United States Senate
COMMITTEE ON FINANCE
WASHINGTON, DC 20510–6200

January 10, 2012

The Honorable Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
Washington, D.C. 20551

Dear Mr. Chairman:

I read with interest the January 4, 2012 white paper, entitled "The U.S. Housing Market: Current Conditions and Policy Considerations," produced by your staff and sent by you to members of Congress.[1] We all can agree that work needs to continue to address the ongoing correction in the housing market, establish pro-growth policies to reduce unemployment, and restructure the housing finance system and mortgage giants Fannie Mae and Freddie Mac, which continue to absorb hard-earned money from innocent taxpayers.

I hope, also, that we can agree to establish a clearer distinction between monetary policy and fiscal policy, especially following a blurring of the distinction that has occurred following the Federal Reserve's extraordinary interventions in the economy, including what amounted to fiscal policy actions, during the financial crisis.

In the crisis, the Board of Governors, in conjunction with New York Fed, took private risk onto the Fed's balance sheet when the Fed intervened to extend credit to the Bear Stearns Companies, Inc. and when it provided loans to the American International Group, Inc.

Moreover, the Fed created a number of programs that allocated credit to narrowly-defined sectors and classes of borrowers (e.g., commercial paper, asset-backed securities, money market mutual funds), despite clearly stating in a March 23, 2009 joint statement with the Treasury that such allocation should not be your aim and that: "Government decisions to influence the allocation of credit are the province of the fiscal authorities." The Fed, nonetheless, continued to purchase housing agency mortgage-backed securities and agency debt to increase credit availability and reduce the cost of credit in the housing market.

Because many of those Fed activities involved government intervention into private markets and government assumption of private risks on behalf of taxpayers, I believe they constituted bailouts and fiscal policy actions, independent of whether the Fed ends up making money or losing money. The Fed is not a hedge fund, and profit and loss on its extraordinary asset purchases are not the appropriate metric by which to judge the efficacy of those actions. Many Fed actions led to increased moral hazard, which will unfortunately persist.

The Fed's recent "Operation Twist," intended to alter interest rates across the yield curve by altering relative supplies of and demands for short- and long-term Treasury securities is something

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[1] Available at http://www.federalreserve.gov/publications/other-reports/files/housing-white-paper-20120104.pdf .

that the Treasury itself could conduct acting as a fiscal agent of Congress. And the Fed's recent extension and expansion of its U.S. dollar liquidity swap arrangements with foreign central banks arguably constitute fiscal policy actions (indeed, a dissenting vote against such actions on the grounds that they amount to fiscal policy is noted in the minutes of the December 13, 2011 Federal Open Market Committee meeting).

Many in Congress have had sympathy for the Fed's belief that its forays into the fiscal space were necessary to address the financial crisis. However, I believe that your recent housing white paper, and recent advocacy by Federal Reserve officials for further taxpayer-funded government "intervention" in housing and mortgage markets, intrudes too far into fiscal policy advice and advocacy. Indeed, one Fed official called put-back rules of Fannie Mae and Freddie Mac as "excessively stringent." Such comments seem, to me, to be out of bounds.

It should not surprise you that members of Congress, who preside over fiscal policy, have considered the tradeoffs and policy options contained in your white paper. Moreover, various agencies, including the Federal Housing Finance Agency (FHFA), are equipped to research and analyze those tradeoffs and options.

Your staff's white paper contains a number of conjectures and proposes consideration of a number of policies that are clearly in the province of fiscal policy, including policies that would directly allocate losses to innocent taxpayers, even though those taxpayers did not undertake the risks that led to the losses.

The paper states that "...a government-facilitated REO-to-rental program has the *potential* to help the housing market and improve loss recoveries on REO portfolios," including portfolios held by the government sponsored enterprises (GSEs) Fannie Mae and Freddie Mac (italics added). It also has the potential to increase losses incurred by taxpayers.

The paper includes consideration of possible taxpayer-provided subsidies. It includes potential increased funding from taxpayers to land banks. It includes potentially costly (to taxpayers) changes to the Home Affordable Refinance Program (HARP) including allowing "...the GSEs to refinance non-GSE, non-FHA loans that would otherwise be HARP eligible." Of course, as the paper notes, that introduces even greater risks to the GSEs, and therefore taxpayers, but your staff speculates that un-quantified "...broader benefits from an expanded program *might* offset some of these costs" (italics added).

The paper calls for consideration of principal write-downs, at taxpayer expense, as a possible "...mechanism for distributing some of a homeowner's loss (for example, from falling house prices or reduced income) to lenders, guarantors, investors, and in some cases, *taxpayers*" (italics added). Putting the Federal Reserve's seal of approval on consideration of principal write-downs as a mechanism for distributing losses and shifting some losses to taxpayers is very concerning. The paper notes, correctly, that "...targeting principal reduction efforts on those most likely to default raises fairness issues to the extent that it discriminates against those who were more conservative in their borrowing for home purchases or those who rent instead of own." Indeed, citizens of Utah and across America who played by all the rules, put solid down payments on their homes, and chose not to overextend themselves on housing would potentially be asked to be on the hook for bailouts of more profligate borrowers.

I find it of interest that your staff's white paper did not draw on recent research from the Federal Reserve Bank of New York showing evidence that significant fractions of mortgage borrowers during the housing bubble owned more than one house—sometimes four or more—which is highly suggestive of speculative "flipping."[2] Indeed, in the "bubble" states (Arizona, California, and Nevada), the authors find evidence of substantial increases during the housing bubble in "investor" purchase mortgages, indicative of substantial increases in buy and flip activity. Your staff's white paper gives little to no guidance on how to discriminate against use of taxpayer funds, including hard-earned money from taxpayers who played by the rules, to bailout speculative flippers.

The paper calls for consideration of potentially costly (to taxpayers) changes to the Home Affordable Modification Program (HAMP), including expanding HAMP by "…allowing payments to be reduced below 31 percent of income in certain cases." Of course, as the paper notes: "Expanding the magnitude of potential payment reduction in this way would, though, raise difficult issues of fairness and implementation." Indeed. Very disturbingly, the paper identifies for consideration changes that would be "…likely to involve additional taxpayer funding, the overriding of private contract rights, or both…" Many of the changes offered for consideration are clearly fiscal policy considerations. Moreover, the overriding of private contract rights is a bold and dangerous assertion by you and your staff that Congress and the administration may wish to consider abrogating private contracts.

Mr. Chairman, I share your frustration over the painful adjustments taking place in the housing and housing-finance markets following the bursting of the housing bubble, which arose partly because of regulatory failures, including at the Federal Reserve. I share your frustration over the persistently high unemployment rate over the past three years. Yet I believe that it is important to the interests of the Federal Reserve, including the independence of monetary policy, that the Fed refrain from providing any hint of activism regarding what are clearly fiscal policy choices. I worry that the unveiling of your staff's housing white paper, to "provide a framework for thinking" treads too far into fiscal policy, and runs the risk of being perceived as advocacy for particular policy options. I am sure that the Fed would not appreciate a white paper from Congress outlining how to think about and execute monetary policy.

The Fed often blurred the distinction between monetary policy and fiscal policy during the financial crisis, and it is time to move back toward a clearer distinction between the two. Public dissemination of your staff's recent housing white paper is a move in the wrong direction.

Sincerely,

Orrin G. Hatch

Orrin G. Hatch
Ranking Member

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[2] Andrew Haughwout, Donghoon Lee, Joseph Tracy, and Wilbert van der Klaauw (2011), "Real Estate Investors, the Leverage Cycle, and the Housing Market crisis," *Federal Reserve Bank of New York Staff Reports,* no.514, http://www.newyorkfed.org/research/staff_reports/sr514.pdf .