Letter from the President

LETTER FROM THE PRESIDENT

The year 2009 was a difficult one for the Federal Reserve Bank of New York, the Federal Reserve System of which the Bank is a part, and the nation.[1] In the United States and around the world, extraordinary measures were taken to stabilize the financial system and prevent a deep global recession from becoming a full-blown depression.

The Federal Reserve acted to support financial institutions and markets, with the ultimate goal of safeguarding the flow of credit to American families and businesses. At the same time, the Federal Reserve also responded to the recession with aggressive monetary policy.[2] The New York Fed played an integral role in helping to design these initiatives and implemented them in challenging market conditions.

Over the course of 2009, the economy and financial markets did stabilize and the worst economic outcomes were avoided. But even after the economy began to recover, the initial rebound was weak. Unemployment continued to rise through late 2009 both in the Second Federal Reserve District[3] and elsewhere. In addition, ongoing declines in housing prices left many people with negative equity in their homes, and foreclosure rates increased in many areas. While the economic outlook had improved substantially by year-end, some risks remained.

The impact of the financial crisis is a sharp reminder that financial stability is an essential precondition for prosperity. The New York Fed embraces its responsibility as part of the Federal Reserve to translate the lessons of the crisis into concrete actions that will help to create a more resilient financial system for the future.

Last year was my first as president of the New York Fed. In this role, I have been privileged to lead a remarkably dedicated and professional group of public servants and have benefited greatly from the work accomplished under the leadership of my predecessor, Timothy F. Geithner.

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[1] The Federal Reserve Bank of New York, identified informally in this letter as "the New York Fed" or "the Bank," is one of twelve regional Federal Reserve Banks, each of which represents a different part of the nation. The Federal Reserve System is made up in part of these twelve regional Banks and the Board of Governors of the Federal Reserve System, an independent agency of the U.S. government. The Federal Reserve System, typically abbreviated to "Federal Reserve," is the nation's central bank.

[2] Federal Reserve Chairman Ben S. Bernanke described this monetary policy response in his April 2010 speech "Economic Challenges: Past, Present, and Future," available at http://www.federalreserve.gov/newsevents/speech/20100407a.htm.

[3] The New York Fed serves the Second District, which comprises New York State, the twelve northern counties of New Jersey, Fairfield County in Connecticut, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands.

Staff from the New York Fed were key participants in the Federal Reserve-led Supervisory Capital Assessment Program—sometimes referred to as the "bank stress tests"—which aimed to restore confidence in the U.S. financial system.

REVIEW OF 2009

At the start of 2009, the U.S. economy was contracting sharply. Questions about the duration and depth of the recession created extreme uncertainty about asset values and the balance sheet strength of financial firms. The economy and the financial system were caught in a downward spiral of increased risk aversion, declining asset values, constrained credit, and contracting employment and output that threatened to result in a very protracted period of economic and financial distress.

Acting at the direction of the Board of Governors of the Federal Reserve System (the Board)[4] and the Federal Open Market Committee (FOMC),[5] the New York Fed implemented policies that aimed to break this downward spiral. These initiatives included measures to improve the supply of credit from the financial sector by strengthening financial institutions and markets, as well as monetary stimulus to support economic activity and employment.

The New York Fed acted to implement these measures in a timely and effective manner, carefully managing risks by building out its compliance and risk management capabilities. The policy actions fell into four categories:

- **Strengthening financial institutions**
  Staff from the New York Fed were key participants in the Federal Reserve–led Supervisory Capital Assessment Program (SCAP)—sometimes referred to as the "bank stress tests"—which aimed to restore confidence in the U.S. financial system.[6] Regulators examined the nineteen largest bank holding companies to determine the losses they would incur in a more adverse economic scenario than was generally expected at the time. These firms were then required to establish a large enough capital buffer to ensure that they would remain well capitalized in such a scenario. The SCAP, along with intensive ongoing supervision, helped to improve the condition of the largest banks so that they were better able to provide credit to the economy.

- **Implementing asset purchases to reduce the cost of credit**
  The New York Fed implemented the FOMC's decision to buy $1.7 trillion of agency mortgage-backed securities, agency debt, and Treasury securities—actions that were ultimately completed in March 2010. These purchases provided additional stimulus to the economy at a time when short-term interest rates were already close to zero. While the precise impact of this program continues to be debated, our judgment is that these asset purchases supported activity in the housing market by reducing the cost and increasing the availability of mortgage credit, and lowered long-term interest rates more generally.

[4] In addition to its many other duties, the Board is responsible for authorizing actions, under section 13(3) of the Federal Reserve Act, that permit lending by the Reserve Banks to non-deposit-taking institutions in "unusual and exigent circumstances."

[5] The Federal Open Market Committee, which is made up of the Governors, the president of the New York Fed, and four of the remaining Reserve Bank presidents (who vote on a rotating basis), determines monetary policy and directs the New York Fed to implement this policy on its behalf.

[6] Participants from the regulatory community included staff from the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation as well as Federal Reserve staff.

■ **Providing liquidity to support the flow of credit**

The New York Fed worked with the Board and the U.S. Treasury to implement the Term Asset-Backed Securities Loan Facility (TALF). This program helped revive the securitization markets for consumer and business loans by ensuring that financing was available for investors willing to participate in these markets. The Bank also executed a wide range of other programs that provided large amounts of short-term credit to financial institutions and markets domestically and, through currency swaps, internationally. The Bank continuously strengthened the control, compliance, and risk management systems supporting these programs over the course of 2009.

■ **Stabilizing systemically important institutions at risk**

During the year, the New York Fed, along with the U.S. Treasury, restructured the government assistance for AIG (American International Group) in a way that further stabilized AIG, allowed it to begin the process of selling assets and repaying its government aid, and reduced the overall risk to the Federal Reserve. The New York Fed also implemented additional measures to manage the risks relating to the loans secured against the "Maiden Lane" portfolios. The Maiden Lane loans resulted from the AIG and Bear Stearns interventions in 2008, which were undertaken to prevent disorderly financial failures that would have harmed many households and businesses.

In addition, the New York Fed worked to mitigate the foreclosure crisis in the Second District and beyond. The Bank's efforts included the development of a credit conditions website that is now widely used by local governments and community groups to evaluate local conditions and to determine where best to direct scarce resources.[7]

FINANCIAL AND ECONOMIC OUTCOMES

The SCAP process was an important turning point in instilling confidence in the U.S. financial system. The nineteen banks subject to the SCAP process were able to raise $107 billion in common equity from private sources in 2009.

Aided by ongoing liquidity provision, the financial system began to heal around the second quarter of 2009 and this process accelerated as the year progressed. The high interest rate spreads at which banks borrowed from each other—a hallmark of the financial crisis—fell back toward more normal levels. Asset-backed securities were issued in greater volumes, and private demand for commercial paper increased. There was a broad-based rally in overall financial market assets by year-end.

Supported by exceptional monetary and fiscal stimulus, the economy stopped contracting around the middle of 2009 and began to expand at a moderate pace in the second half of the year. However, improvements in wholesale credit markets did not translate into a rapid easing in credit availability, and unemployment continued to climb as firms aggressively shed workers.

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[7] Visit http://data.newyorkfed.org/creditconditions/.

Demand for the Bank's short-term liquidity programs, which were priced to be expensive under more typical market conditions, declined as market conditions normalized; many of the programs were subsequently closed in early 2010.[8]

DEVELOPING TOOLS TO SUPPORT MONETARY POLICY

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The New York Fed developed plans for large-scale reverse repurchase agreements with its primary dealer counterparties as well as with new counterparties, including money market mutual funds. Along with staff from the Board and other Federal Reserve Banks, the New York Fed contributed to the development of plans for a term deposit facility for banks. These tools can be used to withdraw reserves and reinforce the basic tool of paying interest on reserves.[9]

By preparing these tools, the New York Fed reinforced market confidence that the Federal Reserve could effectively tighten monetary policy when the time came to do so, and this helped to contain inflation expectations.

TRANSPARENCY AND ACCOUNTABILITY

The nontraditional actions taken by the Federal Reserve during the crisis gave rise to understandable demands for greater transparency and disclosure. The Federal Reserve took important steps to provide better information about its facilities, including the release of monthly reports to Congress and the creation of new websites.[10] The New York Fed continues to look for additional ways to increase transparency, while at the same time ensuring that the disclosure regime does not undermine the ability of the Federal Reserve to fulfill its mandate, including acting as an effective lender of last resort in times of stress.

The independently audited financial statements in this report are an important and longstanding means of achieving transparency. These statements show that the New York Fed's overall balance sheet declined slightly over the year and the asset mix changed substantially as a fall in short-term loans was largely offset by an increase in long-term securities.[11]

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[8] Currency swaps were revived in May 2010 in response to the re-emergence of strains in short-term funding markets in Europe. The Federal Reserve took this step in cooperation with other central banks to improve liquidity conditions in global money markets and to minimize the risks that strains abroad could spread to U.S. markets.

[9] Interest on reserves should establish a rough floor for private overnight borrowing rates by providing a risk-free overnight rate below which private rates should not fall far, if at all, and thereby allow the Bank to better manage the policy rate set by the FOMC.

[10] Visit http://www.federalreserve.gov/monetarypolicy/bst.htm and http://www.newyorkfed.org/markets/maidenlane.html.

[11] The Bank's securities holdings are reported on a weekly basis throughout the year at http://www.newyorkfed.org/markets/soma/sysopen_accholdings.html. The Federal Reserve System's balance sheet is published weekly in the Federal Reserve's H.4.1 release, at http://www.federalreserve.gov/releases/h41/.

As explained above, the programs executed by the New York Fed were intended to restore market functioning and to advance the dual-mandate goals of full employment and price stability given to the Federal Reserve by Congress. The interest income and fees that accrued to the New York Fed from these programs exceeded its operating costs and generated profit that was remitted to the U.S. Treasury. This profit is a by-product of these operations and should not be viewed as the primary measure of the Bank's success.

In 2009, interest receipts from loans exceeded $5 billion, with no credit losses. The Commercial Paper Funding Facility earned more than $4 billion in net income, also with no credit losses, while the three Maiden Lane facilities all generated significant income.

The long-term securities held by the New York Fed for the Federal Reserve System also produced substantial net income, although in future years the amount of net income from these assets may vary, depending on a number of factors, including the prevailing level of interest rates and policy decisions by the FOMC with respect to the asset holdings. Overall, the Bank remitted almost $24 billion to the Treasury. The Maiden Lane collateral portfolios (only 5 percent of the New York Fed's assets) meanwhile continued to improve.

THE ROAD AHEAD

As I write this letter, the U.S. economy, financial markets, and financial institutions are all in considerably better shape than they were in early 2009. However, the recovery is expected to be slower than those that followed earlier deep downturns, with unemployment likely to diminish only gradually. The New York Fed will continue to support the FOMC's efforts to reduce unemployment and maintain price stability.

Meanwhile, the latest bout of market stress in Europe demonstrates that financial stability can never be taken for granted. As the past three years showed, financial stability is indispensable for economic growth and the maintenance of an environment in which people can confidently plan for the future—whether they wish to go to school, expand their business, or retire with comfort and security. In the period ahead, it is important that policymakers put financial stability policy on a par with monetary policy, because the two are ultimately interconnected: monetary policy cannot achieve the objectives of maximum sustainable employment and price stability without financial stability.

The New York Fed has always had important responsibilities in the financial stability area through its implementation of monetary policy, supervision of banks, and operation and oversight of payment and settlement systems. It is deeply committed to this mission.

APPLYING THE LESSONS OF THE CRISIS

With the benefit of hindsight, it is clear that in the years preceding the crisis, regulators and private sector leaders alike were slow to recognize the vulnerabilities and market excesses spawned by rapid financial innovation and a long period of economic stability.

In the future, regulators collectively need to do a better job of understanding the rapid evolution of the financial system and of challenging benign explanations for the status

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quo. Because the financial system is constantly evolving, supervisory and regulatory policy must constantly adapt to be effective.

Policymakers are unlikely to be able to put an end to financial crises. However, there are steps that can be taken to reduce both the likelihood and the severity of financial shocks.

The New York Fed is only one actor in this process, and its role even within the Federal Reserve's own policy arena is strictly a supporting one. However, we take seriously our obligation to help advance this work. The challenge is to reduce systemic risk in the financial sector while supporting financial vibrancy along with deep and liquid financial markets.

WHAT WE ARE DOING TO MINIMIZE FUTURE CRISES

The New York Fed is contributing to broader efforts to make financial institutions internalize more of the costs of their risk taking in advance and to make the financial system one that dampens rather than propagates shocks. These efforts include initiatives to:

- strengthen derivatives market infrastructure through exchange trading and central clearing of standardized products and the use of trade repositories;
- reform the triparty repo market, a key source of short-term finance;
- develop new capital and liquidity rules that will better capture the risks run by financial institutions and require these institutions to hold more capital and highly liquid assets against their exposures; and
- enhance bank supervision by applying a macroeconomic perspective to the assessment of risk at the firm level and by developing horizontal (sector-wide) reviews.

The New York Fed is researching how new strategies might be used to preempt asset price bubbles more aggressively. It is also studying how "contingent capital" instruments might be used to strengthen the financial position of a weakened firm in a timely fashion.

In all this, we hope to help promote financial stability and impose effective discipline on firms that might otherwise be deemed "too big to fail" to the detriment of smaller competitors and the public.

WORKING TOGETHER IN THE PUBLIC INTEREST

The future, though brighter than it looked a year ago, remains uncertain. In addition to contending with near-term challenges, the global economy will eventually need to adjust in a way that brings national consumption, saving, and investment into better balance. The United States will have to develop a credible plan to put its long-term public finances on a sustainable path, in a way that does not threaten the nascent recovery.

At the time that I write, Congress is considering legislation that would reshape the regulatory and supervisory regime in the United States. Whichever agency or group of agencies is ultimately charged with responsibility for financial stability, it is critical that the different dimensions of financial stability policy be appropriately coordinated.

Regulatory reform may result in changes to our governance as well as to our mandate. Regardless of the form these changes take, the Federal Reserve Bank of New York will strive to achieve the mandate given to us by Congress and the Federal Reserve Board, and honor the trust placed in us by the American people.

I have every confidence that the staff of the New York Fed will do their utmost to live up to these responsibilities in the future, as they have in the past. In that regard, it is important to recognize that the New York Fed's performance in 2009 cannot be attributed to a few individuals or even a few groups. It took the entire institution to manage all of the challenges faced during the year—and to do so while continuing to execute all of the Bank's regular responsibilities.

Research economists worked alongside markets and bank supervision experts to develop and implement new programs. Risk managers evaluated and priced risks. Auditors and accountants created new compliance and reporting regimes. Legal and communications staff faced intense demands. Financial services staff and technology and support services kept our operations running smoothly. Human resources professionals oversaw the hiring and integration of new staff urgently recruited to meet the challenges of the crisis.

Staff at every level showed deep commitment to public service, working long and intense hours. They brought all of the New York Fed's resources to bear in responding to the crisis.

I am very proud of their efforts.

William C. Dudley
June 10, 2010