

For release on delivery
10:00 a.m. EDT
April 3, 2008

Statement by
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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 program². 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, 2008⁴. 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 securities⁵. 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
	Frequency	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

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 Depository Bank:	An entity (or entities) to be determined by the NY Fed (in such capacities, the " <u>Agent</u> ").
Tranche A Lender:	The NY Fed (the " <u>Tranche A Lender</u> ").
Tranche B Lender:	JPMC (the " <u>Tranche B Lender</u> ") and, together with the Tranche A Lender, the " <u>Lenders</u> ").
Asset Manager:	Blackrock Financial Management, Inc. and its affiliates (in such capacity, the " <u>Asset Manager</u> "). 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. TYPES AND AMOUNTS OF LOAN FACILITIES

Loan Facilities

The Lenders hereby agree to provide financing to the Borrower as follows:

Type and Amount: Loan Facilities (the loans thereunder, the "Loans") as follows:

Tranche A Loan Facility: 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 "Tranche A Loan"). The Tranche A Loan shall be repayable or be terminated in the manner described under the section below entitled "Cash Flow Waterfall".

Tranche B Loan Facility: 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 "Tranche B Loan"). 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

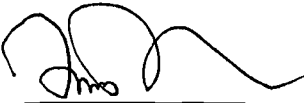
person.

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:

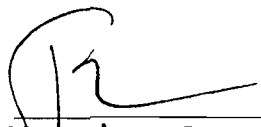
Accepted and agreed to as of
March 28, 2008:

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*