FEDERAL RESERVE BANK OF BOSTON™

Written Testimony of
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Field hearing of the
Committee on Financial Services of the
U.S. House of Representatives:
"Seeking Solutions –
Finding Credit for Small and
Mid-Size Businesses in Massachusetts"

Monday, March 23, 2009
Massachusetts State House
Boston, Massachusetts

Note: The figures (charts) mentioned in this testimony are attached below the text.

Chairman Frank and members of the Committee, it is my pleasure to appear before you today to discuss the availability of credit for businesses amid the current economic and financial turmoil, and the steps the Federal Reserve is taking to help make credit available to small and medium-sized businesses.

In my testimony today I plan to first share some national context, and some perspective on the Federal Reserve System's responses to date. I plan to then comment, more briefly, on the situation in Massachusetts.

The National Context

Since August of 2007, financial markets have been severely disrupted. The functioning of financial markets and the functioning of institutions that serve as financial intermediaries have tremendous downstream impacts on businesses, state and local governments, and households. As a result, these disruptions are of great concern to the Federal Reserve as we pursue our policy goals of maximum sustainable employment, stable prices, and moderate long-term interest rates.

While credit availability has been a concern since the outset of the financial crisis, the credit situation became more severe as problems expanded beyond a few large financial institutions focused on subprime-mortgage securitizations to a broader group of financial institutions. The Federal Reserve's *Senior Loan Officer Opinion Survey on Bank Lending*

Practices has been showing substantial tightening of credit, which dovetails with the perspectives voiced since last summer by many advisory groups we engage at the Boston Fed. Other entities such as Associated Industries of Massachusetts are finding when they survey companies that credit conditions are tightening – and that the tightening may affect companies directly, or indirectly through suppliers and customers who face credit constraints.

The Federal Open Market Committee (FOMC) remains focused on ensuring adequate financing for businesses of all sizes. Last week's official FOMC statement indicated, among other things, that "weaker sales prospects and difficulties in obtaining credit have led businesses to cut back on inventories and fixed investment." Earlier this month, the Federal Reserve's *Beige Book* report suggested that "The availability of credit generally remained tight. Lenders continued to impose strict standards for all types of loans, with scattered reports of further tightening and particular scrutiny focused on construction projects and commercial real estate transactions."

Credit availability issues remain a significant focus at the Federal Reserve and are a significant factor in how we are addressing the current economic and financial problems. The Federal Reserve has acted proactively and creatively to address these concerns – first by aggressively easing conventional monetary policy (the federal funds rate) and, since the fall, using less-conventional monetary policy tools to mitigate continuing problems with the cost and availability of financing for businesses and households.

Figure 1 shows how the Federal Reserve acted to address problems in financial markets, and concerns that market disruptions would impact the cost and availability of finance, by rapidly moving the target federal funds rate to only a little above zero. As the Federal Reserve lowered the target federal funds rate, most short-term market interest rates fell – although not commensurate with the decline in the federal funds rate.

It is important to note that many small and medium-sized businesses have loans tied to the prime rate, or to the London Interbank Offered Rate or Libor, which decreased significantly as we moved the federal funds rate from 5.25 percent in July 2007 to between zero and one-quarter of one percent at the end of December. While a year ago many observers were critical of these rapid rate cuts, it is fortunate that the Federal Reserve *did* move so quickly. While the reduction in interest rates did not prevent the economy's weakening, it helped cushion the economy against some of the shocks experienced over the past year.

With the federal funds rate approaching the zero bound, the Federal Reserve has turned to some alternative approaches to monetary policy, which have rapidly increased the Fed's balance sheet. Many of the new programs are intended to improve the availability of credit in the marketplace and reduce the cost, which had not fallen commensurate with the decline in the federal funds rate. I would like to briefly discuss these Federal Reserve programs.

Figure 2 shows the composition of the Fed's balance sheet. The largest expansion of the balance sheet occurred in the fall, as a series of actions were taken in response to the increasingly fragile state of financial markets. Our actions were designed to improve the functioning of interbank lending. Borrowers and businesses whose rates are tied to interbank rates like Libor benefit as interbank lending markets see more normal spreads and declining rates.

Allow me to mention two programs that have been critical to the improvements in interbank lending markets and the related reduction in market interest rates – the Federal Reserve's Term Auction Facility or TAF, and a network of liquidity swap lines we have arranged with other central banks. The TAF is designed to help ensure that banks can obtain the funds they need to provide credit to their customers. It involves an auction-model variant of discount-window lending to financial institutions (backed by collateral subject to significant "haircuts," to mitigate risk to the Federal Reserve). Central bank liquidity swaps are loans made to foreign central banks so that they can provide dollar funding to their banks in much the same manner as our TAF.

These two programs were designed to stabilize and improve the functioning of the interbank dollar-lending market – indeed, to ease conditions in global dollar markets that were spilling over into our own funding markets. As shown in **Figure 3**, the Libor rate is now much more aligned with the federal funds rate. The reduction in the Libor rate helps a variety of borrowers. Most subprime mortgages have reset rates tied to Libor, many credit card rates are tied to Libor, and the rates on many business loans are tied to Libor. The actions we have taken are reducing the cost of financing for borrowers and businesses whose rates are tied to Libor and thus influenced by the functioning of interbank dollar lending markets.

I would like to mention another area of substantial growth in the Fed's balance sheet – specifically, the Federal Reserve liquidity facilities designed to provide market support and improve conditions in short-term credit markets (see **Figure 4**). Some, like the Commercial Paper Funding Facility (CPFF), provide an alternative funding source to the market when interest rate spreads become very elevated.

In general, the various programs that have expanded the Federal Reserve's balance sheet should be less attractive to market participants as financial conditions improve. **Figure 5** shows that of late, the rate on asset-backed commercial paper has fallen dramatically, and many issuers can receive better terms by issuing commercial paper directly to the market.

Figure 6 shows that the prime money market funds have tended of late to have a net inflow of funds, which has helped stabilize short-term credit markets because money market funds are a key investor in these markets. Correspondingly, money market funds have reduced their reliance on the Fed liquidity facility that was designed to help them – the asset-backed commercial paper money-market mutual fund liquidity facility, or AMLF. This experience provides a clear example of how improved market conditions provide incentives for financial firms to reduce reliance on our facilities. We expect this to be the case for many of our facilities as the economy and financial markets gradually improve. Stabilized short-term credit markets mean that businesses that borrow with commercial paper are able to obtain less costly, more dependable sources of financing. In addition, many issuers of commercial paper used the funding to provide loans to businesses to finance receivables, to provide floor plan financing, and to provide other types of essential short-term credit.

Two new programs should provide additional help to markets. First, the Term Asset-Backed Securities Loan Facility (TALF) is designed to facilitate the renewed issuance of consumer and small business asset-backed securities – essentially providing a financing vehicle for credit instruments that have been disrupted by poor functioning in securitization markets. This facility, which is just starting up, should help make credit more available for student loans, consumer credit, commercial real estate, and small business loans; leading to lower borrowing rates and improved access in the market for consumer and small business credit. The facility will do this by lending against triple-A rated asset-backed securities collateralized by recently originated student loans, auto loans, credit card loans, loans guaranteed by the U.S. Small

Business Administration, mortgage servicing advances, loans or leases relating to business equipment, leases of vehicle fleets, or floorplan loans. A second program involves the large-scale purchases of mortgage-backed and agency securities. As shown in **Figure 7**, conventional mortgage rates that had been around 6 percent have declined since the announcement of this program.

Last Wednesday the Federal Open Market Committee announced that to provide greater support to mortgage lending and housing markets, the Federal Reserve would further increase its balance sheet by purchasing up to an additional $750 billion of agency mortgage-backed securities (bringing its total purchases of these securities up to $1.25 trillion this year), and to increase its purchases of agency debt this year by up to $100 billion (to a total of up to $200 billion). An important effect of this program is that it provides lower cost loans to homeowners, but it should be recognized that the program also bears significant benefits for many small businesses, which often rely on home equity loans as a critical source of initial financing. I should also mention that in order to improve conditions in private credit markets, the Committee on Wednesday decided to purchase up to $300 billion of longer-term Treasury securities over the next six months. This action is expected to ease credit conditions in a wide variety of markets that tie their cost of finance to Treasury yields.

The Situation in Massachusetts

While my goal today has been to provide some national context and perspective, I would like to add a few comments about the situation in Massachusetts and New England. **Figure 8** shows that lending patterns in the United States differ depending on the financial condition of the banks. Banks with the lowest supervisory ratings have reduced their lending while banks in better health show positive asset-growth percentages. Empirical research suggests that during previous banking crises this behavior was, to an important degree, explained by differences in the ability to *supply* credit, not just differences in the *demand* for credit. As you know, extending credit means expanding the asset side of the balance sheet for a bank, and banks must maintain a reasonable capital-to-assets ratio. This underlines the importance of steps to bolster or resolve poorly capitalized banks, in order to address broader problems of credit availability.

Figure 9 shows that the share of commercial and savings banks with the lowest supervisory ratings is quite a bit smaller in New England than it is nationally – and furthermore, that share has remained constant in New England while doubling for the nation overall in a year's time. Considering the aforementioned dynamic, the good news locally is that a greater share of New England banks are in good health and thus more able to supply credit to businesses. Of course, most anecdotal indications are that even among healthy banks willing to lend to creditworthy borrowers, standards have probably tightened in response to the riskier environment (that is, over concern related to the impact of the slowing economy on even creditworthy borrowers).

Concluding Observations

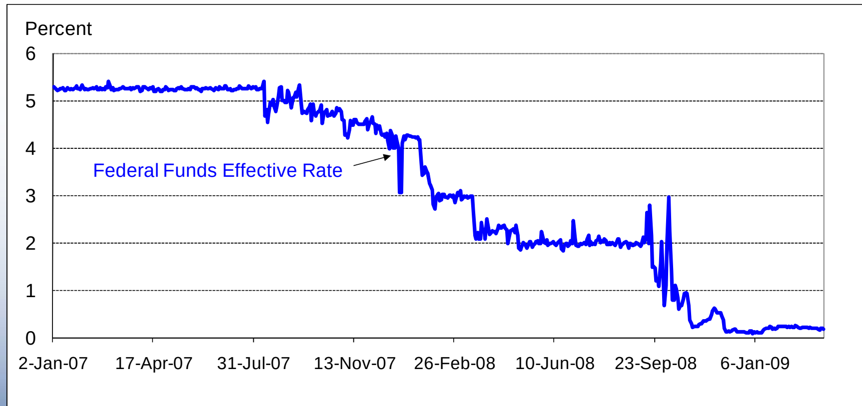
In conclusion, I would offer just a few summary thoughts. Over the last year and a half or so, the Federal Reserve has been proactive and innovative in trying to address problems in financial markets and the broader economy. While traditional monetary policy had focused on lowering the federal funds rate to spur interest-sensitive economic activity, now that this rate has approached the zero-bound floor, the Federal Reserve has focused on more direct means of lowering the cost of credit in the marketplace, which had not fallen commensurate with the decline in the federal funds rate. Federal Reserve programs have intended to offset disruptions to interbank lending, short-term credit financing, the ability of money market mutual funds to meet investor redemption requests, and housing finance – and these program should have beneficial effects on the cost and availability of credit for businesses.

Thank you for inviting me to testify today. If I can answer any questions I would be very pleased to do so.

Figures

Figure 1
Federal Funds Effective Rate

January 2, 2007 - March 18, 2009



Source: Federal Reserve Board / Haver Analytics

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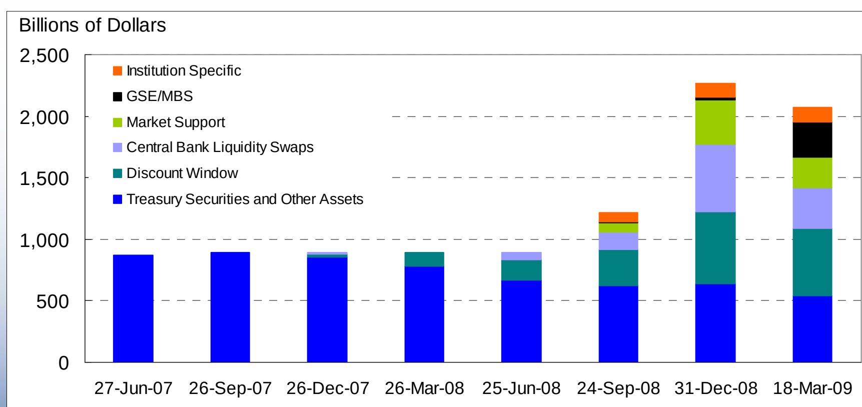
Figure 2
Composition of Federal Reserve System Assets

June 27, 2007 - March 18, 2009



Source: Federal Reserve Statistical Release H.4.1

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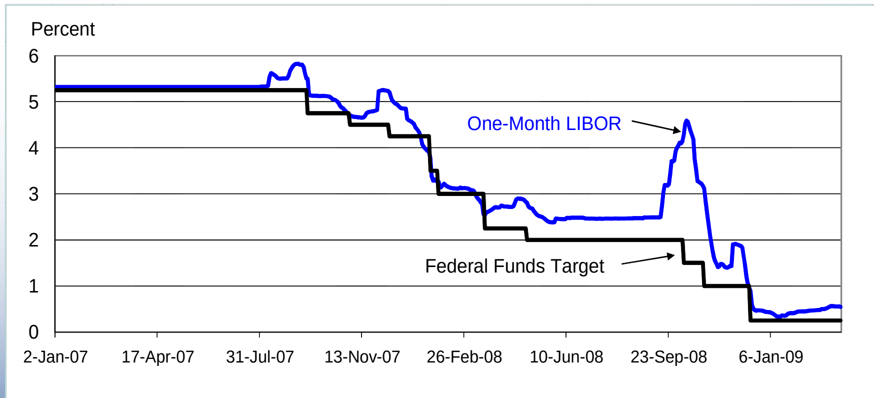
Figure 3
One-Month London Interbank Offered Rate (LIBOR) and the Federal Funds Target Rate

January 2, 2007 - March 18, 2009



Source: Federal Reserve Board, Financial Times / Haver Analytics

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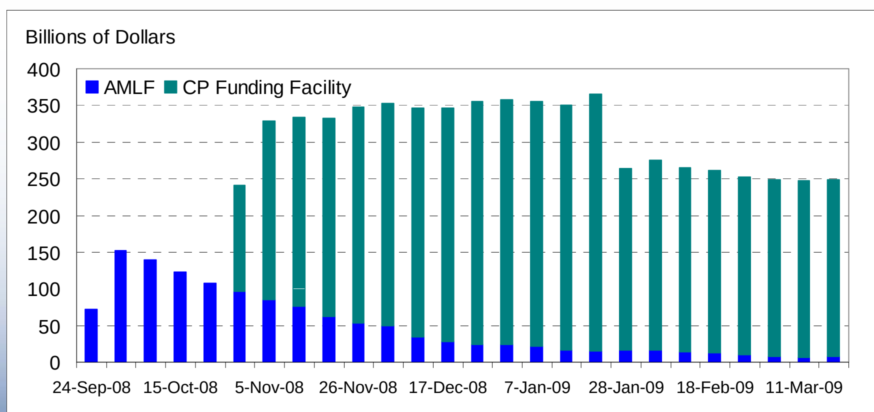
Figure 4
Federal Reserve System Assets held by Market Support Facilities

September 24, 2008 - March 18, 2009



Source: Federal Reserve Statistical Release H.4.1

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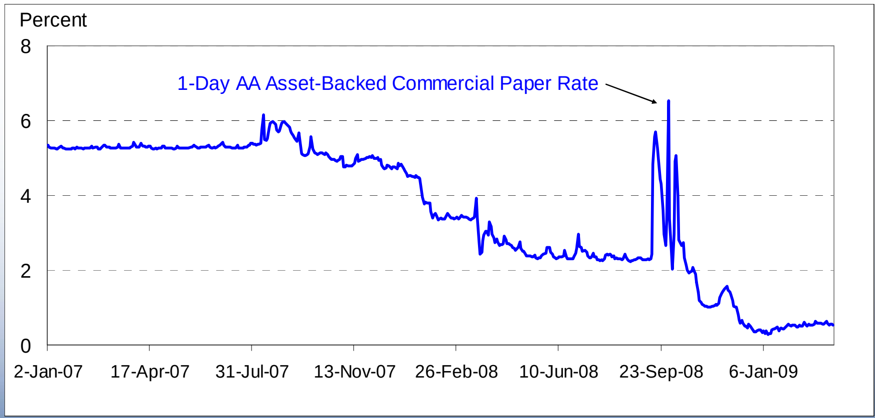
Figure 5
Asset-Backed Commercial Paper Rate

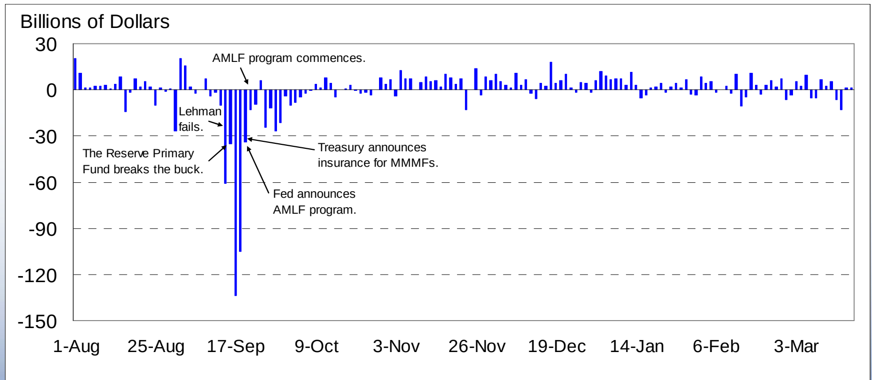
January 2, 2007 - March 18, 2009



Source: Federal Reserve Board / Haver Analytics

Figure 6
Daily Change in Money Market Fund Assets in Prime Funds

August 1, 2008 - March 18, 2009

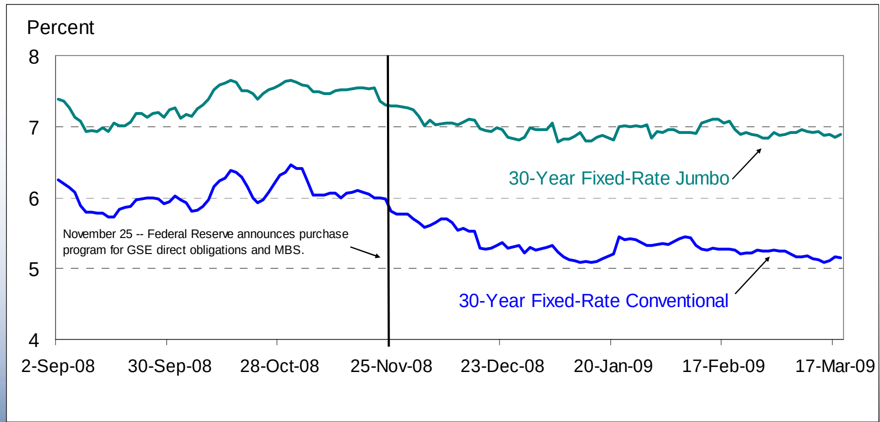


Note: Prime funds include both retail and institutional funds.

Source: iMoneyNet

Figure 7
National Average Mortgage Rates

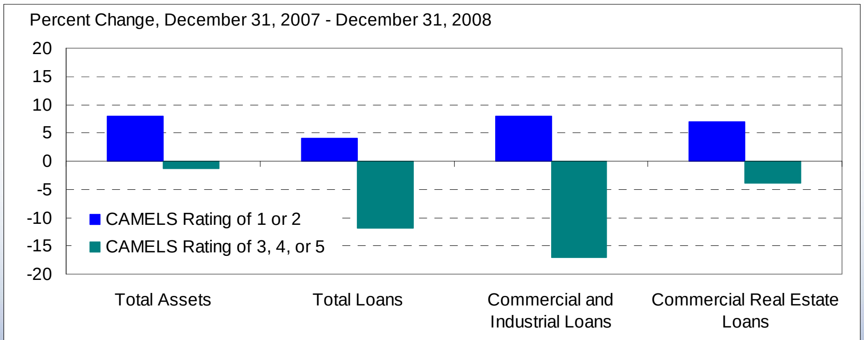
September 2, 2008 - March 18, 2009



Source: Bloomberg

Figure 8
Asset Growth at Commercial and Savings Banks by CAMELS Rating*

December 31, 2007 - December 31, 2008

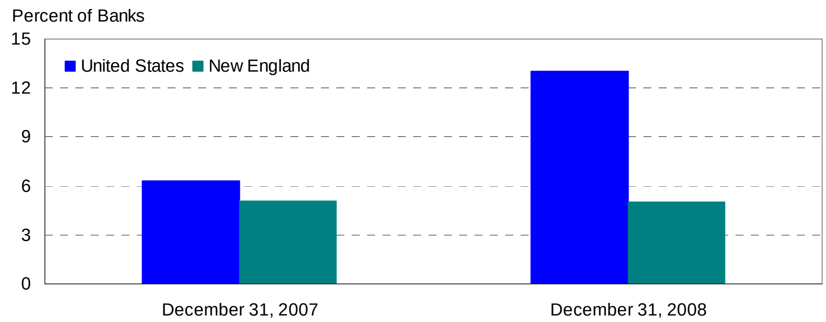


*The CAMELS rating is a highly confidential supervisory rating which assesses six components of a bank's condition: capital adequacy (C), asset quality (A), management (M), earnings (E), liquidity (L), and sensitivity to market risk (S). Ratings are assigned for each of the six components in addition to an overall rating. The ratings are assigned on a scale of 1 (strongest) to 5 (weakest).

Source: Commercial and savings bank call reports, supervisory reports and author's calculations.
Note: Analysis uses CAMELS ratings as of December 31, 2008. Banks included in the analysis are merger-adjusted. De novos are excluded.

Figure 9
Percent of Commercial and Savings Banks with CAMELS Rating* of 3, 4, or 5

December 31, 2007 and December 31, 2008



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Source: Commercial and savings bank call reports, supervisory reports and author's calculations.
Note: Analysis uses CAMELS ratings as of December 31, 2008. Banks included in the analysis are merger-adjusted. De novos are excluded.