and the Treasury, I should add, because the Fed is focused on safety and soundness and the financial system. Treasury is concerned even beyond that with systemic risk as it might pass over into the real economy and affect things beyond the financial system. The SEC is focused very particularly, first, under statute as it applies to these broker-dealers, the investment banks, on their regulated activities and on their customers and the protection of their cash and their securities. We are also focused on orderliness of markets and so on, but within the context of the securities markets themselves.

So there is overlap between the SEC and the Fed's systemic concerns, and certainly where we leave off, they pick up, and where the Fed leaves off, the Treasury picks up.

Senator SHELBY. Chairman Bernanke, are there some comparisons between what happened at Bear Stearns and what happened with the British bank Northern Rock? I know they are different. Was there a liquidity problem there, too, and that caused the bank to fail and the British Government to have to step in or what?

Mr. BERNANKE. There was a similarity. I agree with Chairman Cox that there was a remarkable falling off of liquidity, essentially a run on Bear Stearns——

Senator SHELBY. A run on Bear Stearns.

Mr. BERNANKE. That was analogous in some ways to what happened to Northern Rock, although, of course, all the details are quite different.

Senator SHELBY. Secretary Steel, who first proposed using taxpayer funds to help finance JPMorgan Chase's acquisition of Bear Stearns? Secretary Paulson? Yourself? The Fed? Mr. Dimon? Or who?

Mr. STEEL. I will provide my perspective, Senator, and I can be confirmed by others. But I believe that as the negotiations proceeded through the weekend with the Federal Reserve Bank of New York, with the direct principals, that as we wore into the weekend and people took time, and there are various terms to every transaction, that late Saturday evening or early Sunday morning it was proposed by one of the principals, JPMorgan, to President Geithner that so as to move forward, that this would be a condition that seemed to be appropriate to them. So answer your question specifically, proposed by JPMorgan Chase to President Geithner.

Senator SHELBY. And what kind of security, if any, did the Fed get for this $29 billion?

Mr. STEEL. Yes, sir——

Senator SHELBY. Would you explain that? And what are the chances of loss there?

Mr. STEEL. Well, it is, as I said—excuse me.

Senator SHELBY. Go ahead.

Mr. STEEL. As I said earlier, I think that from the Treasury's perspective, there were two concerns throughout all of this process: No. 1 was the effect on the markets and the marketplace and the stability of markets; and No. 2 was the stewardship that we share—that we were sharing with others with regard to U.S. taxpayers' funds. And the transaction as developed was $30 billion, approximately, of collateral, all investment grade securities, all of them current in interest and principal. And those securities were transferred as the collateral for the $30 billion loan.

Senator SHELBY. What are the chances that this could happen again, either in an investment bank or one of our large banks? I know you are watching them. We see them, a lot of the banks, trying to secure more capital and, of course, they are going to have—as Chairman Cox said, they need liquidity with capital. What are the chances there? And where are we today?

Mr. STEEL. Well, I think our perspective is that this whole situation took a very long time to build up, and it will take a good while to work through.

Having said that, we think we are making progress. We can cite increases in liquidity, as President Geithner said, and things seem to be doing better. And there are signs of improvement, and where I think the actions of the Federal Reserve Board have been constructive to that end, we are doing our best to be vigilant and to monitor the situation. And a cry that Secretary Paulson has made all along has been for financial institutions who believe they will be needing capital to be on their front foot with regard to raising capital. From our perspective, this is really about transparency, liquidity, and capital—the trifecta of issues that will bring confidence back to the market. People understand the assets. People begin to price them and transactions occur, and institutions have the strong capital position they need to work through the specific situations.

Senator SHELBY. But the Treasury and the Fed and the FDIC, all the regulators, they have got to have some deep concern about some of our big banks, commercial banks, and some of the investment banks. You are not telling us that you have supreme confidence that there is not going to be another problem? You cannot say that, can you?

Mr. STEEL. No, sir, I cannot. And so I think our goal is to—as I said, I think this is about—and about 2½ weeks ago my colleagues at this table, as members of the President's Working Group, issued a report to focus on what we have learned to date and what we can begin to do straightaway to make things better. And I really think the three aspects are as I described.

Senator SHELBY. But we cannot send the signal out to the marketplace that if you take the risk and you are too big to fail, the Fed is going to come running, and the Treasury is going to back it, and the taxpayer is going to be on the hook, can we?

Mr. STEEL. No, sir. Basically, my testimony made clear that this was not a specific situation about an organization. This was a decision made with regard to the markets itself, and people should not draw a conclusion from this that there is a message about a specific institution. This was an unusual time, as all my colleagues have said, and a specific decision was made with regard to market protection and to the effect on the potential real economy. That was the nature of the decision.

Senator SHELBY. If this is not a wakeup call to the Fed and to Treasury and everybody else, as far as some of our banks and the risks they take, I do not know what it would take, do you?

Mr. STEEL. Sir.

Senator SHELBY. Thank you.

Chairman DODD. Senator Johnson.

Senator JOHNSON. Chairman Bernanke, on March 18th, the Federal Reserve decreased the interest rate by another three-quarters of a percent. This is the sixth scheduled emergency cut in as many months. Are these cuts helping the economy or will there be any need for further cuts?

Mr. BERNANKE. Well, Senator, we do believe that these cuts are justified by the slowdown in the economy. We believe they are helping. The cuts in the federal funds rate both lower safe interest rates, Treasury rates, and they contribute to a reduction in spreads, which helps to offset—and it is true that many, some rates at least, have not dropped very much since we have begun cutting the federal funds rate, but I think we have offset what might otherwise have been increases in the cost of capital. So I believe we have helped to offset the credit crunch to some extent, and, therefore, I think this is constructive.

I would also point out, first, that we have been using our liquidity measures, which have also helped to reduce spreads to some extent, and I think they have been positive; and, second, that the effects of monetary policy are felt over a period of time, and we expect to see further positive effects of these policies going forward.

Obviously, further actions will have to depend on how the economy evolves, and we are looking, of course, at both sides of our mandate—growth and inflation.

Senator JOHNSON. Are you concerned about inflation?

Mr. BERNANKE. Of course we are concerned about inflation. Inflation has been too high. Over the last year, it has been about 3.5 percent instead of about a little over 2 percent in the previous year. The primary reason for the high inflation is rapid increases in prices of globally traded commodities, including crude oil and food, among others.

It is our expectation, which is consistent with prices seen in futures markets, that these prices will moderate during the coming year and that, therefore, overall inflation will tend to slow. However, we are aware of the uncertainties involved with that, and we are obviously going to be watching the situation very carefully.

Senator JOHNSON. Did the Federal Reserve place any conditions on JPMorgan Chase and Bear Stearns when it extended the $29 billion line of credit?

Mr. BERNANKE. We did that as part of an overall negotiation, the point of which was to try to facilitate the acquisition of Bear Stearns and the guarantee of its liabilities by JPMorgan Chase. As President Geithner has discussed, we have substantial protections. They include $30 billion of collateral as marked to market on March 14th; $1 billion first loss position by JPMorgan; professional investment advice from an advisory company; and the luxury of being able to dispose of these assets over a period of time, not, therefore, have to sell them quickly into an illiquid market.

Senator JOHNSON. Chairman Cox, is the SEC adequately equipped to determine a holding company's liquidity risk? Did the crisis at Bear Stearns bring to light any weaknesses in the Consolidated Supervised Entities Program?

Mr. COX. Senator, there is absolutely no question we have learned much more than any of us would like in the caldron of this experience. The liquidity measures that were thought to be adequate were designed for a scenario in which all of the firm's unsecured funding evaporates, and evaporates for a period of a full year. The capital floor and the liquidity floor, more to the point, that is required of firms to meet that standard was more than met by Bear Stearns, and yet as we described here earlier this morning, they ran through over $10 billion in liquidity in a day. So it is absolutely important for us no longer to believe that that works. We have already, with all of the firms that we supervise, gone back to work with them to make sure that there is the kind of liquidity that is needed to function in this stress scenario. And I have communicated directly with the Basel Committee of Banking Supervisors, who are preparing to take up this subject, to encourage them because, of course, these standards for capital that are used here in the United States in the commercial banking sector and the investment banking sector are also used around the world. They are considering addressing directly this liquidity issue, and I think it would be very wise for them to do so.

Senator JOHNSON. Chairman Bernanke, do you expect the Fed to facilitate market arrangements like the JPMorgan Chase purchase of Bear Stearns for other financial institutions? Does this create a moral hazard for taxpayers?

Mr. BERNANKE. We do not expect to have to do this, but we are obviously going to be watching and monitoring the markets very carefully, and institutions. I think this was a very unusual situation. In particular, things happened very quickly and left a very little time window. In most cases, when firms, banks, have problems, they have a considerable amount of time to take preemptive actions in terms of raising capital, finding a partner, and taking other measures to avoid these problems.

I would like to make a comment on the idea that we bailed out Bear Stearns. As President Geithner pointed out, Bear Stearns did not fare very well in this operation. The shareholders took very severe losses. The company lost its independence. Many employees obviously are concerned about their jobs. I do not think it is a situation that any firm would willingly choose to endure.

What we had in mind here was the protection of the financial system and the protection of the American economy. And I believe that if the American people understand that we were trying to protect the economy and not to protect anybody on Wall Street, they would better appreciate why we took the actions we did.

Senator JOHNSON. Thank you, Mr. Bernanke. No further questions.

Chairman DODD. Thank you, Senator Johnson.

Let me just say as well, I know there are a lot of questions people would like to ask. We are going to leave the record open as well, if you do not feel as though you have had all your questions asked, to submit some from Committee Members in writing, and we would ask you to respond as quickly as you could to some of them.

Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman, and thanks to the panel. This has been very illuminating.

You used a phrase in the Federal Reserve Act, Chairman Bernanke and President Geithner, that says you can do this "in unusual and exigent circumstances." And I think this qualifies, very clearly as unusual and exigent circumstances. But that is clearly not what the framers of the Federal Reserve Act had in mind in 1913. We live in a very, very different world than we did in 1913 when the Fed was created, and one of the questions that I have as I look at this is whether or not the members of the legal profession who are paying very close attention to all of this—because they have great potential for a great deal of income sorting all of this out—are going to look at this event and say, well, this becomes the new standard for an unusual and exigent circumstance and start to demand on behalf of their clients that, well, while you did it that circumstance, here is a similar circumstance, and you have a requirement, therefore, to do it again.

And the circumstance that is very different now than it was in 1913, of course, is the existence of derivatives—the creation of hedge funds, people who use computers to slice and dice various financial instruments and discover things that the normal human being cannot discover without the ability of computers to help them.

Looking ahead to all of this, what do we see in the possibility of future circumstances not just here but worldwide? You made, I think, the appropriate point, Chairman Bernanke. This was not a bailout of Bear Stearns. And you did not have the Bear Stearns shareholders in mind. Indeed, the Bear Stearns shareholders are very upset, I think, about what has happened. But I like the phrase that comes from a specialist who looked at this. He said, "Twenty years ago, the Fed would have let Bear Stearns go bust. Today, it is too interlinked to fail." Not "too big to fail." "Too interlinked to fail." And that, again, is the world of derivatives, the world of hedge funds, the world that we all come together in.

I do not care who specifically responds because you are all very knowledgeable in this area. But give me a response to this future possibility, looking back on what I think we all agree is a truly seminal, historic, and maybe pivotal event in the way this international market is going to be dealt with from now on. Anybody want to look into his crystal ball and help me out on this.

Mr. BERNANKE. Senator, if I just might reply quickly, we have a very high bar for unusual and exigent, so this is twice in 75 years that we have used this, that we have applied this power. In thinking about it, we thought not only about the interconnectedness of Bear Stearns and the issues we have raised, but also about the situation in the financial markets more generally. If the financial markets had been in a robust and healthy condition, we might have taken a very different view of the situation. But given the weakness and the fragility of many markets, we thought the combination was indeed unusual and exigent.

We will certainly be very diligent in resisting calls to use this power in other less exigent situations. As I indicated earlier, I do think this does raise important questions of regulatory design. The world has changed a lot since the 1930s when many of our regulations were put in place, and it will be a challenge for all of us and the Congress to think through how we might adapt to the way the world has changed, the way the institutions have changed, the way the instruments have changed, the way the markets have changed over 75 years.

Senator BENNETT. Anyone else want to comment on this?

Mr. GEITHNER. Yes, sir. I just echo your formulation. What was unique about this is not just Bear Stearns' role in this interconnected, intricate, complex financial system where we have such a large stock of outstanding derivatives, with repo markets as large, but was the circumstances prevailing in markets at the time.

It is the combination of those two things that made it so exceptionally risky for the U.S. economy.

But I would just echo something many of you have said, I think, which is that the most important thing for us to do is try to figure out how to make the system in the future less vulnerable to these circumstances and make it strong enough to be able to withstand the failure of a major institution even in fragile conditions like these. That is a very hard thing to do, requires a very careful set of judgments about regulation and market discipline. But I think that is the dominant policy challenge we face.

Senator BENNETT. And we have the proposal from Secretary Paulson before us as a Congress. We will look at it very carefully.

Mr. Steel, you summarized it, I think, the best when you talked about the need for transparency, capital, and liquidity—all of which are leading to the one thing that is essential here, and that is confidence. If we do not have confidence in our ability to get our checks cashed, we produce a run on the bank in the old model. Here, the international system did not have confidence that there was anybody on the other side of the deal if they were to cash in some of their derivatives, and Bear Stearns stood in the middle of the deal as the bank that would provide that confidence. So if Bear Stearns goes down, that is, if the middle broker goes down, and neither side has confidence that the paper they hold can be redeemed, then the whole worldwide thing melts down. And I think we need to keep that foremost in our minds in all of our discussions.

All of the details are fine. All of the details are more than fine. They are absolutely necessary. But the ultimate goal to which we must constantly pay appropriate homage is confidence that the system is going to work. And if I understand what you have said here today, you were afraid that that confidence was going to go out the window, and the whole world losing confidence could ultimately come crashing down.

So for all of us, Mr. Chairman, this is, I think—the ultimate goal is to see whatever we do, either you in your regulatory actions or we in our policy actions, keep focus on maintaining international confidence in the system of worldwide credit.

Thank you.

Chairman DODD. Thank you, Senator Bennett. I underscore the point, and I have been using it over and over again.

Let me just say, I should have responded quickly to President Geithner's comments earlier. This Committee's intention is at the appropriate time to take a long look at these various proposals regarding the reform measures to reflect the 21st century world we are in, very different than when a lot of these institutions were created, and that have been amended over the years. So I welcome Secretary Paulson's ideas in all of this.

I just want to quickly say, however, that the timing of all of this—I mean, clearly we need to get to that, but I want to make sure we are concentrating our attention on the crisis at hand. And the crisis at hand is at its center a foreclosure crisis. There is the contamination effect here. We need to concentrate on that. But I do not want by that statement to reflect any lack of interest in the broader subject matter, which is an appropriate one. But I do not want to digress or divert attention from the issue at hand. And so we will get to that question, and this Committee will, and conduct a series of hearings—I have talked to Senator Shelby about this already; we will plan on that—to outline all of these ideas and consider it thoughtfully and carefully.

Obviously, nothing will happen this year. We all know that. It is going to take a new administration coming in. But certainly we can set the table on these issues, and my intention is in this Committee to try and do exactly that.

Senator Reed?

Senator REED. Well, thank you very much, Mr. Chairman, and thank you, gentlemen, not only for your testimony today but for steering through a crisis which could have had catastrophic consequences. That is an achievement in itself. As we go forward, though, I think as I said initially, we have got to look carefully at what was done. And let me raise a question that was also raised by Chairman Dodd, that is, the discount window facility.

Listening to Chairman Cox's analysis of the Bear Stearns situation, it seemed to me the biggest failing was the lack of access to secured funding. And yet the discount window facility would have given that secured funding. But, President Geithner, as the point on this effort, you indicated that you would not have extended that facility to Bear Stearns because it was, in your words, "not a sound institution." That was a criteria—you were applying criteria.

Can you tell us why it was not a sound institution? And should the SEC have been aware of those shortcomings?

Mr. GEITHNER. Let me just say this as carefully as I can. I was expressing my personal view. It is very hard to look back and know. But all of these facilities, in all these facilities, as you think—as you would expect, I think, we need to be very confident that we are lending to sound, prudent institutions that are designed to respond to liquidity problems, and it is very hard to know, looking back, whether, given the way they are designed, they would have been powerful enough to help Bear navigate some of these challenges. And I just want to say that it is not obvious to me—just my personal view—that lending freely in the context of the accelerating pressures on Bear would have been a prudent act by the Fed.

Senator REED. Was that your conclusion—I know it is a difficult one to make, and it is inherently subjective because you have to weigh many factors. Was that a function of management, a function of the balance sheet, a function of market conditions beyond their responsibility? And, again, should the regulator, primary regulator, the SEC, have been aware of these faults that you at least recognized, or potential faults?

Mr. GEITHNER. Again, very exceptional conditions we are facing in markets, and everybody is rediscovering and rethinking through what they think is adequate liquidity. And any institution in these markets is discovering that if you lose your unsecured, you may lose your secured. And independent of the concerns that have been—we have been seeing throughout the last 9 months about the strength of individual institutions, we have seen a substantial withdrawal in the willingness of markets to finance a range of different types of collateral. So one thing that is unique about this is the extent to which secured financing markets also became vulnerable.

And a very important point Chairman Cox made several times is—and Chairman Bernanke—that in these markets, these things can happen incredibly quickly. Just incredibly quickly. What you see in this context is a combination of two things. One is these very powerful forces across all markets, impairing liquidity for everybody. And you have a set of institutions that were—some relatively more exposed to those risks, some relatively less exposed. And with great respect to the people and management employees of that institution, they were in a position where they were more exposed to those risks.

Senator REED. Let me follow up on another line of questioning that the Chairman raised, and that is the price, the initial stock price. You indicated—and Mr. Steel and others—that there was no deliberate message from any Federal official about the price. But did you, since I recall when I was a young lawyer, went to closings, and there would be lots of rules but the one rule was the Golden Rule: The person with the gold made the rules.

You had all that, Mr. Geithner. Did you suggest a certain range that you would not allow or any indication that your agreement to the financing, taking the collateral and giving JPMorgan the $30 billion was a function of a price that was, in your view, appropriate?

Mr. GEITHNER. We did not set or negotiate the price.

Senator REED. Did you suggest, if a price was raised, that it was excessive or a deal would not close? Or did you in general indicate to them that—and as I think you indicated in your comments, the real issue of moral hazard, that you could have said without stating a specific price that the price has to reflect a steep discount from book value; otherwise, moral hazard. Is that something you communicated?

Mr. GEITHNER. Well, just to repeat again, those two objectives—finding a solution that would avert default in ways that would make the system stronger, not weaker; not create adverse incentives for future risk taking that would be a problem for the system—were at the center of the judgments we made. But I just want to underscore, both the agreement reached between Bear and JPMorgan on that initial Sunday night, which I think was the 16th, and the agreement reached a week later were—just to speak for myself—in my judgment fully consistent with those objectives.

Senator REED. Chairman Cox, one of the points you raised was this unusual and very rapid runoff of liquidity. Does that suggest to you market activity which is more than unusual that might be manipulative?

Mr. COX. Senator, we do not know the answer to that, but, of course, the Securities and Exchange Commission investigates market manipulation and——

Senator REED. Are you conducting an investigation now?

Mr. COX. I am constrained, as you know, by the general rules of discussion about civil law enforcement matters that have not yet been filed in any court, so I cannot confirm or deny the existence of any particular matter under investigation. But suffice to say that the Securities and Exchange Commission takes very seriously its responsibility to investigate allegations of these kinds, and there have been ample allegations made in this context.

Senator REED. Thank you, Mr. Chairman.

Chairman Bernanke, you indicated that this was not a bailout of Bear Stearns, and at $2, raised to roughly $10, there is some persuasive force in your argument. But was it a bailout of the surviving investment banks? Because with, I think, the context of your discussions, your real fear was that Bear could say, "Oh, but that had to be the line of defense," that the others, if they fail, will be catastrophic, and that, in fact, your action was very calculated and conscious to prop up when remaining investment banks.

Mr. BERNANKE. We were concerned about other institutions. We were concerned about a variety of markets in which Bear Stearns participated. We were concerned about the thousands of counterparties whose positions would have become uncertain. So we were—if you want to say we bailed out the market in general, I guess that is true. But we felt that was necessary in the interest of the American economy.

Senator REED. I do not dispute you. I think that is the role you had to assume. But I think—and many people, homeowners that are looking at action that helps, you know, the markets, helps them indirectly. But I think to say this was a routine action that was not designed to save some institution or prevent them from going into distress is not the most accurate characterization. That is my point.

A final point, Chairman Bernanke. You have got about $30 billion of collateral, and some comments have been made that you feel comfortable because it is highly rated. But a lot of highly rated collateral these days is being subject to questions about that.

Your comments on the quality of this collateral, will eventually the taxpayers be on the hook for a significant amount of that collateral?

Mr. BERNANKE. Senator, as was mentioned, it is all investment grade or current performing assets. The prices at which we are booking them in terms of collateral are not the face value but, rather, the prices to which Bear Stearns marked those assets on March 14th. Therefore, they reflected current market conditions, and they reflected, in addition, the difficult liquidity situation that exists.

We do not know for sure what will transpire, but we have engaged an independent investment advisory firm, who gives us reasonable comfort that if we can sell these assets over a period of time, we will recover principal and interest for the American taxpayer. And certainly under no circumstances are the risks to the taxpayer remotely close to $30 billion. There may be some risk, but it is nothing close to the full amount. We do have collateral, and I would say a good bit of it is very highly rated.

Senator REED. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, and we may come back to a couple of the questions that Senator Reed has properly raised here, I think, as well.

Let me turn to Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

We have had downturns in the economy and periods when it has been rather prosperous, and at times they have involved the banking institutions because of the amount of lending that goes on in our economy to keep it going. And the thing that comes up to me, when you take a lot of these instruments, like what we have here, and you securitize them, you have got a big volume of assets that are going in there.

How do you go about keeping track of those investments? And how do you reach a point where you know that that becomes a very risky security? And do we have the tools in place to make those evaluations from the regulatory standpoint? Or do we just rely on the common approach that, you know, if you get a greater return, there is greater risk, and you ought to be smart enough to balance your portfolio so you do not have that?

So I would like to have some discussion on how you arrive at the creditworthiness of those assets that make up a total security value. And I will open it up to anyone on the panel if they want to address that question or that issue.

Mr. BERNANKE. Are you referring to the collateral?

Senator ALLARD. Yes.

Mr. BERNANKE. I would perhaps turn to President Geithner. The investment firm, again, is doing its own evaluation, has done an evaluation. The Bear Stearns marks I expect were based, to the extent available, on market prices as available. To the extent where market prices are not available, then the marks are developed by a combination of market information and various models that try to anticipate what the cash flows would be for these various securities.

I do not know the specifics of the individual securities and how they were marked.

Senator ALLARD. Yes. Mr. Geithner.

Mr. GEITHNER. Senator, I think you are raising a question that is at the center of this financial crisis in the sense that we have been through a period with extraordinarily rapid innovation at a time where the world was growing, defaults were very low, and a lot of leverage built up. And, therefore, it was hard for anybody to know with confidence what the risk was in a lot of those positions, how they would fare in a more adverse world. And in a sense, you could say that is the dominant lesson of financial crises, and people are learning that lesson again.

And Chairman Cox referred to this comprehensive review of risk management practices, weaknesses and strengths across the major institutions, and I would say that the central lesson from that review was the difficulty in thinking through how much risk you might face in the extreme event and how best to manage that risk, how much capital to hold against that risk, how to make sure that your risk management structure, your compensation incentives protected you from that risk adequately. And because the future is inherently uncertain, it takes experience with crises to learn more about how those positions are going to respond. And I think that is also, I mean, just another example of why this has been so powerful and difficult to manage even for a set of very smart, competent people.

Senator ALLARD. Any other comments? Yes.

Mr. STEEL. I guess, Senator, I would concur with President Geithner that I think your question leads us in a way back into all the root causes of the situation we face.

Senator ALLARD. Correct.

Mr. STEEL. And I am sure that is where you were taking us. I would concur—agree with the observations by Chairman Bernanke and President Geithner, and I think that when the President's Working Group began their first efforts to try to see what we have learned, that focus on transparency, better risk management, and that all aspects—all of the actors in this have to do a better job. And it is not—but it includes credit rating agencies, issuers, investors, securitizers. Everyone has to be focused more on these issues, and greater transparency is really key, and people need to understand what they are buying and selling is at the root of the issue. And hopefully we have some ideas that can focus us in on this so that things can be improved and lessons learned from the stress that we have been through.

Chairman DODD. Could I just interrupt one second, Senator? I would like to maybe ask Chairman Bernanke, maybe it would be helpful for this if the Fed could provide to the Committee in writing the current value of these assets. If we could have that available to the Committee, it would be helpful as well for us. Whether that is to you, President Geithner, or whoever could help us out on that, that would be helpful to the Committee.

Senator ALLARD. Yes, and that was my question. What I am getting into is do you have any concern about the reliability of these ratings as it pertains to credit rating. You know, that is a big part of this, it looks to me like, and credit ratings can change pretty quickly. Sometimes they are under—and there is a whole compilation. And do we have the capability to say that what we have is pretty reliable?

Mr. BERNANKE. I just want to reiterate that we are relying on a well-known expert investment advisory company which specializes in exactly these sorts of valuations, and we are relying on their opinion.

Senator ALLARD. OK. Thank you.

Now, under the Bear Stearns agreement that was reached, one thought that came to me is that the manager—who is going to be the manager of the remaining assets, and it was determined that Blackstone Group would be that. And so that is a key decision, I think, in managing what is left. And how was that decision arrived at? And how do you determine what they are—B, or whatever would be determined to manage those assets?

Mr. GEITHNER. Thank you, Senator. That afternoon of Sunday, March 16th, where we were exploring, again, whether there was a way to make this work, we did a range of things to try to get ourselves as comfortable as we could with the mix of assets that we were willing to consider financing.

Now, the financial system holds typically several hundred billion dollars of collateral at the New York Fed against the possible need to borrow, and we have a team of people that spend their lives thinking about how to value collateral and look at that, and we had those people alongside us as we looked at this portfolio. We established a set of very important conditions described by the Chairman for what we would accept in the portfolio. And we structured it, again, very carefully, very, very carefully to minimize the risk of future loss.

But as part of that, we made the judgment, I made the judgment, that we should have a world-class advisor sitting there with us, and in that period of time, very little time. We made the best judgment we could about what firm would have the mix of expertise, knowledge, experience, and independence that could best provide that judgment. I think they met that test.

I do not think there were any better options available at that moment, and I think we are in a much better position now, certainly than we were in the afternoon and going forward, to have them at our side as we thought through those judgments. And as the Chairman said and emphasized, part of the agreement we worked out to limit risk to the taxpayer was to have them be in a position to help manage these assets over time.

Mr. STEEL. If I could just make a correction, sir?

Senator ALLARD. Yes.

Mr. STEEL. In your question, the correct name is BlackRock.

Senator ALLARD. Oh, was it BlackRock?

Mr. STEEL. BlackRock, not Blackstone.

Senator ALLARD. Well, whoever, yes. I appreciate that. Thank you. That was an error that we had on my notes, and I apologize for that. But just the same, I think the question applies.

Mr. Chairman, I see that my time has expired. Thank you.

Chairman DODD. Thank you very much.

Senator Schumer.

Senator SCHUMER. Well, thank you, Mr. Chairman. I hope next time you do not need to bring in Black Boulder instead of BlackRock or Blackstone.

When Chairman Bernanke came before us yesterday at the Joint Economic Committee, I asked him when did he know that Bear Stearns was in such serious trouble that they might go under if nothing happened, and he said 24 hours before. Is that true of you, Chairman Cox? Did you just know—did you just have any idea that they would go under only 24 hours or so before?

Mr. COX. Well, as I described earlier, the liquidity pool, which had been $8.4 billion on the 31st of January, actually grew in the first week of March to $21 billion. But in 1 day, on Thursday, March 13th——

Senator SCHUMER. So is the answer yes?

Mr. COX [continuing]. It dropped by $10 billion.

Senator SCHUMER. So is the answer yes? You did not know until 24 hours before.

Mr. COX. Well, we knew of the drop in the liquidity pool. On the other hand, we had been focused, as had the New York Fed working with us on these issues for some time, but this precipitous drop occurred——

Senator SCHUMER. OK. I have limited time. I got a simple yes or no from Chairman Bernanke. Did you have an idea that they could go under almost immediately more than 24 hours before it happened?

Mr. COX. The drop occurred on the 13th of March.

Senator SCHUMER. How about you, sir?

Mr. STEEL. No, sir.

Senator SCHUMER. No. How about you, Mr. Geithner?

Mr. GEITHNER. No.

Senator SCHUMER. OK. Thank you.

Now the question I have is: Should you have known? And it relates to the future, not the past. Was it simply regulatory mishmash, if you will, that, in other words, safety and soundness is lodged with Chairman Bernanke, oversight of the SEC with Chairman Cox. We did have signs that Bear had some trouble, obviously, with its hedge funds, et cetera. And as I said, similar places—not similar places, but places that had a lot of mortgage exposure, that had higher capital, even though this was a liquidity crisis, higher capital seemed to be a cushion against a liquidity run starting.

So the question, I guess I will ask you, Mr. Geithner: Could a reasonable regulator have known and been ahead of the curve here? Could someone have called Bear in and said, "You need more capital. You need to reduce your exposure to mortgages"?

Mr. GEITHNER. Very hard to know. I want to underscore—I will say it very quickly. These things can happen incredibly quickly in markets like this. What the world is going through and has gone through the last 9 months are truly extraordinary, described by many as the worst in 50 years, worst in a generation. So it is very important to underscore that because it is easy to look back and say, "But doesn't it look obvious?" And I think that is probably somewhat unfair to the people at——

Senator SCHUMER. Mr. Undersecretary, do you agree with that?

Mr. STEEL. Yes, sir.

Senator SCHUMER. OK. And how about you, Chairman Bernanke?

Mr. BERNANKE. Yes, I do.

Senator SCHUMER. OK. So clearly, then, something is wrong with our regulatory structure unless we just think we should do these things on an ad hoc basis. And so I would like to just talk about going forward to prevent the next Bear Stearns because our credit markets are still not the confidence—confidence equals credit. Confidence is not all there. For all we know, in some other—no one would have thought mortgages would be the place where we would start doubting credit. It should be a simple cut-and-dried thing. And if it happened in mortgages, it could happen in some of these far more complicated instruments, perhaps.

So my question is: What have we done to avoid this from happening in the future, that the next warning signal, if, God forbid, it happens in any of these places, would go off sooner and we would not have to rush in at the last minute but could make corrections before that? Do you have any tools to do that other than the emergency power lodged in the Fed? And what new tools do we need? Could you, again, Mr. Geithner, tell us what is being done now after Bear Stearns that is different than before that might avoid this from happening again if there were another liquidity run on a company?

Mr. GEITHNER. First, we have at the SEC's invitation a team of people in these institutions, the major investment banks, looking carefully at their funding and how they are managing their funding, how they are going to position themselves to be stronger to withstand these kind of pressures.

Second, the Federal Reserve has put in place a very powerful set of liquidity facilities to help mitigate the risks that these things intensify going forward.

Third, we have been working very actively, alongside the Treasury and others, to try to make sure that institutions take steps to strengthen their capital positions so they are better positioned to manage through this crisis.

Those are very important steps. I think we need to look ahead, though, because those will not be enough, and we have to think about—I mean, they will not be enough for the future.

Senator SCHUMER. Right. So there you need a change in regulatory structure, which we have talked about.

Mr. GEITHNER. I believe you do. I think you need to look comprehensively at a broad range of aspects of regulatory policy and structure.

Senator SCHUMER. Right. Because if we do not, it is my judgment—tell me what you think. If we do not change the regulatory structure, given the inter-party risk you have talked about, the quick moving of huge amounts of money, we are going to be subject to these problems sooner or later somewhere or other that we have not—that we might have been able to prevent if we had a better regulatory structure. Is that fair to say?

Mr. GEITHNER. Yes.

Senator SCHUMER. Do you agree with that, Secretary Steel?

Mr. STEEL. Yes, sir.

Senator SCHUMER. You, too, Chairman?

Mr. BERNANKE. It is partly structure, and it is partly practice. Obviously, we have to, you know, understand better how to deal with these risks and how to evaluate those risks, as well as, you know, change the organization chart.

Senator SCHUMER. But right now, in an advisory way, Mr. Geithner, you are looking at firms and seeing their capital and seeing their exposure and giving them more early—more advice, I guess is how I would put it, as to being careful. And are they following you? I do not want to ask any specific names. That would be very bad. But——

Mr. GEITHNER. We are doing everything sensible to——

Senator SCHUMER. And are they following your advice? Your pause worries me.

Mr. GEITHNER. No. I am just trying to be careful. I would say that we are doing everything we can sensibly to encourage them to take steps that would put them in a stronger position, and I think there is a lot of focus and attention across those institutions in doing just that. No one is more worried about them than they are in some sense, and as I said, you cannot look at what happened over that weekend and look at the outcome for that institution and take any comfort from it.

Senator SCHUMER. Correct. And, you know, right now they may be careful, but all of these steps mean they reduce their profits and the pressure on immediate profit and immediate increase in share value will be back very soon if it is not already.

What do you have to say about this, Mr. Secretary?

Mr. STEEL. I think that you are on the right point, and earlier I said I think there are three aspects to this: transparency, liquidity, and capital. The Secretary and all of us at Treasury have tried to be very strong on the idea of capital increase so that firms have the right balance sheet. You know, there are two ways this happens. One is that firms can de-lever to improve their financial position or their capital cushion, or the other is—and that has an unattractive effect vis-a-vis contracting credit.

Senator SCHUMER. Right, and——

Mr. STEEL. Our preference is that institutions raise more capital so as to avoid the pro-cyclical effect of contraction. And we have been adamant and will continue to be so. Unfortunately, I cannot tell you that there is a red light/green light, issue done. I think it is a progression, and we will continue to be vigilant on this point.

Senator SCHUMER. Just one final question. Capital and liquidity are related in some degree.

Mr. STEEL. Absolutely.

Senator SCHUMER. And Mr. Geithner said yes, too.

Thank you, Mr. Chairman.

Chairman DODD. Thank you, Senator, very much.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

It is not unusual that Chairman Bernanke and I disagree on certain things, but I would like for him to answer me this question: Would Bear Stearns' stockholders have fared better in bankruptcy than they did at $2 or $10 a share in what you call not a bailout?

Mr. BERNANKE. It is hard to know. And, besides, the bankruptcy, they would have been facing probably a much worse financial market condition as well. So I am—you know, the shareholders certainly lost a huge amount relative to what they had thought they owned earlier that week. Whether they would have come out with zero or two or four, I don't know.

Senator BUNNING. But the fact is that they are trading on the New York Stock Exchange for over $10 a share today. Is that accurate?

Mr. BERNANKE. I believe so, yes.

Senator BUNNING. If anybody can answer this question, I would like it. How did we get to the point that the failure of one firm can bring us to the edge of collapse, our whole financial markets? We know the Fed and others did not do their job in regulating lending practices and supervising the risk banks were taking on. But how do you let the entire financial system become so fragile that it cannot tolerate one failure?

Mr. BERNANKE. Well, one response, Senator, is that this has been a long time in the making. There was a substantial credit boom that peaked last summer. That credit boom, which was driven by international factors, which I could go into, if you would like, involved a substantial increase in risk taking; a lot of financial innovations, some of which turned out not to work so well; deterioration in underwriting standards; and essentially a letting down of the guard.

Supervisors made many efforts to address these problems. We were not successful, obviously, in preventing the excesses. Starting in August, triggered by but not, I would say, fundamentally caused by the subprime crisis, there was a sudden rethinking of the amount of risk that people were willing to take. There was a major retrenchment in the markets.

Now, in contrast to last year when investors were willing to lend against quite risky assets, now even the safest assets find difficulty in getting financed. And so financial conditions have become much more fragile, much more uncertain. There is a great deal of distrust of counterparties, of the valuation of assets, and a very strong aversion to taking risk, of even liquidity risk, as opposed to credit risk.

As I mentioned earlier, under more robust conditions, under more normal conditions, we might have come to a very different decision with respect to Bear Stearns. We felt that given the context, given the fact that financial conditions are already creating a slowdown in our economy, that the risk was too great.

Senator BUNNING. Anybody else have a different opinion?

Mr. GEITHNER. Well, I do not have a different opinion, Senator, but let me just underscore. In a market-oriented financial system, where people are free to fail, make mistakes, lose money——

Senator BUNNING. I thought so.

Mr. GEITHNER [continuing]. Make imprudent choices, any system designed that way is inherently vulnerable to the risk that a sharp loss of confidence in economic activity induces a dynamic like we are experiencing now. This happens rarely, but it does happen. It happens across all different types of financial systems over time.

But you are exactly right, and I think it is the critical objective for policy. The challenge for policy is to try to make the system strong enough so that it can withstand the failure of even large institutions. But no system in a situation this fragile economically is going to be able to withstand such a failure easily, meaning withstand the risk of default that easily, in conditions this fragile.

What produced this is a very complicated mix of factors. I do not think anybody understands it yet. But we have to spend a lot of time and effort trying to figure out how to get a better handle on this set of stuff. And there are a lot of people that are going to be part of that because it is very important that we try to figure out a way to make the system less vulnerable to this in the future.

Senator BUNNING. There were an awful lot of red flags, not just in the last 6 weeks, not just in the last month, but a year or two before, that we were having some problems in our mortgage markets, that we were having mortgages made that should not be made, that the mortgage brokers were soliciting people into mortgages that they could not afford, and finally they knew were doomed to failure. Nobody was watching the store. So it was eventually going to happen. It just happened to be Bear Stearns who got a hold of all these things in one—well, in 1 week, and the crisis occurred when everybody said, "Watch out for Bear Stearns because they are not going to wind up this week anywhere but in bankruptcy."

I mean, that is what they came and told the Fed. Am I wrong? Didn't they come and tell you that they were going to go belly up and they asked for help?

Mr. GEITHNER. Senator, let me just step back for one second. The people at this table and a bunch of other supervising regulators took a lot of actions over the last several years to try to make the system less vulnerable to this kind of event——

Senator BUNNING. I am sorry.

Mr. GEITHNER. I want to just——

Senator BUNNING. I am sorry. I have been here too long to try to convince me of that.

Mr. GEITHNER. Well, I am not trying to convince you, but I just want to——

Senator BUNNING. You are not going to be able to convince me, because the red flags have been waving long before you showed up at that table.

Mr. GEITHNER. Should I try to—can I just go through just a few important things for the record?

Senator BUNNING. Certainly. Go ahead.

Mr. GEITHNER. We did, working with the SEC, the other major supervisors of the major institutions around the world, a series of very important things, beginning in 2004 in particular, focused on exactly the set of risks that are so pronounced today. These things focused on strengthening the——

Senator BUNNING. The problems come before 2004. It goes back to 2000, 2002, and on down.

Mr. GEITHNER. I am not claiming that people were wise and all-knowing or that we did everything that could have been done. But I just want to underscore the fact that we took a series of actions to try to make the system more resilient to this kind of stress, and those things have made a lot of difference. The system would have been more fragile without those things. As the Chairman said, they did not achieve enough traction in areas where we would have liked them to achieve more. And we are going to be very focused on trying to figure out how to deal with those things in the future, but it is going to require a very comprehensive effort because we do not have the incentives in the system aligned in——

Senator BUNNING. You have talked me out of my time, but the biggest problem with that is that I get the last say. And what is going to happen if a Merrill or a Lehman or someone like that is next?

Thank you, Mr. Chairman.

Chairman DODD. Do you want to respond to that, Senator, or do you——

Senator BUNNING. No.

Chairman DODD. All right. Senator Carper is not here. Let me turn to—who is next? Senator Menendez is not here either. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman. Thank God for absences.

I want to ask a couple questions here. Chairman Cox, you had mentioned some dates in answer to earlier questions about the hedge fund in July of 2007 and adequate liquidity as of the end of January and then it bounced up as of March 1st. I am talking about Bear Stearns' liquidity. And I guess more specific the question is: When did you know—and, Chairman Bernanke, you are next. When did you know that we were in a situation where one of the world's largest investment banks was teetering on insolvency? Was that on the 14th? Or did you know before that?

Mr. COX. Bear Stearns approached the New York Fed on Wednesday night to discuss, as I understand it, possible accelerated access to something like the Term Lending Facility. The following day, on Thursday, there was a precipitous decline, a drop of over $10 billion in the liquidity pool of Bear Stearns. And by Friday, we were in the midst of these discussions, and in particular, the Fed——

Senator TESTER. Sounds good.

Mr. COX [continuing]. And the Treasury discussing with JPMorgan and Bear Stearns.

Senator TESTER. Thank you.

Mr. Bernanke.

Mr. BERNANKE. Well, Senator, just to be clear, we are not the supervisor of Bear Stearns.

Senator TESTER. Just your perspective. When did you know?

Mr. BERNANKE. We were simply—we are monitoring the markets. We received, as was indicated, I think about 24 hours in advance, a call that they were anticipating bankruptcy.

Senator TESTER. Chairman Cox, I want to come back to you on that issue. Has anyone brought to your attention or do you know of the possibility of short selling that helped bring down Bear Stearns?

Mr. COX. I want to be careful in the way that I respond to your question. It is a perfectly appropriate question. It deserves a straight up and factual answer. I am a little bit constrained because the SEC is in the law enforcement business, and I tried delicately to answer that question before.

The SEC very aggressively pursues insider trading, market manipulation, and the kinds of illegal naked short-selling that have been very publicly alleged in this case.

Senator TESTER. OK. Thanks. I will interpret that answer the way I think everybody else in the room interprets it.

The question I had goes also back to Mr. Bernanke. It deals with the $30 billion that has been talked about a lot here today. And I think initially you said it was $30 billion market value, and then with another question, I think it was Senator Allard, you said it was a model—it was a market to model value on it. Who set the value?

Mr. BERNANKE. Bear Stearns.

Senator TESTER. Bear Stearns set the value. You had also mentioned, I think—and if it was not you, you can forward this question to Chairman Cox—that for the most part, these were pretty good collateral.

Mr. BERNANKE. Yes. They were all investment grade and——

Senator TESTER. Why didn't JP Chase take them?

Mr. BERNANKE. I can ask President Geithner to elaborate, but they were swallowing a pretty big chunk. They were concerned about the implications for their capital, for their risk profile, and particularly for the liquidity. One advantage that we have over market participants—the Federal Reserve, that is—is that we do not have any problem in financing the assets, and we could afford to hold them for a period and dispose of them in a more orderly way.

Senator TESTER. OK. So it was a liquidity issue, and you are nodding your head so you must agree. The reason JP did not take them is because it is a liquidity issue for their firm? That is what I heard Mr. Bernanke just say. You can say no. You can disagree. It does not matter.

Mr. GEITHNER. I would just echo what he said, which is that you will have a chance to ask JPMorgan this, but Bear is a very large and complicated institution, a lot of risk. JPMorgan was not prepared to assume the full risk in that, and for reasons that I think were very carefully thought through. So to help make it happen, we agreed to assume some of that risk.

Senator TESTER. Would it be fair to say that the $30 billion in collateral we got was probably the least secure?

Mr. GEITHNER. No.

Senator TESTER. So it was just an arbitrary one—just an arbitrarily cutoff, just you arbitrarily took all the investments from A to D, went to the Federal Reserve, and the rest? How was it determined?

Mr. GEITHNER. Very carefully. It was a negotiation. We set a set of parameters for things we would accept and what we would not accept. And that is how we got to the outcome we got to.

Senator TESTER. You do not have to do it now, but could I get a list of those parameters?

Mr. GEITHNER. Absolutely.

Senator TESTER. OK.

Senator TESTER. Chairman Cox, or whoever is most applicable to answer this question, how much is BlackRock charging for managing the $29 billion?

Mr. GEITHNER. Senator, we have not yet completed our negotiations on the fee. It will be a commercially reasonable fee. We will be very careful in setting it so that we are getting something—or we are paying something that matches the complexity of the responsibilities and the importance to us that it get managed in a way to minimize the risk.

Senator TESTER. Well, I will ask this to the next panel, but is that typically how things are done? You enter into an agreement and set the fees later?

Mr. GEITHNER. Almost nothing is typical about the arrangement that we reached in this context. And as I said, we tried to be very careful to make sure we designed this in a way to minimize any risk to the taxpayer, and part of that was having them there with us.

Senator TESTER. OK. Senator Bunning brought up some good points in his opening statement that talked about how big is too big. Senator Bennett talked about it being intertwined. I am curious, and I think the bigger you are, the more intertwined you are. So I think both points apply.

The question is: Would the Federal Reserve have agreed to this situation if it would have cost $50 billion or $100 billion? And I know you said it was based on markets, and it was said earlier here today that $29 billion—I believe this is a quote—not from you guys but from somebody on this panel—$29 billion, the whole world could have come crashing down if we did not do this. Is that accurate? And at what point do you say no?

Mr. BERNANKE. Well, Senator, it was a negotiation. We think we got a good deal. We did not spend $29 billion. We lent it against collateral. We believe we will recover most or all of it, probably all of it. It was, again, a very important consideration to try to make sure that this failure did not occur. And I would reiterate that, you know, the moral hazard questions that Senator Bunning appropriately pointed to, I think the moral hazard was minimized by the costs borne by Bear Stearns. And in the future, I think, however, we should take actions to make sure that, you know, these problems don't arise again.

Senator TESTER. If another investment bank of similar size were in the same situation tomorrow, would you duplicate your effort?

Mr. BERNANKE. Well, the situation has, I believe, improved now, and we have put in place these liquidity facilities, and we are monitoring, as SEC is doing, the condition of these banks. It was a very unusual situation. Don't expect it to happen again. But if any situation arises which threatens the integrity of the U.S. financial system, we would have to try to address it the best we could.

Senator TESTER. Thank you very much. Seven minutes goes by way too fast.

Thank you.

Chairman DODD. Very good questions, Senator. Thank you very much.

Senator Dole.

Senator DOLE. Chairman Cox, in a recent interview with Barron's, Laurence Fink, the chief executive of asset manager BlackRock, suggested that both hedge funds and the credit rating agencies may have played a role in the downfall of Bear Stearns, and he further calls on the SEC to investigate.

Given BlackRock's own involvement in the JPMorgan-Fed deal, what do you think of Mr. Fink's appraisal?

Mr. COX. When I saw the remarks that he made with respect to credit rating agencies, the downgrade that occurred was on Friday when I think it perhaps was too late to have a different outcome, Thursday having been, as I described, the truly cataclysmic day in that week. I do not know whether it is the responsibility of a credit rating agency which has its own responsibilities, both contractually and legally, to forbear in downgrading in the face of that kind of a situation in collaboration with regulators, which was the suggestion that was made.

It would be an interesting fact pattern in a different set of circumstances, but as I say, it occurred so late on Friday of that week that I do not think it was the proximate cause of what occurred in this case.

Senator DOLE. Let me ask Chairman Bernanke and Secretary Steel: On Tuesday of this week, an article in the Wall Street Journal highlighted the market impact of so-called credit default swaps and estimated these swaps were written against $45 trillion of underlying debt in the first half of 2007.

Given these credit default swaps were a contributing factor regarding the recent troubles at Bear Stearns, as well as the concern about whether or not Federal securities laws actually apply, what are the Fed and Treasury doing to make sure that these financial instruments are better understood and accounted for?

Mr. BERNANKE. Senator, first, to the extent that the credit default swaps were involved in any market manipulation, to which I have no knowledge that is the case, that would obviously be an issue for the Securities and Exchange Commission to be looking at in the course of their duties. So that would not be our particular province.

We are interested in credit default swaps in a number of contexts. First of all, through our regulation of supervised institutions, we want to make sure that they understand and they properly manage the risks associated with their credit default swaps, the counterparty risk, the credit risk and so on. And, second, President Geithner of the Federal Reserve Bank of New York has led a very substantial effort working with private participants, private market participants, to improve the clearing and settlement process for credit default swaps to eliminate or reduce the risk that uncertainties about who owns what that might arise in a period of rapid changes in prices or changes in conditions would be an issue. And that, I would want to commend President Geithner for his work on that front, and we have not seen clearing and settlement issues play a very important role at all in any of these recent financial problems that we have had.

Mr. STEEL. Senator, I think that Chairman Bernanke has pointed to the right issue, and the whole area of the over-the-counter derivatives market is quite complex. It has grown a lot, and it is very, very large and important. When the President's Working Group recently issued a report of issues to be focused on in the near term, we specifically highlighted the area of over-the-counter derivatives as something where policies and procedures need to be enhanced, and President Geithner has been a lead person on that. And so we think you are on exactly the right track, and we are committed to doing that.

Senator DOLE. Let me ask one somewhat tangential question, Secretary Steel. I have, along with Senators Martinez and Hagel and Sununu, been a strong advocate of GSE reform, and our legislation would create, as you know, an independent world-class regulator to oversee the safety and soundness of Fannie and Freddie, which earlier this decade had significant accounting problems.

Last month, OFHEO announced that it was lowering the capital requirements for both Freddie and Fannie, which comes on the heels of the temporary increase of the GSEs' conforming loan limits.

Secretary Steel, in light of this most recent action, is it not now all the more urgent that comprehensive GSE reform be enacted to ease the turmoil in our credit markets and to further ensure that GSEs do not pose more of a systemic risk?

Mr. STEEL. Senator, I think that several of the other Senators now, including you, have raised this issue of what have we learned about regulation and our regulatory regime in general. And I think the importance of clear responsibilities and the ability to have the tools to deal with challenging times is really the note that everyone is singing to.

I believe that comprehensive GSE reform is completely on key with that issue, and the Treasury would be a strong proponent of a comprehensive GSE reform bill.

Senator DOLE. Thank you.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

At that point we turn now to Senator Carper.

Senator CARPER. Thank you, Mr. Chairman. And you all are holding up well. Thank you for your patience and for dealing with us for all this time.

I indicated when I made my brief opening statement earlier that we were going to be asking you to sort of explain what you have done, why you have done it, and what you think the implications are, the lessons learned. We are about to undertake some actions here in the Senate under the leadership of Senators Dodd and Shelby to take up what I call "the housing recovery package." The elements of it include—and you may have heard some of them, but the elements include FHA modernization, trying to bring FHA into the 21st century to make it relevant in the lives of a lot of people; providing the ability to use the proceeds from mortgage revenue bonds to help out in refinancing some subprime mortgages; some extra money for community development block grants to enable State and local governments to work with distressed housing in some of their communities; some extra money for housing counselors to try to steer people into Project Hope Now so they can take advantage of that. The net operating loss carryback for home builders I think goes back about 4 years, and Senator Isakson proposed a tax credit to go to people who actually move into a home, buy a home that has been foreclosed, and agree to stay there for an extended period of time.

Those are all ideas that are included in the bill. There are a few others, but those are the ones that are there.

Senator Dole has just asked you about GSE regulatory reform, and we have debated that this Congress, last Congress, and Chairman Dodd has indicated a strong desire to move us to that legislation quickly and to get—put in place a strong independent regulator for our GSEs, for Fannie and Freddie and for the home loan banks. I applaud that and look forward to that. That is not part of this package, but my hope is that it is something that is going to be acted on real soon, and the Chairman has indicated that is his full intent.

Among the amendments that are going to be offered to the bill, this housing recovery bill on the floor—if not today, then in the next couple of days—is one that would empower a judge in bankruptcy to not only modify the interest parameters with respect to a primary home mortgage, much as they can now with a second home, but to enable them to not only work down or modify the interest parameters of the first mortgage, the primary mortgage, but to also work on the principal itself. And there are some who think that is a good idea, some who are concerned about it.

I just would ask, since this is something we are likely to vote on in the next day or two, I would just ask you what you think is good about that proposal, what is not, or is there a better option out there for us.

Mr. BERNANKE. Well, Senator, first of all, I think you are absolutely right to be focusing on housing. Housing is very central to the current situation. It is affecting both the broad economy as well as borrowers, lenders, and communities. So I compliment you on that focus.

I think some of the areas that I have advocated and I think are productive, one is the FHA modernization, the general idea of letting the FHA, which has seen its market share shrink to a very small amount, ironically displaced to a large extent by subprime lending, to increase its ability, its flexibility, its budget in order to both finance more new purchases and also to be able to refinance people out of troubled mortgages.

A second area that I would mention again is—Secretary Steel mentioned government-sponsored enterprises. They are supposed to be stabilizing the market. To do that, they need both good oversight, and they need to raise more capital so that they can expand their activities and substitute for the weaknesses in the remainder of the housing market.

I would like to mention counseling, which I believe is a very high bang for buck activity. The Federal Reserve at the reserve bank level has worked extensively with NeighborWorks and other community organizations on counseling activities, and I think that is very productive.

On bankruptcy, I think there are arguments on both sides. Some argue that a bankruptcy judge could take a more comprehensive view of a borrower's situation and make a better overall determination. Opponents note the length of time that it might take, the delays that might occur, and argue that it would lead eventually to higher costs of borrowing in the future.

The Federal Reserve did not take a position on the earlier bankruptcy bill, and we are not taking a position on this one. And I think it is a very substantive decision that the Congress will have to face on that one.

Senator CARPER. All right. Thank you very much.

Others, please? Chairman Cox, you may or may not want to comment on this. It is your call.

Mr. COX. Well, I think as the Chairman of the SEC it is difficult for me to comment on this particular piece of legislation. As a former Member of the Congress, it is really easy, but I think I will forbear in the interest of——

Senator CARPER. I will ask you to keep your current hat on rather than put on a new one.

Secretary Steel.

Mr. STEEL. Senator Carper, thank you for the question. A couple of things, and I think that Chairman Bernanke did a good job of kind of walking through the issues.

As you went down the list of all the various components and issues, we have not seen the specifics of this, and some of the things you alluded to are not part of the bill. But I think our position is pretty clear. FHA modernization is important and can allow the FHA to do more right away. FHA has been a force for good throughout this process. They can do more. Modernization is something we support and look forward to doing. We can be helpful for that going through.

I think that also the GSEs, as Senator Dole first raised, consistent with prudent operations if something—it is a time where they can be stepping in and doing more, and we would encourage that. Counseling also.

I think on the issue of bankruptcy, as you said there are arguments on both sides. I think from our perspective, it does not seem to be the right tool for the task, that there are lots of public policies that suggest that there was a very purposeful decision when this was—the process was described this way, and that should you allow bankruptcy to be organized in the same way with regard to single-family residences, it would have a chilling effect. It basically would reduce the amount of capital and raise the price of capital. And I think that has been the public policy perspective, and I think that we need to be very careful to consider anything other than that.

I think the idea that—and also, too, I think something that Chairman Dodd said, that we are working now in real time and it does not seem to me that when we need a fast solution, that heading to the courts is our logical first idea. So I think that given those perspectives, that would not be something we would view as a key tool.

Senator CARPER. All right. Thank you.

Mr. Geithner.

Mr. GEITHNER. I do not have anything to add.

Senator CARPER. All right. Fair enough. Well, thank you very much.

Chairman DODD. Thank you very much, Senator.

Senator CARPER. Mr. Chairman, if I could, I know the Chairman has been working with, I think, his counterparts, Congressman Frank, the Chairman of the House Banking Committee, on a different approach that helps to address the situation where folks have their mortgages underwater, where the amount of money that is owed is significantly worth more than the value of the property, the kind of situation where a lot of people are thinking—are walking away or thinking about walking away.

Some have suggested that that might be actually a better approach than working on the bankruptcy side, and I think that is a question that——

Chairman DODD. Well, you would like to avoid it if you can. Once you are into bankruptcy, you have got another whole set of issues. If you can avoid that situation, obviously—and the value, I have tried to explain all of this, while there is clearly value, obviously, in trying to keep people in their homes, all the residual effects of that, the larger value to me is that you are establishing a floor. You are getting to the bottom of this. And unless you get to the bottom of this, you are not going to see capital begin to flow. That to me is the greatest asset, potentially, of a plan like this.

We are spending a lot of time talking about it and getting other people's advice and opinion on this, and I am anxious—and Senator Shelby and I have talked about it. I am not going to make it a part of this particular bill we have on the floor right now because it is controversial, and I do not want to end up having a lot of people vote against something that I think they might be inclined to vote for if we can frame it right. So we are going to be having some hearings on it, and I am going to be soliciting the opinions of many of you here as to how we do this.

But in my view, in the absence of doing that or something like that, all we are doing is dealing with the effects of all of this rather than dealing with the problem. And the problem is to get capital to flow. So that is another—that is what we are trying to drive at in all this.

With that, Senator Martinez.

Senator MARTINEZ. Thank you, Mr. Chairman.

I want to pursue a little more on the inquiries that Senator Dole raised regarding the Government-sponsored enterprises, Fannie Mae and Freddie Mac, and from two aspects:

No. 1, Mr. Chairman, I would like to know your thoughts on whether a failure of one of these enterprises would pose a systemic risk to the system. And, obviously, I think I know the answer to that, but I would like to be sure I understand your position on that.

Mr. BERNANKE. I think it would. It would be sort of two options. One would be significant systemic risk or Government guarantees. So either way it would be not a good outcome, obviously. So for that reason, I certainly support both good oversight and that the GSEs should continue to raise capital. The recent evidence is that financial firms can raise capital. They can do so, and they can do so profitably, given the opportunities they have right now in the housing market. So I would strongly urge them to do that.

Senator MARTINEZ. In order to raise capital, would it be helpful—do you anticipate that the investor would have a high level of confidence and would bring new money into the market for mortgages if there was a world-class regulator that would give investor confidence at a time like this when there is such fragility and where we have seen a huge failure of one of the investment banks?

Mr. BERNANKE. I think that is an excellent point, Senator. It would assure investors that the GSEs were safe and sound and that they had adequate capital to conduct profitable operations.

Senator MARTINEZ. Secretary Steel, could I get your comments on both of those issues?

Mr. STEEL. I think that the two questions, one, is the size, scale, scope of these GSEs, is there the potential for systemic risk, the answer is yes, period.

I think with regard to the second question, I would concur with Chairman Bernanke that anyone who would consider investing in these entities would have to view the establishment of a clear, strong, appropriately empowered regulator as a positive. And so, therefore, the answer to the question is yes.

Senator MARTINEZ. So it seems to me that based on the fact that we have seen accounting irregularities in the recent past, that they have worked out of, and this is good, with the need for them to play an increasing role with higher conforming limits, with us empowering them to lend more money by reducing their capital requirements, and all of us knowing that OFHEO today does not represent that kind of world-class regulator that Senator Dole was talking about, then maybe the time is now for us to give the investor confidence that is needed as well as provide the kind of security to our taxpayers, because make no mistake about it, these entities cannot be allowed to fail, and there is an implied guarantee of the Federal Government.

So rather than us be here Monday morning quarterbacking sometime down the road, it sure would seem to me to be a good idea for the Congress to get about the business of something I have been advocating even before I was in the Congress, and that is, a world-class regulator. Kind of a long question.

On the current issue, which is the Bear Stearns situation, and I guess this might be to you, Mr. Geithner. One of the issues that has concerned me as it relates to the shareholder is whether there were other suitors, whether there were options available that might have provided a better outcome to the shareholders. Could you comment on that?

Mr. GEITHNER. Absolutely, and I do say quite a bit about this in my written testimony, and, of course, you will have a chance to hear later today their perspective on this.

Bear Stearns began approaching people right away, very quickly, and they, of course, had a very strong incentive in trying to get as many people as possible looking at ways to provide financing. And we encouraged that. It was very important to us, too, that we maximize the chance there be an outcome that was going to be, you know, good for the system as a whole. Ultimately, though, only one institution was willing—had the ability, the will, willing to move that quickly.

Was there a better option available at the time? No, I do not believe so. And I think everything was done to maximize the chance that there would be a set, a range of choices available, but I do not believe there was a better option available.

Senator MARTINEZ. And the governmental entities involved did not presume or select JPMorgan in this instance?

Mr. GEITHNER. Absolutely not. It was Bear's decision who they initially approached, and our interest was only in—and it was very important to us that they open up and allow a range of institutions to do due diligence, which they did.

Senator MARTINEZ. Thank you.

Chairman Cox, a couple of questions more related to the shareholders. One has to do with the value of the $2, which I know there was a financial advisor that provided an opinion of fairness at the $2 level. I guess when the transaction was up significantly, it raises in my mind the question of whether, in fact, the financial advisor's advice was appropriate, adequate, or was it just a better deal when it became $10, the $2 value. Do you have any concern from the shareholder standpoint about the appropriateness of the financial advisor's role in this transaction?

Mr. COX. Well, the Commission's concern is that the shareholders get all of the information that they need to evaluate that for themselves. There are many things about this transaction that are unusual and that have broken the mold, but one thing that is not different is that this is ultimately a transaction between JPMorgan Chase and Bear Stearns. There is a merger. There is going to be a proxy. There are going to be shareholder votes and so on. And all of those decisions have to be understood and approved by shareholders. The SEC has never in its history intervened to determine the price of a transaction, and we would not in this case.

Senator MARTINEZ. Will there be a shareholder vote in this transaction?

Mr. COX. Now, if you are getting into the terms of the transaction and the what-ifs, I think I might better yield to the people that are directly involved in it.

Senator MARTINEZ. Fair enough. Maybe we can get——

Mr. COX. I mean other witnesses as well as the next panel, but——

Senator MARTINEZ. Mr. Geithner.

Mr. GEITHNER. I do not think I am the one in the best position to talk about the way forward in terms of the legal issues around consummating this agreement. But I think you will have the opportunity later today to have them——

Senator MARTINEZ. Maybe I should pursue the question later.

Mr. COX. I will say that just as a generic matter—and under the terms of the merger agreement, which is not unusual in this respect—there is to be a shareholder vote.

Senator MARTINEZ. But is it not a stock exchange?

Mr. COX. It must be approved. It is a stock-for-stock transaction, must be approved by the shareholders.

Senator MARTINEZ. OK. Good enough. Thank you very much.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much, Senator.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman Bernanke, I am trying to get a sense here of the risk for the taxpayers, and I heard some or was informed of some of your answers to Senator Reed before. You know, a letter from the Treasury indicates that these are largely mortgage-based securities and related hedge investments.

Now, I have heard this panel testify in your opening statements that, you know, in essence, what happened here was a lack of confidence. Well, a lack of confidence happens because of underpinnings. I would hate to believe that simply the rumor mill can bring down one of the largest investment banks in the Nation, because then we are really in trouble.

So there had to be some underpinnings of what created that lack of confidence, and that is what I am concerned about, is what is the confidence that we have in where the taxpayers are out there on liability.

Now, I know that you said that you are reasonably comfortable that the risks are not remotely close to the full amount. Well, what are they remotely close to? Because we have seen reports that Bear Stearns was leveraged 30 to 1, in some cases 100 to 1. I mean, what—we have heard other financial institutions say that they, in fact, cannot truly verify the full value of their securities.

So if we do not have a valuation of these securities, how are we so confident—I know that the first billion of loss goes to JPMorgan, but they would not get involved with this transaction unless the Fed came forth. That is still $29 billion. So what is the response to where the risks lie here for the taxpayers as a whole?

Mr. BERNANKE. Well, Senator, first of all, Bear's overall condition or its leverage is irrelevant here because we are only looking at a set of assets. These were assets, as President Geithner mentioned, that we negotiated to get. They are not in any way the residual or the worst assets or anything like that. They are representative assets.

Senator MENENDEZ. Are they worth $29 billion?

Mr. BERNANKE. We have several sources of information. We have Bear's own marks. But, in addition to that, we have the valuation of our own experts. As President Geithner mentioned, we do value assets for the purpose of lending at the discount window. And we have the advice of a well-respected, independent advisory firm that takes the view that if we sell these assets over time—and we have allowed ourselves up to 10 years, although we can sell them any time we would like—and, therefore, avoid the need to sell into a distressed market, that we will recover the full amount, and that, in addition, if we are fortunate, we may turn a profit beyond that. But I think we have a very good chance of recovering the full amount.

Senator MENENDEZ. If that is true, why did JPMorgan say they would never have gotten involved in this but for your guarantee?

Mr. BERNANKE. Well, again, it was an issue of how much they could swallow, how much total risk they could take on, how much capital they have, and just the shortness of time from their perspective.

Senator MENENDEZ. So you are telling the Committee that, as far as you are concerned, the American taxpayer has no liability here.

Mr. BERNANKE. I am not saying that. There is——

Senator MENENDEZ. Well, what is—I am trying to quantify the liability. Give the Committee a sense of what the liability is for the American taxpayer in this regard.

Mr. BERNANKE. I do not know the exact number. I think——

Senator MENENDEZ. And that is my concern.

Mr. BERNANKE. Well, again, our advisor suggests that we have collateral that is worth as much or more as our loan. Senator, I would just simply like to point out that this cost, if it turns out to be a cost—which is by no means obvious—must be weighed against the effects on the American economy and the American financial system of allowing this firm to collapse and all the consequences that would have had for the markets and for the economy.

Senator MENENDEZ. Well, listen, I realize that. I said that in my opening statement. I also realize that a year ago, when I said we were going to have a tsunami of foreclosures, you all downplayed it, and we have not even seen the crest of that tsunami. And I believe that that consequence to the economy is equally consequential.

As a matter of fact, if, in fact, these securities are mortgage-backed residential and commercial securities, I am not sure of the value.

What does "highly rates"—you have mentioned several times "highly rated securities." What does "highly rated" mean in a time where so many highly rated securities have absolutely plummeted?

Mr. BERNANKE. Senator, all I can say is that we are not basing our evaluations on face values. We are basing them on market values from several different sources. I cannot give any firmer guarantees than that. I don't know, President Geithner, if you want to add to this, but we believe based on independent professional advice and our own evaluation that we have an excellent chance of recovering the full amount, as well as interest.

Senator MENENDEZ. Well, I have to be honest with you. Haven't you gone beyond a—it seems to me—as I understand the process that you set up, what the Fed is getting in exchange is a question. That is a bit surprising because the deal is far from a standard loan. That money goes to JPMorgan. The firm is not the borrower. The Fed cannot demand repayment from JPMorgan if the Bear assets turn out to be worth less than what has been promised. And what is odd is that if there is any money left over—which hopefully there will be, but I am not so sure. I am really concerned that it is not. The Fed gets to keep the residual value for itself. That seems to be more of an investment than a collateral loan. You have really stretched the limits of what this is all about.

Chairman Cox, you know, what are you all doing at the SEC? I mean, it seems to me that we always say, oh, we have learned all these things. We can never have the foresight to look ahead and say, you know, we need to change the regulatory system to ensure that in the dynamics of all of these instruments that are being used that we have the appropriate regulation and we are looking for the right standards to ensure that this does not happen. You know, when a JPMorgan analyst says that, in fact, it is not indisputable that rumor and innuendo can bring down a firm, and quickly, you know, that is troubling, particularly at a time when shorting of stocks as a core investment style becomes so widespread.

What are we doing? What are we doing to ensure that that just cannot happen? And to put the taxpayers at the risk—at the risk—because I have not heard anything here that gives me a sense that we are whole by any stretch of the imagination.

Mr. COX. Senator, the fact that unsecured funding might not be available in times of stress is baked into all the regulatory models that are used for both commercial banks and investment banks in this country and around the world. The idea that secured funding, even for good collateral, would be unavailable and in such breathtaking fashion as occurred in this case was indeed a revelation. And everyone has inferred that lesson since the time. As a result, not waiting for new legislation or even new regulation, the SEC and the Fed are in all five of these firms, working with those firms to make sure that they do things such as, first, increase their liquidity pools; second, lengthen the term of their financing; third, redouble their focus on their own risk practices and models. And beyond that, the act that the Fed has taken in opening the discount window to all of the firms has dramatically changed the risk landscape.

So much has changed since this happened, but you are absolutely right that we are living in very different times.

Senator MENENDEZ. Mr. Chairman, I will not belabor it. I just want to make one last point. There are all series of new financial instruments which we have not kept up with in a regulatory context. I urge those of you who have not to read the book "Trillion Dollar Meltdown." I think he does a very good job of describing what we are facing and what we are headed toward. And I have to be honest with you. I am looking for our regulators to be protectors, not following the aftermath, the cleanup brigade. And I do not think that what we have had here—what we have here is a cleanup brigade, not a protector of the very institutions that we need to have protected for the well-being of all Americans.

Thank you, Mr. Chairman.

Chairman DODD. I thank the Senator. I do not know if you were here in the room or not, Senator, when I mentioned earlier that the issue right now, in fact, is there some additional authority that the regulators need that they do not have, since we have now expanded the opportunity to investment banks and broker-dealers at a discount window here where capital requirements and other regulatory sanctions at least exist on the member banks here, should we be doing something.

The Chairman is going to let me know whether or not we need to be giving them some authority in this window. Again, it is a limited period of time, but, nonetheless, that is an important consideration so we do not look back and say why didn't we do something in the middle of all of this. And they are very legitimate questions that you and Senator Tester have raised and were raised as well as to—I look back on some of these other arrangements, to be looking back on the situation at Chrysler or others. You know, to what extent was there some assets that were coming back to cover the very exposure that potentially we have. So a very good set of questions.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you. I think this has been an outstanding hearing, and to all of you for your patience. I know I am one of the few things that separates you from leaving the building and having lunch and doing something maybe more productive. But I want to generally say that there is going to be all kind of postmortems, I know, on this deal, and that you all had to make decisions in a vortex of a short amount of time and a lot happening and a lot at stake. And I am sure there are even decisions that you can think back upon that you might have made a little bit differently. But, generally speaking, I think that you acted in the best interest of the financial markets and our country, and I want to thank you for that. I think it has been a good thing.

And I would actually say that I know a lot of people are asking, you know, what "too big to fail" is. My guess is any of the institutions today, because of where we are liquidity-wise, they are so intertwined, would have been dealt with in this manner, any of them. And, anyway, again, I think it was probably prudent.

I have read the testimony of the witnesses coming after you, and I know that Alan Schwartz—who I know has not had a good life over the last several weeks, nor have his stockholders—talked a great deal about the rumors and how in essence—I mean, it was just laced—I mean, in essence, if you read his testimony, it almost solely occurred because of rumors and the ability of those rumors to move quickly with telecommunications the way they do today.

On the other hand, President Geithner, you were asked the question about, you know, would it have made sense to open up the Fed window, and I think I heard you say that you did not think that was prudent, that you would have, if I heard you correctly, opened the window to other comparatively well-managed firms, but you would not have done so to Bear Stearns, which gives me an indication that it was more than rumors, that you actually felt like the firm was not well managed. And I just would like for you to square that up, if you will, with Mr. Schwartz's testimony.

Mr. GEITHNER. This is a very difficult question, and, again, I cannot—I do not think anybody can say with confidence what would have happened if we had done this, what would have been possible. But just to go back to what I said to Senator Dodd on this, it is not clear to me, it is far from clear to me that the facilities we designed carefully to try to mitigate these market pressures would themselves have been powerful enough, sufficient to insulate Bear from the position they found themselves in at that time.

I do not think I can say it any differently. It is just not clear to me, it is very hard to know—I may be wrong, but I just—it seems to me that the combination of the unique pressures on markets and the specific position Bear was in makes it hard to reach the judgment that would have delivered a different outcome.

Senator CORKER. I would just make the observation, based on the testimony today and other written statements recently, that it appears to me there is a tremendous difference—I know one of the other Senators talked about the relationship between capital and liquidity. There is a relationship, no question, but there is a vast, vast difference. And I do wonder whether any of the firms, any of the major firms that we all know today, any of them could survive, period, with a run on their particular facility. And I would love to have any—it seems to me that none of them could with the liquidity change that Secretary Cox referred to earlier with the run, that we have no firms in our country today that could stand a run on their particular institution.

Mr. GEITHNER. I think you are right that financial systems rely on confidence. Confidence can go quickly. Without liquidity, no leveraged financial institution can survive. And the system as a whole depends on the ability of institutions individually to convince their creditors and people who fund them that they should continue funding them. And every system relies on that.

What is unique about our system is that we put in place almost a century ago a set of protections to reduce the risks to the economy that come from runs on banks. But the system has changed a lot since then, and those protections do not extend to a set of institutions who are also vulnerable to liquidity pressures, who also play a very important role in the economy. And we have been trying to adapt our system to compensate for that change, but we are going to have to think through very carefully a set of other changes in the future to get ourselves a better balance.

But you are absolutely right that every system depends on confidence, and no leveraged financial institution can withstand the abrupt cliff of unwillingness of people to fund it.

Senator CORKER. It just seems to me that in the future, as we look at what might happen over the next couple of years—and I know that is not the focus of our meeting—that really liquidity should be our focus and not capital. Capital I know is important, but at a time like this, liquidity is certainly much more that way. And I know of the things you recommended was shock absorbers, and I think that in essence may be what you are referring to, but

I look forward to expanding that discussion a little bit later. I only have 7 minutes here.

Secretary Steel, I know that Secretary Paulson and you both were involved in the negotiations in, it seems to me, a fairly big way. I am not criticizing that in any way. And I am sure that Secretary Paulson was focusing with the Fed Chairman on the fact that the price needed to be low because of the moral hazard issue, that if there were, in fact, going to be a transaction, the share price needed to be very, very low.

I guess I am a Bear Stearns person, or a former Bear Stearns—I guess a present Bear Stearns stockholder. Where are we as a country, as a Federal Government, as it relates to shareholder suits and those kinds of things? What kind of—I know you all thought about that as you were moving through the process, but where does that put the Federal Government as it relates to shareholder suits?

Mr. STEEL. Well, I am not an expert in this area, and maybe someone else here will be, but I will do my best. I think that this was a transaction that was agreed upon between JPMorgan Chase and Bear Stearns. On behalf of the Government, the Federal Reserve Bank of New York was at the table because——

Senator CORKER. But let me just add something to that. The fact is that my sense is Chairman Bernanke wanted buy-in by Treasury. In other words, they did not want a $29 billion guarantee without the Treasury saying good things about what they had done. I am sure there was—and I mean that in a positive way. I think that is healthy that you all were talking with each other. The fact that Secretary Paulson was saying low price I am sure affected the whole transaction. It is kind of like, look, there needs to be a low price or maybe we will not say good things about what happened.

And so I am just putting in that context. It seemed to me that that does affect, if you will, the terms of the transaction. I am just wondering, again, if you could in that context talk to me.

Mr. STEEL. I will try, and then I would invite Chairman Bernanke to speak. I think that Secretary Paulson and others at Treasury were active participants. I think that this twin responsibility of wanting to be sensitive to the state of the markets and what the situation could cause balanced with also wanting to not encourage a sense of moral hazard. And consistent with that is a price that seems to be appropriate. And I guess the answer to that is low, and I am sure that the Secretary provided that perspective to Chairman Bernanke and President Geithner.

I just would add, though, sir, that throughout this process, I can report to all of you that there was good collaboration, and I view that as a good thing, that people were helping each other, trying to think about various issues, and the 96 hours was fairly fraught. And the Secretary was in constant communication and trying to be helpful to Chairman Bernanke and President Geithner as they came to work through this and offered his perspective.

Senator CORKER. I will ask one last question. It seems to me that the amount of taxpayer liability that the Fed was willing to put up actually determines the value of the stock. In other words, if it had been willing to guarantee $100 million, the stock price might have been $20 or maybe $30. Who knows?

So I know there is going to be a debate that ensues over the next couple of years, a debate as to whether the Fed acting alone can risk taxpayer dollars on its own or whether the Fed needs to seek the approval of other people in political positions. And, by the way, I do not have a position. I am looking forward to learning.

But I wonder if you might comment on that. I know this transaction had to happen in a hurry, and it seems to me there was healthy collaboration between all departments when this occurred. But should, in fact, the Fed need the approval of the Treasury Secretary or somebody else in a "political position" that is looking in a different way at taxpayer funds when something like this is done?

Mr. BERNANKE. Well, Senator, first of all, there was excellent collaboration, and we very much valued not only the Treasury's support as a Department but the market knowledge and insight of Secretary Paulson and Under Secretary Steel. So that was a very useful collaboration, much of it taking place at the wee hours of the morning.

In terms of legal authorities, you should recognize that we loan money against collateral all the time. We do not do it usually in quite these unusual circumstances, but we do have the authority to do it. But certainly given the unusual circumstances, it was helpful for us to have—to consult with the Treasury to make sure that they were comfortable with what we were doing, and it was very helpful that they were.

You also raise a good point, which is that, as I said earlier, my main concern was that this deal happen so that there not be the implications for the market of a Bear default. And I did not personally have a strong view on the share price, but it is true that to the extent that the Fed was facilitating the transaction, it would clearly have been—you would have questioned it I think even more if the price had been very high. You would have asked the question: Why didn't the Government, you know, strike a better deal? So that certainly is a relevant consideration. And, indeed, when JPMorgan raised its offer for Bear based on a number of considerations over the next week, the Government renegotiated and approved our situation as well. So those two things were linked in that respect, certainly.

Senator CORKER. I know my time is up. I would love to ask some more questions, but thank you, Mr. Chairman.

Chairman DODD. Well, you are going to be able to submit them if you want. I realize we have such a heavy participation by members in the second round that it is probably not going to be possible, but we can submit questions, and I would urge you to do so. They are good questions.

Senator CORKER. Thank you.

Chairman DODD. Senator Bayh.

Senator BAYH. Thank you, Mr. Chairman, and thank you to our panelists. I am grateful for your dealing with these very complex, very significant challenges that arose in these circumstances, and I think a fair amount of modesty is in order for those of us who were not there in the room trying to deal with this. And yet I think you understand we need to try for the purposes of going forward to prevent situations like this from recurring as best we can.

Chairman Bernanke, I would like to begin with you. How much, as we gather here today, has been lent through the discount window to investment banks?

Mr. BERNANKE. Well, the amount differs day by day. I think—and, President Geithner, correct me if I am wrong—I think a recent number was on the order of $35 to $40 billion.

Senator BAYH. How long do you anticipate this continuing?

Mr. BERNANKE. Well, we are going to keep the Primary Dealer Credit Facility open so long as conditions remain stressed and these liquidity issues that we have been talking about are still prevalent. We want to make sure that conditions have improved, so we are not going to be precipitate in closing that window. But our legal authority requires, you know, exigent circumstances, and so at some point we would have to close it.

Senator BAYH. I thought Mr. Geithner went through a list of several advisory or supervisory activities that you have been trying to counsel people about how to improve their condition. Is there a requirement on behalf of these investment banks that have used the discount window that they listen to Mr. Geithner and follow up on his recommendations? Or can they just disregard him at their pleasure?

Mr. BERNANKE. Well, first of all, we are cooperating very closely with the primary supervisor, the SEC, and the firms are also providing excellent cooperation both in information and in conduct.

We have a very strong tool. We do not have to lend to them. We can deny anyone who wants to come to the window if we do not feel that they are safe and sound and do not present adequate collateral.

Senator BAYH. I am interested just as a shadow banking system seems to have arisen, perhaps we have the seeds of a shadow supervisory or regulatory structure in nascent form here. But, in any event, I am glad to know that they are aware of your ability to lend or not lend, and perhaps that does lead to them taking suggestions to heart when we do that. Thank you, Mr. Chairman.

Mr. Geithner, to you, second, I think the Chairman was right, and as many, including my colleague Senator Corker, pointed out, we did not bail out, at least in substantial regard, the shareholders of Bear Stearns. But we did ride to the rescue of the credit holders. I think that is fair to say. And the counterparties certainly were rescued in this situation.

Do you have any plans to identify who these counterparties were, what kind of risks they had run, so that we can evaluate whether they had engaged in reasonable behavior or not since we have, you know, provided a substantial service to them?

Mr. GEITHNER. Well, I guess I would just step back and begin by saying that you cannot protect the system against the risks of this type of systemic crisis without some——

Senator BAYH. Well, the reason I ask, Mr. Geithner, I suppose the failure of Bear Stearns, while tragic in and of itself, did not really pose a systemic risk. It was the counterparties, it was the ripple effect from that, correct? So——

Mr. GEITHNER. Yes. I would say they are inseparable.

Senator BAYH. And somebody mentioned a thousand counterparties or thereabouts. I guess in order to keep this from reoccurring and to really understand what was going on here, we need to understand, you know, what was the magnitude of the counterparty risk.

Mr. GEITHNER. Well, I agree. I think that the—I would say anybody in this world today is spending a huge amount of time trying to figure out what their exposure is directly and indirectly, not just the first round but the second round, third round, fourth round effects of this kind of thing. Very hard to do that. But in some sense, what you are seeing in markets—the reason markets are so fragile now is partly the symptom of people preparing for and buying more insurance against those very difficult to measure effects as these things ripple through the system.

But, one, I would say I would put on the top of the agenda for how you think about risk management improvements and reform just the point you made, which is how to make sure people can do a better job of figuring out what that exposure is in extreme events better ahead of the boom.

Senator BAYH. If I could get your reaction to a couple of suggestions that have been made for our consideration going forward, some of these special-purpose, off-balance-sheet vehicles are pretty exotic. Obviously, they had a tremendous impact here, and yet there were no minimum capital requirements, and the holders of these were not really required to report their results. Do you think there should be minimum capital requirements? And in the off-balance-sheet world, should the results be required to be reporter?

Mr. GEITHNER. Bob, Secretary Steel, I cannot remember which part of the President's Working Group report addresses this question, but a lot of issues around accounting treatment, the disclosure, the capital treatment, and how liquidity puts are regulated in that context, which a lot of people thought, you know, are going to be working through. I agree with you it is an important question. We have got to get it right. I do not think we have got it right at the moment.

Mr. STEEL. And it will be a combination of market discipline, which transparency will make clear. Sometimes people did not recognize what was going on, so the combination of transparency with better risk management from financial institutions——

Senator BAYH. We have really got to look at the accounting standards with regard to some of this off-balance-sheet stuff——

Mr. STEEL. Yes, sir.

Senator BAYH [continuing]. And the appropriateness of capital requirements and margin requirements and all that kind of thing.

I just have—oh, I have got a whole minute left. How about that? Two more questions. Chairman Bernanke, to you, and back to your point again, we did not—the equity holders in Bear took a huge hit here. The holders of the bonds, I do not follow the value of their credit instruments, but I suppose they have performed much better. Is that a fair guess on my part, following the government's intervention?

Mr. BERNANKE. That is correct, but you had many short-term lenders, including——

Senator BAYH. Well, here is my question. If going forward the lesson—and perhaps, Secretary Steel, this gets to you a little bit—is that the lenders of equity need to be more prudent in the risks they take. What lesson are we sending to the providers of credit and the kind of risks that they take? And might this not skew the market toward greater risk taking in the credit arena than the equity arena? And what are the consequences of that?

Mr. BERNANKE. You raised an excellent question, Senator. It is hardly the case, though, that the debt spreads for other companies have shrunken to zero, you know, that lenders believe now that they are completely safe. There is still quite a bit of concern about counterparty and credit risk. So it is hardly the case that we have, you know, persuaded the market that debt instruments are entirely safe. But you are absolutely right, there is a bit of an asymmetry there.

Senator BAYH. My final question, Mr. Chairman, and it has been touched upon by a number of others, and I just throw it out for any of you. Obviously, the public is following this, and there are a variety of perspectives. People who have made prudent decisions—I am talking about homeowners here who have made prudent decisions, who are paying their mortgages. You know, they wonder, well, you know, those who did not make prudent decisions, they are receiving some assistance. What about me? And yet at the same time, if we allow some of those to go down, it does have an impact on them. And you had to make a decision here about the systemic risks with a large Wall Street bank and were providing up to $29 million in credit. We have made a—going back to the 1930s, you know, opening up the discount window, again to try and at the top level provide systemic risk.

When constituents of mine ask me about all this, what would you say to them and the appearance of, well, when it comes to large Wall Street institutions, we ride to the rescue, and yet for the little guy—and I think Senator Schumer mentioned this. In the aggregate, which could be just as important, it was at the genesis of all this, there is a greater degree of indifference with regard to them. What would you say to people who raise that concern?

Mr. BERNANKE. Well, I think the key point to make—and I realize it is not an easy sell sometimes, but the truth is that the benefits of our actions were not Bear Stearns' and not even principally, you know, Wall Street. It was Main Street. It was the fact that the financial system has been under a lot of stress, and that has affected our ability to grow. It has affected employment. It has affected credit availability. And I think people are sophisticated enough to understand that if the financial system crashes or at least is severely hobbled, the economy cannot grow in a healthy way either. And that is why we did what we did.

On the other hand, it is also important to address the problem you are referring to, which is the housing issue. I would say that the Fed is trying to help on that dimension as well. By cutting interest rates, for example, we have reduced the pressure of resets, for example. And by improving liquidity in the market, we have helped to reduce mortgage rates. So we are doing our part in that respect. We are also working with communities on the local level through our reserve banks.

So we are trying to address both issues, but our ultimate concern is the health of the American economy and of the average person.

As I said before, I think one of the key issues here is housing, though, and I commend the Congress for focusing on that issue, which I believe is crucial both to the financial situation and to the economic situation.

Senator BAYH. My time has expired, and I do not expect any of you to comment further, unless you want to. But I would just conclude, Mr. Chairman, by saying that the reason for my—and I appreciated your answer very much, Chairman Bernanke. The reason for my question is that it seems to me that in trying to strike the balance between systemic risk and moral hazard, in the moment you made the right decision. And yet I have been somewhat disappointed, Mr. Chairman. You and Senator Shelby have done a great job, but some of the things that would go to the sort of little guy, for lack of a better term, are still out there to be addressed. And I think it is important we send a message to them that we are going to take their concerns to heart as well as those that present systemic risk from the top; those that present in the aggregate systemic risk at the bottom also need to be addressed in a real way so that the reality and perception of fairness in our system is maintained for all the participants.

Chairman DODD. Well, it could not have been said better, and obviously, the point of today, in fact, is to contribute to that sense of confidence that people need to feel. And the perception is—and I appreciate the answer of the Chairman as well. The perception is—and I think all of us are aware of this; I hope we are, anyway—that it seems to be lacking balance, that we are not addressing as directly as we could the problem of those individuals who are at 7,000 or 8,000 a day running the risk of losing the most important investment in their life. Most of them will never own a stock or a bond or anything else, more than likely. They will count on that home, that equity in that home for their retirement, for a health crisis, for their kids' education, for all of these things that can happen. That is the great asset, the great wealth creator for them. And it has been put at great jeopardy and great risk. And so we need to do a far better job, and my hope is in the coming days we are going to. But you have articulated it very, very well, Senator.

Senator Casey.

Senator CASEY. Mr. Chairman, thank you very much. I may be last. Is that correct? I just want the panel to know that, unless someone else walks in.

Thank you for your testimony and your presence here. I want to focus my questions principally, I think initially, to Chairman Bernanke and to President Geithner on a couple of areas. One in particular is this question of collateral, the valuation of the collateral. And I think for purposes of my questions, we could probably establish a couple of things.

First of all, pursuant to a question by Chairman Dodd I guess we are going to get a report as part of this record about that valuation. Is that correct?

Mr. BERNANKE. You will receive certainly a list of the major categories and the valuations.

Senator CASEY. OK. And we can also establish for the record that the valuation of the collateral in this arrangement was established by Bear Stearns. Is that correct?

Mr. BERNANKE. That is correct, but in our accepting it, we had the advice both of our own experts and also the investment advisory firm.

Senator CASEY. And something that, Chairman Bernanke, you know from our Joint Economic Committee hearing from yesterday, I asked you about the question of if there was a shortfall from the valuation placed upon the collateral and then what happens to be something less than $30 billion, if that were to occur, that that differential, that shortfall, the taxpayers would not be able to go back then to JPMorgan to make that up. Is that correct?

Mr. BERNANKE. That is correct.

Senator CASEY. So I wanted to ask and turn my attention, I think, to President Geithner and Chairman Bernanke. Looking at both sets of testimony, you outlined a lot of the detail of what happened here, especially, Mr. Geithner, your fairly exhaustive review of what happened here day by day and sometimes hour by hour.

The one thing I thought was missing—and I want to explore it—or a couple things. First of all, I did not get any sense of—first of all, BlackRock was not mentioned, as far as I could tell by reading it. I am not saying that they necessarily had to be mentioned, but I think there is a missing piece there in terms of the role of BlackRock. You had said that their fee would be—is still being negotiated or the payment terms. But I think what I want to know, in the context of what happened here, this was obviously very complicated. The time pressures were excruciating, and I recognize that. But I want you to fill in some blanks for me and for the Committee members. In terms of just generically, were there steps taken here as it pertains to the particular question of valuation of collateral, concern about taxpayer interest here, all of those basic concerns, were there steps that you took here because of the exigent circumstances that you would not take if you had more time? That is No. 1.

And, No. 2, walk us through the process that you undertook or, Chairman Bernanke, that you and your team undertook to do the due diligence to make sure that we were doing everything possible to make sure that the valuation of the collateral that Bear Stearns provided was adequate for you to go forward? Do you get my sense of what—I am concerned about the process here, even though you had tremendous time pressures. I just want to walk through that with you.

Mr. GEITHNER. Again, it is hard to know what would have been possible, but I think if we had had more time, we would have done exactly the same thing in the sense that we would have had a mix of our own people looking at the collateral and its value; we would have had—we tried to get the best expertise in the world to give us a second opinion on that. We would have had more time certainly to go through the details. But I think the fundamental parameters we established for what we would accept and what we would not accept and the design of the structure to mitigate the risk of any loss are things that we would have done, I think come to, even if we had a lot more time.

But as we have been clear, there is risk in this transaction. There is no doubt about it.

Senator CASEY. Sure.

Mr. GEITHNER. But I think we have been very exceptionally careful to limit that risk, and we have tried to provide as much detail as possible as to how we limited that risk, but there is risk in this. But, of course, the judgment we were making is the comparison between that modest risk and the certainty of very substantial losses across the financial—including to the comparatively prudent.

Senator CASEY. OK. I just want to know more about the role of BlackRock in this. In other words, what did they contribute in this window of time? If you can summarize the due diligence, the analysis.

Mr. GEITHNER. You know, more eyes are better than one, one pair, so there is value in that. They have got a set of expertise that is really exceptional, and they were able to help us get as much confidence as we could in that period of time, that we had some sense of the overall risk we were taking.

So I do not know how else to say it beyond that.

Senator CASEY. But was part of that—was BlackRock charged with the responsibility of providing—well, two questions: one, charged with the responsibility of providing a valuation of the collateral. Were they asked to do that? And I realize the time was short, but were they asked to do that?

Mr. GEITHNER. Well, let me come back to——

Senator CASEY. Or were they asked to do something in substitution of that?

Mr. GEITHNER. No. Let me come back. We reached a decision to finance in a carefully designed structure a portfolio of securities that would be valued at Bear Stearns' marks on March 14th. A lot of uncertainty in how conservative those marks were. Some may have been more conservative than others; as a matter of fact, some less conservative. Very hard to know. But there was uncertainty around what those things were actually worth.

That uncertainty exists today, of course, because these are very complicated markets. It is very unclear over time what the value of those things were likely to be.

What BlackRock did is help us make some judgments, I think good judgments, about what we should take and what level of risk was that going to be leaving us with.

Senator CASEY. But that did not include a valuation.

Mr. GEITHNER. Well, of course. Part of what they are going to be doing in sort of how to think about managing this portfolio with us will be a bunch of judgments about valuation. And as I said in my written testimony, we will disclose quarterly our fair value estimate of this portfolio through the life of this transaction that is outstanding. So that will give people a reasonable picture, a reasonable frequency, about what is happening in terms of best estimate of value over time.

Senator CASEY. Chairman Bernanke, do you want to add anything to that?

Mr. BERNANKE. No. I think that given the remarkable time pressure, President Geithner and his team did a good job of getting a good estimate of the—and a good level of confidence in the quality of the assets, which, again, we had a great deal to do in choosing. They were not some residual.

Senator CASEY. In terms of the question overall of due diligence, not just as it pertains to the valuation of the collateral but just generally, when you are facing this kind of decision, you are making determinations rather quickly. What is the process you undertake on due diligence? In other words, I know you said in your testimony that you dispatched a team of examiners to Bear Stearns; you spoke to due diligence later in the testimony. You go on to talk about the lending against the collateral and the authority or that. But describe for us in summary what that means in terms of——

Mr. GEITHNER. I think the best way to say it is——

Senator CASEY. Is there a checklist of due diligence that you undertake?

Mr. GEITHNER. I would say as much as we can, as carefully as we can in the time allotted, with the best resources available. But we had not faced and hope to not face again quite this level of challenge in terms of complexity in reaching those judgments. But I would be happy to walk you or your staff through in more detail all the things we did.

Senator CASEY. If you could provide that for the record, we would appreciate that.

I think this is the last question. On the question of interest payments, Mr. Geithner, is it correct that your new partner in this received an agreement that they would receive interest payments at a rate 4.5 percent greater than what the Fed would receive?

Mr. GEITHNER. That is correct.

Senator CASEY. And when it comes to the question of arriving at an interest payment, how did you arrive at that determination?

Mr. GEITHNER. That is an interest they are taking on a subordinated note, which has a lot of risk in it. Remember, they are going to absorb the first losses, the first billion of any losses on this. That interest rate, if you look at similar structures in the market, is way, way below what would normally have accompanied that type of position. But, like anything, it was a negotiation.

Senator CASEY. But that interest rate is higher than what——

Mr. GEITHNER. That is right, higher, but——

Senator CASEY [continuing]. Taxpayers will get.

Mr. GEITHNER. But that makes sense given the nature of the risk. And it really should be just relative to the risk and the different funding situation of us and them in that context. And I think in light of that, it is an economically very sensible arrangement for the taxpayer.

Senator CASEY. When you make that determination, are you evaluating risk in the transaction itself plus greater risk to the credit markets in the economy? Or how do you——

Mr. GEITHNER. No, I think in the—well, of course, overall in reaching these judgments, we were trying to find a balance between what was best for the system and what was possible. But in this case, it was just—I think, again, the relative economics of the different risks in the structure we designed support a different interest rate, although if this had been done in a different context, if you look at a similar structure in the market, that interest rate, which, as you said correctly, is 450 basis points above ours, would have been multiples and multiples higher.

Senator CASEY. Thank you, Mr. Chairman.

Chairman DODD. Thank you very much——

Mr. BERNANKE. Senator Casey, could I——

Senator CASEY. Certainly.

Chairman DODD. Sure.

Mr. BERNANKE. I just want to add one point on the interest payments, which is that we, the taxpayers, the Federal Reserve, get paid all our principal and all our interest before JPMorgan gets a penny. So they do not get paid interest until we are fully made whole.

Senator CASEY. Thank you.

Chairman DODD. Thank you, Mr. Chairman.

Let me, because I made the request and Senator Casey raised it again earlier, and that is the requirement or the request by the Committee here to have, if we can, I would say to Chairman Bernanke, the marked-to-market value at the close of business yesterday of these assets. The Committee would like to—I don't know whether that should be addressed to you, Mr. President, or you, Mr. Chairman, but to whomever it should be addressed, it would be helpful to the Committee, I think, to get that.

Mr. GEITHNER. I apologize, Senator. I was just talking to my chief of staff.

Chairman DODD. It was a request I made earlier about the valuation——

Mr. GEITHNER. About the valuation.

Chairman DODD. Yes.

Mr. GEITHNER. Well, we laid out in my written testimony a description of the collateral in broad terms——

Chairman DODD. No, I just want to know the value of it.

Mr. GEITHNER. No, I understand that. And we will—we would like to work out some arrangement with your staff so they could come and confidentially review the portfolio, and in that context, as I said, we will go forward. We will provide a quarterly valuation on fair value—quarterly estimate of the fair value over time.

Chairman DODD. Well, again, this is a very important point, obviously considering the potential exposure——

Mr. GEITHNER. Exactly, precisely.

Chairman DODD. It is important to this Committee that we be able to have access to that. It is going to be very, very important.

Mr. GEITHNER. I understand that.

Chairman DODD. Let me just—a couple of quick points, if I may, and try to raise—one, and it has been raised by some already. I will make this quick if I can. But I was struck. I went back and looked at the volume of transactions. I guess, Chairman Cox, I would like to address this to you, if I can. I was looking at the volume of transactions. It looks like historic volume. I am looking at the amount of transactions that occurred daily, weekly. Transactions on a daily basis, the numbers run at Bear Stearns, running up to this week, 3 million, 5 million, 6 million, 8 million, 7 million, 2 million. She has roughly those numbers.

You get into the week of March 10th through the 14th, and the volume jumps to 32 million, 54 million, 26 million; on Friday, March 14th, 186 million. A substantial jump in volume.

I am also intrigued about the 30-day puts—the 30-dollar puts, excuse me, over 10 days. There seems to have been a rather significant—in fact, someone ran the math on it for me, and if you made a $600 investment on Thursday in Bear Stearns, on Monday that was worth about $37,000. Not a bad deal to make.

To what extent is the Fed looking at this—excuse me, not the Fed. The SEC. And I understand you answered the question earlier you cannot comment on investigations. Let me put it this way to you, I guess, Chairman. I mean, I would hope that you are looking at this, and to the extent this kind of spike that occurred here, it would seem to me must have triggered some sort of bells and whistles at the SEC here. This goes beyond rumors. There is no violation in law about rumors. There is about collusion. And when I look at a 10-day on 30-day puts, I wonder what is going on here, and when I see the spike, it at least raises bells and whistles in my mind what is going on.

I guess I can ask you this: Did your agency react to this at all? Was there a reaction going on that week to these activities?

Mr. COX. Yes, Mr. Chairman. Your hopes will be, I think, met and exceeded with respect to the agency's response to these concerns. There has been some discussion here today about the concept of "too big to fail." The rumors surrounding the activity you describe are too big to miss, and our Enforcement Division is very active for a number of reasons, including the fact that a well-policed market is essential to market confidence. This is all about market confidence.

Chairman DODD. Well, I appreciate that.

Let me, if I can, jump to one other issue. Again, this has been a subject—Senator Menendez, Senator Tester, many people have raised the issue.

Let me frame, if I can, this issue. Again, I want to say what I did at the outset here. I agree with those who said look, we are going back and reviewing this more for future benefit, I sense. At least I am. I obviously want to know what happened, but there are some precedents we may be setting here that I want to make sure we do not necessary duplicate. Or if we are, to understand why we are going to do it in the context of sound policy and prudent judgment.

And it goes to this. If I am incorrect at all in framing this in terms of the transaction, you correct me. I want to focus on the $30 billion worth of assets involved here. As I understand it, Bear Stearns will sell $30 billion worth of its assets to this new LLC which is funded by a $29 billion loan from the Federal Reserve Bank of New York and a $1 billion loan from JPMorgan Chase. Bear then receives $30 billion in cash from this LLC. The deal is contingent and contemporaneous with the merger. So that the $30 billion in cash then goes to JPMorgan Chase.

In effect, JPMorgan Chase will lend $1 billion to buy assets and then get $1 billion back immediately once it buys Bear Stearns, which now has the $30 billion in cash on its balance sheet.

Is that a correct characterization? Is that what this is? Does that describe it?

Mr. BERNANKE. JPMorgan is certainly taking $1 billion of risk on this position. They are not somehow avoiding that risk.

Chairman DODD. But then when they acquire Bear Stearns they get the money back, they get the cash.

Mr. BERNANKE. Right, but they have the $1 billion note financing the LLC which they will not get repaid if the——

Chairman DODD. OK, I understand.

Let me ask you a couple of questions. One is was this—you mentioned earlier that there were a number of other people who expressed an interest in being involved, that you reached out to a number of other people. Were they aware—were all the other potential purchasers aware of this particular offer?

Mr. GEITHNER. Let me just clarify one thing. Bear reached out to a number of different people.

Chairman DODD. Right, and you talked to—you encouraged it.

Mr. GEITHNER. We encouraged them to reach out to as many people as possible.

Chairman DODD. Right.

Mr. GEITHNER. But I think it was pretty clear to me, at least, I think, that at the time when we were contemplating things we could do to facilitate this, there was no other institution that was going to be in a position to make a binding commitment to acquire them and, critically, guarantee their obligations.

Now if—again, it is very hard to know if it would have been possible. If, at that moment, there were more than one institution in that position, would we have done the same thing? Of course, we would have had to have been prepared to do that. It would be in our interest, in some sense, because then we could have had a bit more of a sense of what a feasible set was.

But we made the judgment, which I think is right—and I think it was clearly true late Friday night that that was necessary—that we had to maximize the chance something was in place before Asian markets opened because of the chain of events set in place by the events of late Friday.

Chairman DODD. Which was Sunday night?

Mr. GEITHNER. Yes, that is right. I am sorry, Sunday night. I apologize.

But of course, if we had been in the situation where there were a range of institutions at that point who were really committed to doing this and had the ability to do it and could have stood behind Bear, would we have made a similar arrangement with them? Of course, we would have considered that. And it would have been in our interest, if we had gotten to that point, that would have been better for us.

Chairman DODD. Again, I appreciate that. It is an important point.

I also, and this goes to the issue—and I again, listen, again, the time constraints in dealing with all of this, I think those are very valid points you've made here.

But in terms of any precedent setting nature of this, what it looks like to many of us up here—and we are all, listen, hoping and relying that these assets are going to turn out to be worth more than, in fact, the numbers we are talking about. We hope that is the case. But again, the issues that Senator Menendez raised and others raised obvious questions about it.

What it looks like, if I had to try and frame this to people, is that we have socialized risk and we have privatized reward. We are on the hook—hopefully it does not happen, but we are on the hook. Why didn't we try to take some of those assets and at least cover to some degree the potential, merely the potential, of the liability of the American taxpayer as we have done in other examples—totally different, in many ways, than what we are talking about here. But in the past warrants, for instance, were a part of that risk. That we could bring back at least potentially covering the potential of possible losses to the American taxpayer.

Mr. GEITHNER. I think, Senator, we have actually designed it with that in mind and with that objective and reach, in the sense that if these assets are managed over time—and it is perfectly possible they will be—that there is a positive return to them, then that return is captured for the American taxpayer.

Chairman DODD. I understand that, again, but—you've heard, I made my point on this and I've kept you a long time.

Let me turn to Senator Shelby.

Senator SHELBY. I will try to be quick, just a few observations.

Everybody here knows, banking is managing risk or trying to manage risk. We have extraordinary stress, it seems, in the marketplace today, financial markets. A lack of confidence in the market. A lot of exotic products that probably a lot of us certainly do not understand. I hope you do, as regulators, but I am not sure.

Liquidity, a lot of capital, lack of liquidity. Too much leverage. But we know banking is leverage, to some extent, and managing risk.

I fear, and I feared this for a long time when I was Chairman of the Committee, that the market might be running ahead of the regulators with products and so forth. And if you continue as regulators, whether you are the Fed Chairman, the SEC Chairman, at Treasury, or the New York Fed, which is a very important part of the Fed system, to continue to react to situations after they happen, where are we going to be?

And my last observation would be is this an unusual era we are going into now? Or is this an intervention by the Fed and Treasury and others? Is this a one-time deal? I do not believe you know the answer to that. We certainly do not know the answer to that. We hope. But we had better, I believe, from this point up here on the Banking Committee, and you as regulators, had better be concerned.

And I hope, and Senator Dodd and I have been on this committee a long time together, more than anybody, more on this side or that. But we have seen stress, we have been through the thrift bailout.

I hope—this $29 billion is not peanuts, it is not a few dollars. It is a lot of money. And I hope that the Fed manages that risk. And I hope that they get this money back by managing it.

But we have got some investment banks that you all know here, and some commercial banks, that are dying for capital and probably liquidity. So I hope this is one heck of a wakeup call to you as regulators.

Thank you, Mr. Chairman.

Chairman DODD. Thank you very much.

By the way, I mentioned earlier the fact that there are a lot of people in this country owning stock. I should have made that point. My point is, in terms of great value, it is the home that is the substantial value for people.

You have been incredibly patient. There are probably some additional questions from members on writing, and I will ask them to submit them quickly to you. And if you could respond as quickly, I would appreciate it very, very much.

This has been very helpful to us. I know it is a lot of time to take but this transaction has obviously provoked serious questions from all of us and constituents across the country. So we are very grateful to all of you for taking the time in being here, and we thank you very, very much.

I am sorry, Senator Corker, do you have——

Senator CORKER. I know everybody wants to leave and I know you have got people—if you could just give us, while we have this panel together, which is a unique group—the sense of what inning we are in not as it relates to the economy but just the issue of liquidity itself and sort of getting back to norms, if you will? Chairman Bernanke, and not everybody has to respond if one is sufficient, but I wonder if you would just give us a sense of that today?

Mr. BERNANKE. Well, a lot of losses have been taken and I think a lot of the adjustment in house prices, for example, has taken place. But we have to remain agnostic and see how the economy evolves.

We remain ready to respond to whatever situation evolves and that is, I think, part of the value of having the Federal Reserve and the Treasury have this flexibility to respond to different conditions.

Senator CORKER. But any sense of where we are from the standpoint of liquidity and getting back to norms?

Mr. BERNANKE. I think we have seen some improvement recently, but you know, we have to see if it persists. I cannot guarantee that it will persist.

Senator CORKER. Thank you, sir.

Chairman DODD. Thank you. Thank you all very, very much. We appreciate you being here.

We will take just a couple of minutes of break while we bring in our second panel and we express our gratitude to them, as well.

[Recess.]

Senator REED [presiding]. I would like to, on behalf of Senator Dodd, welcome the second panel. He is taking a momentary break.

I would recognize on this panel James Dimon, the Chairman and Chief Executive Officer of JPMorgan Chase, and Mr. Alan D. Schwartz, the President and Chief Executive Officer of the Bear Stearns Companies, Incorporated.

Gentlemen, thank you. Mr. Dimon, if you are ready, we would be pleased to accept your testimony.

STATEMENT OF JAMES DIMON, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, JPMORGAN CHASE

Mr. DIMON. Thank you very much.

Senator REED. If you could just bring that forward and make sure the microphone is on.

Mr. DIMON. Can you hear me now?

Senator REED. Yes, sir.

Mr. DIMON. Thank you.

Good afternoon, Chairman Dodd, Senator Reed, Ranking Member Shelby, and members of the Committee. My name is Jamie Dimon. I am the Chairman and Chief Executive Officer of JPMorgan Chase. I appreciate the invitation to appear before you today.

Mr. Chairman, your letter inviting me to testify asked me to address a number of issues relating to the JPMorgan-Bear Stearns merger. At the outset, I want to underscore a few key points about the transaction.

First, we got involved in this matter because we were asked to help prevent a Bear Stearns collapse that had the potential to cause serious damage to the financial system and the broader economy.

Second, we could not and would not have assumed the substantial risks of acquiring Bear Stearns without the $30 billion facility provided by the Fed. While we wanted to help, and I believe we were the only firm ultimately in the position to help, we had to protect the interests of our shareholders.

Third, this transaction is not without risk for JPMorgan. We are acquiring some $360 billion of Bear Stearns assets and liabilities. The notion that Bear Stearns' riskiest assets have been placed in the $30 billion Fed facility is simply not true. And if there is ever a loss on the assets pledged to the Fed, the first $1 billion of that loss will be borne by JPMorgan alone.

Let me turn now to how we became involved in the effort to rescue Bear Stearns and avoid a financial crisis. On Thursday evening, March 13th, Bear Stearns called to tell us that it might not have enough cash to meet obligations coming due the next day and that it needed emergency help. We contacted the New York Fed and learned that they were aware of the situation and that they recognized that a Bear Stearns bankruptcy posed a serious risk to the financial system.

Working through the night and into Friday morning, the New York Fed agreed to establish a secured lending facility for the company using JPMorgan as a conduit. But it became clear by the end of Friday that a comprehensive solution would be needed before the markets reopened in Asia on Sunday evening.

We had teams of people working around the clock that weekend in an effort to determine what we could do to help. My perspective from the start was that we could not do anything that would jeopardize the health of JPMorgan. That would not be good for our shareholders and it would not be good for the financial system.

But I also felt that to the extent it was consistent with the best interest of shareholders, we would do everything we reasonably could to try to prevent the systematic damage that the Bear Stearns' failure would cause. We, the management team and the whole board of the company, viewed that as an obligation of JPMorgan as a responsible corporate citizen.

By Sunday morning we had concluded the risks were too great for us to buy the company entirely on our own. We informed the

New York Fed, Treasury, and Bear Stearns of our conclusion. This was not a negotiating posture, it was the plain truth.

The New York Fed encouraged us to consider what kind of assistance would allow us to do a transaction. That is what we did. Finally, on Sunday evening, the private and Government parties announced a plan with three core elements.

First, JPMorgan would acquire Bear Stearns in a binding stock deal worth $2 per share to Bear's shareholders.

Second, the Fed would provide the merged company with a $30 billion non-recourse loan, collateralized by a pool of Bear Stearns assets valued on Bear Stearns' books at the same amount.

Third, JPMorgan would provide an unprecedented guaranty on hundreds of billions of Bear Stearns' trading obligations. This was done to assure the market that it could continue to do business with Bear and prevent a further run on the bank.

We hoped that the initial plan would save Bear Stearns and reassure the market that Bear Stearns would survive, but we also understood that we had to monitor the situation very closely. It soon became clear that we had not done enough. Customers and counterparties continued to flee for two reasons: the market perceived our guaranty as too narrow; and it doubted that the $2 offer price would be enough to get Bear Stearns' shareholders to approve the transaction.

Discussions with Bear Stearns and the Federal Government in the week following the initial merger led to a revised rescue plan with a package of five critical new elements designed to address these real concerns. First, we strengthened our guaranty to cover virtually all of Bear Stearns products, customer relationships, and subsidiaries.

Second, in a response to a request from the Fed, we gave it a separate guaranty on its existing loans to Bear Stearns.

Third, we agreed to take the first $1 billion of losses that might ultimately flow from the Fed's $30 billion non-recourse funding.

Fourth, Bear agreed to sell $95 million newly issued shares to us, representing 39.5 percent of its voting stock.

And fifth, to help achieve finality, we increased our offer to $10 per share.

The amended plan seems to have worked. In the week following its announcement, the liquidity situation at Bear has stabilized. And that day Standard & Poor's raised Bear Stearns' credit ratings.

Let me say a word also about the $30 billion of collateral for the Fed. We are subject to a confidentiality agreement with the Fed in relation to those assets, so I am constrained in what I can say. But I can make a few general points.

The assets taken by the Fed consist entirely of loans that are current and rated investment grade. We kept the riskier and more complex securities in the Bear Stearns' portfolio for our own account. We did not cherry pick the assets in the collateral pool. The process of designating what collateral would be pledged was overseen by the New York Fed's advisor, BlackRock, a recognized expert in the field.

While no one can predict how the portfolio will ultimately perform—and, of course, it could actually increase in value—if the portfolio declines in value, the first $1 billion of that loss will be borne solely by JPMorgan.

Finally, let me turn to the Committee's interest in the implications of this rescue for American taxpayers. The key point, in my view, is this: Bear Stearns would have failed without this effort, and the consequences could have been disastrous. The idea that a Bear Stearns fallout would have been limited to a few Wall Street firms just is not so. People all over America, union members, retirees, small business owners, and our parents and children, are now invested in the financial system through pensions, 401(k)s, mutual funds, and the like.

A Bear Stearns bankruptcy could well have touched off a chain reaction of defaults at other major financial institutions. That would have shaken confidence in the credit markets that have already been battered and it could have made it harder for home buyers to get mortgages, harder for municipalities to get the funds they need to build schools and hospitals, and harder for students who need loans to pay tuition.

Moreover, such a cascade of trouble could have further depressed consumer confidence and consumer spending, resulting in widespread job losses, and accelerated the ultimate downturn.

Mr. Chairman, the events of the past 3 weeks have been extraordinary. I commend you and your colleagues for examining their implications for the future. One thing I can say with confidence: if the public and private parties before you today had not acted in a remarkable collaboration to prevent the fall of Bear Stearns, we would all be facing a far more dire set of challenges.

Thank you, and I look forward to answering your questions.

Chairman DODD [presiding]. Thank you very, very much.

Mr. Schwartz, we thank you.

By the way, let me—I was out of the room for 30 seconds before you came in and I apologize that I was not here personally to welcome both of you. Let me extend that welcome and thank you. You have been here a long time already this morning. But having the benefit of hearing a wonderful distinguished panel of regulators here is certainly—having spent some time with them.

I should have said, by the way, and I want to note this. While I did not speak with either of these two gentlemen over the weekend, Chairman Bernanke and Secretary Paulson called periodically over that weekend to sort of at least keep me posted on generally what was going on. And so I was very grateful they have taken time out at least to generally keep me informed. I was not aware of any of the details of this, I must say.

I will also tell you that I spent 72 hours at the end of that, leaving in fact on Sunday evening, to meet with the Economic Ministers of the European Union in Brussels on Monday morning, having flown all night, leaving without knowing the outcome and fearful that I was going to have to get on a plane and come right back again in the morning.

The press has already reported this, but the reception of the conclusion was warmly received. That is not to suggest they were not understanding of the difficulties, Mr. Schwartz, that you and the employees of Bear Stearns and others and shareholders faced, but going to the point earlier about whether or not this was a better outcome, the reaction was such.

With that, Mr. Schwartz, thank you.

STATEMENT OF ALAN D. SCHWARTZ, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE BEAR STEARNS COMPANIES, INC.

Mr. SCHWARTZ. Thank you, Chairman Dodd, Ranking Member Shelby, Senator Reed.

My name is Alan Schwartz. I am the President and Chief Executive Officer of the Bear Stearns Companies. Bear Stearns and its 14,000 employees provide global investment banking services, securities and derivatives trading, clearance and brokerage services, and asset management services worldwide. I have been part of and have grown with, the Bear Stearns family for over 32 years. I am saddened by the fast-moving events of the past several weeks that bring me here today.

During the week of March 10th, even though the firm was adequately capitalized and had a substantial liquidity cushion, unfounded rumors and attendant speculation began circulating in the market that Bear Stearns was in the midst of a liquidity crisis. The company assured the public that our balance sheet, liquidity, and capital were strong but the rumors and conjecture persisted.

Due to the stressed condition of the credit market as a whole and the unprecedented speed at which rumors and speculation travel and echo through the modern financial media environment, the rumors and speculation ultimately became a self-fulfilling prophecy. Because of the rumors and conjecture, customers, counterparties, and lenders began exercising caution in their dealings with us, and during the latter part of the week outright refused to do business with Bear Stearns.

Even if these counterparties and institutional investors believed, as we did, that we were stable, it appears that these parties were faced with the dilemma that if the rumors proved to be true they could be in the difficult position of having to explain to their clients and others why they continued to do business with Bear Stearns.

As the week progressed, unfounded rumors grew into fear and our liquidity cushion dropped precipitously on Thursday, as customers withdrew cash and repo counterparties increasingly refused to lend against even high-quality collateral. There was, simply put, a run on the bank.

I want to emphasize that the impetus for the run on Bear Stearns was in the first instance the result of a lack of confidence, not a lack of capital or liquidity. Throughout this period, Bear Stearns had a capital cushion well above what was required to meet regulatory standards. However, by Thursday of that week, a tipping point was reached on liquidity. The market rumors became self-fulfilling and Bear Stearns' liquidity pool began to fall sharply.

At that point, we needed to find a source of emergency financing to stabilize the situation and calm our clients and counterparties. On Thursday, we reached out to JPMorgan, among others, in part because JPMorgan served as our clearing agent and was therefore already familiar with our collateral position. We also informed the SEC and the Federal Reserve as to what was happening.

We worked through the night and on Friday morning, March 14th, JPMorgan agreed to make a short-term loan available to Bear Stearns, supported by a back-to-back loan from the New York Federal Reserve Bank. We believed at the time that the loan, and the corresponding backstop from the New York Fed, would be available for 28 days. We hoped this period would be sufficient to bring order to the chaos and allow us to secure more permanent funding or an orderly disposition of assets to raise cash if that became necessary.

However, despite the announcement of the JPMorgan facility, market forces continued to drive and accelerate our precipitous liquidity decline. Also, that Friday afternoon, all three major rating agencies lowered Bear Stearns' long-term and short-term credit ratings. Finally, on Friday night, we learned that the JPMorgan credit facility would not be available beyond Sunday night.

The choices we faced that Friday night were stark: find a party willing to acquire Bear Stearns by Sunday night, or face what my advisors were telling me could be a bankruptcy filing on Monday morning which could likely wipe out our shareholders and cause losses for certain of our creditors and all of our employees.

Therefore, we set out to find a potential purchaser to acquire Bear Stearns that had the wherewithal to provide the backing we needed, an arrangement we hoped would reassure our constituencies and curtail the flight of our clients and counterparties. And we needed to find and reach agreement with such a party over the weekend.

On Sunday, March 16th, after an intense effort to find the best transaction possible, we reached the first agreement with JPMorgan which has been much discussed in the press. JPMorgan would acquire Bear Stearns for $236 million, or $2 a share. Significantly, JPMorgan also agreed immediately to guarantee the trading obligations of Bear Stearns and its subsidiaries.

As part of this deal, as has been noted, JPMorgan obtained an agreement from the New York Fed to loan up to $30 billion to JPMorgan, secured by certain of Bear Stearns' assets. While we at Bear Stearns had some understanding that JPMorgan was seeking this commitment, we were not directly involved in the negotiations between JPMorgan and the Government.

The following week, due to market uncertainty about the guarantees and the successful completion of the deal, the agreement between Bear Stearns and JPMorgan was renegotiated. In the end, JPMorgan agreed to pay $10 a share for Bear Stearns in a stock-for-stock merger. Enhancements were made to JPMorgan's guarantee of our operating and certain other obligations, and a number of other changes were made to give greater certainty of closing.

At the same time, we understand that JPMorgan's agreement with the New York Fed was modified to make the terms more favorable to the New York Fed.

In sum, before unfounded rumors began circulating in an already precarious credit market, leading to the run on Bear Stearns, the company had adequate capital and liquidity, and a book value of approximately $12 billion. Facing the dire choice of bankruptcy or a forced sale under exigent circumstances, we salvaged what we could to avoid wiping out our shareholders, bondholders, and 14,000 employees.

Federal officials that you talked to today and JPMorgan are in a better position than I to discuss their rationale and motives for participating in this transaction. I can only say that as devastating as these events have been for the Bear Stearns family, the failure of Bear Stearns could have had an even more extensive, devastating impact on the stability of the financial markets as a whole and it may have triggered a run on other investment banks with potentially disastrous effects on the Nation's overall economy.

Like many of us, I am certainly glad such a disaster did not occur.

Thank you for your time. I am prepared to answer any questions that you might have.

Chairman DODD. Thank you very, very much. It was well said, Mr. Schwartz.

On behalf of all of us here on this dais, our sympathies go out to your employees. I have just read story after story about long-standing employees, having spent careers at Bear Stearns, who watched assets go from a Friday to a Monday that literally were devastating for them. There is no adequate way we can express our sorrow to them what happened.

Obviously, the shareholders have the same sort of feelings, but obviously the employees particularly, it is a particularly hard blow.

You know, you and I chatted some months ago and you raised with me this whole idea of the discount window. I am going back to now—I don't know whether it was last spring. I've forgot exactly when I stopped by and chatted with you at Bear Stearns about the various ideas and you raised this issue.

And I raised the issue, and I do not know if you were in the room or not when I raised the issue this morning, when I had a hearing a couple of weeks ago and raised with, in fact, a panel of regulators including the Vice Chairman of the Federal Reserve Bank about the possibility of opening the discount window. And it was widely rejected out of hand as something that would just be inadvisable.

Then, of course, you had the events on Thursday night and then again on Sunday night. And I raised the question, had that decision been reached earlier—whether on Thursday night or even before—whether or not this might have salvaged the situation and avoided this 96 hours that you and Mr. Dimon and others went through.

You heard earlier, in response I think to Jack Reed's question, it may have been, the question to President Geithner about whether or not, in fact, had this window been opened whether or not Bear Stearns would have qualified for them as a prudent risk.

Would you respond to that, as well?

Mr. SCHWARTZ. I certainly would, Senator. I think what I conveyed to you, if I remember correctly, when we spoke was that it was my view—and I think shared by some others in the investment banking community—that this was the first major credit crisis that we had experienced since there had been an elimination of some of the Glass-Steagall restrictions against the competition or the participation in investment banking by commercial banks.

And that it felt to me that, as this environment unfolded, having direct competition, people being in the same exact businesses between commercial banks and investment banks, and the commercial banks having a known access to a liquidity source for all of their high-quality collateral and the investment banks not having that, that created a situation that I thought was precarious for the whole financial system.

Now getting directly to the point about what might have happened if action had been taken more quickly, I will just parse it in two ways because I remember there were two questions about it: what happened if they had just opened that window on Thursday night? Or what if they had done it sooner?

On Thursday night, I think, as Mr. Geithner pointed out, there was already a run going on—But—when he said that, the experience on Friday that showed that even the facility they came up with did not stop the run, as we know, on Friday afternoon—I think the problem with that analogy is when you make an emergency situation available for one particular bank, that does not shore up the confidence in that particular bank. I think that is different than if you make a facility available for all investment banks as a precautionary note. I think the situation could be different.

Having said that, I do not know whether Thursday night would have been too late, since the run on the bank and the crisis of confidence was occurring Thursday afternoon. It is my strong belief that by every measure that I can think of that our balance sheet, our capital ratios, our risk profile lined up well with all of our leading competitors. So I do believe that if, as a policy measure, the discount window had been opened to investment banks for their high-quality collateral, I think it is highly, highly unlikely, in my personal opinion, that we would be in the situation we find ourselves in today.

Chairman DODD. Let me, getting down to the weeds a bit on this, but I had read your testimony, and you just made the point again here this afternoon, that you were working on an assumption that that extension was going to be good for 28 days. President Geithner said, as I recall his language, it was up to 28 days, which is kind of a different reaction here.

Take me through that a little bit. I presume someone, at some point, raised the question that this was going to be more than 2 days?

Mr. SCHWARTZ. I want to start by saying that everything happened in a very, very short period of time on Monday morning, when we put this together. So we first got a draft of what we were going to be putting out that referenced an agreement between JPMorgan and the New York Fed, and then referenced JPMorgan's facility to us. And I believe the language said that there would be an interim period of up to 28 days.

When we, our advisors, and others read that, I think we interpreted it—just the language—that the initial period would be 28 days, unless we could stabilize the situation in a shorter period of time.

As it turns out, and maybe exacerbated by the situation with the run that continued on Friday, and since this was not stabilizing the situation, we were informed that their view of the language was no, it could be up to 28 days but could be removed.

And so I think there was just an honest different reading of the same words.

Chairman DODD. Let me, if I can, I raised sort of at the end of the appearance by the panel of Federal regulators—again, and you both have forgotten more in the next 10 minutes than I will ever probably understand about all of this. But this question of what happens—when I looked at the volume, and this was just getting up on Yahoo, in fact, I looked at the volume of trades with Bear Stearns historically. I do not know if that was just that month or so, but the numbers are—I do not know if that has been true throughout the last year or so, but that 3 million, 2 million, 5 million, 6 million, 7 million. And then jumping to that Friday of 156 million, not to mention the $30 puts for 10 day, that truncated period that went on here.

Share with the Committee here your own thoughts and observations. It sounds like more than just rumors to me that were contributing to this.

Mr. SCHWARTZ. Well, point No. 1, I do not have any specific facts and I hope some facts will emerge over time. Given what I have been through in the last few weeks, I do not want to encourage too much rumor speculation. I would like the people to find the facts.

But I would say that the nature and the pattern of the rumors—I mean, one of the things we were trying to do was get facts out that discounted the rumors that were out there. And the minute we got a fact out, more rumors started or a different set of rumors. So you could never get facts out as fast as the rumors.

I would just say that as an observer of the markets, that looked like more than just fear. It looked like there were people that wanted to induce a panic. There are lots and lots of reasons why people could have a financial motivation to induce a panic. There is a lot of the trading that would point to that.

I can only hope—there are laws against manipulating the market. There used to be laws in this country against spreading rumors about banks because they could cause a run on the bank. There are no such laws on investment banks, but there are laws against manipulating the markets.

If facts can come to light, I think that would be very appropriate to go after.

Chairman DODD. Mr. Dimon, welcome, and thank you for being here, as well. Appreciate it very, very much.

In your testimony, you said that the—and I quote here—"The New York Fed encouraged us to consider what kind of assistance would allow us to do a transaction."

Mr. Steel, the Secretary, in his testimony said that JPMorgan first approached the New York Fed asking for Government assistance.

Can you help us out as to which of these versions is——

Mr. DIMON. Mr. Chairman, I think lots of things took place in a very brief period. When we had the conversation that we would be unable to do the loan, we had a quick conversation what would it take if you got help to do it?

So I do not actually remember who suggested it or not suggested it, but it was the only way that we could have done it.

Chairman DODD. Let me just ask you the question here, if I can. Did you or any of the senior management at JPMorgan Chase ever have a conversation with anyone in the Federal Government about the price that you were going to offer for Bear? And if so, who did you talk to and what did they say?

Mr. DIMON. With President Geithner, the answer is he knew the price but he always said that it was a decision of JPMorgan Chase. And at one point with Secretary of Treasury Paulson, he also knew the price. We had spoken several times. He also made it very clear that that was the decision of JPMorgan Chase but did express the point of view, which was held by a lot of people including on the JPMorgan Chase side that the higher the price, the more the so-called moral hazard. So that was simply taken into consideration among all the other factors in what the price would be.

Chairman DODD. So the stories that have gone around and been circulating about your willingness to pay $4 a share, and that that was rejected flatly in a very direct way by the Treasury are not true?

Mr. DIMON. Right. And I think another fact that can answer that, Mr. Chairman, is that soon thereafter we were willing to pay more. And we felt completely free to make such a suggestion.

Chairman DODD. I understand that came, but I am looking at that 96 hour period, in that window.

Mr. Schwartz, let me ask you, were you ever offered $4 a share?

Mr. SCHWARTZ. No. We were, at differing times during the negotiation, different prices were discussed as potential prices. But the only actual offer we ever received was $2 a share.

Chairman DODD. Senator Shelby.

Senator SHELBY. Mr. Dimon, you are the CEO of one of our largest banks. Do you believe that most of our bigger banks are well capitalized and have enough liquidity today? Or do you not know?

Speak of your own bank first. I know you know where you are.

Mr. DIMON. We have always believed in being extremely well capitalized, conservative accounting, filling loss reserves, and being prepared for what we call bad weather, which happens when you do not really expect it.

I really cannot speak about all the other financial institutions in the country.

Senator SHELBY. Do you believe, do you have any inkling that the Fed might have to go to intervene again—we keep bringing this up—if another house failed?

Mr. DIMON. Senator, I do not know the answer to that but I think they have done an awful lot of powerful financing that hopefully will either eliminate or greatly reduce the chance of having that happen again.

Senator SHELBY. Mr. Schwartz, do you believe that your management team at Bear Stearns has any responsibility for the company's collapse?

Mr. SCHWARTZ. Well, Senator, I do not think a management team can ever say it bears no responsibility for anything that happens.

Senator SHELBY. Sure, because the buck stops with you, basically.

Mr. SCHWARTZ. Yes, the buck stops here and we, and our shareholders, pay the price.

Senator SHELBY. Sure.

Mr. SCHWARTZ. I can just tell you that—I can guarantee you it is a subject I have thought about a lot. Looking backwards, and with hindsight, saying if I had known exactly the forces that were coming, what actions could we have taken beforehand to have avoided the situation. And I just simply have not been able to come up with anything, even with the benefit of hindsight, that would have made a difference to the situation that we faced.

Senator SHELBY. Did you believe at Bear Stearns, when the week began, that you had adequate capital and liquidity to carry on business? By Thursday you had problems. On Monday, how were you on Monday?

Mr. SCHWARTZ. Well, I certainly believed on Monday that we had adequate capital and liquidity. They were in our normal ranges. And by most measures, I believe our capital was measured as being above standard.

I always had a concern. I never dreamed it would be as rapid as things happened here, but I always had a concern that the lack of a known liquidity facility for your collateral is something that can cause a problem with the lenders against that collateral. All of us, as investment banks, lend against high-quality collateral and we turn around and use that collateral. We never believed we could rely on unsecured financing. We always felt like we needed a collateral pool.

And I did worry that there was an environment that could happen that if we did not have—if the market could not see that we had some place to go and borrow against that collateral, then the fears could start. I just never, frankly, understood or dreamed that it could happen as rapidly as it did.

Senator SHELBY. Do you believe that a lot of the value of the collateral just collapsed?

Mr. SCHWARTZ. No, I do not think——

Senator SHELBY. Caused by rumors and other things?

Mr. SCHWARTZ. I do not think the value of the collateral collapsed. The willingness of people to lend against it——

Senator SHELBY. Dissipated.

Mr. SCHWARTZ [continuing]. On our behalf just dissipated because of fear.

Senator SHELBY. Mr. Dimon, for some time, JPMorgan Chase has acted as the clearinghouse for Bear Stearns. I believe that JPMorgan Chase also has extensive OTC derivative contracts with Bear Stearns. What was the extent, sir, of JPMorgan Chase's interconnectedness with Bear Stearns prior to Bear's announcement of their intention to file for bankruptcy? And what would have been the impact on your company's balance sheet if Bear Stearns had been liquidated? Were these considerations that went through your mind? Because you were connected. You were the banker, basically, the commercial banker for the investments.

Mr. DIMON. Senator, yes. We were one of their bankers and one of their main clearinghouses. So we had obviously extensive relationships and exposures.

But the answer to the question, our direct exposure on that day was approximately zero. And where we did have exposure, it was fully and totally collateralized.

Our real exposure would have been if Bear Stearns went bankrupt, the impact it would have had on the financial system. We probably would have lost money, but we still would have been in fine shape.

So it really was not one of the reasons we went ahead and did this transaction.

Senator SHELBY. Mr. Dimon, in your testimony, you also point out that the assets securing the Fed's loan, and I will quote your words, "consist entirely of loans that are current and domestic securities rated investment grade" and that JPMorgan Chase is retaining "the riskier and more complex securities in the Bear Stearns' portfolio."

Since your company, and you gave us an amount earlier of $300-something billion——

Mr. DIMON. $300 billion was the amount of assets we are buying from Bear Stearns; right.

Senator SHELBY. OK. Since your company will be purchasing, according to your testimony, the riskiest assets of Bear, why did you opt not to purchase Bear without Federal assistance? If the Fed is truly getting good assets—and we hope and pray they are and they work out—why does JPMorgan Chase not want to purchase those assets, or why did you not? Want some assistance?

Mr. DIMON. Senator, one of the concerns we had was how much exposure can we take on top of our other exposures. So we already had plenty of mortgage exposures and risky security exposures and we could do nothing that would leave JPMorgan in the precarious position—like you have seen happen to lots of other institutions.

Senator SHELBY. You could not jeopardize your bank——

Mr. DIMON. You have to look at how many straws can you put on the camel's back. And we are fairly conservative and we went as absolutely far as we could go, both in terms of taking risky assets, taking more mortgage assets, and having to borrow another $30 billion.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman DODD. Senator Reed.

Senator REED. Thanks very much, Mr. Chairman. Thank you, gentlemen.

I just want to clarify, Mr. Dimon, the guarantee that you have, that you mentioned in your testimony. The loan is for $30 billion which was extended by the Fed. You are guaranteeing the first $1 billion of that?

Mr. DIMON. Yes, so the $30 billion special facility, Senator, we are going to take the first $1 billion of loss. The Fed has also lent $25 billion to Bear Stearns under the primary facility, another $25 billion, which exists today. And we have also guaranteed that.

Senator REED. So you are guaranteeing the $25 billion total facility, the first facility, and $1 billion of the second facility?

Mr. DIMON. That is correct.

Senator REED. Thank you very much.

Mr. Schwartz, you have said, and I think Chairman Cox also said, that your capital ratios were adequate as far as the supervisors were concerned. Many things seemed to be in order just several days before this transaction was entered into. But others have raised the issue of your leverage, the fact that you might have been more highly leveraged than other competitive institutions. Can you comment on that leverage issue?

Mr. SCHWARTZ. Yes, I can.

I think that when people examined our balance sheet, a lot of people examined it very carefully and got very comfortable with it. There is one measure of leverage, which is total assets to equity, which I do not think that any sophisticated analysis of a balance sheet says that one measure is a sign of leverage. It depends on what kinds of assets with what kinds of risk.

The way capital cushions are monitored is you look at all of the liabilities that you have or all of the assets that you have, and you take a haircut based on the risk of those assets. And those are basically across the board, across the industry, the same.

And so when you looked at our capital versus the perception of risk by those measures compared to other people, our capital looked very adequate for the risk that we had on our balance sheet.

Senator REED. The other issue that is raised is that a lot of your funding was very short-term funding and that you left yourself exposed to a sudden seize up of the market, as happened. Could you comment on that?

Mr. SCHWARTZ. I could, and it is a good question because I think some of the testimony you have heard today said that this credit problem has been intensifying for many, many, many months. Coming into it, we had made a decision to reduce our reliance on unsecured financing at all and get all of our high-quality collateral out, and as much as we could get it out on longer term lines. We also borrowed in the long-term markets when we could.

As this credit environment has frozen, it became very, very hard to continue to borrow in the long-term market and the facilities that one had against secured collateral that were term, as they termed out people did not want to lend for a longer period of time and they started shortening.

Having said that, we worked as hard as we could against that and we actually had a bigger liquidity cushion than we have had in a long, long time from the actions that we took.

Senator REED. Let me ask you another question. You had two funds that failed, basically, and mortgage securities were principal items in the funds. And it caused concern not only here but in Wall Street. And your response to the failure of those funds, did that dramatically alter your behavior? Or can you comment about how you reacted to those fund failures?

Mr. SCHWARTZ. I am not sure I understand the question.

Senator REED. Well, some would suggest that that was a strong wakeup call about the overall condition. Also, it alerted to many people in the market the potential for further disruption at your firm and raised, I think, in my mind the obvious question of how do you not only compensate but perhaps even overcompensate for that, not only the economic effect but the psychological effect? I mean, you are a major firm, one of the premier firms. You have had two funds that you have backed your reputation with, and they have totally failed.

Mr. SCHWARTZ. Correct. Well, there is no question that those funds that had our reputation, they were not our economic exposure. But they were our reputation and we took a significant reputational hit because of that. We were extremely aware of that.

We did an awful lot of things. And the thing that we could do the most was just put our heads down and perform as we went forward because we could not set the clock back.

We also, we did step in. We had no obligation to make a loan to those funds, but we decided to make a loan to one of those funds in an attempt to try and save investors money, if we could liquidate the collateral in an orderly basis. The markets continued to go down, we were not able to accomplish that, and then we did take some losses on that loan.

But we ended up with a loss for the quarter. I think if somebody puts in context the losses that we took relative to many, many financial institutions, they actually were not particularly large.

And once again, if you took a look at our balance sheet, as many people did, we had recovered. Our capital ratios were strong. Our liquidity was strong. We were back to earning money. And our business was actually moving along at a nice pace.

Senator REED. I have one more question.

After your experience with these funds, and I think also with the growing economic situation that all of your competitors were facing, there was a need to raise additional capital even though you might technically be well capitalized. I think you had attempted to enter into a transaction with China's CITIC Securities in October and that transaction did not close. Was there any particular significance to the failure to close that transaction or to raise capital by other ways?

Mr. SCHWARTZ. No, there are two parts to that question, if I could. First, in terms of raising capital, it is my understanding that if you looked at the capital raising that went on at other financial institutions, it was often—it was always accompanied by a very significant loss that was reported, and that that loss had brought their capital down. And it is my understanding that the capital they raised brought their capital ratios back up to acceptable levels. So that is a different situation than anticipatory.

The transaction with CITIC Securities, the largest securities firm in China, was a transaction that we thought had tremendous strategic value to the firm. And as part of the transaction, we were raising $1 billion in capital. They did extensive due diligence on us. They agreed to go forward with the transaction. We needed to get approvals from the various regulatory authorities in the United States. We had just gotten those approvals. They were about to go and get the same approvals from the CSRC when all of the events of the week we described happened.

Senator REED. Thank you very much, Mr. Chairman. Thank you, gentlemen.

Chairman DODD. Thank you, Senator, very much.

Senator Corker.

Senator CORKER. Mr. Chairman, thank you, and thank both of you for being here today. I know that this is kind of a bittersweet situation with stockholders of one company feeling good and the others not. But I thank you both for being here. I know you have had both distinguished careers.

From the standpoint of JPMorgan, I know there has been comments. Our Chairman mentioned the large amount of options, trading that took place, toward the end of the week on the downside. I know that Mr. Schwartz has talked about things stronger than rumors, if you will, driving that. You obviously had this relationship and were obviously paying attention to what was happening. I wonder if you have any editorial comments regarding what was actually happening, whether it was actually driven by people who had nefarious kind of thoughts and actions, or whether it was just in fact rumors from your standpoint?

Mr. DIMON. Senator, I do not know what the real facts are here, but I think there is enough smoke around the issue that it is a proper thing for the regulators to look at what actually happened. And I personally think that if people knowingly created or passed on false rumors, they should be punished under the law.

Senator CORKER. The negotiation that took place at the end of the day, I mean, it was either not be in business or sell. So it really was not much of a negotiation. It sounds to me—which I understand under the circumstances. It seems to me that actually the pricing of the stock was based more upon making sure there was not, in essence, some kind of moral hazard.

I wonder if you could speak to that just for a moment?

Mr. DIMON. I think, Senator, the price of the stock was not really based on the value of the company. It was really based upon protecting the downside of JPMorgan. I told you buying a house is not the same as buying a house on fire. While some people look at the upside, and we hope there is upside for our shareholders, we were far more focused on the downside. Other people were there and could not do it at all, probably at any price.

And then obviously during the next week we did recognize there was more value there. And I think it ended up for a fair play for the Bear Stearns' shareholder, too.

Senator CORKER. From your side, Mr. Schwartz, in essence it was just whatever the price was, it was; right? I mean, at that point, there was no negotiation. It was, in essence, what was JP willing to do. It does not seem like there was much leverage, from your standpoint?

Mr. SCHWARTZ. Well, I think all the leverage went out the window when a deal had to happen over the weekend. I think that we had another party who had started doing due diligence on Friday, a sophisticated party who after doing due diligence was prepared to write a multi-billion dollar check to invest into equity at Bear Stearns. But he was going to require some significant financial institutions that he had relationships with to provide a funding facility.

That is one example of a type of party that we could have talked to. I think there could have been other large financial institutions that would have liked to, including JPMorgan might have wanted to pay a higher price if they had a chance to do the kind of due diligence that normally goes with a large acquisition.

But I think to go to a board of directors on a weekend and say that we are stepping into the shoes in this credit environment of another financial institution, and say we are going to do that on a basis where we have to commit firmly to the transaction, we understood in those circumstances there were very, very few entities, and we thought maybe if any.

So we understood that JPMorgan was stepping up to doing that, and the price, we had no leverage at all.

Senator CORKER. Mr. Dimon, you obviously are highly heralded and should be, and I am sincerely happy for you and the stockholders of your company.

What is it that you and your colleagues now, in this environment, are doing, if you will? I mean, people are looking at liquidity issue of having short-term debt against longer term obligations.

What is it that, just as a group your colleagues are doing to make sure that you stay strong and that these types of issues do not occur with other institutions?

Mr. DIMON. Senator, I appreciate the nice comment about JPMorgan. I should point out, we have made plenty of mistakes ourselves. So we do not stand in front of you as if we made none.

Senator CORKER. Sure.

Mr. DIMON. And we are always looking at capital measures, risk measures, accounting, loss reserves. How bad can it get? How bad can the storm be? Stress testing, and there are multiple other measures we look at, including just plain old common sense. What happens if you are wrong? Because very often you are wrong.

So we try to maintain as firm a balance sheet and finance the company way ahead of time so that we do not ever get in a position where we can find ourselves in financing difficulty.

Senator CORKER. But are you and your colleagues even changing the way you are doing business right now based on the circumstances of the last 30 days? Are more proactive steps being taken by other colleagues?

Mr. DIMON. I believe the answer is yes a little bit but not in a material way. But we, like everybody else, when events like the past few weeks happen, hopefully we learn from them. So we analyze them to death and then we go through all the facts and we look at what we can do better. And we are in the process of doing that today.

But we feel we are completely properly capitalized and funded.

Senator CORKER. And just the last question. I know when people began accessing the Fed window they realized that right behind that regulatory issues were going to come. I wonder if you might give some editorial comments about some notions in that regard knowing that that has to be coming with access to Fed funds?

Mr. DIMON. Right, so Senator, many people commented this morning about the need for change in the regulatory system and that some of the things we all live under were—those laws were passed, and they are closer to the Civil War than they are today. We all acknowledge we need streamlining, modernization. And I think opening up the primary window to investment banks does have policy ramifications. And I hope the regulators and the Congress spends a good amount of time to come up with good policies and rules that prevent at least this kind of accident from happening again.

Senator CORKER. Thank you, Mr. Chairman.

Mr. DIMON. Thank you very much, Senator.

Senator Carper.

Senator CARPER. Thanks, Mr. Chairman.

Gentlemen, thank you for being here. Thank you for your extraordinary patience and for standing up during a really difficult period of time, for not just your shareholders and your institutions but I think for our country.

I was Treasurer of Delaware a number of years ago when the folks at Chrysler just about went belly up. There was a bailout faction here, an assistance plan faction here in Congress to help save Chrysler. We participated in our State, along with a number of other states that had Chrysler facilities.

There was a bit of a hue and cry about taxpayer bailout at the time. And it turned out the U.S. Treasury made money off the deal. And we in Delaware did, too. And Chrysler has had some ups and downs since. We are hopeful that they are going to survive, but knock on wood they will be around for a lot longer.

But there have been concerns raised in this instance that potentially some taxpayer exposure, Treasury exposure. I do not know that the taxpayers are going to walk away, as we did with Chrysler, actually being better off and being able to show a profit for our intervention. But in terms of whether or not it was worth it for the taxpayers, was it for our country, what comments would you have there for us?

Mr. DIMON. Well, Senator Carper——

Senator CARPER. What would be the upside for——

Mr. DIMON [continuing]. I think the first comment is this would have been far more, in my opinion, expensive for taxpayers had Bear Stearns gone bankrupt and it added to the financial crisis we have today. It would not even have been close.

I think the Fed has protected itself with the expected loss note and the collateral, the long-term funding, the professional management, and we will hopefully get back all this money and possibly more.

And we did have a conversation at one point with the Fed that we could have done it differently, share upside and downside. But I was not aware of all of the regulatory statutory issues they have in doing something like that. I think they have certain constraints they live under by law.

Plus, we did not have a lot of time. We had literally 48 hours to do what normally takes a month.

Senator CARPER. Mr. Schwartz, Senator Corker over there asked you a question I was planning to ask myself. The question is if you go back in time, I do not think the Congress had to pass a law to say to the Federal Reserve, you can open a discount window to investment banks. I believe they did that, they took that step under a law that may have been passed in the Great Depression if I am not mistaken. I do not know that it was ever exercised until now. It may have been exercised prior to now but it has not been exercised often.

The question that Senator Corker has asked is what are the ramifications in terms of regulation, presumably regulation from the Fed. I just want to go back to that and say if this is the kind of thing that is going to happen with more frequency, again what are the ramifications for regulations from the Fed for—JPMorgan Chase already has to deal with that. But Bear Stearns and other investment banks do not.

Mr. SCHWARTZ. Right. So I do think that look, it is a well-established precedent under regulation that financial institutions that rely on confidence, that knowing that there is liquidity for their assets actually inspires that confidence. And so it is much harder to start rumors that they have no place to go with their collateral if there is an identifiable place at the Government where they could take that collateral.

So the rumors and the fear become deflated by the fact that people know that they have a liquidity source. And therefore, you have to find some other thing.

So I believe that going forward, I think everybody had to move here in a very, very, very rapid basis. I think when people sit down, all of the people in Government, and look at this I think they are going to say we need a new system. And I think that one of the elements of that system I am convinced of will be that the major investment banks—I was very glad to see Sunday night that the window was open to those investment banks. I was very, very glad to see that.

I think that some sort of facility will be made available to keep a run on the bank from starting or happening. I think that it is very appropriate to ask if that is going to be part of a new regime of some kind then what are the other oversights and regulatory reviews that have to occur to make sure it is done on a sound basis? And I think that process will begin and I hope it moves in a positive direction.

Senator CARPER. Thank you.

The last question I have deals really with us and our action. We have been sort of observers, to some extent, watching the Federal Reserve be involved in a variety of ways, extraordinary ways, in the last couple of months, and to watch Treasury being involved in setting up Project Hope now, and a number of other things to try to help the situation.

It is our turn now. And it is our turn now, and the leadership Senators Dodd and Shelby bring to the floor today—literally today—for debate and vote legislation that is designed to deal with the situation, again restore some additional liquidity, deal with the homes that are foreclosed on.

What advice would you have for us as to one or two elements that, if we do nothing else in the context of legislative action this week or next week, what would be some of the things on the must do list?

Mr. DIMON. Senator, I think I can do the pretty long to do list. And most people that you speak to, it is kind of non-partisan. We want to get it done. We know we need to make changes. There will be a lot of debate about those changes.

I would say we should do it in due haste. You should get all the help you can get. And obviously JPMorgan, in any way, shape or form they can help would be happy to do so.

And then have a regulatory system which adjusts very quickly after that because I do think that the regulatory authorities need to move very quickly in this new world. And they do not have the luxury to do some of the things you might have wanted them to do.

For example, the Fed might have acted very differently that weekend had they other statutory authorities.

Senator CARPER. Mr. Schwartz, any advice for us as we turn to our legislative responsibilities?

Mr. SCHWARTZ. Not a lot. I do think that raising the limits on the conforming mortgages could be helpful to supply some liquidity to housing. I think expanding the authority of FHA to step back into a market that it was created for would make sense.

I think those are short-term and I think helping homeowners stay in their homes is not only the right thing to do but it is good economic policy.

I think longer term we have to look at the whole way that mortgages get underwritten because there has to be some liability for the people who underwrite the mortgages to make sure that they are applying standards appropriately.

Senator CARPER. Thank you very much. Thank you.

Chairman DODD. Thank you, Senator.

We have been joined by Senator Menendez, who I believe has some questions, as well.

Senator MENENDEZ. Thank you, Mr. Chairman. Thank you, gentlemen.

Let me ask you, Mr. Dimon, with reference to the securities that are backing this transaction that the Fed has done, my understanding is they are largely mortgage-backed securities and related hedge investments. Is that a fair statement?

Mr. DIMON. Yes, Senator.

Senator MENENDEZ. Do you know what the valuation of those assets are?

Mr. DIMON. The valuation at which the Fed has taken them into the books is at the same valuation that Bear Stearns had them marked on March 14th. It is the same valuation that JPMorgan has taken the other $300 billion at as of March 14th.

Senator MENENDEZ. And what is that?

Mr. DIMON. Whatever is on their books for.

Senator MENENDEZ. But in reality, that is not the valuation of them, are they? Is that the real value of it in the marketplace at this moment?

Mr. DIMON. Well, Senator, I think you could have a big debate on what the value is. But I think that Bear Stearns—I believe BlackRock also has looked at it—believes those values are approximately appropriate.

Senator MENENDEZ. Why do you think that there was this first panel testified—I assume you agree with them—that there was a crisis of confidence and a set of rumors. Why do you think an institution of yours, with such reputation, such standing, could simply fall on a series of rumors if it is not a question of valuation at the end of the day?

Mr. SCHWARTZ. I think that, as I said in the earlier testimony or opening statement rather, I think that it is well established in financial history that institutions that lend money against assets, if people are concerned that there is a liquidity crisis or if there are rumors that their money is not going to be there after everybody else withdraws their money, there is a rush to the exit.

In my mind that is what happened this week.

Senator MENENDEZ. Well, let me ask you, do you really know what the value is of the securities that you have?

Mr. SCHWARTZ. I think that when you ask do we know the value of the securities, I think that when you get into—I think Chairman Bernanke testified that if you look at securities that become highly, highly illiquid, if you have to sell them overnight then you will have a much, much lower value than if you look at what is a required return and how you value that return over a reasonable period of time.

So do I think there are some assets on our balance sheet that may turn out to be worth less than what we are carrying them for? Yes. We have some significant hedges against a number of those assets that tend to move in the other direction where we are short.

I also think there are a number of assets on our balance sheet that could be worth a lot more than what they are carried at. One example of that was highlighted in the transaction with JPMorgan where they asked for an agreement to be able to buy our headquarters building for $1 billion. It is not carried on our books at anywhere near that.

Senator MENENDEZ. Well, the problem is that Chairman Bernanke also testified in response to my questions that he cannot tell us what the liability of the American taxpayer is here. So if your valuations are equal to or greater, then we have no problem. If your valuations are less than, we have a problem even over the long term.

And I think that I have seen some statements in some reports that, going back in time, say that when we had analysts doing this home mortgage crisis situation, there were analysts—and I do not know, Mr. Dimon, if your institution was one of them—who said we cannot really tell you the totality of the challenge that we might have.

So I do not particularly think that you all know what the value of the instruments that you have really is. And that is part of our challenge here.

Mr. Dimon, is it wrong to have said that you would not have, on behalf of your institution, entered into this agreement without the Fed's position?

Mr. DIMON. Senator, that is correct.

Senator MENENDEZ. And as such, the reason you took that position is why?

Mr. DIMON. Because, remember JPMorgan was buying another $300 billion of assets, some of which were far riskier than the $30 billion. And we analyzed this from our downside that we can only put on so much debt, so much risky asset, so much risky assets we already had. And we could not leave JPMorgan, for any reason, under any circumstances, in a predicament where we could jeopardize our financial health. And that is a judgment call we made, how many straws can you put on that camel's back? And that is all we could do. And we would have and could have done no more.

Senator MENENDEZ. And so you looked at the transaction and you looked at the assets that would be acquired and you said there are more straws there that might break the camel's back than we can afford?

Mr. DIMON. I think the way we analyze it is what is the chance that things can go wrong or get worse? We do not live in a static world. So while we know that things can get better, the question I had to answer for my board is what if things get worse? Are we in good enough position? And it was plain simple, and we needed the capital and the funding ability so that JPMorgan remained a strong healthy institution after the transaction.

Senator MENENDEZ. And hopefully the Federal Exchange, on behalf of the American taxpayer, asked the same question.

Thank you, Mr. Chairman.

Chairman DODD. It is a great question and I tried to frame it, Bob, after you had left. I do not want to over-simplify it, but the concerns I think on this aspect—and again, all the time constraints and everything else, we are very conscious of—but what I called the socialization of risk and the privatization of reward and that we are all hoping that the case will be that this will turn out well. There is that question mark there, that we have.

If that is a precedent-setting decision, it has incredible implications. And so I think it is important to identify it for what it is and recognize that we all hope this one works out.

But as others have suggested, in the absence of several changes, we could be looking at other situations that come down the pike here, maybe at far greater risk than the ones we are talking about here. And to the extent we want to socialize risk, in a sense, the socialization of it, is going to raise some very serious questions here as well.

But it is an excellent set of questions and I appreciate that.

Senator MENENDEZ. Mr. Chairman, I would just make a note, if we went to socialize risk, then we should look at socializing the risk of mortgage foreclosures in this country.

Chairman DODD. That is a wonderful lead-in to my next question. In the sense that, to digress for a minute, because I do not want to miss the opportunity of having two very talented people here.

And let me say, Mr. Schwartz, as well, when you and I had that conversation—however many months ago—about the discount window, I want to just say in this hearing room I regret that others did not listen to you at the time. I think it might have made a big difference.

You had to have commensurate quality assets and collateral and regulatory framework for all of it. But I think unfortunately at the time there was a failure to understand the gravity of the problem. We kept on hearing the language, the problem is contained, that things are rosy, that things are getting better.

It could not have been more wrong in their analysis of the situation. And had there been people listening and willing to utilize some of these vehicles earlier on at a time when I think we might have had a better response, we might be avoiding the kind of hearing we are having today.

I want to ask you about this issue that—utilizing your talents here and background. Obviously, the points you have made in the absence of this decision, this merger. And I agree with this, I think most of us do here, that we would be looking at a very different situation having come Monday morning. And that is in no way to minimize the impact on employees and shareholders and the like. But I think you have framed it both well in terms of what was involved here.

There are those, and Senator Menendez just raised the issue here. And I have been trying to come up with some ideas, again not new ideas. In fact, in the previous years the idea of trying to figure out a way to keep people in their homes, but also find that bottom here that will unleash capital and begin to move us out of this problem.

I have raised this issue before, and Senator Shelby has been gracious enough to say let us hold some hearings to take a good hard look at it. There is a lot of potential exposure but there is some tremendous benefit as well.

I do not know if you have had a chance to take a look at this idea—and I am not asking you to endorse a specific idea, but just to comment generally on this question of whether or not we can do something.

In the past, actually the Federal Government bought these mortgages at highly discounted value and kept people in their homes for a period of time, and actually made money, I think some $14 million decades ago.

What I am talking about here is ensuring through FHA, obviously getting a write down of the overall value of it, but keeping people in, a voluntary program over an extended period of time. And then have enough transactions occur so that you can help identify that floor.

And if that is the case, then I am told by those who believe this could work, you then begin to see capital begin to move. Could you comment on that idea generally, as to the value of it, or what you——

Mr. SCHWARTZ. Well, I think there are a lot of pieces to the puzzle. I do think that in our own mortgage servicing over the years, we think that it is economically appropriate—getting away from the social side of it for a second—that there are times when it is better to modify a loan, even cut the principal that somebody owes so they have an incentive to continue making their payments and those payments become easier to make.

Because large numbers of people being taken out of their homes, as difficult as it is for those homeowners, also creates additional supply on the market which keeps affecting supply and demand for housing.

So it is a very complicated set of facts and I think that an intersection of seeing where the appropriate modifications to give people a real chance to stay in their homes would help on the supply and demand side to stabilize the housing market which is, underneath all of this, a point I think you are making, Mr. Senator, is until we can stabilize the housing market, it is really hard to say what is going to happen to a lot of securities that relate to the value of homes in the United States.

Chairman DODD. Jamie?

Mr. DIMON. Yes, sir. Senator, I agree—first of all, I think the legislation has moved rather quickly on Fannie Mae and Freddie Mac and changing things to make it more easy to get capital the borrower, the person who actually wants to buy the home.

I think when you are in a crisis like this, you should not stand on ceremony. You should fight the crisis. And those things will all have ramifications for future policy.

I think using FHA to have people take haircuts on their mortgages—which would be the banks. I want to make sure that people understand, we are not looking for any sympathy in this. We are obviously—I think JPMorgan Chase had among the best underwriting standards but we also made mistakes and would like to be very helpful.

I think a program and a policy like that could actually work quite well and we would love to get engaged and to see if we can help come up with something that makes sense for the homeowner and for the American public.

Chairman DODD. Thanks very, very much. I appreciate that.

Senator Shelby, any closing comments?

Senator SHELBY. No, thank you.

Chairman DODD. I thank both of you. You have been very gracious and spent a lot of time here today. The first panel took a little longer than anticipated with the interest, obviously, by my colleagues here as well. But it has been very, very helpful.

And I would like to leave the record open for a few days for members to submit some questions possibly to you that they did not get a chance to raise this afternoon.

But we wish you well and this has been helpful to help clarify a lot of questions people have had out here.

I thank you both.

The Committee will stand adjourned.

[Whereupon, at 2:59 p.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

Statement of Senator Tim Johnson
Senate Committee on Banking, Housing and Urban Affairs
"Turmoil in US Credit Markets: Examining the recent actions of Federal Financial Regulators"
April 3, 2008

Thank you, Chairman Dodd, for holding this hearing today. There is no doubt in my mind that all of us sitting on this side of the dais have many questions regarding the recent actions by the Federal Reserve since our last Banking Committee meeting; questions not only for the Federal Reserve, but for all of the stakeholders involved in the actions that resulted in JPMorgan Chase's purchase of one of the largest investment banks—Bear Stearns.

I had the opportunity to discuss the Bear Stearns purchase and subsequent actions taken by the Federal Reserve with Chairman Bernanke in the days following Sunday March 16. I am pleased that all the panelists before us today have taken time out of their schedules to talk with members of the Committee about these recent actions and the implications on the markets, the regulators and taxpayers.

There appears to be little consensus on the effects of the recent Federal Reserve action. There has been criticism waged from a large spectrum of people. I have received letters from my constituents with concerns that this is a federal bailout of a big bank that creates a moral hazard. Others have wondered if it is appropriate to offer help to Wall Street firms, while insisting on market discipline for troubled homeowners. There has also been applause for the decision from some quarters. The US markets responded favorably; other investment banks believed to be in trouble saw their stock value rise; foreign governments applauded this as a positive move for global markets, and other analysts suggested that the Federal Reserve actions averted what could very well have been a modern-day run on the bank. The reality of the situation is probably somewhere near the middle.

While I will save my questions for later, there are a couple issues I want to raise. Credit markets continue to be volatile in part because banks and other financial institutions do not know what their subprime mortgages and related securities are worth. Yet, in the transaction for JP Morgan Chase to purchase Bear Stearns, the Federal Reserve extended a $29 billion line of credit for subprime mortgage and related securities based on an arbitrary value of those securities. What assurances are there that the numbers add up?

Additionally, banking and Wall Street firms have reported over $200 billion of losses from CDOs and residential mortgage-backed securities related to subprime mortgages, as well as from loan commitments and obligations related to leveraged corporate buyouts. The 10 largest firms account for about two-thirds of those losses. Many banks and investment firms have been experiencing difficulties, yet Bear Stearns is the firm that was "rescued" by the Federal Reserve. Why Bear Stearns? And if Bear Stearns had not been helped, what would the failure of Bear Stearns or any of the largest securities firms have done to the economy? What about their situation at the moment warranted the help? Will other firms, should they find themselves in the same position as Bear Stearns, receive the same help?

Confidence, liquidity, and transparency are key to a stable market. The hearing today regarding the current turmoil in the U.S credit markets is an important discussion to be had as we attempt to restore confidence, liquidity, and transparency in the markets. I look forward to hearing from the panelists what the Federal Reserve, Treasury, SEC, other regulators can and should do. Most importantly, I look forward to the regulators and other panelists suggestions on what Congress can and should do to help restore confidence, liquidity and transparency.

For release on delivery
10:00 a.m. EDT
April 3, 2008

Statement of

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Banking, Housing, and Urban Affairs

United States Senate

April 3, 2008

Chairman Dodd, Senator Shelby, and other members of the Committee, I appreciate this opportunity to discuss current economic and financial conditions and the actions the Federal Reserve has taken to stabilize financial markets and the economy.

Although the situation has recently improved somewhat, financial markets remain under considerable stress. Pressures in short-term bank funding markets, which had abated somewhat beginning late last year, have increased once again. Many lenders have been reluctant to provide credit to counterparties, especially leveraged investors, and increased the amount of collateral they required to back short-term security financing agreements. To meet those demands, investors have reduced their leverage and liquidated holdings of securities, putting further downward pressure on security prices. Credit availability has also been restricted because some large financial institutions, including some commercial and investment banks and the government-sponsored enterprises (GSEs), have reported substantial losses and writedowns, reducing their capital available to support increased lending. Some key securitization markets, including those for nonconforming mortgages, continue to function poorly if at all.

These developments in financial markets--which themselves reflect, in part, greater concerns about housing and the economic outlook more generally--have weighed on real economic activity. Notably, in the housing market, sales of both new and existing homes have generally continued weak, partly as a result of the reduced availability of mortgage credit, and home prices have continued to fall. Private payroll employment fell substantially in February, after two months of smaller job losses, with job cuts in construction and closely related industries accounting for a significant share of the decline. But the demand for labor has also moderated recently in other industries. Overall, the near-term economic outlook has weakened relative to the projections released by the Federal Open Market Committee (FOMC) at the end of January.

Inflation has also been a source of concern. We expect inflation to moderate in coming quarters, but it will be necessary to continue to monitor inflation developments carefully.

Well-functioning financial markets are essential for the efficacy of monetary policy and, indeed, for economic growth and stability. Consistent with its role as the nation's central bank, the Federal Reserve has taken a number of steps in recent weeks to improve market liquidity and market functioning. These actions include reducing the cost and increasing the allowable term of discount window credit to commercial banks; increasing the size of our Term Auction Facility, through which credit is auctioned to depository institutions; initiating a Term Securities Lending Facility, which allows primary dealers to swap less-liquid mortgage backed securities for more-liquid Treasury securities; and creating the Primary Dealer Credit Facility, which is similar to the discount window but accessible to primary dealers. Although these facilities operate through depository institutions and primary dealers, they are designed to support the broader financial markets and the economy by facilitating the provision of liquidity by those institutions to their customers and counterparties. With respect to monetary policy, at its March meeting the FOMC reduced its target for the federal funds rate by 75 basis points to 2-1/4 percent.

It was in this context of intensifying financial strains that, on March 13, Bear Stearns advised the Federal Reserve and other government agencies that its liquidity position had significantly deteriorated and that it would have to file for bankruptcy the next day unless alternative sources of funds became available.

This news raised difficult questions of public policy. Normally, the market sorts out which companies survive and which fail, and that is as it should be. However, the issues raised here extended well beyond the fate of one company. Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties and perhaps of companies with similar businesses. Given the exceptional pressures on the global economy and financial system, the damage caused by a default by Bear Stearns could have been severe and extremely difficult to contain. Moreover, the adverse impact of a default would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability.

To prevent a disorderly failure of Bear Stearns and the unpredictable but likely severe consequences for market functioning and the broader economy, the Federal Reserve, in close consultation with the Treasury Department, agreed to provide funding to Bear Stearns through JPMorgan Chase. Over the following weekend, JPMorgan Chase agreed to purchase Bear Stearns and assumed Bear's financial obligations.

The purpose of our action, as with our other recent actions--including our provision of liquidity to financial firms and our reductions in the federal funds rate target--was, as best as possible, to improve the functioning of financial markets and to limit any adverse effects of financial turmoil on the broader economy. We will remain focused on those objectives.

Clearly, the U.S. economy is going through a very difficult period. But among the great strengths of our economy is its ability to adapt and to respond to diverse challenges. Much necessary economic and financial adjustment has already taken place, and monetary and fiscal policies are in train that should support a return to growth in the second half of this year and next year. I remain confident in our economy's long-term prospects.

Thank you. I would be pleased to take your questions.

Testimony Concerning

Recent Events in the Credit Markets

by Christopher Cox
Chairman
U.S. Securities & Exchange Commission

Before the Senate Committee on Banking, Housing, and Urban Affairs

April 3, 2008

Chairman Dodd, Senator Shelby and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about recent events in the financial markets and the implications of the merger agreement between JPMorgan Chase & Co. and The Bear Stearns Companies, Inc. The recent actions by the Federal Reserve, as Chairman Bernanke has described, are unprecedented and of unquestioned significance. They include not only the extension of guarantees and credit in connection with JPMorgan's acquisition of Bear Stearns, but also the opening of the discount window to every one of the major investment banks.

What happened to Bear Stearns during the week of March 10th was likewise unprecedented. For the first time, a major investment bank that was well-capitalized and apparently fully liquid experienced a crisis of confidence that denied it not only unsecured financing, but short-term secured financing, even when the collateral consisted of agency securities with a market value in excess of the funds to be borrowed. Counterparties would not provide securities lending services and clearing services. Prime brokerage clients moved their cash balances elsewhere. These decisions by counterparties, clients, and lenders to no longer transact with Bear Stearns in turn influenced other counterparties, clients, and lenders to also reduce their exposure to Bear Stearns. Over the weekend of March 15th and 16th, Bear Stearns faced a choice between filing for bankruptcy on Monday morning, or concluding an acquisition agreement with a larger partner.

In the cauldron of these events, the actions that the Federal Reserve took – in particular, extending access to the discount window not only to Bear Stearns, but also to the major investment banks – were addressed to preventing future occurrences of the run-on-the-bank phenomenon that Bear endured. It remains, however, for regulators and Congress to consider what other steps, if any, are necessary to harmonize this significant new safeguard with other aspects of the existing legislative scheme, and the regulatory structure that resulted from the enactment of the Gramm-Leach-Bliley Act.

The SEC, of course, does not have the function of extending credit or liquidity facilities to investment banks or to any regulated entity. Instead, through our consolidated supervised entities (CSE) program, the Commission exercises oversight of the financial and operational condition of Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan

Stanley at both the holding company and regulated entity levels. Our oversight of the CSEs includes monitoring for firm-wide financial and other risks that might threaten the regulated entities within the CSE, especially the U.S. regulated broker-dealer and their customers and other regulated entities, here and abroad. In particular, the SEC requires that firms maintain an overall Basel capital ratio at the consolidated holding company level of not less than the Federal Reserve's 10% "well-capitalized" standard for bank holding companies. CSEs provide monthly Basel capital computations to the SEC. The CSE rules also provide that an "early warning" notice must be filed with the SEC in the event that certain minimum thresholds, including the 10% capital ratio, are breached or are likely to be breached. At all times during the week of March 10 – 17, up to and including the time of its agreement to be acquired by JPMorgan Chase, Bear Stearns had a capital cushion well above what is required to meet the Basel standards. Specifically, even at the time of its sale, Bear Stearns's consolidated capital, and its broker-dealers' net capital, exceeded relevant supervisory standards.

Even prior to the experience with Bear Stearns, the SEC's supervision of investment bank holding companies has always recognized that capital is not synonymous with liquidity – and that more is required to determine a firm's financial health. A firm can be highly capitalized – that is, it can have far more assets than liabilities – while also having liquidity problems. While the ability of a securities firm to withstand market, credit, and other types of stress events is linked to the amount of its capital, the firm also needs sufficient liquid assets – cash, and high-quality instruments such as U.S. Treasury securities that can be used as collateral – to meet its financial obligations as they arise.

For this reason, the CSE program requires substantial liquidity pools to allow firms to continue to operate normally in such environments. Specifically, CSEs are required to maintain funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows in a stressed liquidity environment where access to unsecured funding is not available for a period of at least one year.

In these ways, the supervisory model has focused on the importance of both capital and liquidity. In particular, the liquidity measurement has been designed to withstand the complete loss, for an entire year, of all sources of unsecured funding. But what neither the CSE regulatory approach nor any existing regulatory model has taken into account is the possibility that secured funding, even that backed by high-quality collateral such as U.S. Treasury and agency securities, could become unavailable. The existing models for both commercial and investment banks are premised on the expectancy that secured funding, albeit perhaps on less favorable terms than normal, would be available in any market environment. For this reason, the inability of Bear Stearns to borrow against even high-quality collateral on March 13th and March 14th – an unprecedented occurrence – has prompted the Federal Reserve's action to open the discount window to investment banks. Beyond this obviously powerful step, the Bear Stearns experience has challenged the measurement of liquidity in every regulatory approach, not only here in the United States but around the world.

It was in this connection that I recently wrote to the Basel Committee offering my strong support for their proposed work to consider whether the capital adequacy standards applicable to internationally active sophisticated institutions should be extended to deal explicitly with liquidity risk.

The Federal Reserve's decision to provide funding to Bear Stearns through JPMorgan Chase was made because, as you have heard Chairman Bernanke testify, Bear's extensive participation in a range of critical markets meant that a chaotic unwinding of its positions could have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties, placed additional pressures on the financial system, and caused damage that would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability. These are considerations of systemic risk that extend far beyond the Commission's mandate to protect investors, ensure orderly securities markets, and promote capital formation through such means as the CSE program. But it is important to observe that the SEC's statutory and regulatory regime, including not only our broker-dealer net capital regime, but also the protection provided by the Securities Investor Protection Corporation and the requirement that SEC-regulated broker-dealers segregate customer funds and fully-paid securities from those of the firm – worked in this case to achieve the purpose for which it was designed. Despite the run on the bank to which Bear Stearns was subjected, its customers were fully protected. At no time during the week of March 10th – 17th, up to and including the date of the agreement with JP Morgan, were any of the customers of the Bear Stearns's broker-dealers at risk of losing their cash or their securities.

The question has been asked what might have happened if, notwithstanding the Federal Reserve's action, the transaction with JPMorgan had not been announced before Monday, March 17. Unfortunately, unlike a laboratory in which conditions can be held constant and variables changed while the experiment is repeated, in the social science of the market the selection of one course of action forever forecloses all other approaches that might have been taken. But there is one thing we know to a certainty: with or without JPMorgan Chase's acquisition of Bear, and with or without a bankruptcy, Bear Stearns's securities customers are and would have been fully protected from any loss of cash or securities.

Beyond demonstrating the importance of short-term liquidity in the form of available sources of secured funding, the Bear Stearns experience has highlighted the statutory supervisory gap in this area. Congress recognized the importance of having in place a framework for considering the resolution of difficulties experienced by commercial banks, but not investment banks, when in 1991 it enacted the Federal Deposit Insurance Improvement Act ("FDICIA"). FDICIA, together with the Federal Deposit Insurance Act, provides the FDIC with the authority to take preemptive action to resolve a troubled bank or other federally insured depository institution and prescribe methods for resolving those that fail. These statutes reflect Congress's conviction that it is best not to improvise the principles which will guide federal intervention in financial institutions. That is a principle that I believe is equally valid not only with respect to depositary institutions, but other systemically important financial institutions as well.

Now, as always, the SEC is working closely with the Department of the Treasury, the Federal Reserve, and the Federal Reserve Bank of New York among others to ensure that our regulatory actions contribute to orderly and liquid markets. In addition to the specific actions that the Commission staff took in connection with the Bear Stearns – JP Morgan transaction, the Commission's broader work to address the subprime turmoil has involved nearly every major

SEC division and office, and every area of emphasis. It includes, among other things, monitoring the financial condition of securities firms, guarding against market abuses, assessing the performance and revising the rules for credit rating agencies, and clarifying the application of accounting rules concerning the restructuring of mortgages. To coordinate the efforts of all of the Commission's Divisions and Offices, Erik Sirri, the Director of the Division of Trading and Markets, is leading an agency-wide Subprime Task Force composed of senior leadership from each of the relevant disciplines within the SEC, including the Division of Enforcement.

The SEC's mission – the protection of investors, the maintenance of orderly markets, and the promotion of capital formation – is more important now than it has ever been. The recent turmoil in credit markets has made this a particularly challenging time. We will continue to work not only within the SEC but in close cooperation with the Federal Reserve and our other regulatory counterparts to promote the continued health and vibrancy of our markets, the strengthening of investor confidence, and the economic growth to which our securities markets are so essential.

Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.

U.S. TREASURY DEPARTMENT OFFICE OF PUBLIC AFFAIRS

EMBARGOED UNTIL 10 a.m. (EDT), April 3, 2008
CONTACT Jennifer Zuccarelli, (202) 622-8657

UNDER SECRETARY FOR DOMESTIC FINANCE ROBERT K. STEEL TESTIMONY BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

WASHINGTON – Chairman Dodd, Ranking Member Shelby, Members of the Committee, good morning. I very much appreciate the opportunity to appear before you today to represent Secretary Paulson and the U.S. Treasury Department, and to join the independent regulators leading the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Federal Reserve Bank of New York. As you know Secretary Paulson is on a long-scheduled trip to China.

You have invited Treasury here today to discuss the ongoing challenges in our credit markets, and specifically the agreement between JPMorgan Chase & Co. and the Bear Stearns Companies Inc. The Treasury Department continues to closely monitor the global capital markets, and the past several months have presented to us many important issues and situations to evaluate and address.

As Secretary Paulson stated earlier this week, a strong financial system is vitally important – not only for Wall Street, not only for bankers, but for all Americans. When our markets work, people throughout our economy benefit – Americans seeking to buy a car or buy a home, families borrowing to pay for college, innovators borrowing on the strength of a good idea for a new product or technology, and businesses financing investments that create new jobs. And when our financial system is under stress, all Americans bear the consequences.

Mr. Chairman, as you appropriately noted in your letter to Secretary Paulson, "it is important to maintain liquidity, stability, and investor confidence in the markets." The recent events in the credit and mortgage markets are of considerable interest to this Committee, other Members of Congress, and most importantly, the citizens of this country.

For several months, our financial markets have gone through periods of turbulence, followed by periods of improvement. A great deal of de-leveraging is occurring, which has created liquidity challenges for financial institutions and thereby compromised our credit markets' ability to help be an engine of economic growth.

It took a long time to build up the excesses in our markets, and we are now working through the consequences. Market participants are adjusting, making disclosures, raising capital, and re-pricing assets.

We have continued to engage with our fellow regulators and market participants, so that collectively, we work through these challenges to limit the spillover effects to our economy and make our markets even stronger.

During times of market stress, certain issues may hold the potential to spill over to the broader markets and cause harm to the American economy. This was the case with the events surrounding the funding capability of Bear Stearns between March 13, 2008 and March 24, 2008.

The funding condition of Bear Stearns had deteriorated rapidly, and by March 13, 2008 had reached such a critical stage that the company would have faced a bankruptcy filing on March 14, 2008 absent an extraordinary infusion of liquidity. During this period, regulators were continuously communicating with one another, working collaboratively, and keeping each other apprised of the changing circumstances.

Our focus was not on this specific institution, but on the more strategic concern of the implications of a bankruptcy. The failure of a firm that was connected to so many corners of our markets would have caused financial disruptions beyond Wall Street. We weighed the multiple risks, such as the potential disruption to counterparties, other financial institutions, the markets, and the market infrastructure. These risks warranted a very careful review and thorough consideration of potential implications and responses.

Our role at the Treasury Department was to support the independent regulators and their efforts with private parties as credit markets were operating under considerable stress, and we believed that certain prudent actions would help to mitigate systemic risk, enhance liquidity, facilitate more orderly markets, and minimize risks to the taxpayers.

The Treasury Department supports the actions taken by the Federal Reserve Bank of New York and the Federal Reserve. We believe the agreements reached were necessary and appropriate to maintain stability in our financial system during this critical time.

Obviously, each independent regulator had to make its own individual assessment and determination as to what actions it would or would not take. While the Treasury Department was not a party to any agreements, we have a great deal of respect for the leadership of each regulator and appreciate their efforts during this extraordinary time.

Upon assessing the Bear Stearns' situation, the Federal Reserve decided to take the very important and consequential action of authorizing the Federal Reserve Bank of New York to institute a temporary program for providing liquidity to primary dealers. Recent market turmoil has required the Federal Reserve to adjust some of the mechanisms by which it provides liquidity to the financial system. Its response in the face of new challenges deserves praise.

At the Treasury Department, we will continue to monitor market developments. We remain focused on the issues surrounding the recent developments, including the important responsibility of safeguarding government funds.

Recent events underscore the need for strong market discipline, prudent regulatory policies, and robust risk management. The Treasury Department and our colleagues comprising the President's Working Group on Financial Markets are addressing the current and strategic challenges, and are doing all we can to ensure high quality, competitive, and orderly capital markets. We seek to strengthen market discipline, mitigate systemic risk, enhance investor confidence and market stability, as well as facilitate stable economic growth.

Thank you and I am pleased to take your questions.

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For release on delivery
10:00 a.m. EDT
April 3, 2008

Statement by

Timothy F. Geithner

President and Chief Executive Officer, Federal Reserve Bank of New York

before the

U.S. Senate Committee on Banking, Housing and Urban Affairs

regarding

Actions by the Federal Reserve Bank of New York in Response to

Liquidity Pressures in Financial Markets

United States Senate

April 3, 2008

Introduction

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

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

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

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

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

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

Part of the dynamic at work was that banks were forced to provide financing for – or take over – the assets in a range of structured investment vehicles and conduits financed by asset-backed commercial paper. As some investors attempted to liquidate their holdings of these assets, many of the traditional providers of unsecured funding to banks pulled back from their counterparties in anticipation of the potential withdrawals of funds by their own investors.

Market participants' willingness to provide term funding even against high-quality collateral declined dramatically. As a consequence, the cost of unsecured term funding rose precipitously and the volume shrunk. Banks were funding themselves at shorter and shorter maturities. As unsecured term funding markets deteriorated, the premium on liquid, marketable collateral – such as Treasury securities – rose considerably.

Even with the dramatic actions by the Federal Reserve and other central banks to address these liquidity pressures, the strains in financial markets persisted. In many respects, conditions worsened materially in February and March. Credit spreads on financial institutions widened, equity prices declined, and market functioning deteriorated sharply. By the early part of March, the threat of a disorderly adjustment was growing.

What we were observing in U.S. and global financial markets was similar to the classic pattern in financial crises. Asset price declines – triggered by concern about the outlook for economic performance – led to a reduction in the willingness to bear risk and to margin calls. Borrowers needed to sell assets to meet the calls; some highly leveraged firms were unable to meet their obligations and their counterparties responded by liquidating the collateral they held. This put downward pressure on asset prices and increased price volatility. Dealers raised margins further to compensate for heightened volatility and reduced liquidity. This, in turn, put more pressure on other leveraged investors. A self-reinforcing downward spiral of higher haircuts forced sales, lower prices, higher volatility, and still lower prices.

This dynamic poses a number of risks to the functioning of the financial system. It reduces the effectiveness of monetary policy, as the widening in spreads and risk premia worked to offset part of the reduction in the Fed Funds rate. Contagion spreads, transmitting waves of distress to other markets, from subprime to prime mortgages and even to agency mortgage-backed securities, to commercial mortgage-backed securities, and to corporate bonds and loans. In the current situation, effects were felt in the municipal and student loan markets.

The most important risk is systemic: if this dynamic continues unabated, the result would be a greater probability of widespread insolvencies, severe and protracted damage to the financial system and, ultimately, to the economy as a whole. This is not theoretical risk, and it is not something that the market can solve on its own. It carries the risk of significant damage to economic activity. Absent a forceful policy response, the consequences would be lower incomes for working families, higher borrowing costs for housing, education, and the expenses of everyday life, lower value of retirement savings, and rising unemployment.

Federal Reserve Response

The Federal Reserve has taken a series of policy actions to help contain the risks to the economy posed by this financial crisis. The Federal Open Market Committee (FOMC) has reduced the nominal federal funds rate target by 300 basis points since August of 2007. Alongside these appropriately aggressive monetary actions, the Federal Reserve has taken a series of initiatives aimed at improving market liquidity and overall market functioning. A more detailed description of these liquidity initiatives is included as Annex I.

These actions are designed to allow financial intermediaries to finance with the central bank assets they can no longer finance as easily in the market. And in this way these liquidity facilities reduce the need for those institutions to take the types of actions, such as selling other assets into distressed markets or withdrawing credit lines extended to other financial institutions, that would serve to amplify the pressures in markets.

In addition to these monetary policy and liquidity actions, the Federal Reserve has been working with community groups and housing advocates across the country to help homeowners navigate the complex challenges of higher resets and falling home prices. The Federal Reserve is actively working with homeowners and communities to identify solutions to avoid foreclosures and their negative effects, support appropriate consumer protection and responsible lending practices, and apply our expertise in research and evaluation to provide community groups, counseling agencies, regulators, and others with detailed analysis to support efforts to help troubled borrowers and communities.

I believe that the Federal Reserve System's response has helped reduce the risk of systemic damage to the financial system, and thereby helped mitigate a potential source of downside risk to growth. This in turn has helped mitigate the risks to the broader economy. It is important to recognize that a substantial adjustment, recognition of losses, and reduction in risk has already taken place. And a range of different prices of financial assets now reflect a very cautious view of the future. The severity of the pressures in markets evident over the last few months are in part a reflection of the speed and force with which markets and institutions in our financial system adapt to fundamental changes in the outlook. This capacity to adjust and adapt is one of the great strengths of our system. Nevertheless, we still face a number of challenges ahead. The seeds of this crisis took a long time to build up, and they will take some time to work through.

The Role of Banks and Investment Banks in Our Financial System

A driving force behind Congress's creation of the Federal Reserve System in 1914 was its recognition of the need for a public institution to perform the role of lender of last resort. The financial landscape in 1914 (and continuing until relatively recent times) was one dominated by traditional banks. When the Federal Reserve was founded, there was no deposit insurance, so the willingness of individuals and businesses to hold deposits at a particular bank depended wholly on their degree of trust that the bank would be able to promptly furnish them with the money they had deposited – whenever they might request it. But – as Congress understood – the business of banking involves making loans as well as taking deposits. Because banks, in order to make money, needed to extend long-term credit to customers for things like the purchases of homes or investments in business equipment, not all of the money taken in by banks could be readily available to be paid out if depositors were to request it. In fact, only a small fraction of a typical bank's assets were kept in liquid enough form to be immediately paid to depositors upon demand. This fundamental fact of bank operation left banks – and the banking system – open to liquidity shocks that, nearly a century later, have their echoes in recent market developments.

The financial crises around the turn of the century were the historic catalyst for the Federal Reserve's creation by Congress. It is panic or fear that drives depositors *en masse* to the door of the banking house to demand their money back. In such a case, even an institution that is fundamentally solvent – *i.e.*, whose assets (mostly longer-term loans) are worth more than its liabilities – may find that it does not have enough cash on hand – that is, enough *liquidity* – to satisfy its customers.

The function of a lender of last resort in such a case is to lend to the institution that is facing heightened customer demand for repayment in an amount sufficient to satisfy customer demands, while taking assets of the institution as security for the lending. If the lender of last resort does not act to fulfill this role, the institution facing heightened customer demands for repayment may be forced to begin a "fire sale" of its assets, the distressed and hurried nature of which will cause them to be sold at less than their true long-run value, which may quickly lead to the insolvency of the institution. The insolvency may precipitate further downward pressure on the market value of such assets magnifying the risk to other financial institutions.

Over the past thirty years, we have moved from a bank-dominated financial system to a system in which credit is increasingly extended, securitized and actively traded in a combination of centralized and decentralized markets. In many ways, the business models of banks and non-bank financial institutions – especially large securities firms – have converged, with banks playing a greater agency role in the credit process, and securities firms doing more of the financing.

It is important to understand that investment banks now perform many of the economic functions traditionally associated with commercial banks, and they are also vulnerable to a sudden loss of liquidity. Unlike commercial banks, which rely significantly on deposits for funding, investment banks operate according to a business model in which they fund large portions of their balance sheets on a secured, short-term basis in what is known as the repo market.[1] Because the assurance of access to short-

[1] In the repurchase agreement, or "repo" market, the borrower sells securities to the lender (the "buyer" of the securities) in return for cash, and agrees to repurchase those securities at a later date for a greater sum of cash, with the difference representing the rate of interest.

term secured funding on a daily basis is such a critical component of business functioning for these entities, they are vulnerable to the possibility of a sudden pullback in short-term lending, or a reduction in the willingness of investors to lend against certain classes of securities.

As we have seen throughout the past nine months, these changes in the relative roles of traditional commercial banks and investment banks have changed the nature of financial stability. In the U.S., the regulatory framework and most of the tools that were created to prevent and manage financial crises were developed in a bank-dominated era, and we have had to adapt those tools to deal with current market realities.

Bear Stearns

With this important context, let me return to the actions taken by the Federal Reserve in response to the situation that arose at Bear Stearns. That response was shaped in roughly four stages: (1) the decision on the morning of March 14 to extend a non-recourse loan through the discount window to JPMorgan Chase so that JPMorgan Chase could in turn lend that money to Bear Stearns; (2) the decision on March 16 by JPMorgan Chase and Bear Stearns for JPMorgan Chase to acquire Bear and guarantee certain of its liabilities, along with an agreement in principle that the Federal Reserve Bank of New York would provide certain financing in the context of that acquisition; (3) the launching of the Primary Dealer Credit Facility; and (4) the events of the following week, culminating in the March 24 announcement of revised merger agreement and guaranty terms between JPMorgan Chase and Bear, and the finalizing of the terms and structure of the associated loan from the Federal Reserve Bank of New York.

Let me begin with the market situation in which Bear was operating in the days leading up to March 13. Fixed income traders had begun hearing rumors that European financial institutions had stopped doing fixed income trades with Bear. Fearing that their funds might be frozen if Bear wound up in bankruptcy, a number of U.S.-based fixed-income and stock traders that had been actively involved with Bear had reportedly decided to halt such involvement. Many firms started pulling back from doing business with Bear. Some hedge funds that had used Bear to borrow money and clear trades were withdrawing cash from their accounts. Some large investment banks stopped accepting trades that would expose them to Bear, and some money market funds reduced their holdings of short-term Bear-issued debt. The rumors of Bear's failing financial health caused its balance of unencumbered liquidity on March 13 to decline sharply to levels that were not adequate to cover maturing obligations and funds that could be withdrawn freely. This precipitated the phone call that I described in the beginning of my testimony.

The news that Bear's liquidity position was so dire that a bankruptcy filing was imminent presented us with a very difficult set of policy judgments. In our financial system, the market sorts out which companies survive and which fail. However, under the circumstances prevailing in the markets the issues raised in this specific instance extended well beyond the fate of one company. It became clear that Bear's involvement in the complex and intricate web of relationships that characterize our financial system, at a point in time when markets were especially vulnerable, was such that a sudden failure would likely lead to a chaotic unwinding of positions in already damaged markets. Moreover, a failure by Bear to meet its obligations would have cast a cloud of doubt on the financial position of other institutions whose business models bore some superficial similarity to Bear's, without due regard for the fundamental soundness of those firms.

The sudden discovery by Bear's derivatives counterparties that important financial positions they had put in place to protect themselves from financial risk were no longer operative would have triggered substantial further dislocation in markets. This would have precipitated a rush by Bear's counterparties to liquidate the collateral they held against those positions and to attempt to replicate those positions in already very fragile markets.

In short, we judged that a sudden, disorderly failure of Bear would have brought with it unpredictable but severe consequences for the functioning of the broader financial system and the broader economy, with lower equity prices, further downward pressure on home values, and less access to credit for companies and households.

Following that initial call with the SEC on March 13, my colleagues in New York and in Washington spent the night focusing on the implications of a large-scale default by Bear and how we might contain the consequential damage. Bear renewed conversations that began earlier that day with JPMorgan Chase, which is Bear's clearing bank for its repo arrangements, to explore a range of possible financing options. The New York Fed dispatched a team of examiners to Bear Stearns to look at its books so that we could get a better handle on what could be done. We gathered the best information we could, evaluated the risks involved, and explored a range of possible actions.

At 5 a.m., we participated in a conference call with our colleagues at the Board of Governors and the Treasury to review the options and decide on the way forward. After careful deliberation, together we decided on a course of action that would at least buy some time to explore options to mitigate the foreseeable damage to the financial system. With the support of the Secretary of the Treasury, Chairman Bernanke and the Board of Governors agreed that the New York Fed would extend an overnight non-recourse loan through the discount window to JPMorgan Chase, so that JPMorgan Chase could then "on-lend" that money to Bear Stearns.

This action was designed to allow us to get to the weekend, and to enable us to pursue work along two tracks: first, for Bear to continue to explore options with other financial institutions that might enable it to avoid bankruptcy; and second, for policymakers to continue the work begun on Thursday night to try to contain the risk to financial markets in the event no private-sector solution proved possible.

Over the course of that day, March 14, Bear was downgraded by the credit rating agencies, and the flight of customer business from Bear accelerated. This set in motion a chain of decisions across the financial system as market participants prepared for the possibility that Bear would not be open for business once Asian markets opened on Sunday night. This highlighted the urgency of working toward a solution over the weekend, ideally a solution that would definitively address the prospect of default by Bear.

Bear approached several major financial institutions, beginning on March 13. Those discussions intensified on Friday and Saturday. Bear's management provided us with periodic progress reports about a possible merger. Although several different institutions expressed interest in acquiring all or part of Bear, it was clear that the size of Bear, the apparent risk in its balance sheet, and the limited amount of time available for a possible acquirer to conduct due diligence compounded the difficulty. Ultimately, only

JPMorgan Chase was willing to consider an offer of a binding commitment to acquire the firm and to stand behind Bear's substantial short-term obligations.

As JPMorgan Chase and other institutions conducted due diligence, my colleagues in New York and Washington continued to examine ways to contain the effects of a default by Bear. As part of these discussions, we began to design a new facility that would build on other liquidity initiatives taken by the Federal Reserve System, and provide a more powerful form of liquidity to major financial institutions.

Following the announcement on March 12 of the Term Securities Lending Facility, which allowed primary dealers to pledge a wider range of collateral in order to borrow Treasury securities, we had consulted with market participants on how to structure the auctions to maximize their potential benefits to market functioning. Those discussions yielded a number of helpful suggestions. In view of those suggestions, and after considering the greater risks to the financial system posed by the Bear situation, we were able to work quickly on a companion facility that would transmit liquidity to parts of the market where it could be most powerful.

This is what led the Board of Governors of the Federal Reserve System to approve the establishment of the Primary Dealer Credit Facility on March 16. Under Section 13(3) of the Federal Reserve Act, the Board of Governors is empowered to authorize a Federal Reserve Bank like the New York Fed to lend to a corporation, such as an investment bank, in extraordinary circumstances under which there is evidence that the corporation cannot "secure adequate credit accommodations from other banking institutions." The Board of Governors needed to make the statutory finding that the circumstances were exigent and extraordinary, and it did so, based on the situation prevailing in the financial markets and the distinct possibility that absent an assurance of liquidity to major investment banks the deterioration in financial conditions likely would have continued with substantial effects on the economy.

We recognized, of course, that the use of this legal authority was, in itself, an extraordinary step. At the same time, we were mindful that Congress included this lending power in the Federal Reserve Act for a reason, and it seemed irresponsible for us not to use that authority in this unique situation. Even with an agreement in place that might reduce the probability of a default by Bear, we decided that independent of that outcome, it was important to get assured liquidity to primary dealers by Monday morning, to address the accelerating process of deleveraging and tightening liquidity seen in the financial system.

On Sunday morning, executives at JPMorgan Chase informed us that they had become significantly more concerned about the scale of the risk that Bear and its many affiliates had assumed. They were also concerned about the ability of JPMorgan Chase to absorb some of Bear's trading portfolio, particularly given the uncertainty ahead about the ultimate scale of losses facing the financial system. In this context, we began to explore ways in which we could help facilitate a more orderly solution to the Bear situation. We did not have the authority to acquire an equity interest in either Bear or JPMorgan Chase, nor were we prepared to guarantee Bear's very substantial obligations. And the only feasible option for buying time would have required open ended financing by the Fed to Bear into an accelerating withdrawal by Bear's customers and counterparties.

We did, however, have the ability to lend against collateral, as in the back-to-back non-recourse arrangement that carried Bear into the weekend. After extensive discussion with my colleagues at the New York Fed, Chairman Bernanke, and Secretary Paulson, and with their full support, the New York Fed and JPMorgan Chase reached an agreement in principle that the New York Fed would assist with non-recourse financing. Using Section 13(3) of the Federal Reserve Act, the New York Fed agreed in principle to lend $30 billion to JPMorgan Chase and to secure the lending with a pledge of Bear Stearns assets valued by Bear on March 14 at approximately $30 billion. This step made it possible for JPMorgan to agree to acquire Bear and to step in immediately to guarantee all of Bear's short-term obligations. This guarantee was especially important to stave off the feared systemic effects that would be triggered by the panic of a Bear bankruptcy filing and of the failure to honor its obligations. And by agreeing to lend against a portfolio of securities, we reduced the risk that those assets would be liquidated quickly, exacerbating already fragile conditions in markets. The portfolio of securities is described in Annex II to this testimony.

On the evening of Sunday the 16th, I sent a letter to James Dimon, the CEO of JPMorgan Chase, to memorialize the fact that we had reached a preliminary agreement that the New York Fed would assist the acquisition with $30 billion in financing, with the understanding that the parties would continue working during the week towards a formal contract. We also provided regulatory approvals, including under Section 23A, to assist with the merger and a transitional period for phasing in the assets under our capital rules.

The announcement of the agreement between Bear Stearns and JPMorgan Chase and the announcement of the Primary Dealer Credit Facility were finalized just before

Asian markets opened on Sunday night, and the announcement of these actions helped avert the damage that would have accompanied default.

On Monday morning, March 17, the $13 billion back-to-back non-recourse loan through JPMorgan Chase to Bear was repaid to the Fed, with weekend interest of nearly $4 million. The Primary Dealer Credit Facility was made available to the market. And at the request of and with the full cooperation of the SEC, examiners from the New York Fed were sent into the major investment banks to give the Federal Reserve the direct capacity to assess the financial condition of these institutions.

Discussions were also continuing regarding the details of the Fed's financial arrangement with JPMorgan Chase. Our legal teams engaged in the meticulous work of finalizing the legal structure of the lending arrangement that had been agreed to in principle, including defining the precise pool of collateral and related hedges that would secure the $30 billion loan.

At the same time, several infirmities became evident in the agreement between JPMorgan and Bear during the week of March 17th that needed to be cured.

Negotiations between the two sets of counterparties proceeded almost immediately between the New York Fed and JPMorgan Chase on the one hand, and between JPMorgan Chase and Bear Stearns on the other. The New York Fed and JPMorgan discussed the details for the secured financing. Bear Stearns and JPMorgan continued to negotiate changes to the merger agreement that would tighten the guarantee and provide the necessary certainty that the merger would be consummated. All the parties shared an overriding common interest: to move toward a successful merger and avoid the situation in which they found themselves on March 14.

The extended Easter weekend saw intense sets of bilateral negotiations among the three parties. The deal, finally struck in the early morning hours on March 24, held benefits for all parties. That deal included a new, more precise guaranty from JPMorgan, which lifted the cloud of default risk that had been hanging over the transaction. Bear stockholders were to receive a higher share price. In addition to fixing the guaranty, JPMorgan gained assurance that its merger with Bear would take place. And the New York Fed obtained significant downside protection on the loan and a tighter guaranty on its exposure. The new Fed financing facility will be in place for a maximum of ten years, though it could be repaid earlier, at the discretion of the Fed. This is an important feature: the assets that are being pledged as collateral can be managed on a long-term basis so as to minimize the risks to the market and the risk of loss. They can be held or disposed of at any time over the next decade. A summary of Terms and Conditions is attached as Annex III.

In keeping with the traditional role of a lender of last resort, the extensions of credit to Bear Stearns that the Fed made to facilitate the merger were secured by collateral. The $29 billion loan will be extended only when and if JPMorgan Chase and Bear merge. We will be protected from loss by three different risk mitigants: first, a substantial pool of professionally-managed collateral that, as of March 14, was valued at $30 billion; second, the agreement on the part of JPMorgan Chase to absorb the first $1 billion of any loss that ultimately occurs in connection with this arrangement; and third – and perhaps most importantly – a long-term horizon during which our collateral will be safe-kept and, if sold, will be sold in an orderly fashion that is not affected by the unnaturally strong downward market pressures that have been associated with the recent liquidity crisis.

Are there risks here? Yes, but the risks are modest in comparison to the substantial damage to the economy and economic well-being that potentially would have accompanied Bear's insolvency. Congress created the Federal Reserve after the Panic of 1907 with broad authority and a range of instruments to assume precisely this type of risk, in support of overall financial stability and economic growth. Assisting the JPMorgan Chase merger with Bear was the best option available in the unique circumstances that prevailed at the time.

There are those who have suggested that by intervening to forestall, and ultimately prevent, a bankruptcy filing by Bear Stearns, the Federal Reserve risks magnifying the chance of future financial crises, by insulating market participants from the consequences of excessive risk taking. It is important to recognize that had we not acted we would in effect have penalized those individuals, companies, and financial institutions that had behaved more prudently, but would have suffered significant damage from the effects of default by a major institution.

The negative consequences to Bear's owners and employees from recent events have been very real – so real that no owner or executive or director of a financial firm would want to be in Bear Stearns' position. While we clearly knew that our actions, both in the context of the JPMorgan Chase transaction and in the establishment of the Primary Dealer Credit Facility would affect incentives for financial market participants, adding to the risk of "moral hazard," we believe that the lesson of the actual outcome for equity holders will serve to check and even diminish incentives for undue risk-taking.

I believe that the actions taken by the Federal Reserve on a number of fronts in recent months have reduced some of the risk to the economy that is inherent in this adjustment in financial markets. By reducing the probability of a systemic financial crisis, the actions taken by the Fed on and after March 14 have helped avert substantial damage to the economy, and they have brought a measure of tentative calm to global financial markets. Relative to the conditions that existed on March 14, risk premia have narrowed, foreign exchange markets are somewhat more stable, energy and commodity prices are lower, perceptions of risk in the financial system have diminished, and the flight to quality is less pronounced.

Nevertheless, liquidity conditions in markets are still substantially impaired and the process of de-leveraging remains underway. And this will amplify the headwinds facing the U.S. and global economy. In this context, policy makers and financial market participants need to continue to act forcefully. And their actions need to be proportionate to the challenges.

Financial institutions need to continue to improve the quality of disclosure, and even the strongest institutions face compelling incentives to raise new equity capital so that they can take advantage of the opportunities ahead.

Actions to strengthen the capacity of the major government sponsored enterprises, the Federal Housing Finance Board, and the Federal Housing Administration to provide finance to the mortgage market and help reduce the risk of avoidable foreclosures are a very important complement to the broader policy actions already in place to contain the downside risks to the economy.

The Federal Reserve, working closely with other major central banks, will continue to provide liquidity to markets to help facilitate the process of financial repair.

Looking forward, we face as a nation a number of very important policy questions. This financial crisis, as all past crises, has highlighted vulnerabilities that require action. No economy is stronger than its financial system, and as we continue to focus on the immediate challenges of financial repair and supporting economic growth, we need to begin the process of building consensus on a comprehensive set of change to our regulatory framework.

In addition to a stronger set of protections for consumers, the overwhelming imperative of reform must be to put in place a stronger framework for financial stability. Our objective should be a system that preserves the unique strengths of our financial markets in providing individuals and entrepreneurs access to capital and credit, but with a greater capacity to withstand stress.

This will require significant changes to regulatory policy and the supervisory framework. And the focus has to be on changing the incentives that all financial market participants face in managing the risk in exposure to adverse outcomes.

In my view, there are a set of important objectives and principles that should guide this effort.

- We need to ensure there is a stronger set of shock absorbers, in terms of capital and liquidity, in those institutions, banks and a limited number of the largest investment banks, that are critical to market functioning and economic health, with a stronger form of consolidated supervision over those institutions.

- We need to substantially simplify and consolidate the regulatory framework, to reduce the opportunity for regulatory arbitrage, not just in the mortgage market, but more broadly.

- We need to make the financial infrastructure more robust, particularly in the derivatives and repo markets, so that the system can better withstand the effects of default by a major participant.

- We need to redesign the set of liquidity facilities that we maintain in normal times, and in extremis, in the United States and across other major central banks. And these changes will have to come with a stronger set of incentives and requirements for the management of liquidity risk by financial institutions with access to central bank liquidity.

- And we need to make sure that the Federal Reserve has the mix of authority and responsibility to respond with adequate speed and force to the prospects of systemic threats to financial stability.

Conclusion

We look forward to working with the Congress and the Executive Branch to put in place a system of financial sector oversight and crisis management that works well in the context of a 21st-century financial system.

The actions that we took were intended to protect the economy from the consequences of risks to the financial system that could have decreased the availability of home mortgage and other credit, put further downward pressure on home values, eroded retirement savings, and ultimately led to a loss of jobs and incomes as businesses faced added difficulties in financing expanded operations and job creation.

Policymakers – both in the Federal Reserve and in the federal government – must continue to be proactive in their response to rapidly changing circumstances.

Finally, I want to express my admiration and appreciation to members of my staff who have performed with great skill and care under extreme pressure. And I would like to also thank Chairman Bernanke, Secretary Paulson, Chairman Cox and my many other colleagues in the Fed and the supervisory community.

Thank you again for giving me the opportunity to appear before you today.

Annex I

Understanding the Recent Changes to Federal Reserve Liquidity Provision

Since August 2007, the Federal Reserve System has designed a series of changes to its lending facilities to help improve market liquidity and overall market functioning. Although these changes were made incrementally in response to changing market conditions, they share the common objectives of reducing risks to financial stability and strengthening the effectiveness of monetary policy in addressing risks to the outlook for growth and inflation.

The suite of facilities now in place is designed to enable a set of institutions that play an important role in financial markets to access liquidity from the Federal Reserve against collateral they would normally be able to finance easily with other financial market participants. By giving depository institutions and primary dealers more confidence in their access to current and future funding, these new facilities should reduce the incentives these institutions would otherwise face in these exceptionally challenging market conditions to take actions that might exacerbate pressure on market functioning and they should improve the institutions' ability to extend funding to their customers and counterparties.

The recent changes to the Fed's liquidity provision have entailed a substantial modification of the terms of the primary credit program of the discount window (DW)[1] and the introduction of

[1] Aggregate information on the amount of borrowing through the TAF and the PDCF as well as through the Federal Reserve's other lending facilities is made available each Thursday, generally at 4:30 p.m., on Federal Reserve Statistical Release H.4.1 Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks. The H.4.1 release will contain the total amount of PDCF and TAF credit outstanding as of the close of business on the prior business day and the average daily amounts for each week. Summary information will be posted on the New York Fed website following each TSLF auction. Information on amounts lent through the TSLF will also be provided on the H.4.1 statistical release. The identities of the institutions using these facilities will not be made public.

three new facilities: the Term Auction Facility (TAF), the Term Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF).

Together, these initiatives alter several dimensions of the Fed's liquidity facilities:

1. They lengthen the duration of access to liquidity.
2. They broaden the types of eligible collateral.
3. They expand the range of eligible counterparties for some activities.
4. They reduce the cost of borrowing from the Fed relative to the Federal Funds rate.

With the introduction of these new facilities, eligible depository institutions and primary dealers now have access to two complementary types of facilities.

- The discount window for depository institutions and the Primary Dealer Credit Facility for primary dealers are effectively "standing" facilities that provide daily access to funding for eligible institutions. Access to funds through these facilities occurs at the initiative of the borrowing institution, in an amount determined by the borrowing institution's needs and collateral. The Fed charges a fixed interest rate set at a premium to market rates on this type of facility to discourage institutions from unnecessary use of Fed lending.
- The Term Auction Facility for depository institutions and the Term Securities Lending Facility for primary dealers constitute a second type of facility in which a pre-determined amount of longer-term funding is available at auction on pre-announced dates for settlement on a later date. These facilities are designed to improve overall liquidity conditions in term and secured funding markets, rather than to satisfy the needs of a

particular institution on a particular day. The interest rate and the distribution of the awards across institutions in this second type of facility are determined by an auction.

Liquidity provided through these facilities is offset in the implementation of monetary policy through open market operations (OMO) so as to achieve the Federal Open Market Committee's (FOMC) federal funds target rate. Thus, these facilities enable the Fed to alter the composition of its balance sheet in ways that address strains in market conditions, but also to use its other reserve management tools to maintain any particular overall size it desires for the supply of reserves to the banking system and hence the federal funds rate.

The Federal Reserve will keep this new array of liquidity facilities in place for as long as is necessary. It will also continue to consult with market participants and will adapt these facilities as necessary to enhance their effectiveness as market conditions evolve. Below we describe the recent changes to the Fed's lending facilities and discuss how each is intended to improve liquidity conditions in the markets in which banks and primary dealers participate. The key features of these facilities are summarized in Table 1.

Facilities for Depository Institutions

The primary credit facility of the DW and the TAF are available to depository institutions (DIs) in sound financial condition. Borrowing at each of these facilities can be secured by a wide variety of collateral, including loans to businesses and households.

The Primary Credit Program of the Discount Window

From January 2003 to August 2007, eligible depository institutions could borrow from the DW on an overnight basis at a penalty rate set at a fixed 100 basis point spread over the target federal funds rate. Starting in August 2007, in view of the significant strains in term interbank funding markets, the Federal Reserve made a number of changes to terms of DW borrowing. On August 17, 2007, the Fed extended the maximum term for borrowing to 30 days, renewable at the request of the borrower, and reduced the spread to the target federal funds rate from 100 to 50 basis points. On March 16, 2008, the Fed further extended the term for borrowing to 90 days, and further reduced the spread to the target federal funds rate to 25 basis points.

The DW facility is available every business day and is designed to ensure that sound depository institutions can meet their funding needs, even if those needs occur unexpectedly or late in the day. For example, if a DI receives an unexpected delivery of securities or experiences operational difficulties with its funds management systems, it would be at risk of an overnight overdraft. Funding need at an individual institution can also arise from circumstances in which aggregate reserves in the banking system are significantly lower than what the Open Market Desk (the Desk) was anticipating in its management of the federal funds rate target. To avoid an overdraft in any of these situations, the bank can borrow funds under the primary credit program of the DW.

The Term Auction Facility

Established on December 12, 2007, the TAF provides term funding secured by the same collateral that is accepted at the discount window to the same depository institutions that are eligible for the primary credit program[2]. In contrast to the DW, the total amount of funds available at any TAF auction is determined and announced in advance by the Fed, and the rate is set in a competitive process among the eligible depositories, so those depositories with the highest bid rates receive the funds. Thus, the rate charged for borrowing (known as the "stop-out rate") can vary from auction to auction depending on overall demand for funds relative to the amount being auctioned. Bids at each auction are subject to a minimum bid rate that is equal to the one-month overnight index swap (OIS) rate—this is equal to the market's expectation of the average federal funds rate over that month—and limits are imposed on how much of the available funds a particular DI can bid for in the auction in order to ensure that the funds are be distributed across a number of institutions.[3]

Introducing the TAF in December 2007 allowed the Fed to provide term funds to DIs in a manner that alleviated the strains arising from a generalized reduction in the willingness of sound depository institutions to lend to one another. The TAF allows banks to borrow against a wide range of collateral, including securities that are not widely pledged in private markets, such as bank loans.

In response to the continued strains in term funding markets even in the wake of the first few months of TAF auctions, the Federal Reserve announced on March 7, 2008, that it would

[2] When announcing the TAF, the Federal Reserve also announced that it had approved the extension of temporary reciprocal currency arrangements (swap lines) with the European Central Bank (ECB) and the Swiss National Bank (SNB). On March 11, 2008, the Federal Reserve extended the arrangements through September 30, 2008, and established their current sizes of $30 billion and $6 billion with the ECB and the SNB, respectively. These lines allow the ECB and SNB to lend dollars to depository institutions in their jurisdictions, which complements the ability of the TAF to provide dollars to banking institutions in the United States.

[3] It is also the case that bidders in the TAF are required to hold an amount of collateral beyond that necessary to secure TAF borrowing. This requirement ensures that depository institutions retain some capacity to borrow under the primary credit program in the event they encounter unexpected overnight funding needs.

continue to conduct TAF auctions for at least an additional six months unless market conditions evolved in a manner that clearly indicated the auctions were no longer necessary.

Unlike DW borrowing, which has same-day settlement, the delivery of funds from TAF is delayed and hence is not designed to satisfy an individual depository institution's immediate need for funding. Also in contrast to DW borrowing, the total amount of funds offered in a TAF auction is predetermined, and the settlement date for the funds is announced in advance, which makes it easier for the Desk to offset the effect of TAF borrowing on overall reserves.

Facilities for Primary Dealers

The Desk at the Federal Reserve Bank of New York conducts operations in U.S. government and select other securities on a regular basis with the set of banks and securities broker-dealers that constitute the Fed's designated primary dealers. These operations are an essential part of the implementation of the FOMC's monetary policy objectives. Open market operations are auction transactions in which the Desk buys, or sells, securities with the primary dealers or it lends funds to the primary dealers through the sale and repurchase of securities in agreements known as "repos" (though it occasionally borrows using reverse repurchase agreements) in order to add, or drain, reserves from the banking system. Repo transactions are the principle means by which the Desk achieves the federal funds rate target set by the FOMC. Collateral for open market operations consists of U.S. Treasury, agency and agency mortgage-backed securities.

From the perspective of the primary dealers' balance sheets, these repo transactions with the Desk are only a small fraction of their overall volume of repo market activity. In recent months, repo markets have come under significant strain as well, and the volume of repo financing has shrunk considerably, while the cost has risen. The two facilities below were developed in response to those strains.

The Primary Dealer Credit Facility

The establishment of the PDCF was announced by the Board of Governors of the Federal Reserve System on March 16, 2008. The Board determined that unusual and exigent circumstances existed in financial markets, including a severe lack of liquidity that threatened to impair the functioning of a broad range of markets, and announced that the PDCF will be in place for at least six months and may be extended as conditions warrant.

Use of the PDCF by primary dealers differs from their participation in OMO in two important ways. First the PDCF allows primary dealers to borrow funds from the Fed against a broader range of collateral than is eligible for OMO. Second, the rate on that borrowing is fixed rather than determined through an auction mechanism.

The PDCF is similar in spirit to the primary credit program of the DW available to depository institutions. As with the DW, the amount of funds being lent is determined at the request of an individual primary dealer, and the interest rate paid on borrowings through the PDCF is equal to the rate by depository institutions for credit obtained at the DW. Under normal market conditions, this rate would constitute a penalty rate for these types of transactions.

As with the DW, the PDCF is available every day and is meant to provide funding to individual dealers in situations in which the dealer's ability to fund its holdings of securities in the broader repo market is impaired. This impairment might occur because poor liquidity conditions in the trading of particular classes of securities prevent them from being readily used as collateral in the repo market. In this situation, the PDCF will help to prevent the forced sale of specific types of securities by providing temporary financing for the collateral. In general, by assuring dealers of their access to funding against program-eligible collateral, the PDCF is intended to improve market liquidity and encourage primary dealers to make markets and to provide credit to customers.

The Term Securities Lending Facility

The TSLF is a term lending facility for primary dealers established on March 11, 2008[4]. Like the TAF, the TSLF is an auction facility, but unlike the TAF, which auctions funds from the Federal Reserve in exchange for securities and loans, the TSLF auctions securities in exchange for securities. Specifically, the TSLF allows dealers to offer relatively illiquid securities as collateral in exchange for a loan of Treasury securities[5]. In doing so, this facility is designed to improve overall market liquidity conditions by increasing the relative supply of Treasury securities and very high-quality mortgage-related securities in the hands of the public.

[4] On March 7, 2008, the Federal Reserve announced that it would initiate a series of 28-day term repurchase transactions in its open market operations that are expected to cumulate to $100 billion. For these transactions, primary dealers may elect to deliver as collateral any of the types of securities that are eligible as collateral in its regular open market operations—Treasury, agency debt or agency mortgage-backed securities. As with the TAF auction sizes, the Federal Reserve will increase the sizes of these term repo operations if conditions warrant. These operations are designed to address the same strained liquidity conditions in these markets as the TSLF.
[5] The TSLF auctions a fixed amount of general collateral (GC) Treasury securities from the System Open Market Account (SOMA) in exchange for any collateral eligible for repurchase agreements arranged by the Desk, AAA/Aaa-rated private-label residential mortgage-backed securities, agency collateralized mortgage obligations and AAA/Aaa-rated commercial mortgage-backed securities that are not on review for downgrade.

TSLF auctions are held on a weekly basis, and the term of a TSLF loan is 28 days. Bidding is subject to a minimum bid rate that is chosen to be slightly higher than the spread between the Treasury GC rate and the GC rate of the particular collateral accepted in the facility under more normal market conditions. The resulting rate on the collateral loan is set through a competitive auction process, and as with the TAF auctions, limits are imposed on the share of the auction allocated to each winning bidder in order to ensure that the lending is distributed across a multiple institutions.

In contrast to other the Fed's other liquidity facilities, the TSLF is reserve neutral because it lends Treasury securities against collateral. In other words, no OMO are needed to offset lending done through the TSLF.

KEY FEATURES OF LENDING FACILITIES

		DEPOSITORY INSTITUTION IN SOUND FINANCIAL CONDITION	PRIMARY DEALERS
Backstop Standing Facilities	**Name**	**Primary credit program of discount window**	**Primary Dealer Credit Facility**
	Size	Limited by eligible collateral and aggregate credit needs. Aggregate amount made public with a lag.	
	Price	Primary credit rate	Primary credit rate plus frequency based fee
	Frequency	Available daily	
	Term	Overnight – 90 days	Overnight
	Collateral	Discount window collateral	Standard OMO plus investment grade debt securities
	Prepay	Yes	N/A
Auction Facilities	**Name**	**Term Auction Facility**	**Term Securities Lending Facility**
	Size	Fixed and public. Also constrained by availability of collateral.	
	Price	Single	Single
	Fequency	Biweekly	Weekly
	Term	28 days	28 days
	Collateral	Discount window collateral	Standard OMO plus AAA private label RMBS, CMBS, plus agency CMOs not on review for downgrade
	Prepay	No	No

Annex II

Annex II – Portfolio Overview

Following is an overview of the portfolio supporting the loan to be extended by the Federal Reserve in connection with the proposed acquisition of Bear Stearns by JPMorgan Chase.

The $29 billion credit extension is supported by assets that were valued at $30 billion by Bear Stearns, which valued the assets at market value on March 14. JPMorgan Chase will extend a subordinated loan for $1 billion that will absorb losses, if any, on the sale of these assets before the Federal Reserve.

The portfolio supporting the credit extensions consists largely of mortgage related assets. In particular, it includes cash assets as well as related hedges.

The cash assets consist of investment grade securities (*i.e.* securities rated BBB- or higher by at least one of the three principal credit rating agencies and no lower than that by the others) and residential or commercial mortgage loans classified as "performing". All of the assets are current as to principal and interest (as of March 14, 2008). All securities are domiciled and issued in the U.S. and denominated in U.S. dollars.

The portfolio consists of collateralized mortgage obligations (CMOs), the majority of which are obligations of government-sponsored entities (GSEs), such as the Federal Home Loan Mortgage Corporation ("Freddie Mac"), as well as asset-backed securities, adjustable-rate mortgages, commercial mortgage-backed securities, non-GSE CMOs, collateralized bond obligations, and various other loan obligations.

The assets were reviewed by the Federal Reserve and its advisor, BlackRock Financial Management. The assets were not individually selected by JPMorgan Chase or Bear Stearns.

The Federal Reserve would be required by GAAP to report the valuation of the portfolio on an annual basis. We will report the valuation and recoveries from liquidation of the portfolio on a quarterly basis, subject to annual review by our outside auditors Deloitte Touche Tohmatsu.

The Federal Reserve will make arrangements with the appropriate Committee staffs to allow review of the list of assets on a confidential basis that permits appropriate Congressional oversight of the Federal Reserve's actions while also protecting the ability of the Federal Reserve to minimize risk of loss and danger to markets and preserve privacy and other confidentiality concerns.

Annex III

EXECUTION COPY

Summary of Terms and Conditions

March 28, 2008

Concurrently with, and subject to the consummation of the merger (the "Merger") in all material respects on the terms described in the Agreement and Plan of Merger, dated as of March 16, 2008 (as amended, the "Merger Agreement"), between The Bear Stearns Companies Inc. ("Bear Stearns") and JPMorgan Chase & Co., a newly formed Delaware limited liability company (the "Borrower") will enter into an agreement with Bear Stearns and/or certain of its subsidiaries and/or affiliates (collectively, the "Seller") pursuant to which the Borrower will acquire (whether directly or through participations) the Portfolio (as defined below) and the Pre-Closing Date Proceeds Amount (as defined below) from the Seller pursuant to an asset acquisition agreement (the "Asset Acquisition Agreement") in consideration of the payment of a cash Purchase Price (as defined below) and the assumption of certain liabilities, the source of the funding of which shall be the proceeds of (a) borrowings under a Tranche A senior secured loan facility (the "Tranche A Loan Facility") provided by the Federal Reserve Bank of New York (the "NY Fed") in an aggregate principal amount, not to exceed $29,000,000,000, equal to the Purchase Price plus the par value of the Unfunded Forward Commitments (as defined below) less $1,000,000,000 and (b) borrowings under a Tranche B subordinated secured loan facility (the "Tranche B Loan Facility" and, together with the Tranche A Loan Facility, the "Loan Facilities") provided by JPMorgan Chase Bank, N.A (the "JPMC") in an aggregate principal amount equal to $1 billion. In addition, the NY Fed will be entitled to a residual interest in the Portfolio (such interest, the "Residual Interest"). Set forth below is a summary of the terms and conditions for the Loan Facilities.

1. PARTIES

Borrower:	The Borrower (as defined above).
Administrative Agent, Collateral Agent and Depositary Bank:	An entity (or entities) to be determined by the NY Fed (in such capacities, the "Agent").
Tranche A Lender:	The NY Fed (the "Tranche A Lender").
Tranche B Lender:	JPMC (the "Tranche B Lender" and, together with the Tranche A Lender, the "Lenders").
Asset Manager:	Blackrock Financial Management, Inc. and its affiliates (in such capacity, the "Asset Manager"). The Asset Manager will be solely the agent of the NY Fed, but will owe the other Secured Parties (as defined below) and the Borrower a duty of good faith and fair dealing. The Asset Manager shall be paid fees as determined by the NY Fed and notified to JPMC.

2. DESCRIPTION OF ASSET ACQUISITION AGREEMENT

Seller:	The Seller.
Buyer:	The Borrower.

Asset Acquisition Agreement: Pursuant to the Asset Acquisition Agreement, the Seller will sell to the Buyer (whether directly or through participations) without recourse (but subject to, and with full recourse for the breach of, representations and warranties relating to good title and authority to transfer) the assets identified by JPMC, the NY Fed and the Asset Manager as described on Schedule A hereto (the "Scheduled Collateral Pool"), together with the hedges identified by JPMC, the NY Fed and the Asset Manager as described on Schedule B hereto (the "Related Hedges") and including the Pre-Closing Date Proceeds Amount. For the avoidance of doubt, the Related Hedges include the amount that the Borrower would have to pay to, or the amount that the Borrower would receive from, the applicable counterparty if the Borrower had entered into an identical transaction on March 14, 2008 based on the Bear Stearns marks as of such date (the "Transfer Value"), as well as all accumulated mark to market gains or losses thereafter and any cash proceeds as a result of Related Hedges' being unwound.

Purchase Price: The purchase price (the "Purchase Price") for the Scheduled Collateral Pool and the Related Hedges (including the Pre-Closing Date Proceeds Amount) is an amount, not to exceed $30 billion, determined as provided in "Pricing of the Scheduled Collateral Pool and Related Hedges" below minus the par value of the total unfunded forward commitments, whether contingent or non-contingent (the "Unfunded Forward Commitments") included in the Scheduled Collateral Pool.

Seller Payment: On the Closing Date, the Seller will pay (the "Seller Payment") to the Borrower, in consideration of the Borrower's assumption of the Seller's liabilities under the Unfunded Forward Commitments, an amount equal to the difference (if positive) between (x) the par value of such commitments and (y) the market value of such commitments as of March 14, 2008 or, if such market value is unavailable, the market value shall be determined by reference to the market value of the related funded portion of any such commitment as of March 14, 2008, but, if no related funded portion exists and there is otherwise no market value associated with such commitment, the market value shall be determined based on "haircuts" to par as shall be mutually agreed between the NY Fed, JPMC and the Asset Manager. Such amount will be deposited into the Reserve Account.

Related Hedges: As of the Closing Date, the Borrower will assume as an economic matter the obligations under the Related Hedges and receive the benefits thereof by entering into a total return swap with the Seller, such total return swap having an initial fair value as of the Closing Date equal to the fair value of the Related Hedges as of the Closing Date. The Controlling Party (as defined below) shall have the right to make all determinations related to the underlying hedges (e.g., whether and when to terminate) that are subject to the total return swap. At the request of the NY Fed, the Seller will use its commercially reasonable efforts to replace the total return swap with direct hedges with underlying counterparties through novation.

Guaranty:	JPMC will irrevocably and unconditionally guaranty the obligations of the Seller under the Asset Acquisition Agreement and the total return swap.

3. AGREEMENTS IN EFFECT PRIOR TO THE CLOSING DATE

Pricing of the Scheduled Collateral Pool and Related Hedges:	The price of the Scheduled Collateral Pool shall equal the sum of (i) the value of such collateral pool on the books of the Seller as of March 14, 2008 (including with respect to the assumption of liabilities for Unfunded Forward Commitments), irrespective of any mark-downs or mark-ups in such collateral after March 14, 2008 and irrespective of when such collateral pool is actually pledged to secure the Loan Facilities and (ii) the Transfer Value of the Related Hedges.
Management of Scheduled Collateral Pool and Related Hedges:	Prior to the Closing Date and upon final determination of each particular asset or hedge comprising a part of the Scheduled Collateral Pool or the Related Hedges, JPMC will delegate management rights with respect to such assets or hedges to the NY Fed which in turn will delegate such rights to the Asset Manager, and the NY Fed and the Asset Manager will have the right to liquidate assets in the Scheduled Collateral Pool and Related Hedges or both in their discretion at any time.
Pre-Closing Date Proceeds Amount:	On the Closing Date, the Pre-Closing Date Proceeds Amount (to the extent such amount is positive) will be deposited into the Reserve Account.

The "Pre-Closing Date Proceeds Amount" means an amount, determined as of the Closing Date, equal to the sum (without duplication) of the following amounts paid or received in respect of the assets and liabilities in the Portfolio during the period from March 14, 2008 to the Closing Date:

(i) the cash proceeds from the sale of assets comprising a portion of the Scheduled Collateral Pool; plus

(ii) all amounts received from the amortization or prepayment of principal on any assets comprising a portion of the Scheduled Collateral Pool; plus

(iii) the interest payments on the Scheduled Collateral Pool; plus

(iv) all periodic, termination and other payments (excluding the posting of margin) received from counterparties on the Related Hedges; minus

(v) all periodic, termination and other payments (excluding the posting of margin) made to counterparties on the Related Hedges; minus

(vi) allocated funding costs (at the Primary Credit Rate (as defined below)).

It is understood that prior to the Closing Date, the NY Fed has no responsibility to provide any margin or other credit support for any hedge.

Guaranty:	JPMC will enter into, and keep in full force and effect, the Guarantee, dated as of March 23, 2008, in favor of the NY Fed.
NY Fed Commitment:	The NY Fed commits to provide the financing described herein in connection with JPMC's acquisition of Bear Stearns to address the extraordinary circumstances in the market on March 14, 2008 and the surrounding days. The NY Fed has not committed to make a similar facility to any other party or under any different circumstances.
Confidentiality:	The transactions contemplated by this Summary of Terms and Conditions and all other materials, information, documents and discussions regarding this Summary of Terms and Conditions and the transactions contemplated hereby shall be kept confidential by JPMC.

4. <u>TYPES AND AMOUNTS OF LOAN FACILITIES</u>

<u>Loan Facilities</u>	The Lenders hereby agree to provide financing to the Borrower as follows:
Type and Amount:	Loan Facilities (the loans thereunder, the "<u>Loans</u>") as follows:

<u>Tranche A Loan Facility</u>: A ten-year term loan facility (subject to extension as provided below) provided by the Tranche A Lender to the Borrower in a principal amount equal to the Purchase Price plus the par value of the Unfunded Forward Commitments minus $1,000,000,000, but in any case not to exceed $29,000,000,000 (the loan thereunder, the "<u>Tranche A Loan</u>"). The Tranche A Loan shall be repayable or be terminated in the manner described under the section below entitled "<u>Cash Flow Waterfall</u>".

<u>Tranche B Loan Facility</u>: A ten-year term loan facility (subject to extension as provided below) provided by the Tranche B Lender to the Borrower in a principal amount of $1,000,000,000 (the loan thereunder, the "<u>Tranche B Loan</u>"). The Tranche B

	Loan will be subordinate in right of payment to the Tranche A Loan and shall be repayable or be terminated in the manner described under the section below entitled "Cash Flow Waterfall".
Availability:	The Loans shall be made in a single drawing on the Closing Date (as defined below).
Maturity Date:	The Loans will mature on the tenth anniversary of the Closing Date; *provided* that the NY Fed may in its sole discretion at any time and from time to time extend the maturity date of either or both of the Loan Facilities; *provided, further*, that the NY Fed may not extend the maturity date of the Tranche B Loan after the Tranche A Loan is paid in full or to a maturity date later than the maturity date of the Tranche A Loan without the consent of the Tranche B Lender.
Purpose:	The proceeds of the Loans shall be used to finance the acquisition of the Portfolio and the Pre-Closing Date Proceeds Amount from the Seller and to fund the Delayed Draw Account (as defined below).

5. INTEREST PAYMENT PROVISIONS

Interest Rates:	The Tranche A Loans shall bear interest at a rate per annum equal to the Primary Credit Rate in effect from time to time. The Tranche B Loans shall bear interest at a rate per annum equal to the Primary Credit Rate plus 450 bps in effect from time to time. As used herein, the "Primary Credit Rate" means the discount rate charged by the NY Fed for loans under its primary credit program from time to time in effect.
Interest Payment Dates:	Interest shall accrue and be compounded on a quarterly basis and be payable on payment dates as set forth under the section below entitled "Cash Flow Waterfall".

6. COLLATERAL, RESERVE ACCOUNT AND DELAYED DRAW ACCOUNT

Collateral:	The obligations of the Borrower in respect of the Loan Facilities and the hedge agreements entered into by the Borrower shall be secured by a first priority perfected security interest in (a) all of its assets including the Scheduled Collateral Pool and the Related Hedges (collectively, the "Portfolio"), (b) the Reserve Account (as defined below) and related investments, (c) the Delayed Draw Account and related investments and (d) all proceeds of the foregoing (collectively, the "Collateral"). The

Lenders and the counterparties under the hedge agreements shall collectively be referred to herein as the "Secured Parties".

All of the above described security interests will be created on terms, and pursuant to documentation (including custody and control agreements), satisfactory to the NY Fed, and none of the Collateral will be subject to any other pledges, liens or security interests.

Reserve Account:

On the Closing Date, the Pre-Closing Date Proceeds Amount (to the extent such amount is positive) and the proceeds of the Seller Payment, if any, will be deposited into the Reserve Account. On and after the Closing Date, all cash flow generated by the Collateral and any other income or proceeds earned or received by the Borrower shall be deposited with the Agent and credited to a reserve account (the "Reserve Account") and held in such Reserve Account for the benefit of the Secured Parties pending distribution to the Secured Parties in accordance with the Cash Flow Waterfall as hereinafter provided. Notwithstanding the foregoing, except to the extent funds are required to make a Seller Distribution (as defined below) or to pay any Operating Expenses that were accrued on or prior to the Closing Date and remain unpaid, amounts on deposit in the Reserve Account may not be distributed (other than in respect of payments required under the hedge agreements) to the extent that the amount on deposit therein will be less than the Unfunded Swap Exposure (the "Minimum Balance Requirement"). "Unfunded Swap Exposure" means the maximum total liability of the Borrower under all hedge agreements minus all amounts posted as collateral to the related hedge counterparties.

Amounts on deposit in the Reserve Account shall be invested in certain eligible investments at the discretion of the Controlling Party (as defined below).

Subject to the Minimum Balance Requirement, the Controlling Party (and its agents, including the Asset Manager) shall control in its sole discretion all decisions regarding the Collateral, the proceeds on deposit in the Reserve Account and decisions as to timing and amounts of distributions from the Reserve Account.

Delayed Draw Account:

On the Closing Date, a portion of the proceeds from the Loans equal to the amount of Unfunded Forward Commitments shall be deposited with the Agent and credited to a delayed draw account (the "Delayed Draw Account").

Amounts on deposit in the Delayed Draw Account shall be withdrawn from time to time by the Agent in order to satisfy any payment obligations of the Borrower in respect of any such commitments when and as such obligations become due.

Amounts on deposit in the Delayed Draw Account shall be invested in certain eligible investments at the discretion of the Controlling Party (as defined below).

To the extent any such Unfunded Forward Commitments expire or amounts remain on deposit in the Delayed Draw Account in excess of any remaining Unfunded Forward Commitments, the Agent shall transfer such amounts from the Delayed Draw Account to the Reserve Account.

7. CASH FLOW WATERFALL

Funds in the Reserve Account shall be paid on any business day as determined by the Controlling Party in its sole discretion in the following order of priority, subject, except as set forth in the last paragraph of "Waterfall Priority", to the Minimum Balance Requirement:

Waterfall Priority:

(a) First, to pay Operating Expenses that are then due and payable.

"Operating Expenses" mean all costs and expenses of administering the Portfolio, the Reserve Account, the other Collateral, the Loan Facilities and Loan Documentation (as defined below) and the Borrower, including all fixed fees and expenses of the Asset Manager and the Agent, all legal, accounting and other professional fees and expenses and other administrative costs and expenses of the Borrower, all legal, accounting and other professional fees and expenses and other administrative costs and expenses (other than those of the Tranche B Lender, the Seller or any of their respective advisors or agents) associated with the negotiation, preparation, execution and delivery of this term sheet and the Loan Documentation (as defined below) and with the administration of the Loan Documentation and any amendment or waiver or enforcement action with respect thereto (including the fees, disbursements and other charges of counsel), taxes that are determined to be payable from time to time, all amounts payable in respect of hedges (including, without limitation, periodic payments and termination payments), the costs of entering into any additional hedges as may be determined to be necessary or appropriate by the Controlling Party and any indemnity claims.

(b) Second, beginning on or after the second anniversary of the Closing Date or such earlier date as shall be determined by the Controlling Party (the period from the Closing Date until the second anniversary of the Closing Date or such earlier date the "Accumulation Period"), to pay all or any portion of the outstanding principal amount of the Tranche A Loan Facility; *provided* that, if the Controlling Party elects to pay any of the outstanding principal amount of the Tranche A Loan Facility prior to the second anniversary of the Closing Date, the full outstanding principal amount of the Tranche B Loan Facility, together with all accrued and unpaid interest thereon, shall be simultaneously repaid.

(c) Third, after the Accumulation Period, but so long as the entire outstanding principal amount of the Tranche A Loan Facility has been repaid in full, to pay all or any portion of the accrued but unpaid interest outstanding under the Tranche A Loan Facility.

(d) Fourth, after the Accumulation Period, but so long as the entire outstanding principal amount, all accrued and unpaid interest and all other outstanding amounts, in each case under the Tranche A Loan Facility have been repaid in full, to pay all or any portion of the outstanding principal amount of the Tranche B Loan Facility.

(e) Fifth, after the Accumulation Period, but so long as the entire outstanding principal amount, all accrued and unpaid interest and all other outstanding amounts, in each case under the Tranche A Loan Facility have been paid in full and so long as the entire outstanding principal amount of the Tranche B Loan Facility has been repaid in full, to pay all or any portion of the accrued but unpaid interest outstanding under the Tranche B Loan Facility.

(f) Sixth, after the Accumulation Period, but so long as the entire outstanding principal amount, all accrued and unpaid interest and all other outstanding amounts, in each case under both the Tranche A Loan Facility and the Tranche B Loan Facility have been paid in full, all hedges have been terminated and all amounts payable under the hedges have been paid in full, to pay any fees and expenses or other amounts owing to the extent not constituting Operating Expenses.

(g) Seventh, after the Accumulation Period, but so long as the entire outstanding principal amount, all accrued and unpaid interest and all other outstanding amounts, in each case under both the Tranche A Loan Facility and the Tranche B Loan Facility have been paid in full, all hedges have been terminated and all amounts payable under the hedges have been paid in full, and any fees and expenses or other amounts owing to the extent not constituting Operating Expenses have been paid in full, to pay all remaining amounts to the NY Fed as holder of the Residual Interest.

Notwithstanding the foregoing on any business day (including the Closing Date) as determined in the sole discretion by the Controlling Party, (i) to the extent that the Pre-Closing Date Proceeds Amount is negative, funds in the Reserve Account shall be withdrawn, from time to time if necessary, to make a payment or payments to the Seller in an amount equal to the absolute value of the Pre-Closing Date Proceeds Amount (the "Seller Distribution") and (ii) after giving effect to all payments required by clause (i), funds in the Reserve Account shall be withdrawn, from time to time if necessary, and used to pay all Operating Expenses that accrued on or prior to the Closing Date and remain unpaid.

Once prepaid, Loans may not be reborrowed.

Termination: Regardless of whether any amounts remain outstanding thereunder, each of the Loan Facilities and the Residual Interest shall be terminated on the date on which the entire Portfolio has been fully liquidated and all proceeds thereof, including all amounts on deposit in the Reserve Account and the Delayed Draw Account, have been distributed in the manner set forth above.

8. CERTAIN CONDITIONS

Initial Conditions: The availability of the Loan Facilities shall be conditioned upon the satisfaction of the following conditions (the date upon which all such conditions precedent shall be satisfied, the "Closing Date"): the execution and delivery by the Agent, the Lenders, the Borrower and the Asset Manager of Loan Documentation satisfactory to the NY Fed, the closing of the Merger in all material respects on the terms set forth in the Merger Agreement, the consummation of the sale of the Portfolio (including the Pre-Closing Date Proceeds Amount) on the terms set forth in the Asset Acquisition Agreement and the creation and perfection of security interests in the Collateral pursuant to arrangements satisfactory to the NY Fed.

9. CERTAIN DOCUMENTATION MATTERS

The documentation for the Facilities (the "Loan Documentation") shall contain representations, warranties, covenants and events of default (in each case, applicable to the Borrower) customary for financings involving special, limited purpose borrowers and with other terms deemed appropriate by the NY Fed.

Voting and Control: The NY Fed shall be the "Controlling Party" on and after the Closing Date and shall be permitted to make all decisions regarding the Collateral, the Reserve Account, the Delayed Draw Account and the Loan Documentation, including the timing and amounts of distributions and whether or not a default or event of default has occurred and whether or not to begin the exercise of remedies.

In addition the Controlling Party will have complete discretion with respect to all decisions regarding the management of the Collateral (which it may elect to delegate to the Asset Manager), including decisions as to when to liquidate Collateral and as to when or if to terminate hedges or enter into hedges. In exercising such control the Controlling Party and its agents shall have no duty to maximize returns on the Collateral or to take into account the interests of the Tranche B Lender.

Notwithstanding the foregoing, the consent of (i) each Lender directly affected thereby shall be required with respect to (a) reductions in the outstanding principal amount of any Loan (except as otherwise expressly permitted above) and (b) any amendment to the Loan Documentation or any other transaction document that is materially adverse to such Lender and (ii) each Secured Party directly affected thereby shall be required with respect to any materially adverse change in such Secured Party's position in the cash flow waterfall.

Assignments and Participations:	The Tranche B Lender shall not be permitted to assign all or a portion of its Tranche B Loan or sell participations in its Tranche B Loan except to its affiliates.
Indemnification and Exculpation:	The Agent, the Asset Manager, the Controlling Party and the Lenders (and their affiliates and their respective officers, directors, employees, advisors and agents) will have no liability for, and will be indemnified by the Borrower and held harmless against, any losses, claims, damages, liabilities or expenses (collectively, "Liabilities") incurred in respect of, or arising out of, or in connection with, the financing contemplated hereby (including in connection with the management of the Portfolio and other Collateral) or the use or the proposed use of proceeds thereof, except to the extent they are found by a final, non-appealable judgment of a court of competent jurisdiction to arise from the gross negligence, bad faith or willful misconduct of such person.

Each Secured Party agrees not to assert or claim that the Agent, the Asset Manager, the Controlling Party or any other Secured Party (and their affiliates and their respective officers, directors, employees, advisors and agents) has any liability for any Liabilities incurred in respect of, or arising out of, or in connection with, the financing contemplated hereby (including in connection with the management of the Portfolio and other Collateral) or the use or the proposed use of proceeds thereof, except to the extent they are found by a final, non-appealable judgment of a court of competent jurisdiction to arise from the gross negligence, bad faith or willful misconduct of such

	person.
Governing Law and Forum:	State of New York.

Accepted and agreed to as of
March 28, 2008:

This Summary of Terms and Conditions may be executed in counterparts.

THE FEDERAL RESERVE BANK OF NEW YORK

By: ______________________
Name: Timothy F. Geithner
Title: President

JPMORGAN CHASE & CO.

By: ______________________
Name:
Title:

Accepted and agreed to as of
March 28, 2008:

This Summary of Terms and Conditions may be executed in counterparts.

THE FEDERAL RESERVE BANK OF NEW YORK

By: ____________________
Name:
Title:

JPMORGAN CHASE & CO.

By: ____________________
Name: James Dimon
Title: Chairman and Chief Executive Officer

Testimony of Jamie Dimon

Before the Senate Committee on Banking, Housing and Urban Affairs

April 3, 2008

Good morning Chairman Dodd, Ranking Member Shelby, and Members of the Committee. My name is Jamie Dimon and I am the Chairman and Chief Executive Officer JP Morgan Chase. I appreciate the invitation to appear before you today.

Mr. Chairman, your letter inviting me to testify asked me to address a number of issues relating to the JPMorgan-Bear Stearns merger. At the outset, I want to underscore a few key points about the transaction:

- First, we got involved in this matter because we were asked to help prevent a Bear Stearns collapse that had the potential to cause serious damage to the financial system and the broader economy.

- Second, we could not and would not have assumed the substantial risks of acquiring Bear Stearns without the $30 billion facility provided by the Fed. While we wanted to help, and I believe we were the only firm ultimately in a position to help, we had to protect the interests of our shareholders.

- Third, this transaction is not without risk for JPMorgan. We are acquiring some $360 billion of Bear Stearns assets and liabilities. The notion that Bear Stearns' riskiest assets have been placed in the $30 billion Fed facility is simply not true. And if there is ever a loss on the assets pledged to the Fed, the first $1 billion of that loss will be borne by JPMorgan alone.

* * *

Let me turn now to how we became involved in the effort to rescue Bear Stearns and avoid a financial crisis. On Thursday evening, March 13, Bear Stearns called to tell us that it might not have enough cash to meet obligations coming due the next day and needed emergency help. We contacted the New York Fed and learned that they were aware of the situation and recognized that a Bear Stearns bankruptcy posed a serious risk to the financial system.

Working through the night and into Friday morning, the New York Fed agreed to establish a secured lending facility for the company, using JPMorgan as a conduit. But it became clear by the end of Friday that a comprehensive solution would be needed before the markets re-opened in Asia on Sunday evening.

We had teams of people working around the clock that weekend in an effort to determine what we could do to help. My perspective from the start was that we could not do anything that would jeopardize the health of JPMorgan. That would not be good for our shareholders, and it would not be good for the financial system. But I also felt that to the extent it was consistent with the best interests of our shareholders, we would do everything we reasonably could to try to prevent the systemic damage that a Bear Stearns failure could cause. I viewed that as the obligation of JPMorgan as a responsible corporate citizen.

By Sunday morning, we concluded that the risks were too great for us to buy the entire company on our own. We informed the New York Fed, Treasury and Bear Stearns of our conclusion. This wasn't a negotiating posture. It was the plain truth.

The New York Fed encouraged us to consider what kind of assistance would allow us to do a transaction. That is what we did. Finally, on Sunday evening, the private and government parties announced a plan with three core elements:

- First, JPMorgan would acquire Bear Stearns in a binding stock deal worth $2 per share to Bear's shareholders.
- Second, the Fed would provide the merged company with a $30 billion non-recourse loan, collateralized by a pool of Bear Stearns assets valued on Bear Stearns' books at the same amount.

- Third, JPMorgan would provide an unprecedented guaranty on billions of dollars of Bear Stearns trading obligations. This was done to assure the market that it could continue to do business with Bear Stearns and prevent a further run on the bank.

We hoped that the initial plan would save Bear Stearns and reassure the market that Bear Stearns would survive. But we also understood that we would have to monitor the situation closely. And it soon became clear that we had not done enough. Customers and counterparties continued to flee for two reasons: the market perceived our guaranty as too narrow; and it doubted that the $2 offer price would be enough to get Bear Stearns shareholders to approve the transaction.

Discussions with Bear Stearns and the federal government in the week following the initial merger announcement led to a revised rescue plan with a package of five critical new elements designed to address these real concerns:

- First, we strengthened our guaranty to cover virtually all Bear Sterns products, customer relationships and subsidiaries.
- Second, in response to a request from the Fed, we gave it a separate guaranty of its loans to Bear Stearns.
- Third, we agreed to take the first $1 billion of any losses that might ultimately flow from the Fed's $30 billion non-recourse funding.
- Fourth, Bear agreed to sell 95 million newly issued shares to us, representing 39.5% of its voting stock.
- Fifth, to help achieve finality, we increased our offer to $10 per share.

This amended plan worked. In the week following its announcement, the liquidity situation at Bear Stearns stabilized. And the day the revised plan was announced, Standard and Poor's raised Bear's credit ratings.

* * *

Let me say a word about the $30 billion of collateral for the Fed. We are subject to a confidentiality agreement with the Fed in relation to those assets, so I am constrained in what I can say. But I can make a few general points: The assets taken by the Fed consist entirely of loans that are current and domestic securities rated investment grade. We kept the riskier and more complex securities in the Bear Stearns portfolio for our own account.

We did not cherry pick the assets in the collateral pool. The process of designating what collateral would be pledged was overseen by the New York Fed's advisor, BlackRock, a recognized expert in the field. While no one can predict how that portfolio will ultimately perform -- and, of course, it could actually increase in value -- if the portfolio declines in value, the first $1 billion of that loss will be borne solely by JPMorgan.

*   *   *

Finally, let me turn briefly to the Committee's interest in the implications of this rescue for American taxpayers. The key point, in my view, is this: Bear Stearns would have failed without this effort, and the consequences could have been disastrous. The idea that the Bear Stearns fallout would have been limited to a few Wall Street firms just isn't so. People all over America -- union members, retirees, small business owners, and our parents and children -- are now invested in the financial system through pensions, 401(k)s, mutual funds and the like.

A Bear Stearns bankruptcy could well have touched off a chain reaction of defaults at other major financial institutions. That would have shaken confidence in credit markets that already have been battered. And it could have made it harder for home buyers to get mortgages, harder for municipalities to get the funds they need to build schools and hospitals, and harder for students who need loans to pay tuition. Moreover, such a cascade of trouble could have further depressed consumer confidence and consumer spending, resulted in widespread job losses, and accelerated the current economic downturn.

* * *

Mr. Chairman, the events of the past three weeks have been extraordinary. I commend you and your colleagues for examining their implications for the future. One thing I can say with confidence: if the private and public parties before you today had not acted in a remarkable collaboration to prevent the fall of Bear Stearns, we would all be facing a far more dire set of challenges. Thank you and I look forward to answering your questions.

STATEMENT OF ALAN SCHWARTZ
PRESIDENT AND C.E.O. OF THE BEAR STEARNS COMPANIES, INC.
BEFORE THE U.S. SENATE BANKING COMMITTEE
April 3, 2008

Good Morning, Chairman Dodd and Ranking Member Shelby.

My name is Alan Schwartz. I am the President and Chief Executive Officer of The Bear Stearns Companies. Bear Stearns and its 14,000 employees provide global investment banking services, securities and derivatives trading, clearance and brokerage services, and asset management services world-wide. I have been a part of, and have grown with, the Bear Stearns family for over 32 years. I am saddened by the fast-moving events of the past several weeks that bring me here today.

During the week of March 10, even though the firm was adequately capitalized and had a substantial liquidity cushion, unfounded rumors and attendant speculation began circulating in the market that Bear Stearns was in the midst of a liquidity crisis. The Company assured the public that our balance sheet, liquidity, and capital were strong, but the rumors and conjecture persisted.

Due to the stressed condition of the credit market as a whole and the unprecedented speed at which rumors and speculation travel and echo through the modern financial media environment, the rumors and speculation became a self-fulfilling prophecy. Because of the rumors and conjecture, customers, counterparties, and lenders began exercising caution in their dealings with us – and during the latter part of the week outright refused to do business with Bear Stearns. Even if these counterparties and institutional investors believed – as we did – that we were stable, it appears that these parties were faced with the dilemma that if the rumors proved true, they could be in the difficult position of having to explain to their clients and others why they continued to do business with Bear Stearns. As the week progressed, unfounded rumors grew into fear and our liquidity cushion dropped precipitously on Thursday, as customers withdrew cash and repo counterparties increasingly refused to lend against even high-quality collateral. There was, simply put, a run on the bank.

I want to emphasize that the impetus for the run on Bear Stearns was in the first instance the result of a lack of confidence, not a lack of capital or liquidity.

Throughout this period, Bear Stearns had a capital cushion well above what was required to meet regulatory standards. However, by Thursday of that week, a tipping point was reached on liquidity. The market rumors became self-fulfilling and Bear Stearns' liquidity pool began to fall sharply.

At that point, we needed to find a source of emergency financing to stabilize the situation and calm our clients and counterparties. On Thursday, we reached out to JP Morgan, among others, in part because JP Morgan served as our clearing agent and was therefore already familiar with our collateral position. We also informed the S.E.C. and the Federal Reserve as to what was happening.

We worked through the night and on Friday morning, March 14th, JP Morgan agreed to make a short-term loan available to Bear Stearns, supported by a back-to-back loan from the New York Federal Reserve Bank. We believed at the time that the loan (and the corresponding back-stop from the New York Fed) would be available for 28 days. We hoped this period would be sufficient to bring order to the chaos and allow us to secure more permanent funding or an orderly disposition of assets to raise cash, if that became necessary.

However, despite the announcement of the JP Morgan facility, market forces continued to drive and accelerate our precipitous liquidity decline. Also, that Friday afternoon, all three major rating agencies lowered Bear Stearns' long-term and short-term credit ratings. Finally, on Friday night, we learned that the JP Morgan credit facility would not be available beyond Sunday night. The choices we faced that Friday night were stark: find a party willing to acquire Bear Stearns by Sunday night, or face what my advisors were telling me could be a bankruptcy filing on Monday morning, which could likely wipe out our shareholders and cause losses for certain of our creditors. Therefore, we set out to find a potential purchaser to acquire Bear Stearns that had the wherewithal to provide the backing we needed – an arrangement we hoped would reassure our constituencies and curtail the flight of our clients and counterparties. And we needed to find and reach agreement with such a party over the weekend.

On Sunday, March 16th, after an intense effort to find the best transaction possible, we reached the first agreement with JP Morgan, which has been much-discussed in the press. JP Morgan would acquire Bear Stearns for $236 million, or $2 a share. Significantly, JP Morgan also agreed immediately to guarantee the trading obligations of Bear Stearns and its subsidiaries. As part of this deal, JP Morgan obtained an agreement from the New York Fed to loan up to $30 billion to

JP Morgan, secured by certain of Bear Stearns's assets. While we at Bear Stearns had some understanding that JP Morgan was seeking this commitment, we were not directly involved in the negotiations between JP Morgan and the government.

The following week, due to market uncertainty about the guarantees and the successful completion of the deal, the agreement between Bear Stearns and JP Morgan was renegotiated. In the end, JP Morgan agreed to pay $10 a share for Bear Stearns in a stock-for-stock merger, enhancements were made to JP Morgan's guarantee of our operating and certain other obligations, and a number of other changes were made to give greater certainty of closing. At the same time, we understand that JP Morgan's agreement with the New York Fed was modified to make the terms more favorable to the New York Fed.

In sum, before unfounded rumors began circulating in an already precarious credit market, leading to the run on Bear Stearns, the Company had adequate capital and liquidity, and a book value of approximately twelve billion dollars. Facing the dire choice of bankruptcy or a forced sale under exigent circumstances, we salvaged what we could to avoid wiping out our shareholders, bondholders, and 14,000 employees.

Federal officials and JP Morgan are in a better position than I to discuss their rationale and motives for participating in the transaction. I can only say that, as devastating as these events have been for the Bear Stearns family, the failure of Bear Stearns could have had an even more extensive, devastating impact on the stability of the financial markets as a whole. And it may have triggered a run on other investment banks, with potentially disastrous effects on the nation's economy. Like all of us, I am certainly glad such a disaster did not occur.

Thank you for your time. I am prepared to answer any questions you may have.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM BEN S. BERNANKE

Q.1. Does the Fed intend to conduct a study of what happened at Bear Stearns, with lessons learned?

A.1. The SEC, which was Bear Steams' prudential regulator, is conducting an in-depth study of the events that precipitated the firm's liquidity crisis. The SEC has promised to share the results of its study with us. We will assess the results of the SEC's review and then consider whether further study of what happened to Bear Stearns is necessary. In terms of lessons learned, one lesson that is already clear is that asset and funding liquidity can evaporate suddenly, even for very high quality assets. Both leveraged financial intermediaries and their prudential regulators must think through carefully the implications for prudent capital and liquidity buffers.

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

PRIMARY DEALER CREDIT FACILITY

Chairman Bernanke, the Federal Reserve is now lending regularly to securities firms under its Primary Dealer Credit Facility. It has been suggested that if the Fed is going to open its discount window to securities firms, additional regulation of securities firms may be needed.

Q.1. How do we balance the need to have appropriate supervision of securities firms, especially now that they can receive Federal loans through the Fed, against the need to preserve the competitiveness of our financial services sector and avoid over-regulation?

A.1. All the primary dealers eligible to borrow from the Federal Reserve under the Primary Dealer Credit Facility (PDCF) are subject to supervision and regulation by the SEC. In addition, the parent companies of nearly all of these primary dealers are subject to consolidated supervision—either by the Federal Reserve in the case of dealers that are owned by a U.S. bank holding company, a foreign bank supervisory agency in the case of dealers that are owned by a foreign bank, or the SEC or OTS in the case of dealers that are not affiliated with banks.

The Federal Reserve is working closely with the SEC to ensure that we have access to necessary financial, risk management, and other information about primary dealers—including information about their capital and liquidity positions—and this coordination has been very useful to date. In the near term, the Federal Reserve does not see a need for any additional supervisory authorities with respect to primary dealers.

Over the longer term, the Federal Reserve is analyzing the costs and benefits of possible changes in the supervision and regulation of securities firms and their parent holding companies (particularly as regards their capital adequacy and liquidity). Upon completion of this review, we would be pleased to discuss these issues with you.

REGULATORY RELIEF

It has been reported that as a condition for purchasing Bear Stearns, regulators promised JPMC certain regulatory relief, including SEC no-action letters and forbearance on capital requirements.

Q.2. Would you please list any and all regulatory relief your agency or department has agreed to provide JPMC in connection with its merger with Bear Stearns?

A.2. The Board provided two regulatory exemptions requested by JPMC in connection with its proposed acquisition of Bear Stearns.

First, the Board provided JPMC with a temporary (18–month) exemption from the risk-based and leverage capital requirements for bank holding companies. The exemption allowed JPMC initially to (i) reduce its risk-weighted assets by the total arnount of risk-weighted assets of Bear Stearns for purposes of the Board's risk-based capital adequacy guidelines for bank holding companies; and (ii) reduce its balance-sheet assets by the total balance-sheet assets of Bear Stearns for purposes of the Board's leverage capital guidelines for bank holding companies. The amount of the exemption going forward will shrink by one-sixth during each succeeding quarter until the exemption expires on October 1, 2009. JPMC has committed that it will remain well capitalized during this period, both with and without the exemption.

Second, the Board provided JPMC with a temporary (18–month) exemption from section 23A of the Federal Reserve Act and the Board's Regulation W. The exemption allows JPMorgan Chase Bank to extend credit to Bear Stearns and issue guarantees on behalf of Bear Steams so long as the transactions are (i) fully collateralized; (ii) subject to daily mark-to-market and remargining requirements; and (iii) guaranteed by JPMC. The initial amount of the exemption was 50 percent of the bank's regulatory capital. The amount of the exemption going forward will shrink by one-sixth during each succeeding quarter until the exemption expires on October 1, 2009. All transactions between JPMorgan Chase Bank and Bear Stearns would continue to be subject to section 23B of the Federal Reserve Act, which requires financial transactions between a bank and an affiliate to be conducted on market terms.

A copy of the Board's regulatory capital and section 23A exemption letter is attached.

Although not a regulatory relief matter, the Board also approved the acquisition of Bear Stearns Bank & Trust by JPMC on April 1, 2008, on an expedited basis as provided in the Bank Holding Company Act. A copy of the Board's order approving the acquisition is attached.

EMERGENCY LENDING AUTHORITY

Chairman Bernanke, in my opening statement I mentioned the Federal Reserve's emergency lending authority. The Federal Reserve Act does not clearly specify the goals or purposes for which the Fed should exercise this authority. It only provides that lending to corporations should occur in unusual or exigent circumstances and when a corporation is unable to secure credit from other banking institutions. These relatively simple conditions effectively give the Fed broad discretion on when to exercise its emergency lending authority. You have written widely about the importance of inflation targeting, arguing that inflation-targeting provides "discipline and accountability in the making of monetary policy."

Q.3. If monetary policy benefits from a framework that provides discipline and accountability, would not the Fed's emergency lending authority also benefit from having clearer objectives and conditions provided by Congress?

A.3. In my view, the Congress has achieved an appropriate balance between the needs for discipline and accountability, on the one hand, and flexibility and judgment, on the other, in the statutory frameworks that it has established for both monetary policy and emergency lending.

With regard to monetary policy, the Congress has established the goals of maximum employment, stable prices, and moderate long-term interest rates, and it has set a framework for monetary policy accountability, partly through semiannual reports and testimony on monetary policy. The Congress has left the specific interpretation of the statutory goals for monetary policy to the judgment of the Board of Governors and the Federal Open Market Committee; for example, the Congress has wisely Chosen not to quantify three goals of policy. Similarly, the Congress has provided only general guidance regarding the Federal Reserve's semiannual reports on monetary policy, leaving the specific content of such reports and the accompanying testimony to the judgment of the Federal Reserve.

The Congress has chosen an analogous approach for the conditions and accountability for emergency lending. With regard to the conditions for emergency lending, the Congress has established a clear framework that sets a high hurdle for undertaking such activities: Emergency lending can be done only in unusual and exigent circumstances, only when the borrower cannot otherwise secure adequate credit accommodations, and only with the approval of at least five members of the Federal Reserve Board. However, the Congress left the specific interpretation of the first two conditions to the Board. In my view, this was a wise decision by the Congress: Financial crises tend to be unique events, making it very difficult to set in advance an appropriate set of specific conditions that would have to be met for emergency lending. Moreover, the Congress has established an ongoing framework for the accountability of the Federal Reserve's financial operations by requiring that the Board publish on a regular basis statements of conditions for the Reserve Banks and for the System as a whole. Within this reporting framework, the Board has provided detail on the amounts outstanding under its various credit programs both in routine circumstances and in the current period of financial stress. In addition, the Federal Reserve recognizes that when it undertakes emergency lending it has an obligation to explain why it believes the conditions for such lending have been met. Congress has the authority to review the Federal Reserve's explanations, as it did at the hearing on April 3.

Chairman Bernanke, the Federal Reserve Act grants the Board of Governors broad emergency lending authority. It enables the Fed to extend the Federal safety net to corporations, such as investment banks, that otherwise are not guaranteed by the Federal government.

Q.4. Since taxpayers bear any losses on any emergency loans the Fed extends, should there be limits on the amount of lending the Fed can conduct under its emergency lending authority? And given budgetary implications of such lending, should the Treasury Secretary also have to formally approve these loans?

A.4. When Congress established the Federal Reserve as the nation's central bank, Congress considered it important that an independent agency be created to help maintain the stability of the U.S. financial system. Financial crises can develop quickly and with considerable intensity, and it is crucial that the Federal Reserve have authority to respond rapidly and powerfully to a severe crisis by, if necessary and appropriate, providing liquidity to the financial system.

It is important to note that the Federal Reserve's emergency lending authorities are subject to a number of important qualitative limits. Most notably, the Federal Reserve generally has authority to lend to non-banks only in unusual and exigent circumstances, and when the borrower is unable to obtain adequate credit accommodations from other banking institutions. Moreover, these emergency credits must be secured to the satisfaction of the lending Federal Reserve Bank and approved by a super-majority of the Board of Governors of the Federal Reserve System. Consistent with the spirit of the Federal Reserve Act, we have only used our power to make emergency loans to non-depository institutions on a small number of occasions in the 75 years since Congress granted this authority to the Federal Reserve.

The Federal Reserve also has been very careful in its recent actions to minimize any potential losses to taxpayers. All credit extended to primary dealers under the PDCF and all transactions with primary dealers under the term securities lending facility (TSLF) are fully secured by investment-grade securities with appropriate haircuts. In addition, the March 14 loan to Bear Steams was repaid on March 17 without loss to the taxpayer. There are also substantial protections for taxpayers associated with the prospective $29 billion extension of credit by the Federal Reserve to be made in connection with the acquisition of Bear Stearns by JPMC. The collateral for the loan will be in the form of investment-grade securities and performing credit facilities, JPMC will bear the first $1 billion of losses on the collateral pool, the Federal Reserve will be able to liquidate the collateral over a long-term horizon of at least ten years, and we have hired a professional independent investment adviser to manage the collateral pool.

The Federal Reserve has never incurred any losses in extending credit through the discount window, and we will take every precaution to ensure that that remains the case.

In light of the strict qualitative limits on Federal Reserve emergency lending, the Federal Reserve's practice of using this authority judiciously and safely, and the need for the Federal Reserve to be able to act in a financial crisis with maximum alacrity and independence of judgment, we do not think it would be necessary or appropriate to require the Secretary of the Treasury to approve Federal Reserve emergency loans.

Q.5. Also, does the Fed's mere possession of such broad lending authority create expectations that the Fed will not permit major financial institutions to fail?

A.5. Investors in and creditors of major financial institutions undoubtedly are now more aware of the Federal Reserve's broad emergency lending authority. There are substantial constraints on the Federal Reserve's authority, however, that should help promote continued market discipline. Specifically, in contrast to the FDIC's broad authority to resolve and/or liquidate insured depository institutions, the Federal Reserve does not have authority to acquire or otherwise resolve financial firms. The Federal Reserve may only address the liquidity needs of solvent non-depository companies in unusual and exigent circumstances. In this regard, the Federal Reserve did not prevent the demise of Bear Stearns. The resolution of Bear Stearns relied on a private sector acquisition.

The inability of the Federal Reserve to acquire or otherwise provide a solvency backstop to financial institutions is reflected in the market prices of obligations of financial institutions and derivative instruments based on obligations of financial institutions. Prices of these financial assets imply that market participants are far from certain that the Federal Reserve would prevent major financial institutions from failing. In particular, market participants continue to pay substantial premiums for protection against losses from failure of most major U.S. financial institutions.

Moreover, any incidental costs associated with the Federal Reserve's lending authority must be compared against the substantial benefits that accrue to the financial markets—and ultimately to taxpayers and homeowners—by allowing the central bank to respond quickly in emergency situations as a lender of last resort. Congress created the Federal Reserve in part to serve the traditional central bank function as lender of last resort and thereby to reduce in emergency situations the potential adverse effects of illiquidity on either an individual firm or on the financial system more broadly. The fact that the Federal Reserve has exercised this authority to extend credit to non-depository institutions on only a small number of occasions in the past 75 years underscores the high hurdle that Congress and the Federal Reserve have set for such lending.

MORAL HAZARD

Q.6. Chairman Bernanke, would you please address the extent to which the Fed's actions in this case have increased the risk of moral hazard?

A.6. Access to the federal safety net, including access to central bank credit, necessarily entails a degree of moral hazard. Thus, granting primary dealers access to Federal Reserve credit has increased moral hazard to some degree.

Although the potential for moral hazard should be carefully analyzed and considered by policymakers, it seems more likely that the example of Bear Stearns—in which shareholders and management suffered considerable losses—and the broader distress in financial markets will serve as a potent reminder to primary dealers and other leveraged financial firms about the importance of prudent liquidity risk management. In particular, in developing their liquidity management plans, primary dealers and others must now attach considerable weight to scenarios in which their access to funding in the repo market is sharply curtailed. Of course, the Federal Reserve, the SEC, and other regulatory agencies will be working to reinforce that message.

The adverse effects of moral hazard must and can be mitigated through prudential supervision and regulation. The SEC and the Federal Reserve have been monitoring the leverage and liquidity of the primary dealers. Going forward, the SEC and the Federal Reserve will assess what changes in prudential supervision and regulation of primary dealers (such as increased capital or liquidity requirements) are needed to mitigate moral hazard and ensure that the dealers manage their risks appropriately.

The adverse effects of moral hazard from use of the Federal Reserve's emergency lending powers also must and can be mitigated through judicious, sparing, and disciplined use by the Federal Reserve of these powers. In this regard, as noted above, the Federal Reserve generally has authority to lend to non-depository institutions only in unusual and exigent circumstances and has very rarely exercised this authority.

The Federal Reserve's actions with respect to Bear Stearns are instructive in this regard. The Federal Reserve facilitated the acquisition of Bear Stearns by JPMC because the substantial involvement of Bear Stearns in many important financial markets—at a time when the credit markets were particularly vulnerable—was such that a sudden failure by Bear Stearns would likely have led to a chaotic unwinding of positions in already severely strained circumstances. Moreover, a failure by Bear Stearns to meet its obligations would have cast doubt on the financial strength of other financial firms whose operations bore superficial similarity to that of Bear Stearns, without due regard to the fundamental soundness of those firms. The Federal Reserve judged that a sudden failure of Bear Stearns under these unusually fragile circumstances would have been extremely disorderly and would have risked unpredictable but severe consequences for many sound financial firms and for the functioning of the broader financial system and the economy.

Moreover, as discussed in my answer to the previous question, any incidental costs associated with the Federal Reserve's lending authority—such as increased moral hazard—must be weighed against the substantial benefits that accrue to the financial markets by allowing the central bank to serve as lender of last resort. The Federal Reserve's recent actions under its emergency lending authorities—the establishment of the PDCF and TSLF and the proposed financing of the JPMC acquisition of Bear Stearns—were essential to avert a financial crisis that likely would have had serious repercussions for the U.S. economy.

LESSONS LEARNED AND TOO BIG TO FAIL

We have heard the argument that Bear was "too interconnected to allow to liquidate quickly". This would appear to be the case for a number of financial entities, including both banks and non-banks.

Q.7. What changes in financial surveillance and reporting could the regulators use to make such a situation of "interconnectedness" less likely to trigger the type of resolution the Fed entered into with Bear?

A.7. As noted in our answer to the previous question, although the interconnectedness of Bear Stearns was a consideration in the Federal Reserve's decision to facilitate the acquisition of Bear Stearns by JPMC, it was not a sufficient condition for the Federal Reserve's actions. Other important causes of the Federal Reserve's actions with respect to Bear Stearns were the suddenness of the collapse of the liquidity position of Bear Stearns and the unusually fragile conditions in the financial markets.

Regulators have for some time been paying considerable attention to the extent and nature of commercial and investment banks' credit exposures to other large financial institutions, including exposures arising from OTC derivatives. But clearly this is an issue that deserves further attention. In particular, regulators need to understand and evaluate the effectiveness of the stress tests that these firms use to assess and limit the potential for exposures to increase significantly in stressed market conditions. Regulators also need to take a hard look at the firms' liquidity risk management practices, including their reliance on common sources of funding their vulnerabilities to sudden reductions in the availability of those types of funding.

Q.8. Given that the Fed has pursued this transaction, how can the Fed and perhaps the Congress now convince market participants that something similar will not happen again? And if we cannot convince market participants that is the case, what is the implication for risk-taking behavior in the future?

A.8. As discussed above, it seems likely that the considerable losses suffered by shareholders and management of Bear Stearns should serve to check and possibly diminish incentives for undue risk-taking by the owners and managers of large financial institutions. Moreover, as discussed above, the adverse effects of moral hazard from use of the Federal Reserve's emergency lending powers are mitigated by the sparing and disciplined use by the Federal Reserve of these powers. As noted above, the Federal Reserve generally has authority to lend to non-depository institutions only in unusual and exigent circumstances, when the borrower is unable to obtain credit accommodations from other banking institutions, when the loans are secured to the satisfaction of the Federal Reserve, and when at least five members of the Board of Governors of the Federal Reserve System approve the transaction. The Federal Reserve's decision to extend credit in support of IPMC's acquisition of Bear Stearns was based on a highly unusual confluence of events, including the suddenness of the collapse of the liquidity position of Bear Stearns and the highly fragile state of the financial Markets at the time.

As noted above, the Federal Reserve is currently analyzing whether changes in the supervision and regulation of securities firms and their patent holding companies (particularly as regards their capital adequacy and liquidity) would be appropriate to mitigate potential residual adverse effects of actions such as the Federal Reserve's recent emergency liquidity facilities.

Attachments (2).

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

ADDRESS OFFICIAL CORRESPONDENCE
TO THE BOARD

April 1, 2008

Kathleen A. Juhase, Esq.
Senior Vice President and
Associate General Counsel
JPMorgan Chase & Co.
277 Park Avenue, 19th Floor
New York, New York 10172

Dear Ms. Juhase:

This is in response to the request by JPMorgan Chase & Co. ("JPMC"), New York, New York, for (i) an exemption from section 23A of the Federal Reserve Act and the Board's Regulation W[1] that would permit JPMorgan Chase Bank, National Association ("JPMC Bank"), Columbus, Ohio, to extend credit to affiliates and issue guarantees on behalf of affiliates, in connection with the acquisition by JPMC of The Bear Stearns Companies, Inc. ("Bear Stearns"), New York, New York; and (ii) relief from the Board's risk-based and leverage capital guidelines for bank holding companies[2] in connection with the acquisition by JPMC of Bear Stearns. On March 16, 2008, JPMC entered into an agreement to acquire Bear Stearns.

Exemption from Section 23A and Regulation W

Section 23A and Regulation W limit the aggregate amount of "covered transactions" between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus, and limit the aggregate amount of covered transactions with all affiliates to 20 percent of the bank's capital stock and surplus.[3] "Covered transactions" include, among other things, the extension of credit by a bank to an affiliate and the issuance by a bank of a guarantee on behalf of an affiliate.[4] In

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[1] 12 U.S.C. § 371c; 12 CFR part 223.

[2] 12 CFR part 225, Appendices A and D.

[3] 12 U.S.C. § 371c(a)(1) and 12 CFR 223.11 and 223.12.

[4] 12 U.S.C. § 371c(b)(7) and 12 CFR 223.3(h).

addition, the statute and rule require a bank to secure its extensions of credit to, and guarantees on behalf of, affiliates with prescribed amounts of collateral.[5]

Section 23A and Regulation W authorize the Board to exempt, at its discretion, a transaction or relationship from the requirements of the statute and the regulation if the Board finds the exemption to be in the public interest and consistent with the purposes of section 23A.[6] JPMC has requested that the Board exempt from section 23A and Regulation W, for a period of 18 months, certain covered transactions between JPMC Bank and its affiliates, up to an aggregate of 50 percent of the bank's capital stock and surplus, to facilitate the acquisition by JPMC of Bear Stearns.

The Board previously has granted other companies exemptions from section 23A and Regulation W that are similar to the exemption requested by JPMC. The Board has provided temporary exemptions to facilitate the orderly integration of merged companies,[7] has provided exemptions to facilitate internal reorganization transactions,[8] and has provided exemptions for banks that engage in securities financing transactions with their affiliates.[9]

The Board has determined to impose several conditions that would help protect JPMC Bank in connection with the exemption request:

- The exemption would apply only to extensions of credit by JPMC Bank to an affiliate and guarantees issued by JPMC Bank on behalf of an affiliate that (i) are fully collateralized; and (ii) are subject to daily mark-to-market and re-margining requirements.

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[5] 12 U.S.C. § 371c(c) and 12 CFR 223.14.

[6] 12 U.S.C. § 371c(f)(2) and 12 CFR 223.43.

[7] See, e.g., Board letter to Troland S. Link, Esq. (Deutsche Bank AG) dated May 28, 1999; Board letter to Ronald C. Mayer, Esq. (The Chase Manhattan Bank) dated August 18, 2000.

[8] See, e.g., Board letter to Carl Howard, Esq. (Citigroup) dated June 30, 2006.

[9] See, e.g., Board letter to Carl Howard, Esq. (Citigroup) dated August 20, 2007; Board letter to Courtney D. Allison, Esq. (Wachovia Corporation) dated June 12, 2007; Board letter to John H. Huffstutler, Esq. (Bank of America Corporation) dated June 7, 2005.

- JPMC must guarantee the performance of the affiliate for the benefit of JPMC Bank in connection with any exempt extension of credit or guarantee by JPMC Bank.

- In the second quarter of 2008, the exemption would be limited in the aggregate to 50 percent of JPMC Bank's capital stock and surplus. The amount of the exemption would then be reduced by one-sixth (that is, 8.33 percent of the bank's capital stock and surplus) in each subsequent quarter until the exemption expires after six quarters. For example, in the third quarter of 2008, the exemption would be limited in the aggregate to 41.67 percent of the bank's capital stock and surplus.

- The exemption would expire on October 1, 2009.

In addition, JPMC Bank would continue to be subject to the market-terms requirement of section 23B of the Federal Reserve Act with respect to its transactions with Bear Stearns. Section 23B requires that financial transactions between a bank and an affiliate be on terms that are substantially the same, or at least as favorable to the bank, as those that the bank would in good faith offer to nonaffiliates.[10]

Granting the requested exemption would have substantial public benefits. The exemption would assist JPMC in ensuring the funding liquidity of Bear Stearns and would facilitate the orderly integration of Bear Stearns with and into JPMC after the acquisition. In light of these considerations, the proposed extensions of credit and guarantees by JPMC Bank appear to be consistent with the purposes of section 23A and in the public interest. Accordingly, the Board hereby grants the requested exemption, subject to the conditions and limits discussed above.

Regulatory Capital Relief

JPMC also has requested that the Board provide JPMC with relief from the Board's risk-based and leverage capital guidelines for bank holding companies. Specifically, JPMC has requested that the Board permit JPMC, for a period of 18 months, to exclude from its total risk-weighted assets (the denominator of the risk-based capital ratios) any risk-weighted assets associated with the assets and other exposures of Bear Stearns, for purposes of applying the risk-based capital guidelines to the bank holding company. In addition, JPMC has asked the Board to permit

[10] See 12 U.S.C. § 371c-1(a)(1); 12 CFR 223.51.

JPMC, for a period of 18 months, to exclude from the denominator of its tier 1 leverage capital ratio any balance-sheet assets of Bear Stearns acquired by JPMC, for purposes of applying the leverage capital guidelines to the bank holding company. The Board has authority to provide exemptions from its risk-based and leverage capital guidelines for bank holding companies.[11]

JPMC has agreed to several conditions that would limit the scope of the relief request. First, JPMC proposes to exclude from its risk-weighted assets, for purposes of applying the Board's risk-based capital guidelines for bank holding companies, the risk-weighted assets of Bear Stearns existing on the date of acquisition of Bear Stearns by JPMC, up to a total amount not to exceed $220 billion. The amount of the exemption will be reduced by one-sixth in each subsequent quarter. In addition to this scheduled straight-line amortization of the exemption amount, the amount of the exemption also will be reduced in the event that JPMC sells or otherwise transfers to third parties any of the specified Bear Stearns subsidiaries identified on the attached Schedule. The amount of the reduction in such event would be the amount of risk-weighted assets in such subsidiary at the time of transfer. This exemption would expire on October 1, 2009.

Second, JPMC proposes to exclude from the denominator of its tier 1 leverage capital ratio, for purposes of applying the Board's tier 1 leverage capital guidelines for bank holding companies, the assets of Bear Stearns existing on the date of acquisition of Bear Stearns by JPMC, up to an amount not to exceed $400 billion. As with the risk-based capital exemption, the amount of the leverage exemption will be reduced by one-sixth in each subsequent quarter. In addition to this scheduled straight-line amortization of the exemption amount, the amount of the exemption also will be reduced in the event that JPMC sells or otherwise transfers to third parties any of the specified Bear Stearns subsidiaries identified on the attached Schedule. The amount of the reduction in such event would be the amount of assets in such subsidiary at the time of transfer. This exemption also would expire on October 1, 2009.

These regulatory capital exemptions would assist JPMC in acquiring and stabilizing Bear Stearns and would facilitate the orderly integration of Bear Stearns with and into JPMC. The Board notes that (i) JPMC would be well capitalized (as defined in section 225.2 of the Board's Regulation Y[12]) upon consummation of the acquisition of Bear Stearns, even without the regulatory capital relief provided by the exemptions; and (ii) JPMC has committed to remain well capitalized (as defined in

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[11] See 12 CFR part 225, App. A, § III.A; 12 CFR part 225, App. D, § II.b.

[12] 12 CFR 225.2(r).

section 225.2 of the Regulation Y) during the term of the exemptions, even without the regulatory capital relief provided by the exemptions.

In light of these considerations, the Board hereby grants the requested regulatory capital relief, subject to the conditions and limits discussed above.

These determinations are specifically conditioned on compliance by JPMC and JPMC Bank with all the commitments and representations made in connection with the exemption requests. These commitments and representations are deemed to be conditions imposed in writing by the Board in connection with granting the requests and, as such, may be enforced in proceedings under applicable law. These determinations are based on the specific facts and circumstances of the existing and proposed relationships among JPMC, JPMC Bank, and Bear Stearns. Any material change in those facts and circumstances or any failure by JPMC or JPMC Bank to observe any of its commitments or representations may result in a different determination or in revocation of the exemptions.

Sincerely yours,

Robert deV. Frierson
Deputy Secretary of the Board

Attachment

cc: Federal Reserve Bank of New York
Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation

SCHEDULE

Principal Subsidiaries of Bear Stearns

- Bear Stearns Asset Management Inc.
- Bear Stearns Securities Corp.
- Bear Stearns & Co. Inc.
- Texas Investment Holding Inc.
- Any other subsidiary of Bear Stearns that represented more than 10 percent of the total assets of Bear Stearns on the date of acquisition of Bear Stearns by JPMC

FEDERAL RESERVE SYSTEM

JPMorgan Chase & Co.
New York, New York

Order Approving the Acquisition of Control of a Bank

JPMorgan Chase & Co. ("JPMC"), a financial holding company within the meaning of the Bank Holding Company Act ("BHC Act"), has requested the Board's approval under section 3 of the BHC Act[1] to acquire indirect control of Bear Stearns Bank & Trust ("BSB&T"), Princeton, New Jersey, a subsidiary of The Bear Stearns Companies Inc. ("Bear Stearns"), New York, New York.[2] JPMC proposes to acquire more than 25 percent of the voting shares of Bear Stearns and then merge Bear Stearns with a newly formed subsidiary of JPMC, with Bear Stearns as the surviving entity.[3]

Based on all the facts and circumstances, the Board has determined that an emergency exists requiring expeditious action on the proposal.[4] In making this determination, the Board has considered the market conditions and the financial condition of Bear Stearns, the parent company of BSB&T, as well as all the facts of

[1] 12 U.S.C. § 1842.

[2] JPMC includes the intermediate holding companies through which it will own the shares of BSB&T. Although BSB&T is a "bank" for purposes of the BHC Act, Bear Stearns is not treated as a bank holding company under the act. Bear Stearns controls BSB&T pursuant to section 4(f) of the BHC Act, which exempts a company from treatment as a bank holding company if the company controlled certain "nonbank banks" prior to March 5, 1987. 12 U.S.C. § 1843(f). JPMC does not qualify for this exemption, however, and requires approval to acquire direct or indirect control of BSB&T.

[3] JPMC is permitted by section 4(k) of the BHC Act to acquire control of Bear Stearns and its nonbanking subsidiaries without obtaining prior approval from the Board. 12 U.S.C. § 1843(f). Because JPMC qualifies as a financial holding company, the BHC Act requires only that JPMC provide the Board notice within 30 days after acquiring control of Bear Stearns and its nonbanking subsidiaries. 12 U.S.C. § 1843(k)(6); 12 CFR 225.87.

[4] 12 U.S.C. § 1842(b).

record. The Board has provided notice to the primary federal and state supervisors of BSB&T and the Department of Justice ("DOJ"); all have indicated they have no objection to the consummation of the proposal.

JPMC, with total consolidated assets of approximately $1.6 trillion, is the third largest depository organization in the United States, controlling deposits of approximately $511 billion, which represent 7.4 percent of the total amount of deposits of insured depository institutions in the United States.[5] JPMC operates four subsidiary insured depository institutions in eighteen states[6] and engages in numerous nonbanking activities that are permissible under the BHC Act. JPMC is the sixth largest depository organization in New Jersey, controlling deposits of approximately $7.1 billion.

BSB&T operates in New Jersey and is the 45th largest depository organization in the state, controlling deposits of approximately $398 million. On consummation of the proposal, JPMC would remain the third largest depository institution in the United States, with total consolidated assets of approximately $1.6 trillion. JPMC would control deposits of approximately $511 billion, which represent 7.4 percent of the total amount of deposits of insured depository institutions in the United States. In New Jersey, JPMC would become the fifth largest depository organization, controlling deposits of approximately $7.4 billion, which represent

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[5] National asset, deposit, and ranking data are as of December 31, 2007. Statewide deposit and deposit ranking data are as of June 30, 2007. In this context, insured depository institutions include commercial banks, savings banks, and savings associations.

[6] JPMC's largest subsidiary bank, JPMorgan Chase Bank, National Association ("JPMC Bank"), Columbus, Ohio, operates branches in Arizona, Colorado, Connecticut, Florida, Illinois, Indiana, Kentucky, Louisiana, Michigan, New Jersey, New York, Ohio, Oklahoma, Texas, Utah, West Virginia, and Wisconsin. JPMorgan Chase Bank, Dearborn ("Dearborn Bank"), Dearborn, Michigan, operates only in Michigan. Chase Bank USA, National Association ("Chase Bank"), Newark, Delaware, operates as a credit card bank. JPMC also operates J. P. Morgan Trust Company, National Association, Los Angeles, California, which is an insured trust company.

approximately 3.8 percent of the deposits in insured depository institutions in the state ("state deposits").

Interstate Analysis

Section 3(d) of the BHC Act allows the Board to approve an application by a bank holding company to acquire control of a bank located in a state other than the home state of such bank holding company if certain conditions are met. For purposes of the BHC Act, the home state of JPMC is New York,[7] and BSB&T is located in New Jersey.[8]

Based on a review of all the facts of record, including relevant state statutes, the Board finds that the conditions for an interstate acquisition enumerated in section 3(d) of the BHC Act are met in this case.[9] In light of all the facts of record, the Board is permitted to approve the proposal under section 3(d) of the BHC Act.

Competitive Considerations

Section 3 of the BHC Act prohibits the Board from approving a proposal that would result in a monopoly or would be in furtherance of an attempt to monopolize the business of banking in any relevant banking market. The BHC Act also prohibits the

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[7] A bank holding company's home state is the state in which the total deposits of all subsidiary banks of the company were the largest on July 1, 1966, or the date on which the company became a bank holding company, whichever is later. 12 U.S.C. § 1841(o)(4)(C).

[8] For purposes of section 3(d) of the BHC Act, the Board considers a bank to be located in the states in which the bank is chartered or headquartered or operates a branch. 12 U.S.C. §§ 1841(o)(4)-(7) and 1842(d)(1)(A) and 1842(d)(2)(B).

[9] 12 U.S.C. §§ 1842(d)(1)(A)-(B) and 1842(d)(2)-(3). JPMC is adequately capitalized and adequately managed, as defined by applicable law. There is no applicable age-requirement law in New Jersey, and BSB&T has been in existence and operated for more than five years. See 12 U.S.C. § 1842(d)(1)(B)(i)-(ii). On consummation of the proposal, JPMC would control less than 10 percent of the total amount of deposits of insured depository institutions in the United States and less than 30 percent of the state deposits in New Jersey. JPMC, therefore, would be in compliance with the relevant deposit cap under New Jersey law, which is 30 percent. 12 U.S.C. § 1842(d)(2)(B)-(D). All other requirements of section 3(d) of the BHC Act would be met on consummation of the proposal.

Board from approving a bank acquisition that would substantially lessen competition in any relevant banking market, unless the anticompetitive effects of the proposal are clearly outweighed in the public interest by the probable effect of the proposal in meeting the convenience and needs of the community to be served.

JPMC and Bear Stearns have subsidiary depository institutions that compete directly in the Metropolitan New York-New Jersey banking market.[10] The Board has reviewed carefully the competitive effects of the proposal in this banking market in light of all the facts of record. In particular, the Board has considered the number of competitors that would remain in the market, the relative shares of total deposits in depository institutions controlled by JPMC and Bear Stearns in the market ("market deposits"),[11] the concentration level of market deposits and the increases in those levels as measured by the Herfindahl-Hirschman Index ("HHI") under the Department of Justice Merger Guidelines ("DOJ Guidelines"),[12] and other characteristics of the market.

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[10] The Metropolitan New York-New Jersey banking market is defined as Bronx, Dutchess, Kings, Nassau, New York, Orange, Putnam, Queens, Richmond, Rockland, Suffolk, Sullivan, Ulster, and Westchester Counties, all in New York; Bergen, Essex, Hudson, Hunterdon, Middlesex, Monmouth, Morris, Ocean, Passaic, Somerset, Sussex, Union, and Warren Counties and the northern portions of Mercer County, all in New Jersey; Monroe and Pike Counties in Pennsylvania; and Fairfield County and portions of Litchfield and New Haven Counties in Connecticut.

[11] Deposit and market share data are as of June 30, 2007, and are based on calculations in which the deposits of thrift institutions are included at 50 percent. The Board previously has indicated that thrift institutions have become, or have the potential to become, significant competitors of commercial banks. See, e.g., Midwest Financial Group, 75 Federal Reserve Bulletin 386, 387 (1989); National City Corporation, 70 Federal Reserve Bulletin 743, 744 (1984). Thus, the Board regularly has included thrift deposits in the market share calculation on a 50 percent weighted basis. See, e.g., First Hawaiian, Inc., 77 Federal Reserve Bulletin 52, 55 (1991).

[12] Under the DOJ Guidelines, a market is considered unconcentrated if the post-merger HHI is under 1000, moderately concentrated if the post-merger HHI is between 1000 and 1800, and highly concentrated if the post-merger HHI exceeds 1800. The DOJ has informed the Board that a bank merger or acquisition generally will not be challenged (in the absence of other factors indicating anticompetitive effects) unless the post-merger

Consummation of the proposal would be consistent with Board precedent and within the thresholds in the DOJ Guidelines in the Metropolitan New York-New Jersey banking market.[13] On consummation of the proposal, the market would remain moderately concentrated as measured by the HHI, and numerous competitors would remain in the market.

The DOJ has conducted a review of the potential competitive effects of the proposal and has advised the Board that consummation of the transaction would not likely have a significantly adverse effect on competition in any relevant banking market. In addition, the appropriate banking agencies have been afforded an opportunity to comment and have not objected to the proposal.

Based on all the facts of record, the Board concludes that consummation of the proposal would not have a significantly adverse effect on competition or on the concentration of resources in the banking market where JPMC and Bear Stearns compete directly or in any other relevant banking market. Accordingly, the Board has determined that competitive considerations are consistent with approval.

Financial, Managerial, and Supervisory Considerations

Section 3 of the BHC Act requires the Board to consider the financial and managerial resources and future prospects of the companies and depository institutions involved in the proposal and certain other supervisory factors. The Board has considered

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HHI is at least 1800 and the merger increases the HHI by more than 200 points. The DOJ has stated that the higher-than-normal HHI thresholds for screening bank mergers and acquisitions for anticompetitive effects implicitly recognize the competitive effects of limited-purpose and other nondepository financial entities.

[13] JPMC operates the largest depository institution in the Metropolitan New York-New Jersey banking market, controlling deposits of approximately $228 billion, which represent 29 percent of market deposits. BSB&T controls $398 million in deposits, which represents less than 1 percent of market deposits. On consummation, JPMC would remain the largest depository institution in the market, controlling deposits of approximately $228 billion, which represent approximately 29 percent of market deposits. Approximately 271 depository institutions would remain in the banking market. The HHI would remain unchanged at 1118.

these factors in light of all the facts of record, including confidential reports of examination and other supervisory information received from the relevant federal and state supervisors of the organizations involved in the proposal, and other available financial information, including information provided by JPMC.

In evaluating financial factors in expansion proposals by banking organizations, the Board reviews the financial condition of the relevant companies involved on both a parent-only and consolidated basis, as well as the financial condition of the subsidiary depository institutions and other subsidiaries. In this evaluation, the Board considers a variety of information, including capital adequacy, asset quality, and earnings performance. In assessing financial factors, the Board consistently has considered capital adequacy to be especially important. The Board also evaluates the financial condition of the applicant organization after consummation of the proposed transaction.

The Board has considered the proposal carefully under the relevant financial factors. JPMC, its subsidiary depository institutions, and BSB&T are well capitalized and would remain so on consummation of the proposal.

The Board also has considered the managerial resources of the organizations involved and the proposed combined organization. The Board has reviewed the examination records of JPMC and its subsidiary depository institutions, including assessments of their management, risk-management systems, and operations. In addition, the Board has considered its supervisory experiences and those of the other relevant bank supervisory agencies with the organizations and their records of compliance with applicable banking law, including anti-money laundering laws. JPMC and its subsidiary depository institutions, as well as BSB&T, are considered to be well managed.

Based on all the facts of record, the Board has concluded that considerations relating to the financial and managerial resources and future prospects of the organizations involved in the proposal are consistent with approval, as are the other supervisory factors under the BHC Act.

<u>Convenience and Needs Considerations</u>

In acting on a proposal under section 3 of the BHC Act, the Board is required to consider the effects of the proposal on the convenience and needs of the communities to be served and to take into account the records of the relevant insured depository institutions under the Community Reinvestment Act ("CRA").[14]

As provided in the CRA, the Board has reviewed the convenience and needs factor in light of the evaluations by the appropriate federal supervisors of the CRA performance records of the relevant insured depository institutions. An institution's most recent CRA performance evaluation is a particularly important consideration in the applications process because it represents a detailed, on-site evaluation of the institution's overall record of performance under the CRA by its appropriate federal supervisor.[15] Each of JPMC's subsidiary depository institutions that is subject to the CRA received an "outstanding" rating at its most recent CRA performance evaluation.[16] BSB&T currently does not receive a CRA evaluation due to the bank's designation as a special purpose bank by the Federal Deposit Insurance Corporation.[17]

The Board has considered carefully all of the facts of record, including reports of examination of the CRA records of the institutions involved and confidential supervisory information. JPMC's acquisition of BSB&T will enhance and maintain the

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[14] 12 U.S.C. § 2901 <u>et seq.</u>; 12 U.S.C. § 1842(c)(2).

[15] <u>See Interagency Questions and Answers Regarding Community Reinvestment</u>, 66 <u>Federal Register</u> 36,620 and 36,639 (2001).

[16] JPMC's lead bank, JPMC Bank, received an "outstanding" rating at its most recent CRA performance evaluation by the Federal Reserve Bank of New York, as of September 8, 2003. JPMC Bank converted to a national bank on November 13, 2004. The Board has consulted with the Office of the Comptroller of the Currency ("OCC"), which is now JPMC Bank's primary federal supervisor, about the bank's performance since its evaluation in 2003. J. P. Morgan Trust Company received an "outstanding" rating at its most recent CRA performance evaluation by the OCC, as of November 4, 2006. Chase Bank received an "outstanding" rating at its most CRA examination by the OCC, as of January 9, 2006. Dearborn Bank engages in cash management activities for its affiliated banks and is not subject to the CRA.

[17] 12 CFR 345.11.

level of service provided to the customers currently served by BSB&T. Based on a review of the entire record, and for the reasons discussed above, the Board concludes that considerations relating to the convenience and needs factor and the CRA performance records of the relevant insured depository institutions are consistent with approval of the proposal.

Conclusion

Based on the foregoing, and in light of all the facts of record, the Board has determined that the application should be, and hereby is, approved. In reaching its decision, the Board has considered all the facts of record in light of the factors that it is required to consider under the BHC Act. The Board's approval is specifically conditioned on compliance by JPMC with the conditions in this order and all the commitments made to the Board in connection with the proposal. For purposes of this transaction, these commitments and conditions are deemed to be conditions imposed in writing by the Board in connection with its findings and decision and, as such, may be enforced in proceedings under applicable law.

The transaction may not be consummated before the fifth calendar day after the effective date of this order, or later than three months after the effective date of this order, unless such period is extended for good cause by the Board or by the Federal Reserve Bank of New York, acting pursuant to delegated authority.

By order of the Board of Governors,[18] effective April 1, 2008.

(signed)

Robert deV. Frierson
Deputy Secretary of the Board

[18] Voting for this action: Chairman Bernanke, Vice Chairman Kohn, and Governors Warsh, Kroszner, and Mishkin.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM BEN S. BERNANCE

Q.1. If Bear Stearns, which was only the 5th largest dealer, was prevented by the Fed from failing, will you allow anyone to fail?

A.1. As a threshold matter, it is important to note that the Federal Reserve's authority to provide emergency support to non-depository institutions is limited to lending. In contrast to the FDIC's broad authority to resolve and/or liquidate insured depository institutions, the Federal Reserve does not have authority to acquire or otherwise resolve financial firms. We may only address the liquidity needs of solvent companies in unusual and exigent circumstances. The resolution of Bear Stearns relied on a private sector acquisition.

The Federal Reserve's actions with respect to Bear Stearns are instructive in this regard. The Federal Reserve facilitated the acquisition of Bear Stearns by JPMorgan Chase because the substantial involvement of Bear Stearns in many important financial markets—at a time when the credit markets were particularly vulnerable—was such that a sudden failure by Bear Stearns would likely have led to a chaotic unwinding of positions in already severely strained circumstances. Moreover, a failure by Bear Stearns to meet its obligations would have cast doubt on the financial strength of other financial firms whose operations bore superficial similarity to that of Bear Stearns, without due regard to the fundamental soundness of those firms. The Federal Reserve judged that a sudden failure of Bear Stearns under these unusually fragile circumstances would have been extremely disorderly and would have risked unpredictable but severe consequences for many sound financial firms and for the functioning of the broader financial system and the economy.

The inability and unwillingness of the Federal Reserve to acquire or otherwise provide a solvency backstop to financial institutions is reflected in the market prices of obligations of financial institutions and derivative instruments based on obligations of financial institutions. Prices of these financial assets imply that market participants are far from certain that the Federal Reserve would prevent major financial institutions from failing. In particular, market participants continue to pay substantial premiums for protection against losses from failure of most major U.S. financial institutions.

Q.2. Are there functions or transactions that have developed in our financial system today that are so essential that we need to update regulations or protections to ensure they do not fail?

A.2. A number of important financial markets have developed or gown considerably in the past decade. These include the markets for mortgage-backed securities and other asset-backed securities, over-the-counter derivatives (including in particular credit derivatives), securities lending and borrowing transactions, and repurchase and reverse repurchase agreements. Significant progress has already been made to improve the clearing and settlement of over-the-counter credit and equity derivatives, but more work needs to be done. The Federal Reserve and other financial regulators continue to review the resiliency of, and the adequacy of the infrastructure surrounding, these markets and are reviewing the supervision and regulation of the financial institutions that participate meaningfully in these markets.

Q.3. Chairman Bernanke, as recently as last February I asked you if you thought the inverted yield curve was signaling trouble ahead. Your answer was that you did not think the yield curve was a good indicator anymore. Do you still agree with that?

A.3. My views on this issue have not changed. I continue to believe that the slope of the yield curve, taken on its own, is not a particularly useful indicator about future economic conditions. As I noted in my response to your question in February 2007, a flat or inverted yield curve that results from a decline in long-term interest rates need not signal a slowing of economic activity; instead, the lower long-term rates act to reduce financing, costs for businesses and households and encourage spending. In addition, recent empirical work has highlighted that a number of other financial indicators help predict future activity. These indicators include credit risk spreads on corporate bonds, measures of market liquidity, and lending policies at banks. Please be assured that we at the Federal Reserve are monitoring a wide range of indicators, both financial and nonfinancial, to assess the current state of the economy and to inform our forecasts of its path over time.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM CHRISTOPHER COX

Q.1. The SEC as a consolidated regulator differs from the Fed because it does not have the ability to make loans to the entities under its jurisdiction. Is this a flaw in the SEC's ability to effectively regulate an investment bank? Or can the SEC work cooperatively and effectively with the Fed as the central bank to effectively address liquidity crises that may arise in the future? Does the SEC need any additional legislative authority?

A.1. The supervision of the CSE firms and the function of providing a back stop liquidity facility are separate activities, although they should be coordinated. There are other holding company supervisors in the U.S. and abroad that are not back stop liquidity providers. By way of analogy, a lender typically does not regulate, supervise, or manage a loan recipient, although it has a significant interest in monitoring the health of the borrower to protect its investment.

The SEC should not be able to make loans to the entities under its jurisdiction, and the fact that it is not a lender is not a flaw in the regulatory approach. The CSE firms are fundamentally securities firms, and SEC is the most knowledgeable financial regulator in overseeing these complex trading operations. The Commission has a long history of cooperation and coordination with other domestic and international supervisors, including particularly the Federal Reserve, which quite properly does have lending authority. During the events at Bear, the SEC worked exceptionally closely with the Federal Reserve, as well as the Department of the Treasury, and we are continuing to work together to ensure that our regulatory actions contribute to orderly and liquid markets. We are currently formalizing our coordination in an information sharing arrangement with the Federal Reserve, so that processes are in place and a common set of data is understood by the interested supervisors.

With regard to legislation, I believe Congress should establish a statutory framework for the mandatory consolidated supervision of systemically important investment banks and adopt, where appropriate, the applicable concepts from the Federal Deposit Insurance Corporation Improvement Act to govern the resolution of any future financial difficulties at a systemically important investment bank. Should Congress enact legislation to provide access to an external liquidity provider under exigent conditions in the future, the cooperative sharing of information and collaborative assessment of capital and liquidity that the SEC and the Federal Reserve are currently formalizing would provide the basis for making such an arrangement work.

Q.2. The Wall Street Journal wrote that the SEC "is debating whether it would have been useful to have data about short-term, or repo, financing from the banks that clear trades and hold collateral for the securities firms under the agency's review . . . It . . . could have been useful in identifying the problems at Bear. Currently, the Fed has access to the information, but the SEC doesn't." ["SEC Role is Scrutinized in Light of Bear Woes," March 27, 2008.] How would you respond to this?

A.2. Understanding the functioning of the interbank funding market is critical to understanding the process by which Bear Stearns came to face a liquidity crisis. Prior to March 13, Commission staff were in close contact with the Federal Reserve Bank of New York, which provided information on developments affecting not only Bear Stearns' ability to access this market, but also overall market conditions. In light of the importance of this information, the SEC and the Federal Reserve are currently formalizing an agreement to share this information.

Q.3. Do you believe that certain investment banks should be "too big to fail" or that are, as Chairman Bernanke said, "too intertwined to fail," and, if so, under what circumstances? Do you feel that investment banks under certain circumstance should have access to the discount window?

A.3. The reality of the modern financial system is that there are a relatively small number of interconnected financial institutions—commercial banks, investment banks, and insurance companies both in the U.S. and globally—that are systemically important. Having a comprehensive and effective financial markets supervision regime—including established plans for the resolution of financial difficulties at one or more of these institutions—is critical to the stability of today's financial markets and by extension the broader economy. This does not mean that any insolvent bank is categorically "too big" or "too interconnected" to fail, but rather that under certain circumstances its orderly resolution might prevent broader market problems.

With regard to access to a backstop liquidity provider, current law provides for predictable access to the Federal Reserve 's liquidity facilities for certain financial institutions, but presently provides for access only under limited circumstances for other financial institutions that are arguably of equal systemic importance. This disparity presents a challenge for Congress and regulators for coping with the changing nature of the financial markets and the increasingly similar activities undertaken by the major financial firms regardless of whether they are labeled as commercial banks, investment banks, or with some other title.

The PDCF facility is providing the investment banks and their supervisors invaluable tune and breathing room to analyze the events that led to the collapse of Bear Stearns, and to take steps to make investment bank funding plans more resilient. Whether such a facility should be available in the future depends on a number of factors, including the state of the supervision regime for the institutions that would be eligible to participate, the nature of the business in which these institutions are engaged, and the level of risk associated with those business activities.

Q.4. Investor confidence in Bear Stearns eroded sharply leading to its serious financial problems in the days leading up to its collapse. In its regulatory oversight, does the Commission assess the confidence that the markets have in securities firms in order to anticipate future problems?

A.4. Yes. In the course of its supervision, the CSE staff reviews and considers a wide array of information, including information from other regulators, market participants, analyst reports, and the financial press on market sentiment.

Q.5. Chairman Cox, you said in your letter to the Basel Committee that "the fate of Bear Stearns was the result of a lack of confidence, not a lack of capital" and cited "rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm." Should, or can, the Government address false rumors circulating in the market?

A.5. The SEC has broad enforcement authority to sanction rumors that constitute fraud. For example, the Commission recently filed an enforcement action against a Wall Street trader for spreading false rumors. In the context of the CSEs, I believe maintaining strong liquidity and capital positions at the CSE holding companies, improving transparency, and the current access to the PDCF go far to tempering the contagion that may result from false rumors. I also believe improving the clearance and settlement of OTC derivatives and addressing operational issues that arose when counterparties novated large volumes of OTC derivatives contracts away from Bear would assist in this effort.

Q.6. Some observers have alleged that during the week of March 10 there was a great deal of improper short selling of Bear Stearns stock by investors who were spreading false rumors about problems at Bear Stearns. As a result, significant investors stopped doing business with Bear which caused a liquidity crisis that drove the stock price lower.

In light of the discussion in recent years about short selling, will the Commission review whether it would be beneficial to impose greater sanctions for market participants who fail to deliver shares to cover on settlement dates or to reinstitute an uptick rule, perhaps with a larger increment?

A.6. Economic studies have shown that short selling is higher when there is a greater degree of uncertainty, and the period prior to and since the financial difficulties at Bear Stearns was associated with a high degree of uncertainty. If we uncover traders who attempted to make profitable trades by selling short and intentionally propagating false rumors, we will pursue those individuals in the enforcement context. With respect to Bear Stearns, specifically, we have yet to find any evidence that the lack of an uptick rule contributed to its collapse.

Q.7. Does the SEC intend to conduct a study of what happened at Bear Stearns, with lessons learned?

A.7. Yes. Commission staff are currently undertaking a granular review of the loss of secured funding and its impact on the operations and liquidity of Bear Stearns.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM CHRISTOPHER COX

FDICIA PRECEDENT

Chairman Cox, in your testimony you point out that FDICIA established a framework for resolving difficulties experienced by commercial banks where systemic risk is involved. Because investment banks are not part of the deposit insurance system, the FDICIA process does not cover their failure even where systemic risk may be involved. The purpose of FDICIA, you note, is to ensure that Federal intervention involving systemic risk is guided by clear principles rather than improvised in the midst of a crisis.

Q.1. Do you believe that the regulatory response to the collapse of Bear Stearns was done on an ad hoc or improvised fashion due to the lack of clear statutory guidelines?

What principles should guide Federal intervention involving institutions, other than depository institutions?

A.1. Yes, I do. The principles we should now follow should be informed by the experience of dealing with "lender of last resort" issues, including moral hazard, in the commercial bank regulatory context. In 1991, after experiencing record bank failures and with the FDIC deposit insurance fund at a record low level, Congress eliminated much of the FDIC's discretion in resolving troubled commercial banks by adopting the "least cost test." At that time, Congress also recognized the importance of having a mechanism in place for senior government officials considering the resolution of difficulties at systemically important commercial banks. However, Congress has not provided for analogous provisions relating to investment banks, which meant that there was a sparse statutory framework within which regulators were operating during the difficulties with Bear Stearns.

The Federal Reserve Board judged that it was appropriate to use its emergency lending authorities under the Federal Reserve Act to avoid a disorderly closure of Bear Stearns. The existing authority in the Federal Reserve Act gives the Federal Reserve broad authority to lend to many kinds of entities. In appropriate circumstances, that flexibility provides an important safety valve as is illustrated by Bear Stearns' financial crisis.

Although there is not a specific framework in place that governed resolution of a systemically important investment bank not affiliated with a commercial bank during a financial crisis, the agencies worked together well and in a coordinated fashion that could only be enhanced by adopting a statutory framework. This statutory framework should provide for a mandatory consolidated supervision regime, borrowing where appropriate from applicable concepts in the Federal Deposit Insurance Corporation Improvement Act ("FDICIA ").

Legislation to enhance the Commission's authority over consolidated supervised entities ("CSEs') should strengthen the oversight regime by providing the Commission statutory examination authority, capital setting and monitoring authority, and specific authority to impose progressive restrictions on activities and capital. This authority could be modeled on the Federal Reserve's authority over bank holding companies under the Bank Holding Company Act.

Second, any such legislation should include requirements for a minimum frequency of examinations, for certain types of examinations (such as internal control examinations), and for the Commission to apply progressively more significant restrictions on an institution's operations as its capital adequacy falls.

The FDICIA "prompt corrective action" capital categories would not be appropriate for CSEs in their precise form because the businesses of a broker-dealer and a bank differ in ways that make it inappropriate to impose exactly the same capital requirements. For example, a bank uses insured deposits from customers to make illiquid loans. A commercial bank's capital requirement is based on a percentage of the bank's assets, which includes those loans. In contrast, a broker-dealer must reserve 100% of customer cash at a bank and also supplement the reserve account with its own cash. A broker-dealer cannot use customer cash to fund its business. Only with appropriate consent from customers can either a bank or a broker-dealer lend customer securities.

Similarly, the "least cost resolution" requirement in FDICIA would not be appropriate for a broker-dealer, or bankruptcy-eligible institution such as a bank holding company or an investment bank holding company. The "least cost resolution" requirement is directed at constructing an FDIC-managed resolution of a failed bank in a manner that will be least costly to the FDIC's deposit insurance fund and potentially to taxpayers. The analogous regulated affiliate of an investment bank holding company, the registered broker-dealer, is already covered by a statutory regime, the Securities Investor Protection Act, which addresses the financial failure of broker dealers, and protects customers whose money, stocks, and other securities are either stolen by a broker or put at risk when a brokerage fails for other reasons.

A statutory mechanism for the resolution of systemically important institutions would be valuable and would provide predictability and certainty to the markets. FDICIA also provides an exception to the restrictions on federal intervention for situations involving systemic risk affecting the financial marketplace. Under FDICIA, such a finding requires a two-thirds vote of the FDIC's and the Federal Reserve 's boards of directors and concurrence by the Secretary of the Treasury after consultation with the President. A similar framework (involving the relevant investment bank regulators) would be necessary to prevent a systemically important institution from declaring bankruptcy.

IMPACT OF BANKRUPTCY FILING BY BEAR STEARNS

Chairman Cox, it has been suggested that allowing Bear Stearns to file for bankruptcy could have triggered a much larger and more severe financial crisis. Since bankruptcy was not an option, and no firm was willing to buy Bear Stearns on its own, a Federal bailout was the only viable alternative left to regulators. The purpose of the bankruptcy code, however, is to provide an orderly process for the liquidation of firms.

Q.2. Would you please explain what would have happened if Bear Stearns had filed for bankruptcy and whether you believe a bankruptcy filing would have triggered a larger crisis? Would the same outcome occur today if another major investment bank filed for bankruptcy?

Does the Bear Stearns example mean that a major investment firm cannot file for bankruptcy without triggering a financial panic? If so, do we need consider whether a specialized process is needed for the liquidation of such firms?

A.2. Unfortunately, unlike a laboratory in which conditions can be held constant and variables changed while the experiment is repeated, in the social science of the market the selection of one course of action forever forecloses all other approaches that might have been taken. To better understand the potential effect of the operation of the bankruptcy laws with respect to a complex financial institution such as Bear Stearns, it is important to highlight the different types of entities included in the Bear Stearns conglomerate.

The Bear Stearns Companies, Inc., the publicly-traded holding company registered with the Commission, has over 350 subsidiaries. These subsidiaries include broker-dealers registered with the Commission, futures commission merchants registered with the CFTC, foreign regulated financial firms, and unregistered U.S. and foreign entities including unregistered over-the-counter derivative trading entities. An entity such as Bear Stearns that decides to file for bankruptcy protection has numerous options concerning which entities may be included in the bankruptcy petition. For example, the holding company and certain unregistered affiliates may file for bankruptcy under Chapter 11. However, a registered broker-dealer with customers is not eligible to file under Chapter 11 but rather is governed by other statutory provisions (e.g. the Securities Investor Protection Act).

A bankruptcy filing by one or more of the Bear Stearns entities would have triggered immediate action by Bear's counterparties in securities and financial transactions. While a bankruptcy filing generally is designed to maintain the status quo by imposing an automatic stay on all efforts by creditors to recover their claims against the debtor to give the debtor time to resolve its financial difficulties, the Bankruptcy Code excepts commodity, forward, and securities contracts; repurchase agreements; swap agreements; and master netting agreements from the operation of the automatic stay. Consequently, Bear Stearns holding company counterparties could have exercised their rights with respect to any collateral securing their transactions if Bear Stearns had failed to satisfy its obligations to those counterparties.

In addition, in the case of these financial transactions and agreements, the Bankruptcy Code permits enforcement of contractual provisions that are triggered by an insolvency or bankruptcy filing (so-called "ipso facto" clauses), immediately permitting any counterparty to liquidate, terminate, or accelerate securities and financial transactions. If Bear Stearns filed for bankruptcy, its counterparties likely would have begun liquidating repurchase agreements and other collateral held to securitize those open positions, leading to further difficulties for the markets and possible liquidity problems for other firms.

These consequences are not limited to broker-dealers, but would affect any large financial institution dealing in these types of contracts, including banks.

This is not to say, however, that under no circumstances could a major investment firm use the bankruptcy laws without triggering a crisis. The events at Bear Stearns occurred during a time of pre-existing widespread market stress. Any future circumstance in which a major financial firm were to face bankruptcy would have to be judged in the context of then-current market conditions. Moreover, since the Bear Stearns sale, the SEC and other financial markets supervisors in the U.S. and around the world have already taken steps to modify their approach to investment bank liquidity risk management, as well as broader problems in the credit markets that were understood to have contributed to the subprime crisis.

CSE PROGRAM

Q.3. Chairman Cox, would you please provide an overview of the nature and scope of your oversight of investment banks under the SEC's Consolidated Supervised Entities program? How many regulators do you have assigned to monitoring each investment bank? What type of financial reporting do you require?

A.3. Since 2004, through our voluntary consolidated supervised entities (CSE) program, the Securities and Exchange Commission has supervised Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley at both the holding company and regulated entity levels. The program entails monitoring for firmwide financial and other risks that might threaten the regulated entities within the CSE, especially the US. regulated broker-dealer and their customers and other regulated entities, here and abroad. Prior to the Bear Stearns sale, the SEC required that firms maintain an overall Basel capital ratio at the consolidated holding company level of not less than the Federal Reserve 's 10% "well-capitalized" standard for bank holding companies. Since that time we have further tightened both capital and liquidity standards. CSE firms provide monthly Basel capital computations to the SEC. The CSE rules also provide that an "early warning" notice must be filed with the SEC in the event that certain minimum thresholds are breached or are likely to be breached.

Even prior to the experience with Bear Stearns, the SEC's supervision of investment bank holding companies has always recognized that capital is not synonymous with liquidity—and that more is required to determine a firm's financial health. For this reason, the CSE program requires substantial liquidity pools to allow firms to continue to operate normally in such environments. Prior to the Bear Stearns sale, CSEs were required to maintain funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows in a stressed liquidity environment where access to unsecured funding is not available for a period of at least one year. Since then, the SEC has further strengthened the liquidity requirements based on scenarios that contemplate significant impairment of access to secured funding as well.

The Commission's CSE program supervises holding companies in a manner similar to the "Federal Reserve 's oversight of bank holding companies. In addition to monthly computation of a capital adequacy measure consistent with the Basel II Standard and maintenance of substantial amounts of liquidity at the holding company, CSEs are required to document a comprehensive system of internal controls which are subject to Commission inspection. Further, the holding company must provide the Commission on a regular basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures.

The CSE program provides prudential holding company supervision that augments the oversight of regulated affiliates. Specifically, regulated broker-dealers are supervised both by the SEC and the primary self-regulatory organization, FINRA, which devotes a large amount of resources to overseeing the broker-dealers that are the core regulated entities within the CSE groups. This extensive supervision of the regulated entities in addition to the holding company is akin to bank supervision at the depository institution level as well as the holding company level. That is, the oversight of the registered broker-dealer is based on regulation at the SEC and SRO (such as FINRA) level, backed by examinations and enforcement. The oversight of the CSEs at the holding company level is similarly based on rules that incorporate principles of prudential oversight, backed by ongoing monitoring and examinations. Similarly, bank and insurance company affiliates are subject to functional regulation by the respective supervisors.

The specific elements of this supervision include:

- At least monthly review of:
  - Consolidated capital adequacy measures computed under the Basel Accord;
  - Liquidity measures computed under liquidity guidelines developed by the firm and approved by the Commission; and
- Credit and market risk measures computed using methods developed by the firm and approved by the Commission.
- At least quarterly review of consolidating financial statements that provide insight into the activities, measured by balance

sheet usage and revenue production, conducted in unregulated affiliates.

- At least quarterly meetings with corporate treasury to monitor, inter alia:
- The liquid assets available to the holding company, namely those held at the parent and not in regulated entities, and the nature of the funding supporting the assets;
- The funding model used to determine the amount of long-term debt and equity necessary to support the balance sheet, including the schedule of "haircuts" for different types of balance sheet assets; and
- The impact on the firm of a liquidity stress scenario, intended to reflect the impact of both firm-specific and market events on the liquidity of the holding company.
- At least quarterly meetings with financial controllers at each firm to monitor, inter alia:
- Significant profit and loss (P&L) events at the desk level, including large losses, large gains, and large variances with prior quarters;
- P&L for non-trading businesses such as investment banking and retail brokerage;
- Significant accounting policy changes, especially those related to mark-to-market accounting; and
- The mark-to-market review process.
- At least monthly meetings with market and credit risk managers at each firm to monitor, inter alia:
- The firm's market risk profile, as reflected by VaR and other market risk measures;
- Validation of exposure measures through comparison of ex ante risk measures with realized profit and loss;
- Risk limits, usage of limits, and related governance issues;
- Concentrated credit risk exposures, and related governance issues; and
- Analysis of historical and theoretical scenarios intended to capture the impact of low-probability but severe events.
- At least quarterly meetings with the internal auditors at each firm to monitor, inter alia:
- Evolution of the audit plan throughout the year as projects are added or deferred;
- Resolution, or escalation to the Audit Committee of the board, of significant audit findings; and
- Detailed discussions of selected audits, typically those with implications for risk governance.
- Targeted on-site inspections to test whether the firm robustly implements its documented policies and procedures with respect to, inter alia:
  - Operational controls, including transaction processing and risk measurement systems, applicable to products booked in unregulated legal entities;
  - Marking to market of complex and less-liquid positions;

- Consolidated capital computations; and
- Anti-money laundering.

• Topical reviews of businesses, activities, risk models, products and other topical issues as warranted by market developments, corporate acquisitions, and regulatory initiatives.

The SEC has 25 staff persons in the CSE program with a range of backgrounds including financial analysts, statisticians, economists and lawyers. The size of the program has risen as the complexity and range of supervisory activities has grown, and further expansion is currently underway. As part of the Commission's FY 2009 budget request, the Commission is on the path to increasing by 60 percent the number of staff assigned to the CSE program.

REGULATORY RELIEF

It has been reported that as a condition for purchasing Bear Stearns, regulators promised JPMC certain regulatory relief, including SEC no-action letters and forbearance on capital requirements.

Q.4. Would you please list any and all regulatory relief your agency or department has agreed to provide JPMC in connection with its merger with Bear Stearns?

A.4. On Sunday, March 16, 2008, JPMorgan Chase contacted SEC staff about relief and guidance that they sought in furtherance of a possible deal. To assist in advancing a possible transaction, the SEC staff was able to provide several letters clarifying the staffs position on certain matters connected with the merger.

Specifically, the Division of Trading and Markets wrote a letter addressing the timing of JPMorgan 's filing of a Form BD with the SEC. The Division of Investment Management wrote two letters concerning issues under the Investment Company Act and Investment Advisers Act arising out of the change in control of investment advisers affiliated with Bear Stearns. The Division of Corporation Finance wrote a letter addressing sales by client accounts managed by JPMorgan and Bear Stearns of the other firm's securities, in view of the control relationship created by the merger agreement. The Division of Enforcement wrote a letter concerning investigations and potential future inquiries into conduct and statements by Bear Stearns before the public announcement of the transaction with JPMorgan. The staff declined to provide assurances about possible future enforcement actions, or to provide relief on capital requirements.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM CHRISTOPHER COX

Q.1. Are there functions or transactions that have developed in our financial system today that are so essential that we need to update regulations or protections to ensure they do not fail?

A.1. The complexity and interconnectedness of financial markets is both a source of strength and an area of concern. It is therefore a key responsibility of the SEC and every regulator to update regulations and protections to keep pace with changes in the marketplace. Doing so is a process and not a result, so at all times the

Commission and other financial regulators must review our existing statutes and rules to determine how well the existing framework applies in the current financial marketplace.

One recent example where financial supervisors have been concerned is the proliferation of over-the-counter derivatives and their potential destabilizing effect on the markets and market participants. The SEC and the Federal Reserve Bank of New York are cooperating on an initiative to improve the clearance and settlement processes as well as documentation of OTC derivatives. Improvement in these areas is an important first step in reducing risk in this space.

Q.2. Chairman Cox, can you elaborate on the point in your testimony that we need to put in place methods for resolving problems in troubled investment banks?

A.2. I believe that a statutory mechanism for the resolution of systemically important institutions would be valuable and would provide predictability and certainty to the markets. Such a statutory framework should provide for a mandatory consolidated supervision regime for investment banks and adopt, where appropriate, applicable concepts from Federal Deposit Insurance Corporation Improvement Act ("FDICIA") to govern the resolution of any future financial problems at an investment bank holding company.

Legislation to explicitly authorize the Commission's authority current voluntary program for supervision of consolidated supervised entities ("CSEs") should strengthen the oversight regime by providing the Commission statutory examination authority, capital setting and monitoring authority, and specific authority to impose progressive restrictions on activities and capital. This authority could be modeled on the Federal Reserve's authority over bank holding companies under the Bank Holding Company Act.

Second, any such legislation should also borrow certain applicable elements from FDICIA. These could include requirements for a minimum frequency of examinations, for certain types of examinations (such as internal control examinations), and for the Commission to apply progressively more significant restrictions on an institution's operations as its capital adequacy falls.

Q.3. What role do you think elimination of the "uptick" rule played in the demise of Bear Stearns, and in market turmoil generally? Are you reevaluating that rule change in light of recent events?

A.3. With respect to Bear Stearns, specifically, we have yet to find any evidence that the lack of an uptick rule contributed to its collapse. A high level of short selling in Bear Stearns was likely even if the uptick rule was in place.

By way of background, last year the SEC repealed Rule 10a–1, the rule that required that short sales on exchanges occur in an upward market. Before we made this change, the Commission engaged in a multi-year pilot program to test the effects of the uptick rule, in which the rule was lifted for all trades in about 1,000 stocks. The results of a study of this pilot conducted by SEC economists, as well as studies conducted by several academics, showed that removal of the uptick rule did not significantly affect market quality.

A number of observers have subsequently called for reinstatement of the short sale rule because they believe that its repeal has contributed to increased market volatility. Others have cited its repeal as a contributing factor to the trouble facing securities firms. These concerns are misplaced for at least two reasons. First, volatility has increased in foreign markets as well as domestic. These foreign markets did not see a change in their short-selling rules, suggesting the increase in market volatility has causes unrelated to the elimination of the uptick rule. Second, the uptick rule was not an effective barrier to short selling, even when the price of a security was declining, because today's equity markets trade in pennies.

Questions regarding the 2004 "Alternative Net Capital Requirements for Broker-Dealers That Are Part Consolidated Supervised Entities":

Q.4. Please evaluate what impact the 2004 rule change had on the collapse of Bear Stearns. In that evaluation, please compare and contrast how Bear Stearns would meet regulatory capital requirements under the alternative method and the traditional method. If possible, please provide the data quarterly since the rule was implemented, as well as a similar comparison for the other four large investment banks.

A.4. The simple answer is that The Bear Stearns Companies, Inc. was not subject to any consolidated capital requirement. Prior to 2005, the Commission supervised the capital of only the registered broker-dealer affiliates of The Bear Stearns Companies Inc, and did not supervise the capital of the entity as a whole. When Bear Stearns' application to become a consolidated supervised entity (CSE) was approved by the Commission in 2005, the holding company was for the first time required to compute capital based on the Basel Standard and to maintain a ratio of regulatory capital to risk-weighted assets of no less than 10 percent. Thus the Alternative Net Capital rule resulted in the imposition of a new capital requirement, and the imposition of a significant monitoring regime administered by the Commission that had never before existed.

For Bear Stearns' regulated broker-dealers, the alternative net capital calculation did not reduce the actual amount of capital. The same is true for the other CSE firms. In fact, tentative net capital at many firms rose as a result of the new requirements. While as a general matter, the alternative method could reduce the position-based charges for market risk and counterparty credit exposures as implicit recognition is given for diversification effects, these potential reductions are coupled with new requirements on liquid capital. Under the alternative method, broker-dealers are required to hold a minimum of $1 billion in tentative net capital, defined as capital less deductions for illiquid assets. They are similarly required to formally notify the Commission in the event that tentative net capital falls below a $5 billion early warning threshold, imposing a de facto $5 billion standard. Finally, for practical purposes, the minimum net capital requirement for the CSE broker-dealers using the alternative method of computing net capital is 2% of aggregate debit items. As a result of this balance of requirements, the minimum required capital of the major broker-dealers was not reduced when they joined the CSE program.

Q.5. Please explain why in the cost benefit analysis of adopting the rule, the Commission considered the benefit the broker-dealers would receive from lower capital charges, but in the cost analysis the Commission failed to consider any possible cost for the increased systemic-risk from reducing the capital requirements for the large broker-dealers.

A.5. As stated above, the rule did not reduce the minimum required capital.

The risks to the broader market in connection with Bear Stearns arose not from the alternative method for calculating net capital at the regulated broker-dealer, but from the loss of access by the parent firm, The Bear Stearns Companies, Inc., to the secured financing market. This sudden loss of liquidity by a major financial firm posed potential risks to Bear Stearns' counterparties and threatened to more broadly shake market confidence in the overall U.S. financial system.

It should be added that the net capital rules are designed to preserve investors' funds and securities in times of market stress, and they served that purpose in this case. This investor protection objective was fully met by the current net capital regime, which—together with the protection provided by the Securities Investor Protection Corporation (SIPC) and the requirement that SEC-regulated broker-dealers segregate customer funds and fully-paid securities from those of the firm—fully protected Bear Stearns' customers without creating any new systemic risks.

Q.6. Please explain why the Commission amended the definition of Tentative Net Capital to include securities for which no ready market existed. Please evaluate what impact that decision had in causing Bear Stearns to fail.

A.6. In 2004, the Commission promulgated rules to implement its alternative net capital requirements for broker-dealers that are part of consolidated supervised entities [1] to allow certain broker-dealer [2] to include as part of their tentative net capital certain securities that have no "ready market." The amendments allow broker-dealer subsidiaries of CSE firms to calculate market and credit risk charges using internal models, such as value-at-risk ("VaR") for market risk and potential future exposure for credit risk. These amendments also modified the definition of tentative net capital for the broker-dealers that are part of a consolidated supervised entity to allow them to use a different methodology to determine whether a security has a "ready market" for purposes of the net capital rule.

The 2004 amendments did not eliminate the "ready market" test for allowable assets. Rather, they subjected less liquid positions included in tentative net capital to market and credit risk charges,

[1] See Exchange Act Release No. 49830, Jun. 8, 2004 (69 FR 34428, Jun. 21, 2004).

[2] This treatment is open only to those broker-dealers that apply, and are approved, to calculate net capital in accordance with Appendix E to the Net Capital Rule. As of May 15, 2008, there are six broker-dealers approved to calculate net capital in accordance with Appendix E to the Net Capital Rule. Broker-dealers approved to calculate net capital in accordance with Appendix E must maintain at least $1 billion in tentative net capital, and must immediately notify the Commission if their tentative net capital falls below $5 billion.

as well as to additional market risk charges above and beyond value-at-risk where warranted. Only if the broker-dealer is able to demonstrate to the staff that its models adequately capture the material risks associated with those positions may the broker-dealer include a portion of those positions after appropriate charges. If a broker-dealer is unable to make such a demonstration, it cannot include those securities as part of its tentative net capital.

The staff of the Division of Trading & Markets believes that the run on Bear Stearns was unconnected to the nature of assets held in the broker-dealer, and that the changes to the broker-dealer net capital standards permitted by the 2004 rule changes played no role in Bear Stearns' financial distress.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM ROBERT STEEL

Q.1. Does the Treasury intend to conduct a study of what happened at Bear Stearns, with lessons learned?

A.1. In March, members of the President's Working Group on Financial Markets ("PWG") issued a comprehensive review of policy issues related to recent financial market turmoil. The PWG recommended measures to reform mortgage origination, strengthen risk management, enhance disclosure and improve market discipline in the securitization process, and reform disclosure and use of credit ratings. When implemented, these recommendations will change behavior and strengthen our markets through greater risk awareness, enhanced risk management, strong capital positions, prudent regulatory policies, and greater transparency. The PWG has committed to measuring progress by the end of this year, so as to ensure the implementation of these recommendations.

Treasury remains prepared to work with you or your staff on specific questions related to the Bear Stearns acquisition.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ROBERT STEEL

REGULATORY RELIEF

It has been reported that as a condition for purchasing Bear Stearns, regulators promised JPMC certain regulatory relief, including SEC no-action letters and forbearance on capital requirements.

Q.1. Would you please list any and all regulatory relief your agency or department has agreed to provide JPMC in connection with its merger with Bear Stearns?

A.1. The Treasury Department has not agreed to provide regulatory relief to JPMC in connection with its acquisition of Bear Stearns. We understand that the independent bank regulators, including the Office of the Comptroller of the Currency, have provided such relief, but we cannot speak on their behalf.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM ROBERT STEEL

Q.1. If Bear Stearns, which was only the 5th largest dealer, was prevented by the Fed from failing, will anyone be allowed to fail?

A.1. It is not accurate to say that Bear Stearns was prevented from failure. Bear Stearns shareholders experienced significant losses, many Bear Stearns' employees will have to find other jobs, and a company that has survived for 85 years will no longer exist. Instead, the Federal Reserve's actions facilitated the orderly acquisition of Bear Stearns so as to promote more stable markets and minimize financial disruptions beyond Wall Street. Our role at the Treasury Department was, and continues to be, to minimize any impact on the real economy and to support the independent regulators and their efforts to enhance risk management practices for our financial institutions and ensure our financial institutions are well-capitalized.

Q.2. Are there functions or transactions that have developed in our financial system today that arc so essential that we need to update regulations or protections to ensure they do not fail?

A.2. The current regulatory framework for financial institutions is based on a structure that has been largely knit together over the past 75 years. Moreover, it has evolved in response to problems without any real focus on overall mission. In order to address these shortcomings, Secretary Paulson introduced Treasury's Blueprint for a Modernized Financial Regulatory Structure on March 31st. This report outlines a number of short, intermediate, and long-term improvements that can strengthen the U.S. financial system. We at the Treasury look forward to engaging with Congress on these recommendations.

RESPONSE TO WRITTEN QUESTIONS OF CHAIRMAN DODD FROM TIMOTHY F. GEITHNER

Q.1. President Geithner, you testified that the New York Federal Reserve Bank, "began to explore ways in which [it] could help facilitate a more orderly solution to the Bear situation. [It] did not have the authority to acquire an equity interest in either Bear or JPMorgan Chase." Do you feel that the Federal Reserve Bank should have the authority to acquire equity interests in private companies?

A.1. The potential benefits of providing the Federal Reserve with explicit authority to acquire equity interests in financial institutions would have to be balanced against the potential risk that such authority could raise expectations about the probability of future intervention, thereby contributing to moral hazard. We are in the process of examining the adequacy of our existing authority and instruments and are working closely with other supervisors to examine the lessons we should draw from this episode. This includes giving careful consideration to how best to adapt supervisory policies and the overall supervisory and regulatory framework, as well as the legal framework for insolvency and liquidation of financial institutions, to address the challenges we face going forward.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM TIMOTHY F. GEITHNER

SYSTEMIC RISK AFTER MERGER

Q.1. President Geithner, what impact will JPMC's merger with Bear Stearns have on its capital levels and are you confident that the merger will not expose JPMC to any liabilities that could threaten its solvency? In other words, what assurance can you provide that this merger will not produce a much larger systemic risk by undermining the financial position of one of the nation's largest banks?

A.1. JPMC remained well-capitalized (as defined in section 225.2 of the Board of Governors Regulation Y) following its acquisition of Bear Stearns. Although there are significant risks in this transaction, we believe that JPMC has the capacity to manage those risks and to absorb any potential losses that may result from the merger.

LESSONS LEARNED AND TOO BIG TO FAIL

We have heard the argument that Bear was "too inter-connected to allow to liquidate quickly". This would appear to be the case for a number of financial entities, including both banks and non-banks.

Q.2. What changes in supervision or financial surveillance and reporting could the regulators use to make such a situation of "interconnectedness" less likely to trigger the type of resolution the Fed entered into with Bear?

A.2. The The President's Working Group on Financial Markets, the Senior Supervisors Group and the Financial Stability Forum have each recently issued reports aimed at identifying some of the critical weaknesses in the system that were revealed by this crisis. These reports also outline a range of recommendations for making the global financial system more resilient in the future. Included among those recommendations are the following:

- Strengthen the capacity of the core financial institutions to withstand periods of severe stress by increasing the size of the capital and liquidity buffers they hold even during periods of robust growth and highly liquid markets;
- Strengthen risk management practices by enhancing oversight and creating better incentives for firms to manage their risk in a forward-looking manner that incorporates both on and off-balance sheet exposures as well as the potential for distress to be firm-specific or system-wide;
- Improve the capacity of the system to absorb a default by a major market participant by enhancing the robustness of the market infrastructure, particularly in the over-the-counter derivatives and repo markets; and
- Increase the effectiveness of market discipline by improving the disclosure practices of sponsors, underwriters, and investors with respect to a range of instruments including securitized and structured credit products.

Our first and most—important priority continues to be helping the economy and the financial system get through the present crisis. Longer term, we will be working closely with financial supervisors in the U.S. and abroad to advance the objectives described above and strengthen the resiliency of our financial system.

Q.3. Given that the Fed has pursued this transaction, how can the Fed and perhaps the Congress now convince market participants that something similar will not happen again? And if we cannot convince market participants that is the case, what is the implication for risk-taking behavior in the future?

A.3. Congress gave the Federal Reserve the responsibility and the authority to act to promote financial stability. The particular legal authority used to facilitate the Bear Steams transaction has been used very sparingly by the Federal Reserve over the last 75 years, and its use in this context was motivated by the specific—and extraordinary—circumstances that prevailed at that time. The fact that we found ourselves in those extraordinary circumstances makes a compelling case for undertaking a comprehensive reassessment of how we use regulation to strike an appropriate balance between the efficiency and dynamism of the financial system on the one hand and resiliency and stability of the system on the other. Achieving this balance will entail a mix of changes to our regulatory policies—some of which are described above in my response to your previous question as well as to our broader regulatory structure and to certain aspects of our crisis management framework. Policymakers in the U.S. and around the world are actively engaged in the process of identifying and implementing the necessary changes.

It is important to note that the actions we took in the context of these extraordinary circumstances were designed to protect the system in a way that minimized the "moral hazard" consequences of providing that protection. No owner or executive or director of a financial institution would look at the outcome for Bear Stearns and choose to see their firm managed in such a way as to court a similar outcome.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM TIMOTHY F. GEITHNER

Q.1. If Bear Stearns, which was only the 5th largest dealer, was prevented by the Fed from failing, will you allow anyone to fail?

A.1. Our decision to lend in connection with the acquisition of Bear Stearns by JPMC was based on the systemic risk generated by the confluence of a number of extraordinary factors, including the rapidity with which Bear Steams' funding capacity had eroded and the exceptionally fragile conditions that prevailed in short-term funding markets at that time. Bear Stearns, although smaller than the other major investment banks, was a significant counterparty in these and other critical markets. In our view, these extraordinary circumstances meant that the disorderly unwinding of a major market participant could likely trigger contagion and transmit distress to a much wider range of markets and market participants than just those directly connected to that firm. The combination of the fragile state of markets and Bear's role as counterparty in derivatives and secured funding markets meant that a default would likely have caused very substantial damage to the financial system and to the economy as a whole.

Substantial changes to our regulatory policies and regulatory structure are needed. The Federal Reserve is working in concert with the U.S. Treasury Department and supervisors and regulators from around the world to improve the capacity of our financial system to withstand stress, including the stress that would occur in the wake of the failure of a major institution. A description of some of the key elements that should guide this process is provided in the response to your second question below.

Q.2. Are there functions or transactions that have developed in our financial system today that are so essential that we need to update regulations or protections to ensure they do not fail?

A.2. The U.S. financial system has long been one of the most dynamic and innovative systems in the world. It is an ongoing challenge for regulators and supervisors to keep abreast of the innovation taking place, and to devise and adopt the right mix of incentives and constraints to keep the system stable without reducing that dynamism. As has been the case in past crises, this episode has highlighted a number of areas in which innovation outpaced market participants' understanding of the risks, and the system became less transparent and more vulnerable to acute instability. We have begun the process of considering what set of changes to our regulatory and supervisory framework are needed to enhance financial stability. Our objective should be to preserve the dynamism of our markets while also strengthening their capacity to withstand stress. This will require changes to our regulatory policies and our regulatory structure, as well as a careful look at the set of crisis management tools at our disposal. Among the changes that will be needed are: (1) a stronger set of capital and liquidity "shock absorbers" in those institutions that are critical to market functioning and the overall health of the economy, with a stronger form of consolidated supervision over those same institutions; (2) a more robust financial infrastructure, especially in the derivatives and repo markets; (3) a more effective mix of tools to manage crises; and (4) a more streamlined regulatory framework that provides the Federal Reserve System with the right mix of authority and responsibility for promoting financial stability and responding to systemic threats when they arise.

Our first and most important priority continues to be helping the economy and the financial system get through the present crisis. In the longer term, we will be working to advance the objectives described above, with the goal of strengthening the resiliency of our financial system.