# Letter from the President

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## ADVANCING OUR MANDATES AND PREPARING FOR THE FUTURE

In 2010, the Federal Reserve Bank of New York worked to strengthen a weak economic recovery and to help lay the foundations for a more robust and stable financial system following the crisis of 2007-09. In doing so, we sought to serve the public interest and advance the mandate given to the Federal Reserve System by Congress: to promote both maximum sustainable employment and price stability.

The aftermath of a financial crisis presents many challenges, and the road to recovery in the United States in 2010 was difficult and bumpy. As a System, we made aggressive use of the limited set of monetary policy tools at our disposal to bolster growth and employment. We did so knowing that while monetary policy could not avert needed adjustments in household balance sheets, the housing market, and the financial system, it could to some degree provide support to the economy as these painful transitions were under way.

At the New York Fed, we also redoubled our efforts to contribute to financial reform initiatives at home and internationally, acting in support of the Federal Reserve Board of Governors. The financial crisis taught all of us many harsh lessons, but the most important is that without financial stability, we cannot attain the economic goals set out in our dual mandate.

This understanding has led us to put financial stability on a par with monetary policy as a System priority. Accordingly, in 2010 we sought to sharpen the financial stability aims of everything that we do as an institution.

## HIGHLIGHTS OF 2010

- Second Round of Asset Purchases

  Although the year began well for the economy with a brisk first quarter, hopes for a rapid rebound soon faded, and by the summer we saw a sustained loss of economic momentum, coupled with a dangerous fall in inflation expectations. My colleagues on the Federal Open Market Committee (FOMC) and I decided to take action to strengthen growth and reduce the risk of deflation. With short-term interest rates already close to zero, we used asset purchases as our tool—first voting to reinvest the proceeds of maturing securities and then moving to purchase an additional $600 billion of long-term Treasury securities.

  The large-scale asset purchase program worked by taking duration out of the market and inducing private investors that sold Treasury securities to rebalance their

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portfolios through purchases of other longer term assets—actions that drove down yields more broadly and helped support equity prices.

The New York Fed's Markets Group, with the assistance of the Research and Statistics Group and other areas of the Bank, advised the FOMC on its balance sheet policy options and implemented the program as instructed by the Committee. The program was no silver bullet, but it achieved its desired goal of easing financial conditions, stabilizing inflation expectations at levels consistent with the FOMC's medium-term inflation objectives, and supporting growth.

The asset purchase program was put into effect with minimal market disruption and without an undesirably large rise in inflation risk premia. I believe that it contributed to a firming of economic activity around year-end, although the recovery remained distinctly subpar into 2011.

Even as the Bank was executing the program, it continued to prepare for the time when the FOMC would need to tighten monetary policy again. To this end, the New York Fed tested new tools—first, reverse repurchase agreements using System Open Market Account securities as collateral and, second, term deposits offered to depository institutions. These tools can be used to reinforce the Fed's basic tool of paying interest on reserves and will help ensure that, even in a world where banks have excess reserves, the Fed can achieve the level of short-term interest rates it has targeted in the money markets.

### ■ Gradual Exit from Emergency Facilities

As financial market functioning continued to improve through 2010, the Bank closed or wound down many of the special liquidity facilities put in place at the peak of the financial crisis. These facilities helped stabilize our market-based financial system in order to sustain the flow of credit to households and businesses in the real economy.

For example, the Term Asset-Backed Securities Loan Facility (better known as TALF) ended in June 2010, after arranging more than $71.1 billion in loans to fund consumer and small business credit. This facility alone supported more than a million auto loans, several hundred thousand student loans, and tens of thousands of small businesses. It did so while generating $721 million in net income with no losses to date.

The Commercial Paper Funding Facility, which backstopped the short-term commercial paper market used by many financial and nonfinancial firms to fund receivables, also ended in 2010—again without a single loss, and having accumulated more than $6 billion in net income for the public.

In addition, the Bank in 2010 made significant progress in helping new management stabilize American International Group, Inc. (AIG) so that the firm no longer posed a risk to financial stability and could begin repaying its public obligations. This effort culminated in the announcement on September 30, 2010, of the AIG recapitalization plan.

In accordance with the plan, on January 14, 2011, AIG repaid the New York Fed's loans, including interest and fees, thereby terminating Fed assistance to the company. Repayment of the New York Fed's loans was an important step in the eventual repayment of all of AIG's obligations to the U.S. government.

In addition, the three Maiden Lane special-purpose vehicles—limited liability companies that hold assets transferred as part of the Federal Reserve's efforts to prevent the disorderly failure of Bear Stearns and AIG—all increased in value over the course of 2010. As of December 31, 2010, the value of the assets in all three portfolios exceeded the balances of the loans extended by the New York Fed, in two cases by a considerable margin.

■ Financial Reform: The Dodd-Frank Act and the Basel III Framework

The damage caused by the financial crisis underscored the urgent need to strengthen financial regulation and build a more systematic and dynamic risk oversight framework. The New York Fed is deeply committed to supporting these efforts in the United States and globally.

In 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), bringing far-reaching regulatory change to the nation's financial system. It charged the Federal Reserve System with important new financial stability responsibilities and required the Federal Reserve and other financial regulatory agencies to take a macroprudential approach to supervision and regulation. Such an approach focuses on risks to the system as a whole as well as the external costs imposed by the failure of any firm or critical market infrastructure.

The Bank will be required to implement many of the new rules under the Dodd-Frank Act, and in 2010 we began preparing for these changes. We are also firmly committed to supporting Federal Reserve Chairman Ben Bernanke in his role as a member of the new Financial Stability Oversight Council, which was created by the Act to bring together regulators from across the nation to identify and address risks to financial stability and promote market discipline.

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In 2010, the Bank's Financial Institution Supervision Group made important contributions to the development of an enhanced set of prudential measures for globally active banks under the Basel III framework. Basel III is aimed at improving the ability of large globally active banks to absorb financial and economic shocks and to maintain the supply of credit to the real economy in times of stress without the need for taxpayer support. The agreements reached in 2010 require banks to hold more and better-quality capital, guard more effectively against the risks run by banks, and give banks greater incentives to recapitalize promptly with private sector funds when they incur losses.

The New York Fed also contributed to many other efforts to strengthen international regulatory coordination. Bank senior managers chaired or co-chaired the Committee on Payment and Settlement Systems, the Financial Stability Board's Over-the-Counter (OTC) Derivatives Working Group, the OTC Derivatives Regulators' Forum, and the OTC Derivatives Supervisors Group.

All told, important progress was made in 2010 and continues into 2011. Nevertheless, it is essential that we stay the course. The strengthened financial stability regime we are aiming for is still under construction. Many important decisions await us, particularly concerning the implementation of the Dodd-Frank Act and the Basel III agreements.

We foresee occasions when promoting financial stability will require actions that are opposed by parts of the financial services industry. In such circumstances, we should listen carefully to industry perspectives, but we should make our decisions based exclusively on our assessment of the public interest.

At the New York Fed, we recognize the need to focus attention on the reform of market structures and practices as well as the reform of bank regulation. As part of a market-based reform agenda, the Bank in May 2010 produced a white paper identifying weaknesses in the infrastructure of the tri-party repo market and eliciting comments from a wide variety of market participants on the reform proposals of a Bank-sponsored task force. This initiative promises to bring about material improvements in tri-party repo practices. However, more can be done to strengthen this critical market.

## OUR CHALLENGES

### ■ Develop World-Class Human Capital and Systems

Our greatest asset at the New York Fed is the quality of the people who work here and their commitment to serve the public. Still, we must always strive to improve our ability to attract, develop, and challenge top talent in a culture of meritocracy in which people at all levels are encouraged to question received wisdom—in a manner that is oriented toward action rather than debate for its own sake.

Because we want the Bank to have the best people, we need to draw broadly from all parts of our community. We actively seek the differences in background and experience that provide varied perspectives for our work. To this end, the Bank in 2010 increased its efforts to attract and retain a diverse staff with deep expertise, strong leadership capabilities, high ethical standards, and a broad range of technical skills.

In addition, we want our people to be thought leaders in their field. This is a core responsibility for members of our Research and Statistics Group, but we see it as a goal that extends to all areas of the Bank's policy work and operations.

A world-class institution requires world-class technology that is secure against ever-increasing cyber-threats. Our technology must also be robust, so that it can respond effectively to shifting demands and priorities in a cost-effective fashion. In 2010, we undertook a number of efforts to update our technology.

Some of our largest modernization projects involved the Fedwire® Securities Service and the Fedwire® Funds Service, which provide vital services to financial institutions. Over the next several years, we expect to pursue further improvements to Fedwire® technology. We recognize that our success in this endeavor will be measured in large part by our ability to implement important enhancements in a manner that minimizes disruptions to our customers.

### ■ Build Capacity in the Area of Financial Stability

A further challenge for the Bank is to increase our capacity to promote financial stability across many different dimensions. To this end, we need to develop an organizational mindset that focuses on system risk and, at the same time, to take concrete steps to strengthen our people and processes. The cross-disciplinary approach that we put in place during the crisis can provide an important building block for this work. So too can the enhanced risk management infrastructure we developed in 2010 with the creation of the Risk Oversight Committee and other actions.

Although financial stability is the responsibility of the whole Bank, a heavy share of the burden will inevitably fall on the Financial Institution Supervision Group. Strengthening our practice of supervision, particularly as it applies to the largest financial institutions, is a top priority for 2011 and beyond.

### ■ Connect Globally and Locally

To succeed in its public mission in a rapidly transforming international economy, the Bank needs a global orientation and a richly textured understanding of developments around the world that affect our economic outlook and prospects for financial stability.

In 2010, our Emerging Markets and International Affairs Group provided key insights into the sovereign debt crisis in Europe. In the medium term, we need to

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strengthen further our relationships with emerging economies in light of their ever-larger and fast-changing role in the global economic system.

As we think globally, we also have to connect locally, investing the time to build relationships with the public we serve in our own Second District. These outreach initiatives, if conducted in a structured manner, can provide valuable direct insight into Main Street economic concerns and the viewpoints of a wide range of stakeholders, including small business owners, community bankers, workers, and moderate-income groups. Certainly, I can say that the Bank's regional outreach program has given me important new perspectives on the District and national economies.

## MOVING AHEAD

In preparing for the challenges ahead, we must be persistent and disciplined in our approach. As the crisis recedes in memory, the natural reflex may be to grow complacent. However, much more can be done to make the global and national financial system resilient and robust. There can be no return to pre-crisis business as usual.

We will not be able to avert all future failures or crises, but we can improve our ability to limit the frequency, severity, and breadth of their impact. We must be steadfast in pursuing our commitment to make the system more stable while we protect the dynamism of our economy as it fuels growth. We must also constantly challenge our assumptions about monetary policy, and incorporate awareness of global economic developments in all that we do.

We must act with transparency and honesty, acknowledging the limits of our scope. Central banks are not all-powerful, and monetary policy is a limited tool. No single regulatory institution, or even all regulators acting in concert, can guarantee that future financial crises will not occur. What we at the New York Fed can promise is a deep commitment to vigilance and a continual effort to use our abilities and the powers entrusted to us to advance the public interest in financial stability as the foundation of prosperity and growth.

We are committed to this essential mission.

William C. Dudley
July 22, 2011