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FEDERAL RESERVE OVERSIGHT: EXAMINING THE CENTRAL BANK'S ROLE IN CREDIT ALLOCATION

HEARING

BEFORE THE

SUBCOMMITTEE ON MONETARY POLICY AND TRADE

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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FEDERAL RESERVE OVERSIGHT: EXAMINING THE CENTRAL BANK'S ROLE IN CREDIT ALLOCATION

Wednesday, March 12, 2014

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MONETARY
POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:03 a.m., in room 2128, Rayburn House Office Building, Hon. John Campbell [chairman of the subcommittee] presiding.

Members present: Representatives Campbell, Huizenga, Pearce, Posey, Stutzman, Mulvaney, Pittenger, Cotton; Clay, Foster, and Kildee.

Ex officio present: Representative Hensarling.

Chairman CAMPBELL. The Subcommittee on Monetary Policy and Trade will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time. And the Chair now recognizes himself for 5 minutes for an opening statement, which will not be anywhere near that long.

This is another chapter in our continuing examination of the Federal Reserve (Fed) on the occasion of the 100th anniversary of the Fed this year—last year, technically. I am not going to make any pontifications about what I think things are or ought to be, because that is what our distinguished panel is for, but we want to examine the idea of quantitative easing, and of setting interest rates, and of what the Fed is doing right now and how that is impacting markets, and how that is impacting credit.

Is it helping some and hurting others? And just what are the ramifications of those actions and those decisions, both currently and with a perspective on history and on things the Fed has done in the past?

So, I will look forward to the testimony, and I now recognize the ranking member of the subcommittee, the gentleman from Missouri, Mr. Clay, for 5 minutes for his opening statement.

Mr. CLAY. Thank you, Mr. Chairman, especially for holding this hearing regarding the Federal Reserve's role in credit allocation. Due to the financial crisis of 2008, the Federal Reserve Bank purchased commercial paper, made loans, and provided dollar funding through liquidity swaps with foreign central banks. Because of this action, the Federal Reserve Bank balance sheet expanded.

Currently, the Federal Reserve Bank has gradually tapered its asset purchases from $85 billion per month to $75 billion per month due to evidence that the economy is improving. The Federal Reserve Bank will purchase a total of $65 billion in Treasury and mortgage-backed securities each month. This is a $20 billion decrease, and this action was taken due to the improvement in the labor market.

And there has been no other period since 1939 in which government employment has been so weak for so long. This is twice as long as the 26 months of the double-dip recessions in the Reagan Administration cutbacks of the 1980s.

The U.S. economy was vastly affected by the financial crisis in 2008, and one of the most affected markets was the housing market, and one of the major factors that affects the housing market is employment and wage level. I will stop there, Mr. Chairman, because I am also anxious to hear the testimony. I yield back.

Chairman CAMPBELL. The gentleman yields back.

The Chair now recognizes the vice chairman of the subcommittee, the gentleman from Michigan, Mr. Huizenga, for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman. I don't intend to utilize all that, because I, too, want to get to these presentations. And I think, gentlemen, what I am looking for is an answer to my question: What has all this spending in QE2 and 3 and Twist and all the others really accomplished?

The effectiveness of the Fed's efforts to stimulate the economy, I think, has a lot of us questioning some of those decisions. And, I have a serious concern that their encroachment into fiscal policy through credit allocation seems to me to break down the historical safeguards in a way that is independent from the Federal Government.

Even former Fed Chairman Bernanke noted in his book, "The Federal Reserve and the Financial Crisis," that "Central banks that operate independently will deliver better results than those that are dominated by the government." And I appreciate, Mr. Chairman, you setting this time aside so we can explore it, so thank you.

Chairman CAMPBELL. The gentleman yields back. Thank you very much.

Any other opening statements from anyone? Hearing none, we will move straight to the witnesses. So, I would like to welcome you all.

First, Dr. Marvin Goodfriend is a Professor of Economics at Carnegie Mellon University. He previously served as the Chief Monetary Policy Adviser to the Federal Reserve Bank of Richmond. He also worked as Senior Staff Economist for the White House Council of Economic Advisers. Dr. Goodfriend, you are recognized for 5 minutes.

STATEMENT OF MARVIN GOODFRIEND, FRIENDS OF ALLAN MELTZER PROFESSOR OF ECONOMICS, TEPPER SCHOOL OF BUSINESS, CARNEGIE MELLON UNIVERSITY

Mr. GOODFRIEND. Thank you, Mr. Chairman.

I am pleased to be invited to testify this morning. I am going to argue that the 1951 Treasury-Federal Reserve Accord on monetary policy should be supplemented with a Treasury-Federal Reserve Accord on credit policy.

Monetary policy can be conducted independently by a central bank because the objectives of monetary policy—price stability and full employment—are reasonably clear and coherent. Moreover, monetary policy is about managing aggregate bank reserves and currency to influence the general level of interest rates for the whole economy. Assets are acquired only as a means of injecting bank reserves and currency into the economy. Hence, monetary policy can be implemented by confining asset purchases to Treasuries-only.

Treasuries-only keeps the independent central bank free of politics, because it avoids credit risk and because the central bank simply returns the interest to the Treasury that the Treasury pays to the central bank for the Treasury securities that the central bank holds.

Credit policy satisfies none of the conditions that make monetary policy suitable for management by an independent central bank. Credit policy involves selling Treasury securities from the central bank portfolio and lending the proceeds to private financial institutions or using the proceeds to acquire non-Treasury debt, such as mortgage-backed securities. Credit policy has no effect on the general level of interest rates, because it doesn't change aggregate bank reserves or interest paid on reserves.

Credit policy really is debt-financed fiscal policy carried out by the central bank. Why? The central bank returns to the Treasury interest earned on the Treasuries that it holds. So when the central bank sells Treasuries to finance credit policy, it is as if the Treasury financed credit policy by issuing new Treasury debt.

Credit policy works by exploiting the government's creditworthiness—the power to borrow credibly against future taxes—to facilitate flows to distressed or favored borrowers. Doing so involves a fiscal policy decision to put taxpayer funds at risk in the interest of particular borrowers. All central bank credit initiatives carry some credit risk and expose the central bank, and ultimately the taxpayers, to losses and controversial disputes involving credit allocation.

The 1951 Accord between the Treasury and the Fed was one of the most dramatic events in financial history. The Accord ended an arrangement dating from World War II in which the Fed agreed to use its monetary policy powers to keep interest rates low to help finance the war effort. The Accord famously reasserted the principle of Fed independence so that monetary policy might serve exclusively to stabilize inflation and macroeconomic activity.

Central bank credit policy, too, must be circumscribed with clear, coherent boundaries. Conventional last resort lending by a central bank is reasonably compatible with central bank independence. Last resort lending to supervised, solvent depositories, on a short-term basis, against good collateral provides multiple layers of protection against ex post losses and ex ante distortions. So, the fiscal policy consequences of conventional last resort lending are likely to

be minimal and the scope for conflict with the fiscal authorities small.

On the other hand, expansive credit initiatives—such as those undertaken in the wake of the 2007–2009 credit turmoil—that extend credit reach in scale, in maturity, and in collateral to unsupervised nondepository institutions and the purchase of non-Treasury securities inevitably carry substantial credit risk and have significant allocative consequences. Expansive credit initiatives infringe significantly on the fiscal policy prerogatives of Treasury and Congress and properly draw the scrutiny of fiscal authorities.

Hence, expansive credit initiatives jeopardize central bank independence and should be circumscribed by agreement between the fiscal authorities and the central bank.

Furthermore, an ambiguous boundary of expansive central bank credit policy creates expectations of accommodation in financial crises which blunts the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and their reliance on short-term finance. Moreover, an ambiguous central bank credit reach also blunts the incentive of the fiscal authorities to prepare procedures by which fiscal policy could act systematically and productively in times of financial crisis.

The chaotic, reluctant involvement of Congress in the credit turmoil contributed to the financial panic and worsened the Great Recession, precisely because of the ambiguity about the boundary between Fed policy and the Congress.

Such reasoning suggests the following three principles as the basis for a Treasury-Fed Accord for credit policy: first, as a long-run matter, a significant, sustained departure from Treasuries-only asset acquisition is incompatible with the Fed's independence; second, the Fed should adhere to Treasuries-only except for occasional, temporary, well-collateralized, ordinary last resort lending to solvent, supervised depositories; and third, Fed credit initiatives beyond ordinary last resort lending, in my view, should be undertaken only with prior agreement of the fiscal authorities and only as bridge loans accompanied by takeouts arranged and guaranteed in advance by the fiscal authorities.

Thank you.

[The prepared statement of Dr. Goodfriend can be found on page 40 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. Goodfriend.

Next, we have Dr. Paul Kupiec, a resident scholar at the American Enterprise Institute. In the past, he has served as the chairman of the research task force at the Basel Committee on Banking Supervision. He was also the deputy chief of the Department of Monetary and Financial Systems at the IMF and a Senior Economist in the Division of Research and Statistics at the Federal Reserve Board of Governors.

Welcome, Dr. Kupiec. You are recognized for 5 minutes.

STATEMENT OF PAUL H. KUPIEC, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE (AEI)

Mr. KUPIEC. Thank you.

Thank you. Chairman Campbell, Ranking Member Clay, and distinguished members of the subcommittee, thank you for convening

today's hearing and for inviting me to testify. First, let me say these are my personal views and not the views of the AEI.

Banking regulations can have important impacts on economic growth and financial stability. In the aftermath of the crisis, the government introduced sweeping changes in bank and financial market regulation, and today I will discuss the economic consequences of some of these changes. But before discussing them, let me first mention that the government housing policies that encouraged the housing bubble and triggered a financial crisis are still in place today.

Let me move first to the qualified mortgage (QM) and ability-to-repay (ATR) regulations that were issued by the Consumer Financial Protection Bureau (CFPB). They were intended to limit the risk of new mortgage originations and protect consumers from predatory lending. But the QM and ATR rules that went into effect in January do not accomplish these intended goals. They are reducing consumer access to mortgage credit without providing financial stability or consumer protection benefits. These rules raise compliance costs for originating mortgages, especially for smaller banks.

New evidence has come to the fore which shows that community banks have decided to stop offering their customers mortgages because the business is no longer profitable. The impact of community bank withdrawal from mortgage lending will be especially large in rural markets and small towns that are not served by a large bank.

Another issue in credit is fair lending enforcement. The regulators are using a new statistical approach for enforcing fair lending laws. In a nutshell, the enforcement approach creates an entitlement for bank credit to high-risk borrowers with protected characteristics. A so-called disparate impact enforcement standard will discriminate against high-quality borrowers because banks will be forced to pass the costs of lending to high-risk borrowers with protected characteristics onto their unprotected low-risk customers.

Some legal scholars think that enforcement actions based on disparate impact will eventually be overturned by the courts. Still, the CFPB is making aggressive use of this policy, most recently in a high-profile action against an auto lender.

As you know, the Volcker Rule is intended to ban banks from proprietary trading. However, restrictions in the Volcker Rule are causing unintended consequences for banks that own collateralized loan obligations (CLOs). Because many CLO pools include debt securities, and their senior tranches exercise limited power over the CLO manager, they appear to be inadmissible investments under the final Volcker regulations.

If banks have to sell their CLOs, it is likely to impose significant costs on the banks, and it won't provide any measurable gain in bank safety or soundness. The rule should be amended without delay to remove regulatory uncertainty and allow banks to retain their legacy CLOs.

Moving to other powers that came under the Dodd-Frank Act, mandatory stress tests. There is no scientific evidence that supports the use of macroeconomic stress scenario simulations for the regulation of individual financial institutions, yet the Dodd-Frank Act imposes multiple new stress test requirements on large bank

holding companies. Stress test models have very limited accuracy for explaining individual bank historical profits and losses. Perhaps this is one reason the Fed keeps its stress test models a secret, even from the other bank regulatory agencies that are involved in the CCAR stress tests.

The stress test requirement gives the Fed unchallenged power to exercise regulatory discretion over bank operations and shareholder property rights. The Fed can and has failed banks without providing the banks with the Fed's projection methodology that predicts the bank's future capital shortfall. The methodology remains a Federal Reserve trade secret.

Bank regulators have also used systemic powers to stop banks from making high-yield syndicated loans. They argue that the loans are creating a systemic risk by fueling a bubble in high-yield mutual funds. If there is a bubble, stopping the supply of these loans would be the wrong policy. It would only drive yields lower, further distorting the price of credit risk, which would only make the bubble worse.

Mutual fund investors are demanding high-yield floating-rate corporate loans as a rational response to the Federal Reserve's continuing zero interest rate monetary policy and its announced plans to taper its QE purchases. The Dodd-Frank Act grants financial regulators broad new powers and responsibilities to prevent systemic risk without providing a clear definition of systemic risk. This ambiguity gives regulators wide latitude to exercise their judgment to identify firms, products, specific financial deals, and market practices that create systemic risk and impose new regulatory constraints, and regulators, especially bank regulators, are aggressively exercising this authority, both to designate non-bank firms as SIFIs over objections of other FSOC members and to direct bank lending decisions with the goal of altering investments made by mutual funds that they do not regulate.

Indeed, non-bank SIFIs are being identified well before the Federal Reserve has revealed their enhanced prudential standards that will apply to these non-bank institutions. The FSOC can and has designated non-financial institutions as systemically important using only the most general of arguments. For example, in its designation decision, the FSOC is not required to explain the changes a newly designated institution might take to reverse the decision.

Regulatory systemic risk powers and SIFI designation create enormous regulatory uncertainty for many private sector financial firms and Congress should act to limit this power. Thank you very much for the opportunity to testify, and I look forward to your questions.

[The prepared statement of Dr. Kupiec can be found on page 51 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. Kupiec. And by the way, without objection, all of your written statements will be made a part of the record, in case any of you are unable to finish.

Next, Dr. Larry H. White is a senior scholar at the Mercatus Center and a professor of economics at George Mason University. He also serves as a member of the Financial Markets Working Group; previously taught at the University of Missouri, St. Louis,

and at the University of Belfast; and previously worked as a visiting scholar at the Federal Reserve Bank of Atlanta.

Dr. White, you are recognized for 5 minutes.

STATEMENT OF LAWRENCE H. WHITE, PROFESSOR OF ECONOMICS, GEORGE MASON UNIVERSITY

Mr. WHITE. Thank you, Chairman Campbell, Ranking Member Clay, and members of the subcommittee.

I think my written testimony in many ways complements that of Professor Goodfriend, in that I argue that the Federal Reserve's attempts to direct the allocation of credit, especially since 2007, are an overreach that not only conflicts with independent monetary policy and the independence of monetary policy from fiscal policy, but it is also wasteful, it is inefficient, and it is fraught with serious governance problems.

The Fed has traditionally had five main roles. Two of them are routine—clearing checks; and issuing paper currency—and three are more important—supervision and regulation of commercial banks; serving as a lender of last resort; and conducting monetary policy. Since 2007, and at its own initiative, the Fed has greatly expanded the range of its activities by undertaking unprecedented credit allocation policies that don't fit into any of these traditional categories.

A central bank that is already charged with these five tasks and is not excelling at all of them shouldn't be expanding the range of its activities beyond them, so I think the Fed should be removed or should remove itself from the formulation and implementation of credit policy.

Now, what I mean by credit policy is not only QE1 and QE3 that have been mentioned, but all the special lending programs that the Fed undertook during the financial crisis, ranging from dollar swap lines for foreign-domiciled commercial banks doing U.S. dollar business, to asset-backed commercial paper money market mutual fund liquidity facility, to bridge loans to JPMorgan Chase, to the Maiden Lane subsidiaries of the New York Fed. There is a long list in my written testimony, 22 programs in all.

To the extent that these programs actually do affect the allocation of credit, they are more likely than not to have directed credit to less productive uses than would otherwise have occurred, even if Fed policymakers have the best of intentions. We have to consider the costs of these programs, which is to divert credit away from those who have been judged creditworthy in the market toward those who are favored by Federal Reserve policy, and when we throw good money after bad, when we lend money to insolvent institutions, we are not increasing the efficiency of financial markets, but the reverse.

Now, the Dodd-Frank Act recognized a problem with the lending programs that were directed at specific institutions, and it imposes a restriction on the Fed to limit its lending in the future to broad-based programs. I think this is a step in the right direction. If this rule had been in place before 2010, though, it would have only ruled out about half of the credit allocation programs on the list.

The logic of broadening credit programs leads to wanting the Fed to behave in the broadest way possible, and that means not lending

to segments of the financial market, money market funds here, credit broker-dealers here, and so on, but to the entire market, which is monetary policy, which is open-market purchases of Treasury securities to make more bank reserves available to where the market will allocate them.

The QE1 and QE3 purchases of mortgage-backed securities have been defended as monetary policy, but they are not monetary policy. The purchase of securities is monetary policy, but the choice of mortgage-backed rather than Treasuries is not monetary policy, because it doesn't affect monetary aggregates or things that depend on monetary aggregates. It is a credit allocation choice.

And the Fed has, in fact, used interest on reserves to negate the monetary policy impact of the huge purchases of mortgage-backed securities. In my written testimony, I have a figure showing that, as the monetary base has spiked, M2 has just chugged along on a very smooth path, so the Fed has deliberately offset the monetary policy effect of these purchases.

The targeted lending programs are not lender of last resort programs, as they have sometimes been defended. They don't fit the classical criteria for lender of last resort, which is lending liquidity to solvent institutions. They have been lending or providing capital and boosting net worth for insolvent institutions. Traditional lender of last resort is for banks, and the special lending programs have extended it way beyond banks to other kinds of financial institutions.

The bailout programs, of course, go way beyond that to the sort of thing that used to be considered the responsibility of the fiscal authorities. And the Fed, by paying interest on reserves, is, in effect, borrowing money and spending it the way the Fed sees fit, which is the description of a fiscal policy. Thank you very much.

[The prepared statement of Dr. White can be found on page 71 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. White.

Next, Dr. Josh Bivens is the research and policy director at the Economic Policy Institute. He is the author of, "Everybody Wins, Except for Most of Us: What Economics Teaches About Globalization." He is also a frequent communicator on many high-profile news outlets.

Dr. Bivens, welcome. You are recognized for 5 minutes.

STATEMENT OF JOSH BIVENS, RESEARCH AND POLICY DIRECTOR, ECONOMIC POLICY INSTITUTE

Mr. BIVENS. Thank you. My name is Josh Bivens, and I am the research and policy director at the Economic Policy Institute. My remarks are just my personal views. I thank the committee members for the invitation to testify today.

My remarks and my testimony are largely framed as responses to the concerns raised about the Fed's quantitative easing program in the introductory memorandum for this hearing. Before moving on to some of those specific concerns, most of which center around threats to the Fed's independence, I am going to just say a couple of words about useful ways to define that central bank independence.

I think for far too many in this debate, independence seems synonymous with putting very little or even zero weight on the maximum employment target that is part of the Fed's dual mandate. And sometimes this demand for independence gets translated into an implicit demand that the Fed sort of always and everywhere lean against the stance of fiscal policy, and the presumption seems to be that most policymakers have an inflationary bias that will reap short-term gains in economic activity and employment, but only at the long-run cost of overheating the economy and sending up interest rates and prices.

If you took this presumption as a given, then it would make sense that for a Fed that cared only about price stability, it would, indeed, always have to lean against what other macroeconomic policymakers, especially fiscal policymakers, are doing.

And while there have been historical episodes where central bank independence was surrendered and bankers became excessively deferential to other policymakers' desires for inflationary policy, that is just not what is happening in the U.S. economy today.

Since the beginning of 2008, the U.S. economy has been plagued by a large shortfall in aggregate demand, a shortfall that has put downward pressure on prices and interest rates and has kept joblessness excessively high. In this kind of situation, pursuing stability of inflation and maximum output is not a delicate tradeoff. Both demand that all levers of macroeconomic policy try to push the economy back to potential by generating more spending from households, firms, and governments.

Quantitative easing is one such lever. While long-term interest rates have generally been driven very low by the extraordinary economic weakness in recent years, interest rates low enough to drive a full employment recovery by themselves requires they be even lower, but they are hampered in this by the zero bound on short-term interest rates.

Through its forward guidance and quantitative easing programs, the Fed has aimed to push long-term rates even lower than the economic weakness has pushed them, and this policy action has led to higher rates of economic activity in employment and higher rates of inflationary expectations, which today is a good thing.

How much have they contributed? There is a lot of uncertainty about just the precise degree of economic impact of the quantitative easing programs. There is almost no uncertainty that the direction is positive, that is the quantitative easing programs have surely pushed the economy in the direction of more activity and more employment.

With this backdrop, I will move very quickly onto the three specific concerns raised in the introductory memorandum for this hearing. The first one is, has quantitative easing enabled higher government spending? The short answer is, it has not, and that is actually a bad thing.

Between 2008 and 2010, it is true that fiscal policy and monetary policy generally pulled in the same direction, leading to expansion in the economy. This wasn't a problem. This is what the economy needed. There is a huge shortfall in demand relative to productive potential.

Since then, however, the empirical fact is that Federal spending has slowed so much that it is now the slowest growth of Federal spending during any recovery of comparable length in postwar history. And the very slow growth of public spending overall can essentially explain entirely why economic growth in this recovery has been the slowest on record.

So in summary, the quantitative easing programs have been associated in recent years with very slow, not fast, growth of spending, and we would have a much healthier economy today if that hadn't been the case.

The second concern raised in the memo was, have QE purchases of mortgage-backed securities disproportionately aided the housing finance sector? Yes, they have, but that is a perfectly appropriate response to the financial crisis accompanying the bursting of the housing bubble. This sector was extraordinarily impaired. A primary channel through which lower interest rates are supposed to help boost economic growth is through the mortgage refinance channel, and the impairment in the mortgage-backed security sector was impeding that channel, so I would say, yes, it is true that by targeting that sector, they were going after a sector that was extraordinarily impaired by the crisis, and that is exactly what they should have done.

And then lastly, have regulations promulgated since the Great Recession provided an incentive for banks to favor certain asset classes over others? I would say, yes, they have, and, again, that is an entirely appropriate response to the crisis. The crisis was caused in large part because financial institutions took on too much leverage in far too little liquidity when they were unregulated in the run-up to it.

Basically, the regulations mentioned in the memorandum require banks to hold a higher share of liquid assets on their books. A big problem with the crisis was that the assets which banks had were not liquid when markets went bad. Treasuries are very, very liquid, so regulations that encourage them to have a higher share of those on their books is a very good thing.

I am happy to answer any questions from the committee, and thank you again for the invitation.

[The prepared statement of Dr. Bivens can be found on page 28 of the appendix.]

Chairman CAMPBELL. Thank you, Dr. Bivens. And I thank all four members of our panel of doctors today.

I now recognize myself for 5 minutes for questioning. And in these hearings, I always like to pursue it when I hear something I hadn't necessarily heard before—we had a hearing a month or so ago on how QE was affecting international finance, where a group of people, which may have included one of you, talked about the fragile five and how we were creating instability in Turkey and Argentina and, boom, about 3 weeks later, said instability showed up.

Something I heard today from Dr. Goodfriend and Dr. White that I haven't heard before or if I have heard it, it went in one ear and out the other, which is entirely possible, is that what we see the Fed doing, ranging into credit policy or credit allocation, as you have suggested, and various other things, actually threatens the Fed's independence, or is incompatible, as you said, Dr. Goodfriend.

You would think that it would be logical to assume that when the Fed does other things that is showing their independence, rather than threatening or being incompatible with their independence. So would either of you like to expound on why this thing, which seems counterintuitive, is what you believe to be the case?

Mr. GOODFRIEND. I will start. So you are right, Mr. Chairman. If the Fed pursues expansive actions, it demonstrates its power to do things independently. And if you didn't understand the difference between credit policy and monetary policy and the boundaries that Larry and I have been describing, you might think that is a good thing.

But Congress grants the Fed's independence grudgingly, and only because monetary policy can be independently monitored and because monetary policy, as I describe it, does not involve fiscal policy at all. And so, let me revisit this issue and describe why.

Monetary policy is about changing currency and bank reserves in the economy. The assets that the Federal Reserve acquires to change currency and bank reserves are immaterial for monetary policy to work. So the Fed can acquire Treasury securities in expanding the money supply, currency and reserves. And when the Fed buys Treasury securities, it simply returns all the interest that the fiscal authorities give it back to the Treasury to spend as they see fit.

So, monetary policy is really beautifully suitable for delegation to an independent central bank because it separates monetary and fiscal policy very well.

When the Fed expands policies in the credit direction, it really has nothing to do with monetary policy, per se. Why? Because credit policy is a policy where the Fed sells Treasury securities, it takes the money that it gets and immediately puts the money back into circulation without changing the quantity of money in order to channel credit to distressed or favored borrowers, financed by the sale of Treasury securities from its portfolio.

Now, the trick about credit policy is that when the Fed is holding those Treasury securities, the interest that it earns from the Treasury is simply round-tripped back to the Treasury. So when the Fed sells Treasuries in order to take the funds and allocate those funds somewhere else, it is exactly as if the Treasury issued new securities, took the cash, and made loans.

Chairman CAMPBELL. Okay, I get that. Why does it make them less independent? Or why is that incompatible or threatening?

Mr. GOODFRIEND. Because credit policy is a fiscal policy action that is not essential for the Fed to do monetary policy, which is its primary mission, and there is no way to do a credit policy action without favoring one particular group or another. You have to make a loan to somebody or some sector, and so credit policy is a matter for public policy, for the due process of law under the Congress, to decide who should get the loan and who shouldn't.

Chairman CAMPBELL. I want to make sure Dr. White has some time.

Mr. WHITE. Yes, some Fed officials have suggested that criticizing the Fed's lending decisions during the crisis are challenges to its independence, but the principle of independence applies to monetary policy, not to fiscal policy. So it doesn't challenge the

Fed's traditional independence to conduct monetary policy when people want to know what the Fed has done, who it has lent to, even when they want to audit the Fed's lending programs, because then the Fed is straying into fiscal policy.

So we don't want backseat-driving of monetary policy, right? But we do need oversight when the Fed is lending to some people and not to other people, especially when it is lending to insolvent institutions, especially when we have the governance problems that we see at the New York Fed.

Chairman CAMPBELL. Okay, thank you. My time has expired. Dr. Bivens, I will be interested in your viewpoint on this, but it will have to be in later questioning or whatever, because my time has expired.

I now recognize for 5 minutes the ranking member, the gentleman from Missouri, Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman.

Dr. Bivens, in his testimony today Dr. White wrote that it is desirable to retain member banks' influence for the sake of monetary policy, because Reserve Bank Presidents as a group have a better track record in Federal Open Market Committee (FOMC) voting than do members of the Board of Governors.

In your view, how would further empowering the influence of the regional banks in FOMC decision-making affect policy outcomes and Federal Reserve independence?

Mr. BIVENS. I think as an empirical matter, we definitely disagree on who has the better voting record on Federal Open Market Committee decisions. From my perspective, the Board of Governors, the Members of the Board of Governors have consistently been more aggressive in pursuing the maximum employment part of the mandate in recent years, which is the appropriate way to go.

And I think as a more structural matter, I would say the one case where I think there is some real worry about Federal Reserve independence is the influence of the financial sector on their decisions. If you look at the regional Federal Reserve Bank Presidents, they are largely chosen by the commercial banks in their districts, so anything that provides them with more authority and more sway over the decisions of the FOMC will be surrendering even more Federal Reserve independence to the desires of the financial sector.

So as an empirical matter, I don't think the regional Fed Presidents have done a better job at responding to the crisis, and I think as a structural matter, that would actually be moved backwards if you were actually concerned about Federal Reserve independence.

Mr. CLAY. How might further empowering the regional banks' influence affect the Fed's focus on the employment part of its dual mandate?

Mr. BIVENS. There are two reasons. One, I think, again, empirically, it is just a fact that the regional presidents have seemed much more concerned about the price stability part of the mandate in recent years, which I think is the wrong part of the mandate to be overly concerned about. To me, the maximum employment mandate is the bigger one.

And just as a central fact, the financial sector has an interest in very low rates of inflation that sometimes conflicts with other sec-

tors' desire for pursuing maximum employment. And so anything that gives a louder voice to the concerns of the financial sector in setting Open Market Committee decisions I think would be a bad thing.

Mr. CLAY. And in your testimony, you note that it is too bad that the Fed's QE actions have not encouraged higher levels of Federal spending. You also wrote that very slow rates of Federal spending are the primary reason why at this stage in the recovery, demand remains so muffled. How might additional spending today impact the short- and medium-term macroeconomic outlook?

Mr. BIVENS. We still have a very large shortfall of aggregate demand relative to productive capacity in the economy. Demand is too low, and to reduce that gap, we need more spending. I think, for example, a large package of infrastructure investments would go a long way to boosting employment in the short run, and boosting productivity in the long run. And then something that has fallen off the radar, which is too bad, extending the unemployment insurance extended benefits would provide a good economic boost in the next year, as they increase spending, it would provide real relief to people who need it.

Mr. CLAY. If the Congress and the Fed push stimulative policies at the same time, is there any inherent reason this would call the Fed's independence into question?

Mr. BIVENS. Not as long as the economy remains so weak that the inflation rate that we now see is well below the Fed's, I would argue, probably too conservative target and joblessness remains high. Theoretically, there could be a point where recovery was reached, unemployment was very low, inflation started rising off the charts. In that case, independence on the part of the Fed would require they start to reduce their stimulus, but starting from today, no, a coordinated response to push joblessness lower and try to meet the inflation target from below would be a good thing.

Mr. CLAY. Thank you for your responses.

Dr. Goodfriend, would you consider full employment monetary policy or fiscal policy?

Mr. GOODFRIEND. Full employment is an aggregate condition, and in general, you need an aggregate policy to pursue it. And monetary policy is an aggregate policy that affects the general level of interest rates. Credit policy favors necessarily lending to one group or one sector of the country. So credit policy is not going to be a suitable policy to achieve full employment for the country as a whole.

Mr. CLAY. Thank you. And, Mr. Chairman, I yield back.

Chairman CAMPBELL. The gentleman yields back.

We will move now to the vice chairman of the subcommittee, the gentleman from Michigan, Mr. Huizenga, for 5 minutes.

Mr. HUIZENGA. Thank you, Mr. Chairman.

The ranking member started down a path that I am curious about, and, Dr. Bivens, I would like you to clarify for me, because I heard the word in your testimony "entirely," government growth is entirely the reason—or lack of government growth is entirely the reason why we have a slow economic recovery right now. Is that, in fact, what you believe or what you said?

Mr. BIVENS. I probably said it. I might say almost entirely, but more than 90 percent. If you sort of look at the gap in growth at this point in the recovery compared to all other postwar recoveries, and then you look at the impact of government spending on that growth, the slow government spending at all levels—I said that pretty specifically in the testimony—can explain almost entirely the gap.

Mr. HUIZENGA. So if we had simply doubled our level of stimulus spending, we wouldn't be where we are at?

Mr. BIVENS. Doubled, that is about right.

Mr. HUIZENGA. Okay, so we needed to go $1.8 trillion in debt instead of $900 billion more in debt, and then we would have been okay?

Mr. BIVENS. We would have been much closer to a full recovery. And it should have been spread over years. The problem with it right now—

Mr. HUIZENGA. And have you looked at long term what an additional trillion dollars on our long-term debt would have been in the interest rate situation that we are at?

Mr. BIVENS. Yes, interest rates will begin to rise when we reach full recovery and not before. So basically, if we had done the degree of spending needed to push us back to recovery, we would have higher interest rates today, and that would be a sign of recovery for—

Mr. HUIZENGA. Are we doing anything, though, to then mitigate that—what would be $18.5 trillion in debt instead of $17 trillion in debt for our long term? Because, hey, I pay attention to the Fed, too, and the Fed has said that interest rates are going to be going up. At some point or another, we have to service that debt, not through artificially low interest rates through QE, but through actual market rates.

And I think as Dr. Goodfriend was pointing out, on page 3 of your testimony, you skipped over the part about the 1951 agreement where—the sentence that you did not use is the Fed officials argued that keeping interest rates low would require inflationary money growth that would destabilize the economy and ultimately fail.

That is where my concern is, because the shovel-ready jobs from the first tranche of $900 billion weren't so shovel-ready. The key, as I understand it, is we have to return to private sector productivity, not government sector productivity, to build and sustain true wealth. And what I hear from business owners and from those that are those private sector productivity makers is uncertainty with their health care costs, uncertainty what is going to be happening with their unemployment obligations, their tax uncertainty, their regulatory uncertainty.

These policies—in addition to what the Fed has done to drive more activity into the stock market, which then gives them more incentive to play on Wall Street than it is to buy equipment or hire people, is what has stalled out a lot of that recovery.

So I would appreciate your take on this, Dr. Goodfriend, especially, as you had sort of kind of gone through that.

Mr. GOODFRIEND. I would distinguish the Fed's policy actions in the wake of the credit turmoil in the following ways. In the turmoil

itself, the Fed's expansive policy was called for because the economy was collapsing. Later, you get QE1, QE2, QE3. QE1, okay. QE2, not so—I wasn't so favorably disposed to QE2. And QE3, I thought was premature and unnecessary, and I think the fact that the Fed pulled the plug rhetorically within 6 months indicated that they found that it was premature and unnecessary, as well.

Mr. HUIZENGA. Does anybody else believe that if we had simply doubled our stimulus spending, we wouldn't be where we are at economically?

Mr. GOODFRIEND. I would not want to take that bet.

Mr. HUIZENGA. Dr. White?

Mr. WHITE. No, I don't think so.

Mr. HUIZENGA. Dr. Kupiec?

Mr. KUPIEC. I would offer that we got into the problems we got into because we had very much a bubble in the housing markets. And to use credit policy to try to stimulate housing markets, we are back to the same policies that caused the bubble, so it is very much in line with the fact that the use of credit policy can distort the allocation of resources.

Mr. HUIZENGA. My fear is that we are whitewashing the long-term effects here. My fear is that these are serious financial instruments that affect the global economy, whether it is the fragile five, as the chairman has talked a bit about. We are in uncharted waters here, and we are not selling cupcakes, you know? This is serious stuff that affects the global economy.

And how we are going to unwind this, I think, is my biggest fear and question that I have, so—and I have run out of time. And we need to double these to—just like Dr. Bivens, maybe we need to double our question time, Mr. Chairman, so we can really get at the heart of this. So with that, I yield back.

Chairman CAMPBELL. I will take that up with the House majority leader and the chairman of the committee.

The gentleman from Illinois, Mr. Foster, is recognized for 5 minutes.

Mr. FOSTER. Thank you all for your testimony here. Just a quick yes-or-no question for all four witnesses. If you were in charge of management of the financial crisis in October of 2008, would you have let the money markets collapse? Just give a quick yes-or-no answer.

Mr. GOODFRIEND. No.

Mr. KUPIEC. No.

Mr. WHITE. I am not sure what not letting the money markets collapse would have meant, but—

Mr. FOSTER. Extraordinary support necessary—

Mr. WHITE. —no, of course, we don't want the money markets to collapse.

Mr. BIVENS. No.

Mr. FOSTER. No, okay. And so is this—it seems to me that is allocation of credit to a specific sector in trouble, and so that is not an absolute principle with any of you here. In fact, you acknowledge there are times when adults in the room have to allocate credit to segments of the industry that are in trouble, despite the moral hazard? Okay. Thank you. That is not a universally held point of view

around here, and it got our economy into a tremendous range of difficulty.

Now, during the financial collapse and the extraordinary accommodation in response to it, many of my colleagues on the right routinely predicted runaway inflation. You saw talk about debasing our currency and so on. And in terms of the runaway inflation, which I think we have not seen in the 5 or so years since then, how could they have been that wrong? And if we just go down the line and understand why the predictions of runaway inflation that we heard so much were so wrong.

Mr. GOODFRIEND. We had—the typical model of money supply in the textbooks that uses a money multiplier which says, for every $1 of reserves the banks have, they create $10 of money. That is the way the world worked, as long as—this is a little technical—the interbank interest rate was above zero and interest on reserves was zero, so there was an opportunity cost of holding reserves so that banks had a fraction of reserves that they would hold against their money.

Now, what happened when the Fed dumped reserves into the system was the interbank interest rate went to zero, which was the interest on reserves. In the jargon of academics, there was a zero opportunity cost of holding reserves. We hardly ever see that. And so people who aren't taking money and banking, my class, they are not going to notice that, but that is what happened.

The Fed, by dumping so many reserves in the system, created a zero opportunity cost environment, and the banks just held their reserves. The last time we saw anything like that was in the 1930s. So I forgive people who kind of didn't catch what the Fed was doing and what would happen.

Mr. FOSTER. Yes. Dr. Kupiec?

Mr. KUPIEC. I would just like to add to that, it was worse than that, because they pay them 25 basis points on holding the reserves.

Mr. GOODFRIEND. Yes, that is true.

Mr. WHITE. Yes, so I think that is right. If you just look at the monetary base and see it double and triple the Fed's balance sheet, that is, then you think high inflation is coming, but you have to recognize that the Fed has sterilized those injections it is paying on those reserves.

Mr. FOSTER. Yes, so you would generally attribute—

Mr. WHITE. I just said attribute them to—

Mr. FOSTER. Right, so you would attribute the failure of those on the right to correctly anticipate the fact that there wasn't runaway inflation to a lack of economic sophistication, roughly speaking?

Mr. WHITE. On the right and on the left, yes.

Mr. FOSTER. Okay. Those on the left, I think, did not share this mania about runaway inflation. Dr. Bivens, do you have a diagnosis of this failure to understand the problem?

Mr. BIVENS. Yes, I think inflation remains so low despite those predictions because people totally overestimated how quickly the economy would recover. We still have a deeply depressed aggregate demand in the economy. That is what is keeping prices low.

I just don't buy that a quarter percent interest rate on reserves is what is keeping all those reserves from flying out into the econ-

omy. What is keeping prices low is the enormous gap between potential supply and demand in the economy even today.

Mr. FOSTER. Okay. Now, in terms of the housing market, the enormous intervention—if you look at the history of housing bubbles, when they burst, they often undershoot, so that if you look at the long-term trend line of house prices, a bubble develops, and then the prices crash, and they actually go below the long-term trend line, which is tremendously destructive to families and the economy as a whole.

And so the timing of the massive intervention in the big volume mortgage-backed securities and so on had the effect, whether intended or not, of actually flattening out housing prices along their long-term trend line, which is where they have to return.

And I was wondering if you had comments on whether this actually ended up—the fact that housing prices have steadied down on their long-term trend line, whether this is actually a correct and good result of the massive intervention, in terms of the housing market?

Mr. GOODFRIEND. I would start by saying the question in my mind is, what is the policy vis-a-vis housing in the future? Because subsidizing or directing credit toward housing is taking it away from other sectors. I want to turn it over to Dr. Kupiec in a minute, but I am worried that the housing policy, should it continue, is draining credit from other sectors where we would get more productive capital.

Mr. KUPIEC. I would agree with that. I think that when you try to figure out what the long-term trend in housing would have been, you have to take out all the growth that happened with the bubble before. Housing was way overpriced. There was way too much investment in housing for a number of reasons—financial policies, tax policies, and housing. The building of housing creates new GDP, but after that, it is not a productive tradable good.

Mr. FOSTER. Okay, now would—

Chairman CAMPBELL. The gentleman's time—

Mr. FOSTER. I will yield back.

Chairman CAMPBELL. —has expired. Thank you.

Now, we will move over here to the gentleman from New Mexico, Mr. Pearce, who is recognized for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman. And I appreciate each one of your testimonies.

I guess I would start with Dr. Goodfriend. My question is actually sort of a follow up to Mr. Foster's questions about the speculations of what was going to happen to inflation based on the creating of money kind of out of thin air. What would happen if the United States is removed as the world's reserve currency? What would happen to inflation with all these printed dollars out there that have yet to be pulled back in?

Mr. GOODFRIEND. If—

Mr. PEARCE. Dr. Kupiec, I will follow up with you, too.

Mr. GOODFRIEND. —the United States loses its status as a reserve currency country, essentially that means in practice that holdings of dollar-denominated Treasury securities abroad, which are the vehicle by which the dollars are held, would be returned to the United States. There would be a big depreciation of the ex-

ternal value of the dollar. In other words, the currency would depreciate on foreign exchange markets, and that would create inflation at home.

Mr. PEARCE. I will just let each one of you comment on that.

Mr. KUPIEC. I agree with that. We get enormous benefits vis-a-vis the rest of the world, because we have reserve currency status.

Mr. WHITE. I would agree with those two statements that the danger is a collapse in the exchange value of the dollar.

Mr. PEARCE. Dr. Bivens?

Mr. BIVENS. I think the reserve status also hurts us by keeping the dollar too strong. We have very large trade deficits and have for a long time, and that is because the dollar is too strong to balance our trade, and so there would actually be a countervailing benefit of we would get some export growth if we actually had less demand for foreign reserves of our currency.

Mr. PEARCE. What would happen to the value—what would happen to inflation, in your opinion, if we are removed?

Mr. BIVENS. There would definitely be upward pressure on inflation. It would not be mammoth. We only import 15 percent to 20 percent of our GDP, so there would be an increase in import prices, but actually I think we need higher inflationary expectations, so it is hard for me to see that as a catastrophe.

Mr. PEARCE. We need higher inflationary expectations? That is somewhat curious. I represent one of the poorest districts in America, and inflation hurts the poor worse than anybody else. And so basically, these policies which are being implemented are devastating to the retirees and to the poor. The zero interest rate is helping Wall Street on the backs of the retirees who tell me in my town halls, "We have lived our lives correctly, we paid for our house, and we saved money, and we have money in the bank." Retirees typically have less sophisticated investment instruments. And so, that is a curious statement.

In a previous hearing, that effect on seniors and the poor was called collateral damage that has to just be acceptable, and I sort of disagree with that, because, again, these are people's lives.

But I think that this whole idea that we can export inflation to 200 other countries, we can export this fabricated money to 200 other countries is one that, I think, holds alarm. And then you get the additional effect that other countries now are beginning to respond in kind, so they are beginning to create their own currencies, too. If it is good for us, and it seems like that the people who really strongly favor this quantitative easing policy, they don't have an answer when you ask, if it is okay for us, it ought to be okay for Japan and the other countries.

I was interested in Dr. Bivens' comment on page nine, and so I was wondering if maybe, Dr. Kupiec, if you have some comment about it, but he makes the point that—because the sector was so impaired by the burst housing bubble and resulting financial crisis, and because QE works best when focused on impaired markets, I think this was economically appropriate thing to do, and that is the buying of MBS certificates. Is that the same perception that you would have? Is Would you agree with that particular take on the matter?

Mr. KUPIEC. I view the need to support housing after the housing bust as sort of a political constraint on the system. From a purely economic standpoint, we had too much investment in housing, and housing prices were too high before the crisis. And the need to try to create a recovery in housing was a purely political need at the time. But long term, more emphasis on investing in housing is probably not the right way to create new GDP growth.

Mr. PEARCE. Okay. Thank you, Mr. Chairman. My time has expired.

Chairman CAMPBELL. The gentleman's time has expired.

The gentleman from Michigan, Mr. Kildee, is now recognized for 5 minutes.

Mr. KILDEE. Thank you, Mr. Chairman.

And thank you to the witnesses for being here today. This is obviously an important hearing, and one that I thank the Chair for calling.

So today's hearing—while it concerns the independence of the Fed in its role in credit allocation, I do want to just focus in on—I have been here a year-and-a-half, that Chairman Bernanke in his role did come to Congress several times, referencing the independence of the Fed, imploring this Congress to fulfill its role in strengthening the economy and supporting the economy and dealing with our set of responsibilities regarding the important mandates that also relate to the role of the Federal Reserve.

And although while there were lots of folks here in Congress who were ready to act, and, in fact, structurally Congress, even before my arrival, had sort of set in motion an effort that was purported to create a condition that would force Congress to act, creating the sequester, the fact is that somewhere along the way, there were some who simply embraced that policy. And obviously, from the perspective of many, that has weakened economic growth.

The point being that the Fed took some of the few steps that it could to improve the economy, holding down interest rates, and then pursuing the purchase of Treasury and mortgage-backed securities. And now that the economy is improving, as it said it would, the Fed is reducing those security purchases.

In many respects, it appears to me that the Fed stepped in to address a number of the challenges that were not confronted as they should have been by Congress. So while some question the independence of these actions because the Fed stepped in when Congress would not or did not, and because the Fed basically directed these actions, and they did have, in fact, by most accounts, positive outcomes, it does feel a tad disingenuous to me that because Congress was unwilling to do its job, one could presume that nobody else should do theirs or use the tools that are available to them to deal with the weakness in our economy.

In particular, I am concerned about this, because I think too often we tend to look at data, particularly economic data, on a national scale and completely aggregate it. I represent an older industrial corridor that includes cities like Flint, Saginaw, and Bay City, Michigan, which even during periods of economic growth and expansion have not experienced that growth and expansion, so I am particularly concerned, and I would ask Mr. Bivens and perhaps others to comment on actions that you think, from the standpoint

of the Federal Reserve, the Fed might take in order to promote economic growth and development in places that have not experienced growth even during those periods of economic expansion, the 1990s being a good example? Could you specifically address policies that you think the Fed might pursue in that regard?

Mr. BIVENS. In that regard, I think that the best thing the Fed can do is actually to focus on the aggregate national labor market and to not withdraw support from boosting employment and economic activity until there is something like genuine full employment.

I think even the Fed's decision to begin tapering its purchases is a worrisome signal to me that mostly because of political constraints, they are going to sort of take the foot off the accelerator a little prematurely and that is going to keep the recovery from reaching really deep into distressed communities.

I think other policymakers are much better positioned to do targeted interventions. To me, the Fed can set the overall conditions to make sure the overall economy and labor market is as strong as possible, and then if there are still pockets of distress, I think that is actually a case for other policymakers to step in.

Mr. KILDEE. So even in the event where other policymakers are either unwilling or unable in the—does the Fed have tools? Because to me, it seems that in order to meet the mandates of the Fed, looking at the aggregate data is obviously important, but it is sort like the old line about an economist: If your head is in the freezer and your feet are in the oven, but on average you feel fine, you should leave things alone. I represent one of those communities in the freezer. And I am just curious as to whether you think the Fed has specific tools that could be targeted for those sorts of places.

Mr. BIVENS. I actually don't think the Fed has very good tools for targeting sort of pockets of distress when the overall economy is generally doing okay. It is too bad, but I actually don't think that they really have the right tools for that.

Mr. KILDEE. Thank you.

Chairman CAMPBELL. The gentleman's time has expired.

We will now move to the gentleman from South Carolina, Mr. Mulvaney, who is recognized for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. I have a couple of different questions on a couple of different topics.

I was having a conversation with a friend of mine at Heritage the other day about whether or not the Fed was fixing the price of money, fixing the price of debt through fixing an interest rate. So let see if I can bring any clarity to this discussion, if you have any thoughts on this: If QE was to go to zero tomorrow, if they were to simply stop quantitative easing tomorrow, do you gentlemen have any opinions as to what the yield would be on the 1-year Treasury? The last couple of weeks, it has stayed pretty stable at about 12 basis points. Have you given any thought to that topic as to what would happen—what we would have to pay to borrow money in this country if the Fed wasn't providing us essentially with all of our debt through QE?

Dr. Goodfriend?

Mr. GOODFRIEND. I think as a technical matter the Fed could stop QE tomorrow. And because it can promise within the 1-year timeframe and because its promise is credible to keep the Federal funds rate near zero, that 1-year rate would not move.

Mr. MULVANEY. What about the 3-year?

Mr. GOODFRIEND. Now, you are getting interesting. The 3-year might move and, of course—and I believe that the Fed would have relatively little control over rates 4, 5, 6 years and beyond. I do think that the Fed is overselling its ability to manage longer-term interest rates today with its so-called forward guidance and QE. I agree with you.

Mr. MULVANEY. Interesting. If they were to not give any forward guidance, or if the forward guidance was that QE has ended and we are not going to do it anymore, would that impact the 1-year?

Mr. GOODFRIEND. I don't think so, just because it is short enough that, again, the Fed's promise on the overnight so-called Federal funds rate is credible at 1-year horizon.

Mr. MULVANEY. Anybody else on that topic? Dr. Bivens?

Mr. BIVENS. I think it would have really modest effects on—especially even long-term rates, but especially short-term, for two reasons. One, I actually don't—and most of the empirical estimates of what QE has done to long-term rates, they are pretty modest. The reason why long-term rates are extraordinary low in historic perspective, it is just because the economy is so weak.

And then I would also say, there are two countervailing impacts of QE on interest rates. Part of a long-term interest rate, it is the sum of inflationary expectations, expectations about what the short-term rate is going to do, and then the term premium. But if people think inflationary expectations are a little higher because of QE, if people because of the QE and forward guidance combined think short-term rates are going to stay low for a long time, I think—and if you reverse that, I think both those could put upward pressure, it would be very modest effects on interest rates if we just stopped QE tomorrow.

Mr. MULVANEY. Okay. I guess in a roundabout sort of way, that ties in to my next question. I want to come to what Dr. White mentioned in his testimony, and also went into more detail in his written testimony about the differences or the comparison, I guess, the juxtaposition between the monetary base and M2. And I have not read anybody else saying this, that really what the Fed is doing is using its monetary tools to effectuate fiscal policy, that they have manipulated the monetary base through QE, but they are sucking the money back out of the system through the interest rates they pay on excess reserves.

Dr. White, is it appropriate for the Federal Reserve to be—let me ask it this way. Dr. Bivens, do you agree with Dr. White that the Fed is exercising fiscal policy in this particular circumstance?

Mr. BIVENS. I don't.

Mr. MULVANEY. If they were, would that be appropriate? Could we agree that they shouldn't be doing fiscal policy? This goes back to Mr. Kildee's question, and I think what you were getting at is that you can't get at specific sub-pockets, specific communities, specific parts of the economy through monetary policy. That is the role of fiscal policy. That is correct?

Mr. BIVENS. I think that is fair to say, yes.

Mr. MULVANEY. And I think we can generally agree across both sides of the aisle that the Federal Reserve should not be doing fiscal policy. That is our job. Is that an accurate statement?

Mr. BIVENS. I would—yes, I would say that. I would also say it is impossible to think of a completely allocatively neutral monetary policy. So just the fact that there are allocative implications of the Fed doing something does not automatically mean it is not monetary policy.

Mr. MULVANEY. And that is what I want to go back to Dr. White on, because I have seen the graphs you have provided. I have read your testimony. And here is my question. Is it—you think they are doing—you would think they are doing it on purpose. What you have suggested is that they are using their monetary tools to effectuate fiscal policy. Defend that against somebody who simply says, it looks like that on paper, but really this is just an accident, we are exercising monetary policy that might look on a graph like it is fiscal policy, but we are actually not exercising fiscal policy. So defend your position a little bit more if you would, please.

Mr. WHITE. If the Fed were borrowing money by issuing bonds that were IOUs of the Federal Reserve System and paid interest, and then used the proceeds to, say, subsidize development in Michigan, I think everybody would agree that is a fiscal policy.

Mr. MULVANEY. Yes, sir.

Mr. WHITE. The way the Fed is borrowing money is not by issuing bonds, but by paying interest on bank reserves, which amounts to the same thing. It is a different way of borrowing money. And then they have used the proceeds not to promote development in Michigan, but to promote housing development, to buy mortgage-backed securities, pump their prices up, and that is directing it to one sector of the economy and not the economy as a whole.

Mr. MULVANEY. And I wish we did have a chance to talk more about credit allocation, because one of the things that you and I have talked about, Mr. Chairman, is really what we think they are doing is allocation—they are practicing credit allocation, and one of their favored areas is government, and they are making it easier for us to borrow money, just like they are propping up the prices of mortgage-backed securities, but we won't get that chance today.

Thank you, Mr. Chairman.

Chairman CAMPBELL. Thank you.

Moving up the road a little bit to North Carolina, Mr. Pittenger is recognized for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman. And I thank each of you for being here.

Chairman CAMPBELL. Wait. He lives south of you?

Mr. MULVANEY. The State runs—

Chairman CAMPBELL. Okay, don't confuse me with these things. Yes, we are starting the 5 minutes over again for Mr. Pittenger, who lives in North Carolina, which is south of South Carolina, apparently.

Mr. PITTENGER. I have to think about that one. Thank you, Mr. Chairman.

Dr. White, do you think the government has taken advantage of the low interest rate environment to run larger deficits than it otherwise would have?

Mr. WHITE. I don't see any evidence that Congress looks at the interest rate on Treasury bills before it decides the size of the deficit to run, but maybe I am wrong about that.

Mr. PITTENGER. All right. Dr. Kupiec, this committee has focused extensively on the QM rule and how it affects consumers and lending institutions. Dr. Kupiec, you stated the following: "The QM rule on its own does not seem to force a particular lending outcome. A bank can impose underwriting rules stricter than those specified in the QM rule and underwrite only high-quality mortgages. The problem with this strategy is that such an underwriting rule risks fair lending legal challenges."

What are your concerns regarding the QM rule? Are there things that this committee should consider doing to reaffirm a non-distorted allocation of credit? And what steps would those be?

Mr. KUPIEC. As I discuss at length earlier in my testimony on the QM rule, it imposes a scorecard- or model-based approach to underwriting mortgages that is typically not the approach used in community banks. In many small community banks, loans are made on a relationship basis, where the bankers are familiar with the people in the community and what they do, and they don't have a very model-driven computer, data-driven approach to lending.

And what the QM rule does is, the QM rules makes them adopt these type of approaches, which are expensive, and the extra expense of making mortgages originations is they just can't cover it in small markets, so it is really forcing small community banks in more rural areas and towns out of the mortgage market. They are not making mortgages for their customers, and there is some recent evidence in a survey just out in February that a significant share of banks are just getting out of the business.

Mr. PITTENGER. Correct. Can you give some other examples outside of QM where the U.S. regulatory policy has begun to influence how credit is allocated in our economy?

Mr. KUPIEC. There has been this new phenomenon where the big Federal banking regulators have stopped some of the banks from making syndicated loans. And this is kind of unusual, because they are stopping specific syndicated loan deals on the premise that these loans are part of a credit bubble that is fueling a bubble essentially in high-yield mutual funds.

And so they are trying to stop banks from originating loans that aren't even staying in the banks. They are going to the mutual fund sector and arguing that they are trying to quash a bubble.

The real source of the demand for this, though, is the zero interest rate policy in the QE easing. Investors, as you may all have experienced, savers over the last 6 or 8 years, you make more money on your credit card rebates than you do by any money you have in a bank account or a savings account, and it is rational to look for yield. And these particular types of loans are floating-rate loans. They are high-yield floating-rate loans. There is risk in them, for sure, but at least they pay a decent rate of return, and they are not subject to long-term interest rate risk, because the rate floats.

And so it is a very natural sort of demand that savers would have in this type of environment, and essentially the bank regulators are trying to shut that down, and that is sort of a new use of regulatory powers to direct credit that I don't think we have seen in the past.

Mr. PITTENGER. Thank you. Let's go back to the question, Dr. Kupiec, that I asked Dr. White. Do you think the government has taken advantage of this low interest rate environment to drive larger deficits than it otherwise would have?

Mr. KUPIEC. I really don't have an opinion on that. That is not my area, exactly.

Mr. PITTENGER. Dr. Goodfriend?

Mr. GOODFRIEND. No opinion.

Mr. PITTENGER. No opinion. I have some, but I won't labor through that at this time.

I yield back my time. Thank you.

Mr. MULVANEY [presiding]. The gentleman yields back.

We now recognize the gentleman from Illinois, Mr. Foster, for 5 minutes.

Mr. FOSTER. Yes, I would like to return to something that was mentioned, which is the implicit credit allocation effects of stress tests, which are real, and I think probably unavoidable. In just a simple example, imagine that you had—one of the macroeconomic stress factors was simply that housing prices revert to where they were several years ago. Had that been applied to a bank with a large exposure in Las Vegas, where prices had doubled in 2 years, that would have resulted in very strong capital requirements and a restriction in lending in Las Vegas as the bubble developed, whereas the same identical requirements applied to a bank with a heavy exposure in Cleveland, for example, which never experienced a bubble would have no credit allocation, no credit restrictions applied to it.

And so I was wondering what your attitude is toward general policies, for example, requiring that you stay well-capitalized if housing prices revert to where they were previously, even if they have very specific effects, for example, constricting credit in one area of the United States and not in another. Is that necessarily a bad thing? And how do you—and a related question is, what is the appropriate level of public disclosure? The big banks might not be too enthusiastic about having public disclosure of exactly why they failed or came close to failing a stress test. So I was wondering if we could just have another round of comments on that, starting, actually, on the right this time with Dr. Bivens.

Mr. BIVENS. On the appropriateness of sort of national-level stressors affecting sort of regional banks differently, I haven't thought extensively about it. It does strike me as a little reasonable, though, to at least ask how regional banks would react to, say, a fall in national home prices. It is just not the case anymore that financial institutions only have a portfolio of regional assets that affect regional prices. They probably hold some assets that are correlated with national home prices. And so as long as the proper weight of national home price movements on the effect—on regional bank assets is given, that strikes me as appropriate.

And in regards to public disclosure, my general view is the more, the better. I would like to see more transparency in the stress test models being used, so, yes.

Mr. FOSTER. Dr. White?

Mr. WHITE. I think the important thing at the most general level is to get the incentives right for banks to take accurately into account the risks they are undertaking in their portfolio decisions. And it seems to me the wrong way to approach that to ask if we tweak this rule and look in retrospect at how it would have affected the regional allocation of credit, would that have been a good thing? We don't want banks to put unrealistic values on the assets in their portfolio and thereby overstate their capital. But that is sort of a supervision and regulation question, rather than what we have mostly been addressing today.

Mr. KUPIEC. I would be happy to take that on. I ran the stress testing group in the FDIC for a number of years, and so I am very intimately familiar with these issues. The problem is when you do a stress test, the Fed will specify some national path for housing. And as you are quite right, regional housing prices don't follow the same path.

Now, what happens is, the banks have to translate the national path and the GDP path into something that happens in their own area, and there are different ways to do that. The problem is, it is not easy to do it, and econometrically, these models fit very badly, so it is a guess. It is a guess how housing prices are going to change.

But when the bank does its stress test and presents its models, the Federal Reserve does its own, and it doesn't tell you how it models it. And if the Federal Reserve wants to assume a different transfer of the national house price path to, say, Cleveland versus Las Vegas, it can do it, and it can claim, this is what we think, and what we think is what matters.

So the stress test ends up allocating capital in these different markets because the Federal Reserve is the one deciding what the right way to translate this overall very fuzzy macro scenario into specific things that happens in specific markets. And if the bank disagrees, well, it is too bad. There is no scientific give-and-take. There is no objectivity here. It is all an art. It is all a simulation. And the models fit very badly anyway. So having any discussion on it based on, really, sound economic grounds is a very difficult thing to do.

Mr. FOSTER. Are you a fan of larger disclosure of the debate that happens or not? When you said that the Fed did not tell you why you passed or failed, are you then a supporter of more disclosure, more public discussion of the factors that led to banks—

Mr. KUPIEC. The first point I would make is, it is a very arbitrary regulatory rule, since so much of it depends on the interpretation of the central bank or the regulator versus the interpretation of the bank, so it is very arbitrary. In an arbitrary setting like that, there is no—the property rights, the ability for a business to make decisions, it is all sort of overturned.

So transparency would be a first step, but in general, the science isn't there—isn't really developed enough, nor do I think it ever will be that you could actually make this a hard and fast rule that

was totally objective. There is a lot of subjectivity in it, and in general, it is imposing government regulators' views on business decisions that should be the banks in the area.

Mr. FOSTER. I yield back.

Mr. MULVANEY. Thank you, Mr. Foster. And that appears to be the end of the questions.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without any further objections, we will be adjourned.

Thank you, gentlemen.

[Whereupon, at 11:18 a.m., the hearing was adjourned.]

A P P E N D I X

March 12, 2014

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Submitted for a hearing on:

Federal Reserve Oversight: Examining the Central Bank's Role in Credit Allocation

Subcommittee on Monetary Policy and Trade,
House Financial Services Committee

March 12, 2014
Room 2128 Rayburn Office Building

The question that today's hearing aims to address is whether or not unconventional monetary policies undertaken by the Federal Reserve since the beginning of the Great Recession (particularly "quantitative easing" (QE), or the purchase of long-term securities) have led to the Fed playing too large a role in economy-wide credit allocation, and if this role in credit-allocation constitutes a threat to the Fed's independence.

Specifically, the introductory memorandum for this hearing raises three particular concerns. First, has quantitative easing enabled (presumably excessive) Federal spending? Second, has the Fed's purchase of mortgage-backed securities (MBS) constituted an inappropriate favoring of the housing finance sector of the economy, and would any such bias towards this sector constitute a threat to the Fed's independence? Third, will banking regulations promulgated since the crisis lead to an unwarranted increase in demand for certain specific asset classes relative to others?

In my testimony I will argue that too many observers seem eager to define central bank "independence" as either putting no weight at all on the "maximum employment" target of the Fed's dual mandate, or as mechanically leaning *against* whatever is being done with fiscal policy. Neither of these are good guideposts to Federal Reserve independence, and in fact that Fed's conduct in recent years – including the QE actions – is entirely consistent with its attempt to satisfy the dual mandate of price stability and maximum employment. It is true that the Fed's conduct since 2008 is quite different than its conduct over much of the preceding decades, but that is simply a reflection of the extraordinary economic environment created by the Great Recession and resulting financial crisis.

Lastly, I will offer answers to each of three specific questions posed in the preparatory memorandum to this hearing. To preview these answers:

-**Have the Fed's QE actions have enabled higher levels of federal spending?**

I argue that they have not, and that's actually too bad. The economy remains deeply depressed and a large and persistent shortfall between aggregate demand and potential supply is the main reason why. Further, very slow rates of federal spending are the primary reason why at this stage in the recovery demand remains so muffled. Clearly nothing – not the Fed's actions or anything else – have led to a sustained, atypically large rise in federal government spending because such an increase just has not happened. Just as clearly, such a sustained rise would actually be beneficial to the economy right now.

-**Have the Fed's purchase of Agency bonds and MBS disproportionately aided the housing finance sector of the economy?** I argue that such purchases have indeed helped this sector, but because this sector was disproportionately *damaged* by the burst housing bubble, this was an appropriate thing to do. Focusing QE on particularly impaired financial markets – like housing – increases its impact in generating economic activity and employment.

-**Have regulations promulgated since 2008 encouraged financial institutions to hold a higher share of U.S. debt in their portfolios**? I argue that these regulations are likely to provide such an incentive, but that's an appropriate response to the financial crisis of 2008. That crisis was driven in large part because

assets held by banks turned out to be far less liquid than expected following adverse market shocks. U.S. government debt is highly liquid, even (or especially) in financial panics.

Central Bank Independence In Inflationary Versus Deflationary Economic Environments

In the decades before the Great Recession, a growing majority of macroeconomists and policymakers agreed that the task of macroeconomic stabilization (that is, boosting the economy after negative shocks to aggregate demand and reining in a potentially overheating economy before accelerating inflation broke loose) should be left almost entirely to central bankers. Additionally, it was generally assumed that the main tool used for this purpose by central bankers – the control of short-term "policy" interest rates (like the effective federal funds rate and the discount rate controlled by the Federal Reserve) - would be sufficient to assure that such stabilization efforts would be successful.

This stance seemed to be based on an overarching assumption – that the main challenge faced by central bankers would be to rein in overheating economies and guard against inflation. If this was the primary challenge faced by central bankers, than short-term policy rates are indeed a powerful tool. In inflationary economies, central banks can raise short-term rates to discourage borrowing (and hence economic activity overall) from households and firms. This reduced borrowing and economic activity slows demand growth and hence puts downward pressure on inflation. Crucially, there is no *ceiling* to interest rates, so central bankers were free to push on this policy tool until it had its desired effect.

Another key assumption often embedded in this view is that *fiscal* policymakers, being often more subject to political constraints (the need to win elections in the short-term), are perpetually prone to imparting an inflationary bias to the economy by borrowing too much, both to provide as many services as possible to voters without raising their taxes as well as to boost economic activity and lower unemployment. The fear is that short-sighted politicians would give no weight at all to the longer-run costs of overheating the economy - costs like high interest rates that could crowd-out productive investment and lower future productivity growth and the embedding of inflationary expectations in the economy that could accelerate over time. This assumption has led too many to believe that it is always and everywhere the Fed's job to simply do the *opposite* of what fiscal policymakers are doing, and to label monetary policies that amplify, rather than muffle, fiscal policies' impact on macroeconomic activity, as a *de facto* surrendering of monetary policy independence in the name of pleasing elected fiscal policymakers.

However, the last decade has seen this assurance that conventional monetary policy alone could insure macroeconomic stabilization largely abandoned – and rightly so. In recent years, the primary problem facing developed economies has not been persistent *inflationary* pressures in the system, but has instead been relentless *deflationary* pressures. This relentless deflationary pressure has been caused largely by the bursting of the house price bubble in the United States that has led spending by households, businesses and governments to fall far too low to employ the economy's productive resources. This gap between aggregate demand (desired spending by household, firms, and government) and the economy's productive potential (or, the "output gap", in economists' jargon) has led to rising unemployment and intense downward pressure on both interest rates and inflation.

This makes the primary challenge facing all macroeconomic policymakers – including the Fed – is to engineer a restoration of domestic spending to close this "output gap". But *conventional* monetary policy alone cannot do it – not least because while there is no *ceiling* to interest rates that will be hit when the main problem is fighting inflationary pressures, there is indeed a *floor* to interest rates that can (and has been) hit when central banks attempt to fight deflationary pressures. Nominal interest rates cannot fall below zero. When they do hit zero and large output gaps persist, the economy is often said to have entered a "liquidity trap".

So, with conventional monetary policy largely defanged, this means unconventional monetary policy, along with fiscal policy (and, I'd argue exchange rate policy as well), were needed to stem the crisis. Further, the sheer size of the negative demand shock that led to the Great Recession required a *coordinated,* not cross-cutting, response from all levers of macroeconomic stabilization policy to counter. So, from 2008 to the end of 2011, monetary policy was made extraordinarily accommodative and fiscal policy boosted aggregate demand significantly.

As monetary policymakers have since correctly stressed, the simple fact that both monetary and fiscal policy were pushing in the same direction during this time was *not* a surrender of central bank independence in any reasonable interpretation. As Ben Bernanke said it:

> *"...the role of an independent central bank is different in inflationary and deflationary environments. In the face of inflation, which is often associated with excessive [government borrowing and] monetization of government debt, the virtue of an independent central bank is its ability to say "no" to the government. [In a liquidity trap], however, excessive [government borrowing] and money creation is unlikely to be the problem, and a more cooperative stance on the part of central banks may be needed".*

Another way to put this is that the problem facing macroeconomic policymakers in normal times is to *trade-off* declines in unemployment against rising inflation. When facing this trade-off from a starting point of roughly full-employment, if fiscal policymakers provide stimulus that pushes down unemployment and boosts inflation, then one could indeed argue that central independence would require that they raise interest rates to push down inflationary pressures and to keep unemployment from falling.

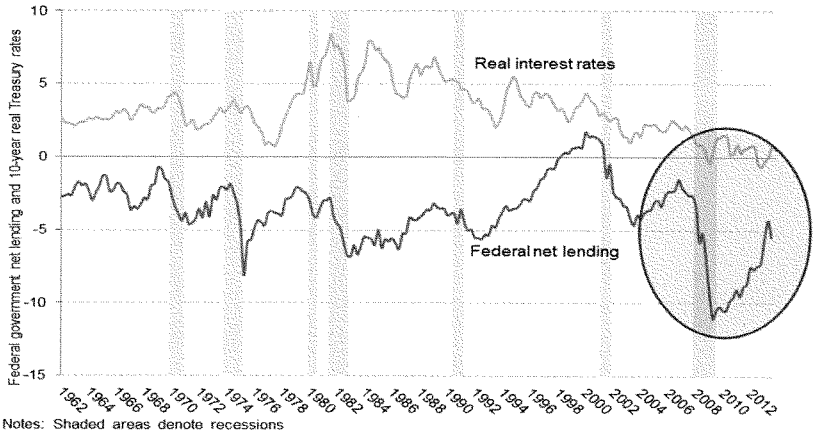
But, over the past six years, as the economy has remained stuck in a liquidity trap with large output gaps persisting even as conventional policy interest rates remain at zero, there *has been no trade-off* between inflation stability and maximum employment. Instead, inflation has fallen even as joblessness has remained far above normal levels. Until this pattern changes, *all* levers of macroeconomic policy can (and should) be oriented to boost economic activity and arrest the downward drift of price-growth. This means that the Fed's effort to keep interest rates low in the face of fiscal stimulus was not an inappropriate surrendering of independence, rather it was a completely appropriate response to the economic environment at hand.

Monetary policy has actually been learning hard against fiscal policy since 2011

Further, it's worth noting that even if one adhered to the incorrect view that monetary policy independence somehow required that monetary policy always and everywhere "lean against the wind" of fiscal policy, the last two years actually *have* seen such a leaning against the wind on the part of the Fed.

Federal fiscal policy has become extraordinarily contractionary in recent years, with the budget deficit seeing its largest three-year fall in history between 2009 and 2012.

Federal budget deficits and interest rates



Notes: Shaded areas denote recessions
Source: Federal net lending from NIPA Table 5.1, 10-year Treasury rates from FRED, real rates calculated by subtract weighted average of CPI-U inflation from Bureau of Labor Statistics (BLS), with higher weights on most recent quarter

Over this same time-period Federal Reserve policy has indeed leaned against this pronounced fiscal contraction by continuing its accommodative monetary policy. But if one believed that the Federal Reserve should simply set monetary policy to do the reverse of fiscal policy, this prescription has actually been fulfilled since the end of 2011. And this insight – that fiscal policy, particularly spending, has become extraordinarily contractionary in recent years – bears directly on the first of the specific questions identified in the introductory memorandum to this hearing.

Three Concerns Raised in the Introductory Memo for this Hearing

Has QE been enabling higher federal spending?

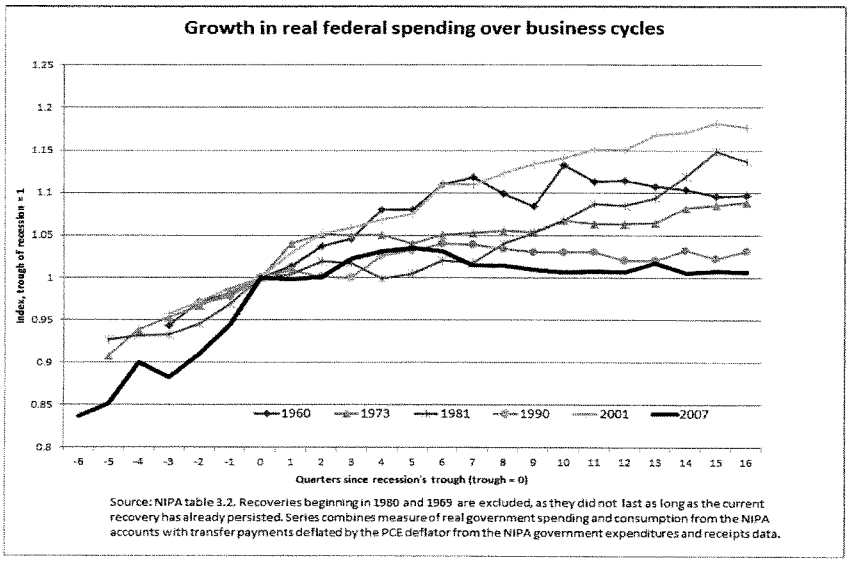
The first issue of concern raised in this memorandum was that accommodative monetary policy – and quantitative easing specifically – could be somehow enabling higher levels of federal spending by artificially keeping one implicit price of this spending (higher interest rates) from materializing.

This is clearly not a cause for concern, for a number of reasons.

First, as noted above, *both* fiscal and monetary policy *should have been* extraordinarily expansionary since the beginning of the Great Recession. So if expansionary monetary policy had managed to keep fiscal policy expansionary as well, that would have been an entirely useful thing for the economy. And even today there remains an extraordinary degree of productive slack in the economy, and inflation is not just *low* but *falling*. So even if accommodative monetary policy were making fiscal policy more expansionary, that would be nothing but useful and appropriate given today's economic environment.

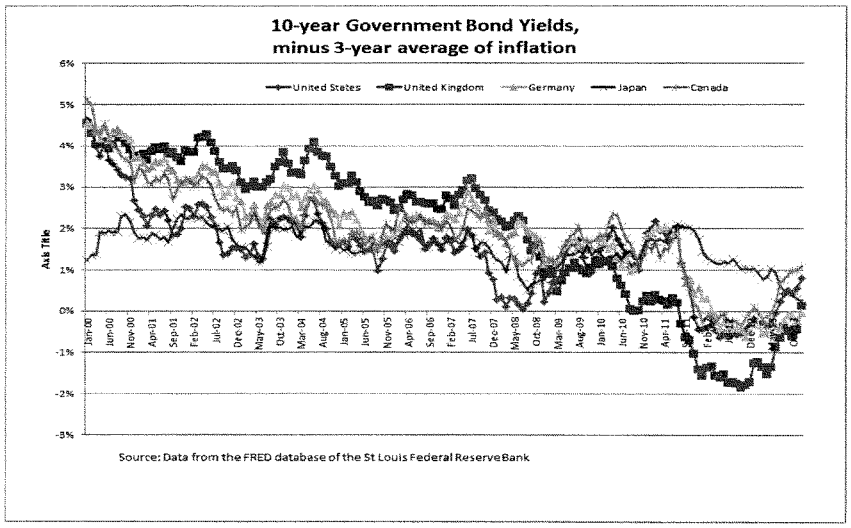
Second, as an empirical matter, it just is not the case that the accommodative monetary policy of recent years has led to rapid federal spending growth. On the contrary, federal spending has been extraordinarily austere in recent years, with the slowest growth of federal spending during any recovery (of comparable length to the current recovery) since World War II (see **Figure 2** below). Again, it should be stressed that this fiscal austerity on the spending side has been quite damaging to the economic recovery, but it has happened, hence it is hard to argue that more rapid spending cuts would have occurred absent the Fed's accommodative monetary policy.

As a side-note, while spending growth has been historically slow in recent years, it is also the case that federal taxes as a share of GDP have been low as well. Part of this reflects cyclical weakness in tax collections, and part of this has reflected temporary efforts to boost growth in the aftermath of the Great Recession (for example, the Making Work Pay tax credits included as part of the American Recovery and Reinvestment Act (ARRA) and the payroll tax cuts negotiated at the end of 2010 as part of the deal to delay the expiration of the 2001 and 2003 tax cuts aimed at higher-income households). Given that tax cuts are much less efficient forms of fiscal stimulus per dollar added to the deficit, this low tax share of GDP does materially change the story about fiscal policy as a whole imposing a large drag on growth in recent years. However, it does illustrate the point that if one is determined to be worried about the enabling effect of accommodative monetary policy on overall fiscal policy, one should take taxes into account as well. And while the case that federal spending has grown too rapidly in recent years does not fit the facts of recent years at all, there is some evidence that the federal tax share of GDP has fallen over the course of the Great Recession and recovery – even after accounting for cyclical effects. The Congressional Budget Office (CBO), for example, has estimated that federal revenue after accounting for cyclical effects was 18.5 percent of GDP in 2007 (the last pre-recession year), yet has averaged just 17.0 percent since 2007 (although it had risen to 18.2 percent by 2013).



Lastly, we should put the empirical effect of QE on long-term Treasury rates into perspective. Long-term interest rates would surely still be historically low even without the impact of QE. For example, Bernanke (2012) has shown that inflation-indexed yields on government bonds have collapsed in recent years to historic lows across a range of countries with quite different monetary policy approaches to the crisis. **Figure 3** looks at a cruder version of the evidence Bernanke cited, charting 10-year nominal yields on government debt minus the 3-year average of growth in consumer prices for each of the countries (a very rough approximation of real interest rates). The rapid downward drift of interest rates – particularly in recent years, is apparent.

This collapse of interest rates should not be a huge surprise. Long-term interest rates essentially reflect three components: expected inflation, the expected path of short-term rates, and the "term premium". The first component, expected inflation, has declined significantly since the start of the Great Recession, driven largely by the gap between aggregate demand and the economy's productive potential. The most closely-watched measure of inflationary pressures in the U.S. economy – the "market-based" core deflator for personal consumption expenditures – rose at just 1.1 percent year-over-year in all 4 quarters of 2013. So this component of long-term interest rates is clearly placing great downward pressure on them.



The second component – the expected path of short-term rates - has also put downward pressure on long-term rates in recent years. This is also due to pronounced economic weakness that has led the Fed (and other central banks throughout the world) to keep short-term policy rates low, and to signal clearly that these shall remain low so long as large unemployment remains elevated, output gaps persist, and inflation remains low.

The third component – the term premium – is the one most directly affected by QE. The term-premium is the amount that holders of long-term debt must be compensated to take on the higher risk of swings in the return of this debt relative to shorter duration assets. By buying Treasuries, the Federal Reserve has reduced this term premium through its QE activities. These effects are detectable in statistical tests, and the lower long-term rates resulting from QE do provide a modest boost to the economy, but they are not the primary reason why interest rates have fallen in recent years to historic lows. For example, some of the larger estimated effects of QE on long-term Treasury interest rates come from Gagnon et al. (2011). They find that "the overall size of the reduction in the ten-year term premium appears to be somewhere between 30 and 100 basis points, with most of the estimates in the lower and middle-thirds of this range". Take a look again at the interest rates in either Figure 1 or 3 above – 30 to 100 basis points (or 0.3 to 1 percent) just would not change the general story that interest rates in recent years have been pushed to extraordinarily low levels relative to historic norms.

Finally, it is worth noting two countervailing effects of QE on long-term interest rates, running through the inflation and term structure components described above. If QE leads the economy to run closer to

potential, this can increase inflationary expectations and shorten the period over which investors believe the Fed will need to keep short-term policy interest rates very low. Both of these expectations-based channels can actually mildly *boost* long-term rates.[1]

So, to conclude this section, it seems quite hard to make the empirical case that the Fed's QE activities have led to such economically large declines in long-term interest rates that would materially change the cost/benefit analysis of federal spending. And, it just is not the case that federal spending has reliably risen as QE has continued – in fact the past two years have seen some of the slowest spending growth in history, and enormous declines in federal budget deficits. In an important sense, this is all to the bad for the recovery. The large drag from fiscal policy is by now the primary reason why growth in the current recovery lags so badly relative to historic norms. If the QE activities had managed to keep this fiscal drag from occurring, we would have a much healthier economy today.

Has the Fed's purchase of MBS been bad for the economy or for the Fed's independence?

The second issue raised in the introductory memorandum concerns the Fed's purchase of mortgage-backed securities (MBS). The memo expresses concerns that these purchases constitute the Fed "favoring certain sectors of the economy over others".

In regards to this concern, the broad premise that focusing much of QE on housing-related finance (both by buying the debt of the federal housing agencies and by buying MBS) has provided disproportionate aid to this sector is actually correct. But because this sector was so impaired by the burst housing bubble and resulting financial crisis, and because QE works best when focused on impaired markets, I think this was an economically appropriate thing to do.

If one takes as given that pushing down long-term interest rates even below where the extraordinarily weak economy had pushed them was a useful response to the Great Recession and resulting slow recovery (and I do take this as given), then the Fed was going to have to buy *some* sort of assets. Buying long-term Treasuries was likely undertaken (at least in part) because these purchases seemed to stray the least distance from conventional Fed open market operations. But concentrating QE *only* on Treasuries would have severely hamstrung its overall effectiveness.

This is because one key benefit of QE is to reduce long-term rates for assets *besides* Treasuries, by reducing the risk premium associated with them – sometimes known as the "market functioning channel". The intuition is that assets that are not Treasuries can sometimes be risky simply because the market trading in them is not as liquid as that for Treasuries, and asset holders looking to sell them may find they cannot do so without impacting the price because of a lack of willing buyers. By boosting their purchase of mortgage-backed securities, the Fed substantially reduced the risk premium associated with them, and the empirical estimates of the interest rate effects on MBS are significantly larger than for Treasuries.

[1] It's important to note that these countervailing effects do not mean that QE is hence ineffective. In essence, QE is at root an effort to return the economy to a state where higher interest rates can be sustained, and the upward interest rate pressure described above is actually evidence that this is (partially, at least) working.

It is well-established that QE is more effective when undertaken in markets that are impaired and afflicted by deficient liquidity – and the MBS market in the aftermath of the Great Recession was almost certainly so impaired. Further, a key benefit of expansionary monetary policy has traditionally been the ability of homeowners to refinance their mortgages at lower interest rates, thereby freeing up more resources for spending elsewhere. QE in MBS market significantly helped this channel of monetary policy.[2]

The key insight behind recognizing that QE needed to go beyond simple Treasury purchases to be most effective is simply that there is not just one "interest rate" in the economy. Instead, there are multiple interest rates, and even multiple long-term interest rates. And expansionary monetary policy should aim to reduce those long-term interest rates most relevant to households' consumption and firms' investment decisions – and these are not the Treasury rates. Putting downward pressure on Treasury rates should result in these other rates coming down as well, but there are times when the risk premium to assets that aren't Treasuries rises substantially (say in the aftermath of the Great Recession and the related financial crisis), and simply pulling down only Treasury rates would not be the most effective way to conduct monetary policy.

So has the QE activity of purchasing MBS "favored one sector of the economy"? Well, yes. But it was a deeply impaired sector, and its impairment was blocking what has been a traditionally powerful transmission mechanism that translated expansionary monetary policy into increased economic activity and employment. Targeting asset purchases on those markets that are most impaired and would benefit the most from such purchases seems like prudent policy. This is not a perspective that is incompatible with rules-based policy either – as Posen (2012) has noted:

> *"What matters for the central banks' mandates is not that you do something that has no distributive effects because that's nonsense to hope for. Everything the central bank does has some amount of distributive effects. What matters is that the committee is pursuing a policy that is not clearly motivated or traced to a distributive effect as a goal - monetary policy can still be motivated by aggregate welfare in design. That should be done upfront when proposing a targeted QE policy. And so central bank committees can identify that, for example, in the U.K. the small business market for lending is the most impaired and therefore, the new FLS should be acting on that. You can identify that in the Euro area, in my view, the key issue was the semi-panic in sovereign debt markets for Italy and Spain, and that is where the ECB has now committed to conditionally intervening. You can identify in the U.S. that the mortgage market remains in many ways impaired, though has been some progress, and that is where the FOMC has since chosen to intervene further...such targeted QE policies should lead to bigger bang for the central banks' created buck"*

[2] Many observers have noted that this mortgage refinance channel has unfortunately been blocked by the fact that many homeowners are underwater (owing more on their mortgage than the house is currently worth), and the failure of housing regulators to modify refinancing rules to allow such underwater homeowners a chance to refinance.

Have regulations promulgated since the Great Recession provided a bias to holding some assets over others?

The final concern raised in the introductory memorandum concerns regulations passed in recent years in response to the financial crisis caused by the burst housing bubble. The memo raises concerns that such regulations "provide strong incentives for banks to crowd into certain asset classes, particularly sovereign debt".

Agree, in regards to this concern, the premise is largely right, but the conclusion is not. Some regulations passed in the wake of the Great Recession and associated financial crisis do indeed provide incentives for banks to have a different capital structure than they would have absent these regulations. But far from being a source of concern, such incentives are a reasonable response to the financial excesses that built up and help cause the financial crisis.

In frictionless textbook models, a firm's (including a bank's) choice of capital structure is irrelevant and no one structure is riskier than another. In such models, a government that then provides incentives for one capital structure over another is bound to simply introduce inefficiencies into the capital allocation process with no corresponding benefit.

However, the last financial crisis should have convinced us that this just is not true. Left to their own devices, financial institutions are prone to over time taking on higher leverage and less liquid capital structures then is healthy in the longer-term in a search for higher short-run returns.

Regulations in recent years have aimed to reduce banks' leverage and to boost requirements for banks' liquidity coverage ratios. It is this last category – boosting liquidity – that probably has the largest impact on the incentive of financial institutions to invest in sovereign debt.

These regulations essentially allow financial institutions to hold some forms of sovereign debt instead of cash and still have it count towards required liquidity coverage ratios. For U.S. debt, this seems completely appropriate. While there is economic risk associated with financial institutions holding U.S. debt, there is also economic risk associated with holding currency or demand deposits. What is relevant in this context is not the complete absence of risk, but the expectation that such debt is liquid. And the *liquidity* of U.S. debt has never been cast into doubt during this crisis.

The Volcker rule allows banks to continue proprietary trading of some sovereign debt using their own funds, while many other trades are limited. The rationale for this is related to the insight above about the Basel III regulations: a highly liquid market in government securities demands that financial institutions play a market-making role.

If one was determined to believe that financial markets were always and everywhere efficient and self-regulating, that many of the regulations promulgated in recent years would not make much sense. But these markets are not efficient and self-regulating, and the routine abandonment of liquidity in favor of higher returns was a key root of the financial crisis. Regulatory changes that provide an incentive for

financial institutions to hold a higher share of more-liquid assets on their books are sensible (though very partial) response to these crises.

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THE CASE FOR A TREASURY-FEDERAL RESERVE ACCORD FOR CREDIT POLICY

Testimony before the

Subcommittee on Monetary Policy and Trade

Of the

Committee on Financial Services

U.S. House of Representatives

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Introduction

I am pleased to be invited to testify before the Subcommittee on Monetary Policy and Trade of the House Committee on Financial Services on "Federal Reserve Oversight: Examining the Central Bank's Role in Credit Allocation." My testimony, "The Case for a Treasury—Federal Reserve Accord for Credit Policy," argues that the 1951 Treasury-Fed Accord on monetary policy should be supplemented with a Treasury-Fed Accord on credit policy.

Flexibility and decisiveness are essential for effective central banking. Independence enables a central bank to react promptly to macroeconomic or financial shocks without the approval of the Treasury or the legislature. Central bank initiatives must be regarded as legitimate by the legislature and the public, otherwise such initiatives will lack credibility essential for their effectiveness. The problem is to identify the limits of independence on monetary policy and credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury.

The Suitability of Monetary Policy for Delegation to an Independent Central Bank

Monetary policy can be conducted independently by a central bank because the objectives of monetary policy—price stability and full employment—are reasonably clear and coherent. Moreover, monetary policy is about managing aggregate bank reserves, interest on reserves, and currency to influence the general level of interest rates for the whole economy. Assets are acquired only as a means of injecting bank reserves and currency into the economy. Hence, monetary policy can be implemented by confining asset purchases to Treasury securities. And "Treasuries only" keeps the independent central bank free of politics because it avoids credit risk, and because the central bank simply returns interest on its Treasuries to the Treasury (net of operating expenses), for the fiscal authorities to spend as they see fit.

The Unsuitability of Credit Policy for Implementation by an Independent Central Bank

Credit policy satisfies none of the conditions that make monetary policy suitable for management by an independent central bank. Credit policy involves selling Treasury securities from the central bank portfolio and lending the proceeds to a private financial institution, or using the proceeds to acquire non-Treasury debt such as mortgage backed securities. Credit policy has no effect on the general level of interest rates because it doesn't change aggregate bank reserves or interest paid on reserves. Credit policy is debt-financed fiscal policy. The central bank returns to the Treasury interest earned on Treasuries that it holds; so when the central bank sells Treasuries to the public to finance credit policy initiatives, the result is as if the Treasury financed the credit policy by issuing new Treasury debt.

Credit policy works by exploiting the government's creditworthiness—the power to borrow credibly against future taxes—to facilitate flows to distressed or favored borrowers. Doing so involves a fiscal policy decision to put taxpayer funds at risk in the interest of particular borrowers. All central bank credit initiatives carry some credit risk and expose the central bank and ultimately, taxpayers to losses and controversial disputes involving credit allocation.

Even fully risk-free collateralized central bank credit policy exposes taxpayers to losses if the borrower fails subsequently. For instance, emergency "last resort lending" that finances the exit of uninsured claimants of a financial institution that fails with the loan outstanding, strips that institution of collateral that would have been available to cover the cost of insured deposits if the institution had been closed more promptly.

Clarifying the Boundary of Independent Central Bank Credit Policy

The 1951 Accord between the Treasury and the Fed was one of the most dramatic events in U.S. financial history. The Accord ended an arrangement dating from World War II in which the

Fed agreed to use its monetary policy powers to keep interest rates low to help finance the war effort. The Truman administration urged an extension of the agreement to keep interest rates low in order to hold down the cost of the huge Federal government debt accumulated during the war. Fed officials argued that keeping interest rates low would require inflationary money growth that would destabilize the economy and ultimately fail.[2] The Accord famously reasserted the principle of Fed independence so that monetary policy might serve exclusively to stabilize inflation and the macroeconomic activity.

Congress early on recognized that the Fed needed financial independence in order to conduct monetary policy effectively. The Fed is exempted from the congressional appropriations process in order to keep the political system from abusing its money-creating powers. The Fed finances its operations from interest earnings on its portfolio of securities. The Fed was given wide latitude regarding the size and composition of its balance sheet so it could react promptly, decisively, and independently to economic and financial conditions. In the early 1980s under the strong, independent leadership of Paul Volcker the Fed succeeded in establishing low inflation as the nominal anchor for monetary policy. Thus, Fed independence is today the institutional foundation for effective monetary policy.

The Fed has long executed credit policy in addition to monetary policy as "lender of last resort" to depository institutions. Credit policy is also subject to misuse for fiscal policy purposes. However, as long as Fed lending was relatively modest, temporary, and confined to depository institutions deemed solvent, and the Fed took good collateral against its loans, the potential for fiscal misuse was limited. Although the Fed has long needed an accord for credit policy, the lack of one was not a particularly pressing matter.[3]

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[2] See Hetzel (2001), and Stein (1969).
[3] Goodfriend (1994) and Schwartz (1992).

The enormous expansion of Fed credit in the 2007-09 turmoil—lending beyond depository institutions and acquiring non-Treasury securities—demands an accord for Fed credit policy to supplement the accord on monetary policy. A credit accord should set guidelines for Fed credit policy so that pressure to misuse Fed credit policy for fiscal purposes does not undermine the Fed's independence and impair the central bank's power to stabilize financial markets, inflation, and macroeconomic activity.

Congress bestowed independence on the Fed only because it is essential for the Fed to do its job effectively.[4] A healthy democracy requires full public disclosure and discussion of the expenditure of public funds. The congressional appropriations process enables Congress to evaluate competing budgetary programs and to establish priorities for the allocation of public resources. Hence, the Fed—precisely because it is exempted from the appropriations process—should avoid, to the fullest extent possible, taking actions that can properly be regarded as within the province of fiscal policy and the fiscal authorities.

When the Fed purchases Treasury securities it transfers all the revenue from monetary policy to the fiscal authorities and hence does not infringe on their fiscal policy prerogatives. Monetary policy, perhaps with the help of interest on reserves, respects the integrity of fiscal policy fully.

Fed credit policy is another matter entirely, because all financial securities other than Treasuries or their equivalent carry some credit risk and all lending involves the Fed in potentially controversial disputes regarding credit allocation. When the Fed extends credit to private or other public entities lacking the "full faith and credit" backing of the US government, the Fed is allocating credit to particular borrowers, and therefore taking a fiscal action and invading the territory of the fiscal authorities.

[4] The following paragraphs are from Broaddus and Goodfriend (2001).

As emphasized above, even fully collateralized lending that is riskless for the Fed exposes taxpayers to losses if the borrower fails subsequently. Fed credit that finances the exit of uninsured or unsecured lenders to a financial institution that fails while the loan is outstanding will have stripped the bank of collateral that could otherwise be available to cover the cost of insured deposits or other government guarantees.

It is important to appreciate the difficulties to which the Fed exposes itself in the pursuit of credit policy initiatives that go beyond ordinary last resort lending to solvent depository institutions. The Fed must decide how widely to expand its lending reach. Lending farther afield creates "an implied promise of similar actions in times of future turmoil," as Volcker put it, which the Fed may then be inclined to accommodate.[5] Fed presence in one credit market can drain lending from nearby credit channels and prompt calls for support in neighboring credit classes. The Fed must determine the relative pricing of its loans based on risk and collateral. The Fed must be accountable for its credit allocations and the returns or losses on its loans or security purchases. The public deserves transparency on Fed credit extensions beyond ordinary lending to solvent depository institutions. Yet, congressional oversight opens the door to political interference in the Fed's lending or non-Treasury acquisitions. Broadly speaking, the Fed is exposed to pressure to exploit the central bank's off-budget status to circumvent the appropriations process.

Moreover, the Fed and the fiscal authorities must cooperate on banking, financial, and payments system policy matters. This interdependence exposes the Fed to political pressure to make undesirable concessions with respect to its credit policy initiatives in return for support on other

[5] See Volcker (2008), page 2, and the discussion of the "limited commitment" problem in Goodfriend and Lacker (1999).

matters. Worse, the Fed could be pressured to make concessions on monetary policy to deflect pressure regarding credit policy.

"Accord" Principles for Central Bank Credit Policy

By its very nature then, credit policy has the potential to create friction between the independent central bank and the fiscal authorities. That friction is evident in the tense relationship between the Fed and Congress in the aftermath of the credit turmoil. The problem is that credit policy undoes "Treasuries only" so to speak, and uses some of the revenue from monetary policy to acquire non-Treasury assets without the authorization of the fiscal authorities. Unlike monetary policy, credit policy directs public funds to specific borrowers, and necessarily favors one class of creditors or one sector of the economy over another.

Even the central bank acquisition of government agency debt or securities packaged by government agencies is problematic. Except in rare cases when Congress has granted "full faith and credit" backing to government agency debt or securities packaged by government agencies, acquisition of such securities by the central bank has allocative consequences because it steers credit in a particular direction and confers an implied preferential status enhancing that agency's creditworthiness.

Central bank credit policy must be circumscribed with clear, coherent boundaries.[6] One could deny credit policy powers to the central bank altogether by requiring the central bank to pursue a "Treasuries only" asset acquisition policy. But credit policy has been useful in the recent turmoil and last resort lending to temporarily illiquid but solvent depositories has long been a valued part of independent central banking. Moreover, conventional last resort lending is reasonably compatible with central bank independence. Last resort lending to supervised, solvent depositories,

[6] Friedman (1962), pp. 232-4.

on a short-term basis, against good collateral provides multiple layers of protection against ex post losses and ex ante distortions. So the fiscal policy consequences of conventional last resort lending are likely to be minimal, and the scope for conflict with the fiscal authorities small.

On the other hand, expansive credit initiatives—those that extend a central bank's credit reach in scale, maturity, and collateral to unsupervised non-depository institutions and the purchase of non-Treasury securities—inevitably carry substantial credit risk and have significant allocative consequences. Expansive credit initiatives infringe significantly on the fiscal policy prerogatives of the Treasury and Congress and properly draw the scrutiny of the fiscal authorities. Hence, expansive credit initiatives jeopardize central bank independence and should be circumscribed by agreement between the fiscal authorities and the central bank.

Furthermore, an ambiguous boundary of expansive central bank credit policy creates expectations of accommodation in financial crises which blunt the incentive of private entities to take preventive measures beforehand to shrink their counterparty risk and their reliance on short-term finance. Moreover, an ambiguous central bank credit reach also blunts the incentive of the fiscal authorities to prepare procedures by which fiscal policy could act systematically and productively in times of financial turmoil. The chaotic, reluctant involvement of Congress in the fall 2008 crisis contributed enormously to the financial panic and greatly worsened the Great Recession.

Such reasoning suggests the following three principles as the basis for a Treasury-Fed "Accord" for credit policy. To reiterate, Congress bestows Fed independence only because it is necessary for the Fed to do its job effectively. Hence, the Fed should perform only those functions that must be carried out by an independent central bank. The problem is to identify the limits of independence on credit policy to preserve a workable, sustainable division of responsibilities between the central bank and the fiscal authorities—the legislature and the Treasury.

Principle 1: As a long run matter, a significant, sustained departure from a "Treasuries only" asset acquisition policy is incompatible with Fed independence.

Principle 2: The Fed should adhere to "Treasuries only" except for occasional, temporary, well-collateralized ordinary last resort lending to solvent, supervised depository institutions.

Principle 3: Fed credit initiatives beyond ordinary last resort lending should be undertaken only with prior agreement of the fiscal authorities, and only as bridge loans accompanied by take-outs arranged and guaranteed in advance by the fiscal authorities.

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Statement before the Subcommittee on Monetary Policy and Trade

Government Financial Policy and Credit Availability

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Government Financial Policy and Credit Availability

Chairman Campbell, Ranking Member Clay, and distinguished members of the Subcommittee, thank you for convening today's hearing, "Federal Reserve Oversight: Examining the Central Bank's Role in Credit Allocation," and thank you for inviting me to testify. My name is Paul Kupiec and I am a resident scholar at the American Enterprise Institute, but this testimony represents my personal views. My research is focused on banking and financial stability. I have years of experience working on banking and financial policy as a senior economist at the Federal Reserve Board, as a Deputy Director at the IMF and most recently as Director of the FDIC Center of Financial Research. I recently completed a three-year term as chairman of the Research Task Force of the Basel Committee on Bank Supervision. It is an honor for me to be able to testify before the subcommittee today.

History is replete with examples where governments direct private sector credit. Without checks and balances, governments often use their powers to direct private institutions into making nonviable loans in order to achieve favored political goals. Such policies often benefit targeted constituencies and appear to be costless in the short run. Eventually, however, they end up costing taxpayers dearly, as loans made to satisfy political goals rarely make economic sense without an explicit government subsidy somewhere in their life cycle. There are many historical instances, including in the U.S., where government directed lending policies not only sowed but fertilized seeds that grew into a financial crisis.

After briefly reviewing the link between government housing policy and the recent financial crisis, I consider a number of important post-crisis bank regulatory reforms and gauge their impact on the availability of consumer and business credit. For better or worse, bank regulatory policies shape bank behavior. They shape the environment in which the Federal Reserve conducts monetary policy, and they can have important impacts on economic growth and financial stability. Overly restrictive bank regulatory policies can discourage banks from lending, making monetary stimulus less effective and slowing the recovery from the Great Recession. Unbalanced bank regulatory policies can lead to a distorted allocation of bank credit, discouraging some types of bank lending while encouraging the oversupply of others.

I review the impact new bank regulations including developments related to financial regulators' use of their new systemic risk powers. In addition to new tools to discharge their new safety and soundness mission, the Dodd-Frank Act (DFA) gave regulators the responsibility of controlling "systemic risk" in the financial sector without ever defining systemic risk. This ambiguity has enabled bank regulators to use poorly supported systemic risk arguments to expand the regulatory jurisdiction of the Federal Reserve to an increasing number of large non-bank financial institutions.

The key points of my testimony are:

- Government policies encouraged the housing bubble that triggered a financial crisis. The same policies are in place today along with new programs to stimulate mortgage borrowing.
- CFPB regulations surrounding mortgage origination are likely to reduce consumer access to mortgage credit without benefiting financial stability or consumer protection.
- Small banks have been negatively impacted by the new mortgage origination rules, and many have decided to stop making mortgages.

- New approaches for enforcing fair lending laws create a new entitlement: bank credit for high-risk borrowers with protected characteristics. This fair lending enforcement standard will raise the costs and reduce credit availability for well-qualified non-protected borrowers.
- Volcker rule restrictions on collateralized loan obligations will impose significant costs on banks with no measurable gain in bank safety or soundness. The rule should be amended without delay to allow banks to retain their legacy CLOs.
- The Dodd-Frank mandatory stress test for large banks and bank holding companies gives the Federal Reserve unchecked power to exercise regulatory discretion over bank operations and shareholder property rights. The Federal Reserve can fail a bank in the stress test without any legal requirement to provide objective evidence that the bank is at risk.
- Bank regulators are stopping banks from making high-yield syndicated corporate loans arguing that these loans are fueling a bubble in high-yield mutual funds. If there is a bubble, this is the wrong policy as reducing the supply of loans will only make the bubble worse.
- Mutual fund investor demand for high-yield corporate loans is being driven by the Federal Reserve's zero-rate monetary policy.
- The Dodd-Frank Act granted financial regulators broad new powers and the responsibility to prevent "systemic risk" without providing a clear definition of "systemic risk." This ambiguity gives financial regulators wide latitude to exercise their judgment to define firms, products, specific financial deals, and market practices that create systemic risk and require additional regulation and expand their own jurisdictions.
- Regulatory systemic risk powers create enormous regulatory uncertainty for many private sector financial firms, including many that do not benefit from deposit insurance or any other implicit government safety net guarantees.

Government Housing Financial Policies and the Financial Crisis

While bank leverage and risk-taking enabled the growth of the mortgage and real estate bubble, the cause of the recent U.S. financial crisis was deeply rooted in excessive consumer leverage in residential mortgages. A host of government policies subsidized home mortgage borrowing, and consumers' ability to overleverage was facilitated and encouraged by government housing policies that seriously weakened national mortgage underwriting standards.[1] More than half a dozen years after the crisis, government housing policy today remains firmly focused on stimulating consumer mortgage borrowing, including borrowing by households with subprime credit quality.

Since the onset of the crisis, government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac have been the repository of most US mortgage market risk. Following conservatorship in 2008, the government fully controls these GSEs' operations through the conservatorship powers of the Federal Housing Finance Agency (FHFA). The crisis required nearly $200 billion in government support to keep the GSEs operating. Next to GSE losses, the $1.7 billion required to bailout the Federal Housing Administration's (FHA) mortgage losses seems minor, but it may only be a down payment on a larger taxpayer bill that will eventually come due.[2]

Still, affordable housing advocates are calling for another dose of distortionary housing policies. As real estate markets stabilize and GSE's pay back the government and return to profitability, their profits provide the government with a cushion to fund new politically-favored housing finance subsidies off-budget and without legislation by using the FHFA to control GSE

operations. Following the release of the administration's 2014 budget proposal, housing advocates have called for substantial reductions in FHA insurance premiums to stimulate mortgage borrowing, arguing that at current insurance rates, the FHA makes money on every new mortgage it guarantees.[3] These arguments, however, ignore the FHA's need to cover large potential losses on its existing mortgage portfolio.

In addition to the mortgage market support provided by FHA and the GSEs, the Federal Reserve has purchased almost $1.6 trillion in mortgage-backed securities to reduce mortgage interest rates and stimulate mortgage borrowing. Thus far, the government strategy to repair a deflated mortgage bubble has been to increase government mortgage subsidies and try to get consumers to take on new mortgage debt.

Post-Crisis Bank Regulatory Policy and Access to Credit

The Dodd-Frank Act (DFA) made extensive changes in the regulatory landscape, but it did not provide the operational details. Instead it instructed the financial regulatory agencies to work out the rulemaking. Post DFA, the responsibility for setting bank regulatory policy has spread beyond the pre-crisis bank regulatory agencies. The CFPB now plays the central role in crafting many of the consumer protection policies that used to be housed in the Federal Reserve Board. Other new bank regulations have been crafted by a committee of financial regulators. For example, the regulations implementing the Volcker Rule required agreement among the Federal Reserve Board, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, the Commodity Futures Trading Commission and the Federal Deposit Insurance Corporation.

In many cases, the Federal Reserve is not the sole Federal banking regulator setting policy. Still, it is important to understand how new DFA financial regulations are likely to impact bank behavior. In this regard, I believe that a host of new regulatory policies are discouraging banks from lending, making it more difficult for the Federal Reserve to use monetary policy to stimulate economic growth by expanding credit through the banking system.

New Rules for Mortgage Originations Discourage Mortgage Lending and Increase Bank Risk

The Qualified Mortgage (QM) and the Ability-to-Repay (ATR) rules will significantly increase many small banks costs of mortgage lending. The QM and ATR rules, moreover, set minimum underwriting standards that are far weaker than underwriting standards consistent with prime, low default-risk mortgages. The QM and ATR rules will not deter predatory lending as a high percentage of borrowers who are fully qualified under these rules would likely default and lose their homes should we again experience a stress similar to the recent financial crisis. The QM and ATR rules will force many small banks to abandon the mortgage business, reducing mortgage credit availability, especially in geographic markets without a large bank presence. Mortgages have been shown to be risk-reducing investments for community banks, so forcing community banks out of the mortgage lending business will increase their risk of distress.

It is well-known that smaller banks, so-called community banks[4], specialize in relationship lending, or the use of "soft information" or qualitative to underwrite loans. Qualitative information is gained through social and business interactions with potential borrowers and is used to assess, for example, a borrower's "character," the strength of the informal financial support a borrower might receive from

family or relatives, or the quality of a small business's business plan. Unlike credit scores and income data that reflect past experiences, qualitative information can be forward looking and identify issues that are not yet reflected in public databases. It is especially helpful for assessing a borrower's ability to repay a loan when verifiable data on income, the value of collateral, or formal guarantees from co-signatories are not available.

Relationship lending differs from high-volume model/scorecard-based lending which assesses the quality of a loan application based on data from credit bureaus, public records, and potentially verifiable information on income, expenses, and assets provided by the borrower. Scorecard-based underwriting models are very useful in large organizations when loans are made across a wide branch network or by independent mortgage brokers. Scorecards provide a means to standardize the loan underwriting process and, when designed properly, impose controls and discipline on the many loan officers or mortgage brokers whose decisions are otherwise not easily monitored.

One important change initiated by the DFA is a virtual requirement that mortgage lenders move toward a model/scorecard-based approach to mortgage lending. In order to limit their exposure to predatory lending allegations, a mortgage underwriter must ensure that a loan satisfies the CFPB's Qualified Mortgage (QM) and Ability-to-Repay (ATR) rules. These rules represent a well-intentioned attempt to prohibit many of the "risky" mortgage products that were associated with the financial crisis. Unfortunately, the rules may have unintended negative consequences for a large number of banking institutions and their customers.

A loan that meets QM standards reduces the risk of a predatory lending action. To qualify as a QM mortgage, contracts may not include negative amortization, interest only, excessive origination points or fees, terms in excess of 30 years, or approved for a borrower with a total debt-to-income ratio in excess of 43 percent. While there are some specific exceptions in the rules, the QM mortgage designation rules exclude mortgage loan contract characteristics that were commonly associated with high default rate subprime and no-doc loans in the crisis.

The CFPB's ATR rules require that a lender must make a reasonable good-faith effort to establish that a borrower has the capacity to repay a loan. The rule establishes 8 underwriting criteria that lenders may use to satisfy this rule and protect themselves from predatory lending enforcement actions. The data items that must be collected, verified and maintained are similar to data that would normally be used to underwrite a loan using a model or scorecard approach.

The ATR rule does not prohibit the use of qualitative information in the underwriting process, but if the lender wants safe harbor, it must adopt the technology and expense of a scorecard lender even if the true loan underwriting decision is based on soft information. Moreover, should the borrower's data not be sufficient or verifiable under the ATR guidelines, a soft-information lender is exposed to the costs of future litigation should the loan become non-performing.

The ATR and QM regulations make it risky to underwrite mortgage loans based on qualitative information gathered through the bank-customer relationship. These requirements impose significant new costs on many smaller institutions, and, for small volume banks, these costs may not be recoverable even if mortgage origination fees are increased to the maximum permissible under QM rules. In addition to creating potentially prohibitive compliance costs, many community bankers believe that the QM and ATR rules preclude them from using soft information to gain a competitive lending advantage over larger scorecard-based lenders.[5]

The QM and ATR rules will significantly increase small bank compliance costs

Community banks argue that the CFBP's QM and ATR rules significantly increase their costs of regulatory compliance and some regulatory officials have acknowledged these arguments. For example, in a February 2013 speech, Federal Reserve Governor Elizabeth Duke estimated that DFA would require small banks, those with less than $50 million in assets, to hire one extra full time person to manage mortgage regulatory compliance.[6] A larger bank, for example one with $500 million in assets, would likely require three extra full time staff.

These compliance cost estimates can be used to gauge the impact of these new mortgage rules on community banks' costs and profitability. For banks with less than $50 million is assets, I estimate the impact of adding one additional full-time employee for DFA mortgage compliance. For banks in the $50-$150 million range, 1.5 full-time equivalent staff are added. Banks in the $150-$250 million range require two additional full-time staff, while banks between $250 and $500 million are assumed to add three full-time employees. In each case, the added compliance cost is estimated by assuming that each new bank employee receives salary and benefits equal to the bank's current actual average cost per employee calculated from June 2013 regulatory report data. Using the average cost of a bank employee is conservative as compliance experts are likely to earn more than an average banker's salary.

Each bank's pre-tax ROA on continuing operations is calculated as the ratio of bank reported pre-tax operating profit to assets.[7] The effect of new DFA mortgage compliance costs are estimated by reducing the bank's reported pre-tax operating profit by the estimated increase in compliance cost and a revised pre-tax ROA is calculated. The results of this simulation are reported in Exhibit 1.

Exhibit 1: Dodd-Frank Mortgage Compliance Cost Implications for Community Banks

Banks Size Group	Number of Banks	Number of banks with negtive pretax operating earnings	Average pre-tax ROA (bps)	Average number of employees	Number of banks with negative pre-tax operating earnings *	Average pre-tax ROA*	Average number of employees*
Banks assets less than $50 million	833	142	32.7	10.39	202	16.5	11.39
Bank assets between $50 million and $150 million	2358	239	56.9	26.27	323	50.3	27.77
Bank assets between $150 million and $250 million	1204	118	48.0	50.01	128	44.4	52.01
Bank assets between $250 million and $500 million	1221	78	55.1	85.58	89	51.9	88.58

Source: June 2013 FDIC Statitics on Depository Institutions and the author's calculations. Pretax operating earings are defined as net income before tax and extraordinay itemsand other adjustments minus gains (losses) on securities not held in trading accounts. Pre-tax ROA is defined as pre-operating earnings divided by bank assets and is expressed in basis points.

**Revised estimates for June 2013 using Federal Reserve estimates of the additional compliance staff required for Community Banks to satisfy DFA*

The compliance cost simulation paints a bleak picture for small community banks. Should banks with assets less than $50 million continue to make mortgages on the same terms, the increase in compliance costs will cause 60 additional institutions to post a pre-tax loss. The average pre-tax ROA for this size group will be cut in half and reduced to a non-sustainable return of only 16.5 basis points. The effect on this size group is especially severe since the new DFA regulations will increase their employee expenses by about 10 percent with no beneficial effect on their revenues.

For banks between $50 and $150 million, additional compliance costs are estimated to cause 84 additional institutions to post a pre-tax loss. On average this group's pre-tax ROA will be reduced by over 10 percent to a level of about 50 basis points. As banks increase in asset size, the effects of new mortgage compliance costs are less pronounced, but they still reduce ROAs by about 10 percent.

Banks between $150 and $250 million would earned less than 45 basis points on their assets while those in the $250-$500 million range would have earned earn less than 52 basis points.

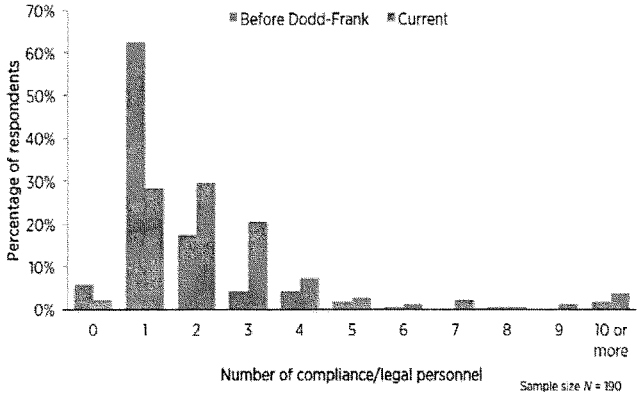
The simulation suggests that, should banks continue to make mortgages on similar terms as in the past, new DFA mortgage regulations will have a large negative effect on the profitability of smaller community banks. Under the Federal Reserve compliance staffing assumptions, larger community banks face a proportionally smaller increase in their staff size, so the compliance effects are less pronounced. Still for all the bank size groups examined above, compliance with the new DFA mortgage regulations are likely to have a pronounced negative effect on the profitability of community banks, and many community banks may simply stop mortgage lending to avoid these new costs.

The implications of the compliance cost analysis are mirrored in the results of a recent survey of community banks.[8] Academic researchers conducted a survey of community banks to gain a better understanding of the effects of DFA regulations on their operations. Bank participation in the survey was voluntarily and anonymous. The finial sample of respondents, 222 banks, have characteristics that are similar to the larger population of community banks. The sample is comprised of small banks (on average $500 million in assets), located across the country but primarily in rural and small metropolitan areas, serving moderate income customers. The average bank in the survey sample had 120 employees, including employees specialized in regulatory compliance. On average, the banks responding to the survey are slightly larger than the average community bank.

Before discussing the results of this community bank survey, it is useful to recall some relevant population characteristics of community banks. FDIC data show that roughly 80 percent of individual banking institutions are smaller than $500 million,[9] the threshold for a bank to qualify as a small business. When it comes to employees, most banks have relatively few. Approximately half of all banks have fewer than 50 employees; almost 25 percent have fewer than 20 employees. A large number of small banks have only a single legal or regulatory compliance professional and many small banks rely on consultants, industry trade organizations, or regulatory outreach to keep track of regulatory changes. The compliance function in many small institutions is not geared to implement hundreds of new rules.[10]

The survey results indicate that the QM and ATR rules have had a substantial impact on community banks' compliance costs. Exhibit 2 shows the number of compliance staff at community bank survey respondents in 2013 compared to their compliance staff before the DFA. Many community banks have more than doubled the number of their staff dedicated to compliance. The biggest factor driving compliance staffing needs are the QM and ATR regulations.

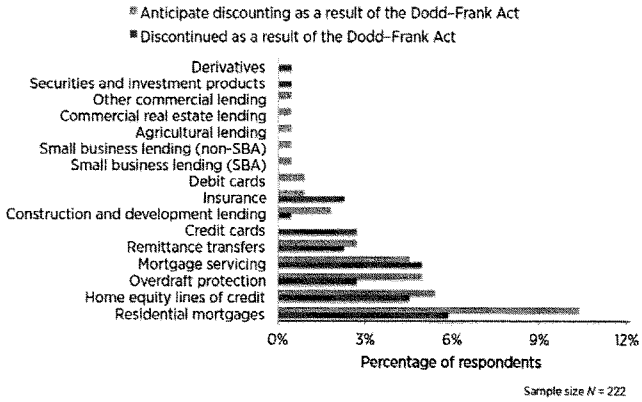
Exhibit 2: Dodd-Frank Impact on Community Bank Compliance Staff



Source: Peirce, Robinson, Stratmann (2014) Figure 20.

In addition to requiring many community banks to increase their compliance staff and costs, the survey results also indicate that many community banks have decided to discontinue their mortgage lending operations rather than absorb higher regulatory compliance costs. Exhibit 3 shows that 16 percent of the community bank sample respondents have either discontinued or plan to discontinue offering residential mortgages, and more than 10 percent have stopped or plan to stop offering home equity lines of credit.

Exhibit 3: Dodd-Frank Impact on Community Bank Product Offerings



Source: Peirce, Robinson, Stratmann (2014) Figure 14.

The evidence on the impact of the DFA QM and ATR regulations is clear: these new rules are making it unprofitable for many community banks to remain in the residential mortgage lending business. When community banks discontinue residential mortgage lending, it is likely to have the greatest impact on rural markets in locations where community banks have few large bank competitors. Large banks frequently do not find it profitable to service sparsely populated rural markets, and in these markets the scale of community bank mortgage operations is unlikely to justify the additional compliance costs associated with QM and ATR regulations.

The discontinuation of mortgage lending at community banks is unlikely to enhance community bank safety and soundness. Historically, residential mortgage lending has been a low risk, low return business for community banks. For the most part, community banks avoided making high-risk subprime mortgages in the past financial crisis. Analysis shows that throughout the financial crisis, residential mortgage lending was, on average, a stabilizing source of profit for community banks.[11]

QM and ATR Regulations Do Not Reduce Risk or Prevent Predatory Lending

The legislative intent behind the QM and ATR regulations is the prevention of predatory mortgage lending. If banks underwrite mortgages that comply with minimum QM and ATR regulatory standards, there is the presumption that borrowers have the ability to repay the mortgages.

In practice, the final form of the QM and ATR regulations is a remarkably lax though onerous government standard for mortgage underwriting. It was designed to aid government policies that encourage mortgage borrowing to reverse home price declines by minimizing constraints on borrowers' ability to qualify for a home mortgage. The QM rule stretches underwriting standards to allow overextended consumers to continue purchasing houses that would otherwise be unaffordable.

Borrowers can satisfy QM standards with only a 3 percent down payment and a subprime (580 FICO) credit score. It is doubtful that the QM rule offers borrows much protection against predatory lending. Regulatory estimates show that, of the GSE mortgages guaranteed between 2005 and 2008, 23 percent of those that meet current QM ATR standards defaulted or became seriously delinquent.[12]

The QM ATR rules do not seem to force a particular lending outcome. A bank could impose underwriting rules stricter than those specified in these rules and underwrite only high-quality mortgages. The problem that arises with this strategy is that such an underwriting rule may risk fair-lending legal challenges.

Disparate Impact Policies Reduce Consumer Access to Mortgage and Auto Loans

One new regulatory tool for directing bank credit is the threat of regulatory charges of loan discrimination. Enforcement actions can now be based on statistical analysis that compares the characteristics of an institution's borrowers to the characteristics of its potential borrowers.[13] If the characteristics of actual borrowers differ from the characteristics of potential borrowers, regulators can undertake an enforcement action based on so-called disparate impact. Regulators have used disparate impact arguments to force banks to restructure their auto and mortgage lending processes.[14]

When bank loan underwriting standards based on objective financial criteria produce an "unbalanced" distribution of credit, lenders can be accused of discrimination. In disparate impact cases, plaintiffs need not any establish evidence of lenders' intent to discriminate. The loan underwriting standards can be completely blind to race, gender, ethnicity, or other protected characteristics, yet if they do not extend credit in a pattern that is consistent with the market population characteristics, the bank may be in violation of fair lending statutes.[15]

Suppose a bank makes loans using a single "facially neutral" underwriting process that uses standard financial analysis to assess a borrower's ability to service a loan. Indeed, neither the bank nor its designated loan officer will record an applicant's race or any other borrower protected characteristics when taking loan applications. A discrimination case can be brought when statistical estimates show that the share of loans that are approved using neutral underwriting standards disproportionately and adversely affect access to credit by a protected characteristic.[16] Again, since the protected characteristics of a bank's borrowers are typically not recorded, these characteristics must be inferred using statistical techniques. Once a plaintiff shows evidence of "statistical discrimination" in lending outcomes, the bank is assigned the burden of proving its own innocence. The disparate impact standard for fair lending enforcement seeks to create a new entitlement for protected characteristics: access to credit from the banking system regardless of borrower credit quality.

How will the disparate impact standard work in practice? Standard finance theory suggests that the bank could serve the underrepresented segment of the population by adding risk premiums to compensate for the expected losses attached to riskier loans. However, this economically sound potential solution could itself easily bring charges of lending discrimination if protected characteristics disproportionally bring about higher rates.

Absent risk pricing, banks seemingly have three possible options to avoid charges of disparate impact. One option is to discriminate against good borrowers. Banks can reduce the credit they grant to non-protected classes until their overall approval ratios balance. Alternatively, banks can extend loans on unfavorable terms to borrowers in protected classes that do not meet their facially neutral underwriting standards and, whenever possible, and raise rates, including those on well-qualified borrowers, to cross-subsidize higher-risk loans. A third option is to combine both strategies.

Because the extension of poorly underwritten and underpriced credits will lower expected bank profits, disparate impact enforcement of fair lending laws is likely to constrain the availability of credit and raise the rates for well-qualified borrowers without protected characteristics.

Disparate impact enforcement of fair lending statutes is controversial. Many scholars believe that a disparate impact standard is inconsistent with the language of the U.S. Fair Housing Act which includes a requirement to prove "intent to discriminate." It is also alleged that disparate impact enforcement violates the Equal Protection Clause of the Fourteenth Amendment to the U.S. Constitution.[17] These issues remain unsettled as many recent regulatory enforcement actions using disparate impact arguments have reached settlements without going to trial.

Volcker Rule CLO Restrictions have Negative Unintended Consequences

Collateralized loan obligations (CLOs) are specialized investment funds that invest primarily in bank loans. CLOs purchase shares in syndicated bank loans, pool the cash flows, and fund the

pool of loans by issuing securities that have a senior-subordinated structure of claims against the loan pool's cash flows. Banks have been involved in organizing CLOs, in originating many of the loans that CLOs purchase, and in purchasing the securities that CLOs issue. CLOs are securitizations similar in concept and structure to private label mortgage-backed securities, only CLOs securitize bank business loans, not residential mortgages.

The Volcker Rule prohibits banks from proprietary trading activities including owning or managing hedge funds or private equity funds. Volcker Rule regulations restrict banks from acquiring or retaining an equity, partnership, or other ownership interest in, or "sponsoring," "covered funds." They also specifically allow banks to purchase or participate in loan securitizations including asset-backed commercial paper and covered bonds. Given the permissible activities enumerated in the final rule, it may come as a surprise to lean that bank investments in many CLOs securities are prohibited by the current Volcker regulations.

Many CLOs have two characteristics that make them inadmissible bank investments under the Volcker Rule. The first issue is that, in addition to owning loans, most CLOs own bonds or have the right to purchase bonds. While bonds typically comprise a small portion of most CLO holdings, any bond holdings make all CLO securities ineligible for bank ownership.

The second feature of CLOs is that senior CLO securities generally have the right to replace the collateral manager should the manager fail to perform required functions. Senior CLO tranches are typically treated as debt securities, but the power to replace the CLO manager gives these securities a key characteristic of an ownership interest and this feature may make them inadmissible under current Volcker regulations.

While the market can probably adapt and issue new Volcker-compliant CLOs structures, the problem of course is that banks already own inadmissible CLOs, more than $70 billion of them according to one estimate.[18] If the rules are unchanged, these inadmissible securities would have to restructured or sold by July 21, 2015. Restructuring existing CLOs to remove and prohibit bonds, and change senior tranche management rights, would be difficult. All of the owners of the various tranches of the CLO would have to agree to the changes, and the interests of all CLO security holders are not aligned. The negotiations needed to accomplish a CLO restructuring would be similar to reorganizing a corporation's capital structure in a bankruptcy.

Following the regulatory release of the final Volcker Rule in December, CLO issuance declined sharply but recovered somewhat in February as CLO structures changed in response to the regulatory rules.[19] Going forward, it appears likely that CLO structures can be adapted to be Volcker-compliant. Still, there is probably no safety and soundness benefit to be gained by forcing banks to restructure or divest their legacy CLOs.

Regulators should move quickly to remove regulatory uncertainty and modify Volcker regulations to grandfather bank existing CLO investments. Bank holdings make up a sizeable share of outstanding CLOs, and it is unlikely banks could divest these holding without negatively impacting CLO security prices. Should banks be forced to take sizeable losses on CLO divestitures, it would likely have negative ramifications for credit availability.[20]

New Systemic-Risk Powers are being used to Restrict Business Credit

Recent reports suggest that regulators intervened and stopped some banks from making specific "leveraged loans." Regulators objected to leveraged loan deals being originated by JPMorgan

Chase, Bank of America, and Citigroup on the grounds that they violated new regulatory safety and soundness guidelines issued in March 2013.[21]

Citigroup reportedly was forbidden to make loans associated with a KKR and Co. buyout of Brickman Group Ltd., and Bank of America and JPMorgan reportedly were pressured to pass on originating loan funding for a Carlyle Group acquisition of a Johnson and Johnson subsidiary. Press accounts estimate these regulatory actions cost Citibank $10 million and JPMorgan and Bank of America more than $20 million each in lost fee income.

These deal-specific regulatory lending prohibitions took many market participants by surprise. In the past, an individual bank might receive a blanket prohibition against certain types of business transactions if regulatory examinations revealed material weaknesses in a bank's risk management or controls. Typically, prohibitions are articulated in a memorandum of understanding between the bank and its regulator. Certain new activities may be banned until specific bank safety and soundness issues are remedied. In the past, it would have been highly unusual for US regulators to prohibit specific loans and approve others—this has typically been the banker's job.

Leveraged loans are a core banking business involving loans to sub–investment-grade firms.[22] Loan shares typically are syndicated to a group of banks and other financial institutions. Like many other types of bank loans, leveraged loans are risky, and some default. Still, as an asset class, regulatory data show that bank-leveraged loans outperformed bank mortgages, construction and development loans and sub–investment-grade bonds throughout the recent financial crisis.

Bank regulators issued new regulatory guidelines for leveraged lending in March 2013. These guidelines include new specific thresholds for commonly used debt-service coverage ratios that will be used by regulators to flag deals that create "excessive" leverage. The new regulations also include vague and far-reaching discretion that allows regulators to prohibit loans even if they pose no immediate risk to the originating bank.

Under the new guidance, regulators need argue only that a loan is poorly underwritten and may become a risk to the ultimate investors, and it can be prohibited. The new regulatory discretion to prohibit loans that create "systemic risk" is especially troubling because systemic risk has never been clearly defined. Still, regulators are increasingly making use of this new systemic-risk power including to quash the specific leverage loan deals mentioned in January 2014 press reports. Regulators did not stop these deals because they posed safety and soundness risks to the originating banks, but rather, because regulators think these deals are fueling a bubble in high-yield mutual funds.

In March 2013, the Federal Reserve voiced concerns of a "bubble" in the leveraged loan market.[23] More recent statements by a senior deputy comptroller of the Office of the Comptroller of the Currency (OCC) specifically mentioned the possibility of a bubble in the market for junk-rated credit.[24] The OCC official argued that financial-sector stability could be at risk if banks continue to work with asset managers to originate leverage loan deals and transfer this loan risk to mutual funds.

Regulators have misinterpreted the Cause of the Leveraged Loan "Bubble"

Bank regulators are using their systemic-risk powers to stop banks from originating leverage loans to stem an alleged bubble in mutual funds. But cutting off the supply of new leveraged loans for mutual funds to purchase will only make the credit bubble worse. If there is strong investor demand for leveraged-loan mutual fund shares, limiting new leveraged loan supply will only reduce leverage loan yields, worsening the mispricing of credit risk and the alleged bubble. With more favorable credit spreads, industry demand for new leveraged borrowing will be further stimulated and bank regulators will be forced to increase their loan rationing. Clearly, it is important to understand why such strong investor demand for leveraged loans exists before intervening to restrict new loan supply in this market.

After bottoming out in 2008, leveraged loan originations recovered as low interest rates allowed firms to refinance their outstanding bank loans. 2013 brought a record $605 billion in originations, besting the prior issuance record of $535 billion in 2007.[25] Takeover activity, often an important source for new leveraged loans, has not been particularly strong.

Before 2013, much of the supply of new leveraged loan originations stayed in the banking system. Collateralized loan obligations (CLOs)—special financial entities that purchase and securitized leverage loans—provided a strong source of demand for leveraged loan originations. CLOs purchase a large number of leveraged loans and tranche the cash flows from the loan pool into senior-subordinated structures similar to those associated with private-label mortgage-backed securities issued in abundance before the financial crisis. The resulting CLO bond securities (tranches) are rated by National Statistical Rating Organizations. Historically, banks have been important sponsors for CLOs and have often purchased highly-rated CLO tranches for bank investments.

In early 2013, bank CLO demand for leveraged loans diminished as changes in the rules for calculating deposit insurance premiums made CLO securities less attractive to large banks. Beginning in April 2013, the FDIC implemented changes in the scorecard it uses to set insurance premiums for banks with more than $10 billion in assets. The changes increased deposit insurance rates for banks holding CLOs and leveraged loans.[26] It effectively became more expensive for banks to hold leveraged loans or CLO tranches and so these exposures migrated out of bank portfolios.

Shortly after deposit insurance rules reduced banks' demand for CLOs and leveraged loans, mutual fund demand for leveraged loans was stimulated by the Federal Reserve taper scare in May. When former Federal Reserve chairman Ben Bernanke suggested the Fed might begin tapering its QE purchases, investors were surprised and reacted by selling long-term Treasury bonds, causing long-term rates to rise. This rise generated losses for bond fund investors. Yield-hungry investors sold bond funds and invested in high-yield loan funds as an alternative to junk bond investments.

Unlike junk bonds, which typically have fixed coupon rates, leveraged loans are floating rate instruments and so are less exposed to the risk of rising Treasury rates. Following the taper scare, high-yield loan funds absorbed a large share of bank-leveraged loan originations. Retail and institutional investors, desperate for yield and fearful of a jump in long rates, moved money into funds filled with leveraged loans and credit risk. Some analysts have compared the risk profiles

of high-yield mutual funds to the risks run by high-yield money funds prior to the Lehman bankruptcy and argued that credit losses could trigger a run on these funds and generate wider systemic risk in financial markets.

Bank regulators are now trying to throw sand in the gears of leveraged loan originations in an attempt to stall what they view to be a bubble building in high-yield mutual funds. In evaluating this policy, it is important to understand that the true source encouraging investor demand for high-yield floating rate loans is the Federal Reserve's zero-interest-rate policy.

Under the prolonged policy of zero interest rates, investors lack short-maturity alternative investments with measurable yields. Indeed, for most retail investors, the rebates on their credit card purchases far outstrip the interest they earn on bank deposits and money funds. Investors also face the prospect of near-certain capital losses on long-term bond investments should they invest for yield using these investments.

In the current environment, it is not surprising that investors have a strong demand for mutual funds that invest in high-yield floating-rate loans. Unless they take equity market risk or choose to earn nearly nothing in short-term deposits and money funds, yield-focused investors have few alternatives but to take on exposure to credit risk through leveraged loan funds. The bank regulatory policy of artificially restricting the supply of leveraged loans will only reduce the yield that investors earn on these mutual fund shares, reinforcing the loss in retail saver interest income earned under Federal Reserve QE policies.

The source of the alleged bubble is not demand for excessive bank or corporate leveraging, but rather investor-driven demand for yield and protection against losses from anticipated increases in long-term interest rates. Safety and soundness bank regulations are being used to restrict business credit and limit the yields retail investors earn to allow the Federal Reserve to continue a monetary policy designed to stimulate growth in consumer mortgage credit.

DFA Mandated Stress Tests Give the Federal Reserve Unlimited Regulatory Power

Legislators were impressed with the results of the 2009 (SCAP) stress tests and so they incorporated mandatory stress test requirements for large banks and bank holding companies into the DFA. The Federal Reserve has been performing stress test for the largest bank holding companies for a few years now, and for the first time this year large deposit-taking institutions must also participate in the stress test process. Are all these stress test really useful?

From a purely scientific standpoint, the ability of macro-scenario stress tests to uncover hidden financial weaknesses in an institution is virtually nil. Anyone who has modelled bank profits and loss and attempted to link them to GDP, unemployment, or any other macro indicator will tell you that these models do not work very well. Within a historical sample period, the best models leave the most of the variation in bank profit and loss data unexplained—meaning that the behavior of bank profits and losses cannot be reliably modeled. The performance of these models out of sample—in a true forecast situation—is truly horrible. This is, of course, why the Federal Reserve will not reveal its own stress test model loss estimates to bank holding companies or even to the other Federal bank regulatory agencies who are involved in the DFA mandated stress tests.

Is the lack of compelling scientific evidence to support a stress testing approach to regulation important? Yes. It gives the Federal Reserve (and now the OCC and the FDIC) a virtual "blank check" to control the lending, capital, and payout policies of the largest banks and bank holding companies.[27]

Should the Federal Reserve want to limit dividends or share buy-backs, or restrict a line of bank business, it merely has to assert that the bank fails the stress test on the grounds that its proprietary stress tests models show bigger losses than the bank's estimates, and the banks just have to accept that finding. These are purely hypothetical bank losses realized in a fictional stress scenario estimated using questionable statistical methods without any minimum standard for disclosure or forecast accuracy. And yet the Federal Reserve can use this process to apply any capital or regulatory standard it desires.

Among the classes of models that banks typically employ to measure financial risk, macro-scenario stress test models are by far the worst performers. And still they are being used as a tool for institution-specific regulation. The DFA stress test requirements are a poster example of bad regulation. While the Federal Reserve (and soon the other bank supervisors too) love them because of the power they convey over large banks operations, there is no sound experience-based history that supports their use. Unfortunately, the stress test requirements have already spawned a very profitable consultancy business where banks pay significant sums to "recognized experts" and consultancies (most in demand are those recently departed from the Federal Reserve) to develop models to satisfy the DFA stress test requirement but are mostly useless for any other practical business purpose.

Regulators should redirect their time and resources toward understanding the institutions they supervise rather than wasting time identifying the "best" hypothetical loss estimate among those generated by really bad alternative models. As currently administered, the stress test requirement destroys banks' shareholder property rights and compromise banks' ability to appeal misguided regulatory findings when they occur.

DFA "Systemic-Risk" Powers Extend the Jurisdiction of Bank Regulators

The exercise of bank regulators' new systemic-risk powers is not limited to banks. Through the very subjective process of systemically important financial institution (SIFI) designation, the Financial Stability Oversight Council (FSOC) may designate large nonbank financial institutions as "systemically important."[28] The DFA enumerates the general designation criteria that the FSOC must consider but gives the FSOC discretion to determine the thresholds needed to achieve SIFI status for each of the DFA criteria.[29]

If a designated institution does not agree with the SIFI designation, it can appeal the decision to the FSOC. If the FSOC does not rescind its designation, the institution has the right of judicial appeal. However, in practice there is little to gain from a judicial appeal. The vagaries of the designation criterion in the DFA make it very unlikely that the courts would overturn an FSOC designation. Perhaps the only way to place limits on the regulators' new-found ability to expand their own jurisdiction with any legislative approval is to amend the DFA and constrain the FSOC's designation authorities.

A SIFI designation requires the Federal Reserve to exercise its large bank holding company powers over the designated financial institution, even though the institution may have nothing to

do with banking. The Federal Reserve, moreover, has determined that the DFA Collins Amendment requires it to impose capital rules consistent with those that apply to banks and bank holding companies on all SIFIs. So each designated SIFI will be regulated like a large bank holding company regardless of whether the institution uses insured deposit funding or even makes extensive use of leverage.[30]

Banking regulators, the dominant principals on the FSOC, have made aggressive use of the SIFI designation power. For example, the FSOC designated a large insurance firm over the formal objections of multiple nonbank regulatory members of the FSOC. Bank regulators are the leading advocates for FSOC SIFI designation for large asset management companies. For example, bank regulators' use of the systemic-risk clause to prohibit leveraged loans destined for mutual fund portfolios echoes arguments recently made in the Office of Financial Research's report *Asset Management and Financial Stability*.[31] The September report, prepared at the request of the FSOC, identified mutual fund "reach for yield," "herding," and the potential for "fire sales" as sources of systemic risk. The FSOC has also expressed the bank-centric regulatory view that money market and close substitute higher-yielding funds pose a continuing threat to financial stability.[32]

Given the skewed voting power and influence on the FSOC, the DFA gives bank regulators a ready path for extending their jurisdiction over nonbank financial institutions. Aside from votes, the bank regulatory agencies resources dwarf those of the remaining FSOC members. For example, the total 2013 budgets for selected FSOC member institutions were: CFTC ($201.7 million), SEC ($1.255 billion), OCC ($1.1 billion), the FDIC ($2.7 billion), and the Federal Reserve ($5.1 billion). The combined Federal bank regulators budget of $8.9 billion is more than 6 times the combined budgets of the SEC and CFTC. The SEC[33] and CFTC[34] moreover have testified that that they lack the resources needed to carry out their oversight responsibilities and craft the rulemakings mandated by the DFA. Meanwhile, the Federal Reserve has expanded its already comparatively enormous staff to devote more resources to systemic risk, the FSOC, and regulatory matters.[35]

While bank regulators are busy making a case for SIFI designations for large insurers and asset management companies based on dubious financial stability arguments, it is reasonable to ask why they have not considered GSE designations. The housing GSEs, despite their size, central importance, and huge need for government assistance, have not been designated as SIFIs. They received more support than any of the designated SIFIs and are the repository of most new mortgage risk since 2008, and yet they are exempt from the heightened prudential capital standards required of designated bank and nonbank SIFIs. Exempting housing GSEs from SIFI designation prolongs the government's ability to direct lending and subsidize housing finance without focusing on sorely needed reforms.[36]

Financial Regulators' Systemic-Risk Powers Threaten Competitive Financial Markets

Banking regulators are interpreting DFA systemic-risk powers as a broad grant to identify and prohibit any lending or financial activity they judge to be potentially destabilizing for the financial system. Unfortunately, history shows that regulators do not always fully understand financial system developments.

Regulators have a history of missing building financial imbalances and, left to exercise their own preferences, could easily discourage new financial innovations that promote financial efficiency and economic growth. Undoubtedly, systemic-risk powers will be beneficial when we have benevolent regulators who can see into the future, but until then, the rules create a dangerous new avenue for government to exercise control over the extension of credit. There are few practical checks or balances on these vague systemic-risk powers.

A particularly troublesome aspect of regulators' new systemic-risk powers is that systemic risk is never clearly defined in law. Essentially nothing prevents regulators from crying "systemic risk" to prohibit any type of lending in disfavor by the government. Regulators might, for example, stop a bank loan funding a specific merger by claiming systemic risk when the real underlying motivation is the protection of a labor union. Or regulators might use systemic risk to veto a bank loan to fund entrepreneurs in an "out-of-favor" (e.g., carbon-based) industry or a loan to a firm competing against firms with politically influential owners.

In the recent case where regulators prohibited leveraged lending, a senior OCC official said the agency would look unfavorably on leveraged loans to private equity firms that are used to pay dividends.[37] At face value, this policy certainly restricts loans that benefit the so-called "1 percent" who work in the private equity industry. As long as regulators can prohibit specific loan transactions by simply arguing that the loans are a source of systemic risk, the scope for the government to use its discretion to withhold bank credit bank is unchecked.

The Dodd-Frank Act granted financial regulators broad new powers and the responsibility to prevent "systemic risk" without providing a clear definition of "systemic risk." As a consequence, financial regulators have been given wide latitude to exercise their judgment in defining firms, products, specific financial deals, and market practices that create systemic risk and require additional regulation. This process lacks Congressional checks and balances and creates an enormous new source of regulatory uncertainty for many private sector financial firms that had nothing to do with prior financial crisis and do not benefit from deposit insurance or other implicit government safety nets guarantees.

Conclusion

History has shown, many times over, that when governments try to use private financial markets to carry out targeted lending policies they often end up promoting the extension of nonviable credits. These credits will require a government subsidy somewhere in their life cycle. Often, the subsidy takes the form of a taxpayer bailout of banking losses when the government-directed loans eventually sour. When government policies force banks and other private financial institutions to make unprofitable loans, they impose an invisible tax that discourages the development of the financial system. Eventually resources leave the financial sector, reducing consumer and business access to credit, which limits economic growth.

The financial reforms enacted in the DFA have given government regulators many new powers, including the ability to use the banking system to implement politically driven lending policies. These new rules, many well-intentioned, have created a number of negative unintended consequences. New consumer mortgage protection rules have layered on compliance costs to a degree that many smaller banks are withdrawing from the mortgage market. Other new

regulatory enforcement policies aimed at preventing loan discrimination treat consumer credit as a virtual entitlement and likely increase the cost and restrict the credit access of well-qualified borrowers. Particularly problematic are the new systemic risk powers the DFA confers on financial regulations. Without a restrictive legislative definition of systemic risk, regulators—particularly bank regulators—are finding systemic risk nearly everywhere they decide to look, and they are taking actions to extend their own jurisdiction to contain the symptoms they identify.

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[1] For additional details see, Peter Wallison, "Only a private housing finance market can create stability," http://www.aei.org/outlook/economics/financial-services/housing-finance/only-a-private-housing-finance-market-can-produce-stability/

[2] Jim Puzzanghera,"FHA to get $1.7 billion in its first taxpayer-funded bailout," http://articles.latimes.com/2013/sep/28/business/la-fi-0928-fha-bailout-20130928

[3] Brian Collins, "Lenders Use Budget Data to Lobby FHA for Lower Premiums," http://www.americanbanker.com/issues/179_45/lenders-use-budget-data-to-lobby-fha-for-lower-premiums-1066076-1.html?utm_campaign=daily%20briefing-mar%207%202014&utm_medium=email&utm_source=newsletter

[4] There are different definitions of community banks. A common definition used by the Federal Reserve is banks with under $10 billion in assets.

[5] See, for example, Andy Peters, "What Would you tell the CFPB? This Georgia Banker Had His Shot," http://www.americanbanker.com/people/what-would-you-tell-the-cfpb-this-georgia-banker-had-his-shot-1066070-1.html?utm_campaign=daily%20briefing-

[6] Federal Reserve Governor Duke's speech at the Southeastern Bank Management and Directors Conference, University of Georgia, Terry College of Business, Duluth, Georgia.

[7] Pre-tax operating profit is income before tax and extraordinary items and other adjustments minus the gain (loss) on securities not held in trading accounts.

[8] Hester Peirce, Ian Robinson and Thomas Stratmann (2014), "How are small banks faring under Dodd-Frank?," Mercatus Center Working Paper No. 14-05, George Mason University.

[9] The analysis in this section are based on the authors calculations using FDIC Statistics on Depository Institutions, http://www2.fdic.gov/sdi/index.asp

[10] This message was clearly conveyed in the community bank interviews that took place during the 2012 FDIC Community Bank Study.

[11] Paul Kupiec and Yan Lee (2012), "What Factors Explain Differences in Returns on Assets Among Community Banks?" http://www.fdic.gov/regulations/resources/cbi/report/cbi-roa.pdf

[12] See the discussion in Edward J. Pinto, Peter J. Wallison, and Alex J. Pollock, "Comment on Proposed Credit Risk Retention Rule," AEI, October 30, 2013, www.aei.org/files/2013/10/31/-comment-on-the-proposed-credit-risk-retention-rule_0725007171.pdf

[13] The US Department of Housing and Urban Development issued its final rule on the use of disparate impact analysis as means for legally assessing compliance with the 1964 Fair Housing Act on February 15, 2013. See Rules and Regulations, *Federal Register* 78, no. 32 (February 15, 2013), www.gpo.gov/fdsys/pkg/FR-2013-02-15/pdf/2013-03529.pdf.

[14] The U.S. Department of Justice has reached fair settlements in cases alleging mortgage fair lending violations based on disparate impact with Countrywide, Wells Fargo, and SunTrust, among others. See, for example, http://www.propublica.org/article/disparate-impact-and-fair-housing-seven-cases-you-should-know. For a decision of a recent auto lending disparate impact settlement see, Richard Riese, "Regulators Forced Ally's Hand on Unlawful Auto Lending Settlement," http://www.americanbanker.com/bankthink/regulators-forced-allys-hand-on-unlawful-auto-lending-settlement-1066038-1.html

[15] The list of what constitute "protected characteristics" in these cases has been expanding over time.

[16] In the case of mortgages, the government can alter the bank's calculus by using GSE affordable housing goals as a means for transferring the risk of low-quality loans from the originating banks to a government-sponsored agency.

[17] See the November 19, 2013 testimony of Hon. Kenneth L. Marcus before the U.S. House of Representatives Committee on Financial Services Subcommittee on Oversight and Investigation, "General Overview of Disparate Impact Theory."

[18] Estimates are provided in Jesse Hamilton and Cheyenne Hopkins, "Volcker Rule Curbs on Banks Owning CDOs Eased in U.S.," http://www.businessweek.com/news/2014-01-14/u-dot-s-dot-regulators-said-ready-to-ease-volcker-cdo-limits-for-banks

[19] Kristen Haunss, "CLO Issuance Jumps as U.S. Managers Bet on Volcker Rule Verdict," http://www.bloomberg.com/news/2014-02-19/clo-issuance-jumps-as-u-s-managers-bet-on-volcker-rule-verdict.html

[20] The academic evidence suggests that when banks take losses, they curtail their loan growth, even when the losses were not generated by bank-originated loans. See, for example, Kupiec, Lee and Rosenfeld (2013), "Macroprudential Policies and the Growth of Bank Credit," and the references therein, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2368989

[21] Gillian Tan, "Banks Sit Out Riskier Deals," *Wall Street Journal*, January 21, 2014, http://online.wsj.com/news/articles/SB10001424052702304302704579334820201530010.

[22] By some estimates, leveraged loan originations generated about 25 percent of all investment banking revenue in 2013. See Matt Wirz, "'Junk' Loans Pick Up the Slack," *Wall Street Journal,* January 9, 2014, http://online.wsj.com/news/articles/SB10001424052702303754404579310643802262108.

[23] Mark Gongloff, "Credit Bubble Comeback: Feds Warn of Dangers in Leveraged Loan Market," Huffington Post, March 2, 2013, www.huffingtonpost.com/2013/03/22/credit-bubble-leveraged-loan_n_2932421.html.

[24] Greg Roumeliotis, "Exclusive: U.S. Banking Regulator, Fearing Loan Bubble, Warns Funds," Reuters, January 29, 2014, www.reuters.com/article/2014/01/29/us-banks-regulators-loans-idUSBREA0S0DG20140129.

[25] Wirz, "'Junk' Loans Pick Up the Slack."

[26] The FDIC's new deposit insurance premium scorecard was finalized in 2011, well before regulators expressed fears of a bubble in leveraged lending. Therefore, the FDIC increase in deposit insurance charges for leveraged loans was completely separate from bank regulators' systemic-risk campaign against leveraged loan origination.

[27] As recently as last summer, the FDIC did not have its own proprietary stress test model.

[28] Designation requires a two-thirds majority, including the vote of the secretary of the Treasury.

[29] The criteria are broad and include size, complexity, importance as a source of credit, and interconnectedness.

[30] Indeed, as the Office of Financial Research report on the asset management industry suggests, the FSOC is considering designating mutual funds even though they have limited ability to borrow and are funded with nearly 100 percent shareholder equity.

[31] Office of Financial Research, *Asset Management and Financial Stability*, September 2013, www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx.

[32] Financial Stability Oversight Council, *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, November 2012, www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

[33] In its 2014 budget appropriation, the SEC chairman testified that it required a 26 percent increase over its 2013 budget to fulfill its regulatory obligations, but was awarded an increase of only 2 percent. See Bruce Carton, "SEC to Receive 2% Budget Increase in F.Y. 2014, Far Below 26% Requested Increase," http://www.complianceweek.com/sec-to-receive-2-budget-increase-in-fy-2014-far-below-26-requested-increase/article/329305/

[34] See Sarah Lynch, "Acting CFTC head pleads with U.S. Congress for more funding," http://www.reuters.com/article/2014/03/06/us-house-cftc-budget-idUSBREA251HR20140306

[35] Detailed data on the Federal Reserve Board's budget and staff size are illusive. The Federal Reserve Board has by far the largest staff of economists of any bank regulatory agency. Still, the Fed's post Dodd-Frank spending outpaces all other regulatory agencies. For example, its budge summary shows it increased spending on employees by 10.3 percent in 2012 and 9.8 percent in 2013. http://www.federalreserve.gov/publications/budget-review/2013-federal-reserve-system-budget.htm

[36] For example, see Alex J. Pollock, "How Do You Solve a Problem Like Fannie?" *Wall Street Journal*, December 23, 2013, http://online.wsj.com/news/articles/SB10001424052702304011304579220154026887972.

[37] Tan, "Banks Sit Out Riskier Deals."

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TESTIMONY

ENDING THE FEDERAL RESERVE SYSTEM'S OVERREACH INTO CREDIT ALLOCATION

BY LAWRENCE H. WHITE

Subcommittee on Monetary Policy and Trade
House Committee on Financial Services

March 12, 2014

Chairman Campbell, Ranking Member Clay, and members of the Subcommittee, thank you for inviting me to testify on "Federal Reserve Oversight: Examining the Central Bank's Role in Credit Allocation." In my testimony I will argue that the Federal Reserve's attempts to direct the allocation of credit are overreaching, wasteful, and fraught with serious governance problems. A central bank charged with the crucial task of conducting monetary policy should focus on monetary policy. Accordingly, the Fed should be removed from the formulation and implementation of credit policy.

Prior to 2007, the Federal Reserve System undertook five main roles: (1) clearing and settlement of checks, (2) issue of paper currency, (3) supervision and regulation of commercial banks, (4) "lender of last resort," and (5) monetary policy. Since 2007, at its own initiative, the Fed has expanded its range of activities by undertaking unprecedented *credit allocation policies* that do not fit into any of these traditional categories.

A LIST OF RECENT CREDIT ALLOCATION POLICIES AND THEIR BENEFICIARIES

By "credit allocation policies" I mean efforts to redistribute financial funds toward uses that Federal Reserve policymakers prefer and (implicitly) away from other uses that market actors prefer. Based on a compilation by the Government Accountability Office (2011), with two additions, here is a list of twenty-two Fed credit allocation initiatives in recent years, the dates they commenced, and their beneficiaries:

- Term Auction Facility (Dec. 2007): depository institutions
- Dollar Swap Lines (Dec. 2007): foreign-domiciled commercial banks doing US dollar business
- Term Securities Lending Facility (Mar. 2008): primary dealers, a set of select Wall Street securities firms (numbering 20 at the time) from whom the New York Fed trading desk routinely buys bonds, and to whom it sells bonds, in the execution of monetary policy operations
- Primary Dealer Credit Facility (Mar. 2008): primary dealers
- Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (Sept. 2008): money market mutual funds (MMMFs)

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- Commercial Paper Funding Facility (Oct. 2008): issuers and holders of commercial paper
- Money Market Investor Funding Facility (Oct. 2008, but never used): MMMFs
- Term Asset-Backed Securities Loan Facility (Nov. 2008): holders of mortgage-backed securities (MBS)
- Bridge Loan to JP Morgan Chase (Mar. 2008): JP Morgan Chase; Bear Stearns shareholders, bondholders, and counterparties
- Maiden Lane LLC (Mar. 2008): JP Morgan Chase; Bear Stearns shareholders, bondholders, and counterparties
- Revolving AIG Credit Facility (Sept. 2008): AIG and its counterparties
- Securities Borrowing Facility (Oct. 2008): holders of MBS
- Maiden Lane II LLC (Nov. 2008): AIG counterparties, esp. Goldman Sachs
- Maiden Lane III LLC (Nov.10, 2008): AIG counterparties, esp. Goldman Sachs
- Life Insurance Securitization (March 2009, but never used): AIG counterparties
- Credit extensions to affiliates of some primary dealers (Sept. 2008): four broker-dealer firms
- Citigroup non-recourse lending commitment (Nov. 2008): Citigroup
- Bank of America non-recourse lending commitment (Jan. 2009): Bank of America
- Agency Mortgage-Backed Securities Purchase Program (Nov. 2008): bondholders of Fannie Mae and Freddie Mac
- Operation Twist (Sept. 2011; enlarged June 2012), replacing short-term securities with long-term securities in the Fed's portfolio to reduce long-term interest rates relative to short-term rates: holders and guarantors of long-term MBS, housing finance firms that originate long-term fixed-rate mortgages, and housing construction firms
- Quantitative Easing 1 (Jan. 2009), $1250 billion in MBS purchases, but with its effects on broader monetary aggregates (M2) offset by paying interest on reserves: holders and guarantors of MBS housing finance firms, and housing construction firms
- Quantitative Easing 3 (Sept. 2012), ongoing MBS purchases of $40 billion per month, similarly offset by interest on reserves: holders and guarantors of MBS, housing finance firms, and housing construction firms

INEFFICIENCY OF DIRECTED CREDIT ALLOCATION

Credit is fungible and can be re-lent in search of the highest risk-adjusted returns, so some of the lending programs listed above may have had little impact on the final allocation of credit. To the extent that they did alter the allocation of credit, the programs are more likely than not to have been wasteful, directing funds to less than most productive uses, even if Fed policymakers have had the best of intentions. While the beneficiaries of the programs are obvious, a full analysis must also consider the costs. The losers from preferential credit allocations are all those potential users of funds—often difficult to identify with any specificity—who suffer by having credit diverted away from them.

Financial markets generate prices and quantities of financial assets by aggregating the decentralized judgments of millions of market investors, who are staking their own funds, about the most promising avenues for investment. In credit allocation policy, Federal Reserve officials, risking taxpayer funds, substitute their own judgment about the proper prices of various securities and the proper shares of the supply of funds that should go to specific firms or segments of the financial

market. The likelihood that any central committee can improve on a competitive market's allocation of funds, even if the committee is limited to tinkering around the margins, is vanishingly small. In particular, a committee that allocates funds to prop up insolvent financial firms, making investments that prudent market participants shun, is following a recipe for throwing good money after bad.

The Dodd-Frank Act of 2010 restricts special Fed lending to "broad-based" programs, ruling out any program limited to a single firm. While a step in the right direction, having this rule in place before 2010 would have ruled out only about half of the credit allocation programs listed above.

QUANTITATIVE EASING PLUS INTEREST ON RESERVES

The Fed has defended the last two items on the list, its massive QE1 and QE3 purchases of mortgage-backed securities, as the conduct of monetary policy. Monetary policy means that the central bank *varies the economy's stock of money* in pursuit of some ultimate goal (like low inflation or milder business cycles). The Fed's decisions about *how many* securities to purchase represent monetary policy, because they alter the size of the monetary base, also known as the stock of "high-powered money." But the Fed's decision to purchase *mortgage-backed* rather than *Treasury* securities does *not* qualify as monetary policy because it does not affect the impact of securities purchases on the monetary base or broader monetary aggregates.

Furthermore, the QE programs have been deliberately *combined with interest on reserves in order to negate their monetary policy impact*, that is, to minimize their impact on the volume of money stock held by the public. This "sterilization" can be seen in the unaltered path in the broader monetary aggregate M2, even while the monetary base has skyrocketed (figures 1 and 2). Credit allocation policy, by contrast, seeks to redistribute a given volume of credit (say, the bank loans and securities purchases funded by M2 deposits) and to change the relative prices of assets.

Figure 1. Monetary base, total (BOGMBASE)

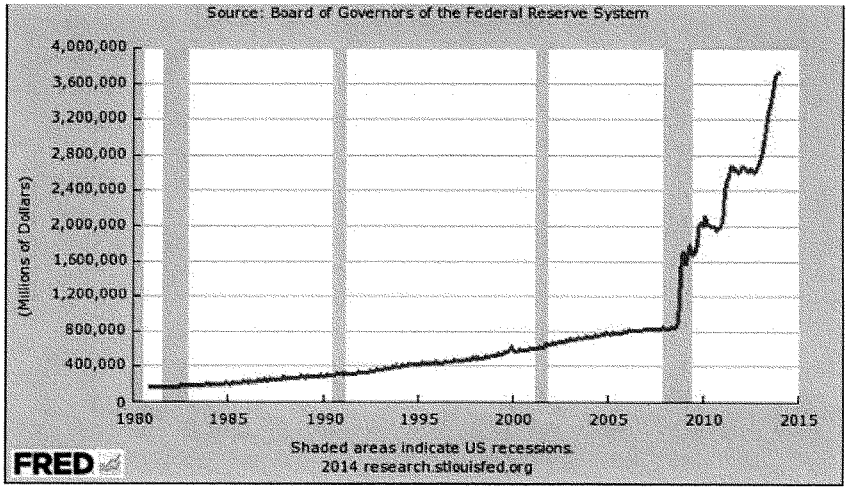
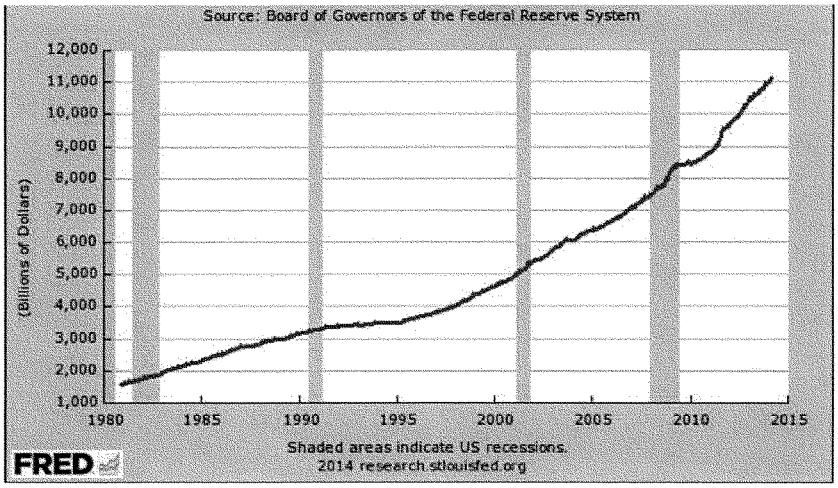


Figure 2. M2 money stock (M2)



The Fed's asset purchases since 2009 (QE1, 2, and 3) have dramatically increased the monetary base, but the Fed has paid sufficient interest on reserves to keep the excess bank reserves bottled up and thus the stock of money held by the public (M2) on a nearly undisturbed growth path.

The combination of QE1 and QE3 with interest on reserves is accurately categorized not as monetary policy but as fiscal policy. The Fed's aim has not been to alter monetary aggregates but to raise the price of mortgage-backed securities relative to other securities. The Fed is, in effect, borrowing funds from the commercial banks (inducing them to hold massive excess reserves by paying interest on reserves at a rate comparable to the prevailing rate on short-term Treasury bills) in order to spend the proceeds bidding up the price of MBS. In general, borrowing and spending in pursuit of a policy goal (here, higher MBS prices) is fiscal policy, not monetary policy.

TARGETED LENDING PROGRAMS

The Fed has defended its extraordinary targeted lending programs, including its bailouts of Bear Stearns and AIG in 2008, as falling under the Fed's traditional role as a "lender of last resort" (LLR). That defense stretches the classical LLR concept beyond all reasonable interpretation. A classical LLR temporarily lends reserves to illiquid banks as copiously as necessary to prevent money and credit from contracting system-wide but avoids moral hazard by lending only at penalty rates and only to solvent banks.[1] In the words of LLR scholar and retired Richmond Fed economist Thomas Humphrey, "the Fed has deviated from the classical model in so many ways as to make a mockery of the notion that it is . . . an LLR in the traditional sense of that term."[2] Referring to the "long-embedded" and "time-honored" classical conception of the LLR role, former Fed chairman Paul Volcker similarly observed in

1. Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: Henry S. King and Co., 1873), accessed Mar. 10, 2014, http://www.econlib.org/library/Bagehot/bagLom2.html.
2. Thomas M. Humphrey, "Lender of Last Resort: What It Is, Whence It Came, and Why the Fed Isn't It," *Cato Journal* 30, no. 2 (Spring/Summer 2010): 33–64.

early April 2008 that in the Bear Stearns bailout the Fed had operated at "the very edge of its lawful and implied powers, transcending in the process certain long-embedded central banking principles and practices. . . . What appears to be in substance a direct transfer of mortgage and mortgage-backed securities of questionable pedigree from an investment bank to the Federal Reserve seems to test the time-honored central bank mantra in time of crisis: lend freely at high rates against good collateral; test it to the point of no return."[3]

A classical lender of last resort does not lend to insolvent banks (nor to insolvent investment houses or insurance companies) and does not lend at below-market rates, even to solvent banks. The Fed's decisions to create new "loan facilities" for primary dealers and money-market mutual funds likewise had nothing to do with traditional last-resort lending. *Bloomberg News*, based on information that became public only later as a result of their Freedom of Information suit, reported that "during the crisis, Fed loans were among the cheapest around, with funding available for as low as 0.01 percent in December 2008."[4] Comparing these low Fed loan rates with the borrowers' earnings on the assets they held (computing the net interest margin), Bloomberg reporters estimated that the subsidy was worth about $13 billion in the aggregate to its recipients.[5] Again, traditional last-resort lending is supposed to be at a penalty rate, not a subsidy rate. It is supposed to provide emergency liquidity, not boost earnings.

The Fed's bailout operations were actually the sort of operations that traditionally have been left to Congress, as in the creation of the Reconstruction Finance Corporation in the 1930s, the Chrysler bailout of the 1970s, or the Resolution Trust Corporation of the 1980s.

The Fed's defenders sometimes warn that criticism of its lending decisions would violate the independence it needs to operate effectively. The principle of independence for the Federal Reserve, however, applies to its *monetary policy* decisions. Congress does nothing to violate the Fed's monetary policy independence when it questions the Fed's credit-allocation or *fiscal policy* decisions. The Fed should not get a free pass from critical scrutiny by miscategorizing its credit allocation policies as monetary policy or last-resort lending.

THE DANGERS OF FAVORITISM AND CAPTURE

When the Federal Reserve System engages in credit allocation policy—but not monetary policy only—at least two governance problems arise. The first is the potential for conflicts of interest or favoritism. The second is an opening for the government regulator to be captured by the regulated industry.

First, potential conflicts of interest created by credit allocation policies make the governance structure of the twelve Reserve Banks problematic, especially at the Federal Reserve Bank of New York (FRBNY), which has done most of the policy design and implementation. The Reserve Banks are legally owned by their member banks, and their boards of directors are drawn from member bank executives (Class A directors), nonbankers nominated by the member banks (Class B), and other financial industry participants (Class C). As the 2011 GAO report noted:

> Some of the institutions that borrowed from the emergency programs had senior executives and stockholders that served on Reserve Banks' board of directors. ... We identified at least 18 former and current Class A, B, and C directors from 9 Reserve Banks who were affiliated with institutions that used at least one emergency program.[6]

For example, General Electric's CEO served as a Class B director while "GE was one of the largest issuers of commercial paper and General Electric was one of the companies FRBNY consulted when creating the emergency program

3. John Brinsley and Anthony Massucci, "Volcker Says Fed's Bear Loan Stretches Legal Power (Update4)," *Bloomberg News*, April 8, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aPDZWKWhz21c&refer=worldwide.
4. Bob Ivry, Bradley Keoun, and Phil Kuntz, "Secret Fed Loans Gave Banks $13 Billion Undisclosed to Congress," *Bloomberg News*, November 27, 2011, http://www.bloomberg.com/news/2011-11-28/secret-fed-loans-undisclosed-to-congress-gave-banks-13-billion-in-income.html.
5. Ibid.
6. Government Accountability Office, *Federal Reserve Bank Governance* (October 2011), http://www.gao.gov/new.items/d1218.pdf.

to assist with the commercial paper market."[7] FRBNY Class A directors included the CEOs of JP Morgan Chase and Lehman Brothers, firms that were beneficiaries of Fed credit allocation programs (Lehman failed anyway). While the board of directors is not directly consulted on credit policy, it hires, interacts familiarly with, and can fire the Reserve Bank president who does make policy.

Most notoriously, the chairman of the FRBNY board was a member of the Goldman Sachs board of directors during the period in which Goldman shareholders (including this individual) benefitted from a not-publicly-disclosed FRBNY credit-allocation decision to have the insolvent AIG (under FRBNY receivership) repay Goldman and others 100 cents on the dollar on collateralized debt obligations that might have been settled for as little as 60 cents on the dollar.[8] The same FRBNY chairman led the search committee seeking a new FRBNY president to replace the departing Timothy Geithner, and chose an individual (William Dudley) who had spent 10 of the previous 12 years as a Goldman Sachs partner, managing director, and chief economist.

In recognition of the potential conflicts of interest, and in accordance with provisions of the Dodd-Frank Act, as the GAO report notes, since 2010 "all of the Reserve Banks have changed the directors' roles to remove the Class A directors from the process of appointing the bank president."[9] This attenuates the member banks' influence over the president, which is unfortunate for the sake of monetary policy.

It is desirable to retain member banks' influence over the president for the sake of monetary policy because Reserve Bank presidents as a group have a better track record in Federal Open Market Committee voting than do members of the Board of Governors. Commercial bankers are inflation hawks because a rise in the expected inflation rate brings a rise in nominal interest rates, which punishes the typical commercial bank that borrows short and lends long. Shorter liabilities means that a bank must roll over its liabilities sooner than its assets, thus paying higher rates on deposits before it starts earning higher rates on loans. Because their constituents are inflation hawks, Reserve Bank presidents tend to be more hawkish on inflation than Governors. In a discretionary monetary policy regime, a more hawkish FOMC is desirable for reasons long ago explained by Kenneth Rogoff: it lowers the public's inflation-rate expectations, allowing the Fed to achieve low inflation more credibly and thus with less unemployment.[10]

Potential conflicts of interest can be entirely avoided while retaining the FRB member banks' desirable indirect input into monetary policy via the FRB presidents only by removing the Fed entirely from credit allocation. If the Fed gives no institution favored credit allocation treatment in the form of a bailout or concessionary loan, it does not matter which institutions are represented on an FRB's board of directors.

The second governance problem, the potential for regulatory capture, arises regardless of which institutions were represented on the FRBNY board of directors. When the FRBNY staff set out to design credit allocation programs to aid favored segments of the financial system, they consulted with the intended beneficiaries. Noted the GAO report:

> According to FRBNY officials, FRBNY's Capital Markets Group contacted representatives from primary dealers, commercial paper issuers, and other institutions to gain a sense of how to design and calibrate some of the emergency programs.[11]

Such a consultation process—"How can we most effectively boost your net worth?"—is clearly ripe for industry capture of its regulator. This episode may already be evidence of such.

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7. GAO, *Bank Governance*, 2011.
8. Richard Teitelbaum and Hugh Son, "New York Fed's Secret Choice to Pay for Swaps Hits Taxpayers," *Boomberg News*, October 27, 2009, http://www.bloomberg.com/apps/news?pid=email_en&sid=a7T5HaOgYHpE.
9. GAO, *Bank Governance*, 2011.
10. Kenneth Rogoff, "The Optimal Degree of Commitment to a Monetary Target," *Quarterly Journal of Economics* 100, no. 4 (November 1985): 1169–90.
11. GAO, *Bank Governance*, 2011.

REFORMS

So long as monetary policy is conducted in a discretionary manner, it is important to maintain the independent input of the Reserve Bank presidents on the FOMC. The Reserve Banks should therefore not become mere outposts of the Federal Reserve Board in order to eliminate commercial bankers' representation on their boards of directors. A better way to remove the potential for conflicts of interest is to require the Federal Reserve System to leave the formation of fiscal and credit-allocation policies to Congress and their execution to the US Treasury.

A straightforward way to accomplish this separation is to commit the Fed to holding only US Treasuries on its balance sheet, as recommended by Prof. Marvin Goodfriend at this hearing.[12] Even a "last resort" provision of bank reserves to the market can be provided through open-market purchases of Treasury securities, letting the interbank market allocate the funds to illiquid but solvent banks, rather than by putting loans to favored banks on the Fed's balance sheet.[13]

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12. Marvin Goodfriend, "The Case for a Treasury-Federal Reserve Accord for Credit Policy," Testimony before the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services, US House of Representatives, March 14, 2014.
13. Marvin Goodfriend and Robert G. King, "Financial Deregulation, Monetary Policy, and Central Banking," in *Restructuring Banking and Financial Services in America*, ed. William S. Haraf and Rose Kushmeider (Washington, DC: American Enterprise Institute, 1988).