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

BEN S. BERNANKE
CHAIRMAN

March 31, 2008

The Honorable Paul E. Kanjorski
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am responding to your letter of March 17, 2008, in which you expressed concerns about developments in the student loan market. You recommended that the Federal Reserve provide discount window credit to certain nondepository institutions that make student loans and that the Federal Reserve accept student-loan asset-backed securities as collateral in the Term Securities Lending Facility. We share your concerns about the difficulties in the student loan market.

As you know, the Federal Reserve rarely extends credit to nondepository institutions; until recently, the Federal Reserve had not extended such credit since the 1930s. The Congress wisely set a very high hurdle for such activities, requiring, among other important conditions, that the Federal Reserve Board find that "unusual and exigent circumstances" exist if such lending is to be collateralized by other than U.S. government and federal agency securities. Given these considerations, the Federal Reserve has extended credit to primary dealers in recent weeks only after it reached a judgment that a failure to lend could well prompt a systemic crisis in the financial system that could threaten the health of the overall economy.

Extensions of credit by the Federal Reserve to nondepositories in situations that do not pose a significant risk of systemic financial crisis would not be consistent with the high hurdle set by the Congress for lending to nondepositories and would raise serious public policy issues. The provision of discount window credit to nondepository institutions risks encouraging moral hazard--that is, it may induce those institutions to avoid the expense of making liquidity provisions that are likely to be adequate for stressed market circumstances as well as more routine situations. Moreover, the extension of such credit to one sector invites credit requests from others, and the Federal Reserve would find it very difficult to determine which sectors should be accommodated and which should not. Ultimately, the losses incurred in any government lending would come at the expense of the U.S. taxpayer. In view of the very serious issues raised in lending to nondepository institutions, the Federal Reserve maintains a very strong presumption against such credit extensions. This approach is in line with the mandate the Congress has given the Federal Reserve and recognizes that the Congress is better suited to make judgments about the allocation of government credit beyond this mandate.

Regarding collateral that can be pledged in the Term Securities Lending Facility, the Federal Reserve has specified that Treasury securities, agency debt, agency mortgage-backed securities, and highly rated private-label mortgage-related securities can be pledged. With the exception of private-label mortgage-related securities, this collateral is similar to that accepted in standard open market operations. I should note, however, that investment-grade securities backed by student loans can be pledged for all of the Federal Reserve's discount window programs, including the primary credit facility, the Term Auction Facility, and the Primary Dealer Credit Facility. The ability of depository institutions and primary dealers to pledge such securities as collateral against Federal Reserve credit provides some support for this market.

As I noted above, we at the Federal Reserve are monitoring ongoing developments in the student loan market. We agree that this is an important public policy issue, and believe that it deserves careful attention by the Congress.

I appreciate the opportunity to provide the Federal Reserve's views on these important questions.

Sincerely,