BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

February 4, 2008

The Honorable Paul E. Kanjorski
Chairman
Subcommittee on Capital Markets,
Insurance and Government Sponsored Enterprises
Committee on Financial Services
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I appreciate the opportunity to respond to your letter of January 23, 2008, regarding financial guarantors.

Historically, the financial guarantors mainly provided insurance for municipal securities. In recent years, they expanded into insuring structured financial instruments and vehicles, including residential mortgage-backed securities and collateralized debt obligations (CDOs), including CDOs of asset-backed securities. With the sharp deterioration in the performance of residential subprime mortgages, the expected losses to be borne by the financial guarantors escalated and caused market participants and ratings agencies to reevaluate guarantors' financial strength and particularly the adequacy of their capital. Several financial guarantors have been downgraded by the ratings agencies and a number are currently on review for possible future downgrades.

There are several channels through which problems at the financial guarantors could have adverse effects on market functioning and on the banking industry. Ratings downgrades and financial deterioration of the guarantors can make it more costly to issue securities for some municipalities and for certain types of asset-backed securities. Banks have exposure to the financial guarantors through banks' holdings of insured municipal securities and structured securities, through derivative transactions for which the guarantors are a counterparty, and through loans and lines of credit they have extended to the guarantors. Banks also have significant exposures to the financial guarantors through the liquidity support that banks provide for certain types of municipal securities and structures, including variable-rate demand obligations (VRDOs) and tender-option bonds (TOBs), as well as some asset-backed commercial paper conduits. Reduced confidence in the financial guarantors could lead some investors to exercise options to put these securities back to the liquidity providers. Moreover, money market funds, who are major investors in these securities, can be required to put the securities back to the liquidity providers if the financial guarantor is downgraded significantly. Thus, banks could be required to bring a sizable volume of assets, especially municipal securities, onto their books.

Prices of corporate equity and credit default swaps for the financial guarantors and their counterparties suggest that market participants have factored in a significant degree of stress. Given the adverse effects that problems of financial guarantors can have on financial markets and the economy, we are closely monitoring developments. In addition, we are closely monitoring the potential effect of downgrades of financial guarantors on bank holding companies, state member banks, and other institutions supervised by the Federal Reserve. We believe we have the appropriate tools to assess exposures to bond insurers of the banks that we supervise.

This letter reflects the views of the Federal Reserve Bank of New York as well.

Sincerely,