Dissenting Views on H.R. 1427, "Federal Housing Finance Reform Act of 2007"

H.R. 1427 fails to address the core problems with the Government Sponsored Enterprises (GSEs). Furthermore, since this legislation creates new government programs that will further artificially increase the demand for housing, H.R. 1427 increases the economic damage that will occur from the bursting of the housing bubble. The main problem with the GSEs is the special privileges the federal government gives the GSEs. According to the Congressional Budget Office, the housing related GSEs received almost 20 billion dollars worth of indirect federal subsidies in fiscal year 2004 alone, while Wayne Passmore of the Federal Reserve estimates the value of the GSE's federal subsidies to be between $122 and $182 billion.

One of the major privileges the federal government grants to the GSEs is a line of credit from the United States Treasury. According to some estimates, the line of credit may be worth over two billion dollars. GSEs also benefit from an explicit grant of legal authority given to the Federal Reserve to purchase the debt of the GSEs. GSEs are the only institutions besides the United States Treasury granted explicit statutory authority to monetize their debt through the Federal Reserve. This provision gives the GSEs a source of liquidity unavailable to their competitors.

This implicit promise by the government to bail out the GSEs in times of economic difficulty helps the GSEs attract investors who are willing to settle for lower yields than they would demand in the absence of the subsidy. Thus, the line of credit distorts the allocation of capital. More importantly, the line of credit is a promise on behalf of the government to engage in a massive unconstitutional and immoral income transfer from working Americans to holders of GSE debt. This is why I offered an amendment to cut off this line of credit.

The connection between the GSEs and the government helps isolate the GSEs' managements from market discipline. This isolation from market discipline is the root cause of the mismanagement occurring at Fannie and Freddie. After all, if investors did not believe that the federal government would bail out Fannie and Freddie if the GSEs faced financial crises, then investors would have forced the GSEs to provide assurances that the GSEs are following accepted management and accounting practices before investors would consider Fannie and Freddie to be good investments.

Former Federal Reserve Chairman Alan Greenspan has expressed concern that the government subsidies provided to the GSEs makes investors underestimate the risk of investing in Fannie Mae and Freddie Mac. Although he has endorsed many of the regulatory `solutions' being considered here today, Chairman Greenspan has implicitly admitted the subsidies are the true source of the problems with Fannie and Freddie.

H.R. 1427 compounds these problems by further insulating the GSEs from market discipline. By creating a `world-class' regulator, Congress would send a signal to investors that investors need not concern themselves with investigating the financial health and stability of Fannie and Freddie since a `world-class' regulator is performing that function.

However, one of the forgotten lessons of the financial scandals of a few years ago is that the market is superior at discovering and punishing fraud and other misbehavior than are government regulators. After all, the market discovered, and began to punish, the accounting irregularities of Enron before the government regulators did.

Concerns have been raised about the new regulator's independence from the Treasury Department. Although the Treasury now supports the creation of a new regulator, the compromise between Treasury and the drafters of H.R. 1427 does not address concerns that isolating the regulator from Treasury oversight may lead to regulatory capture. Regulatory capture occurs when regulators serve the interests of the businesses they are supposed to be regulating instead of the public interest. While H.R. 1427 does have some provisions that claim to minimize the risk of regulatory capture, regulatory capture is always a threat where regulators have significant control over the operations of an industry. After all, the industry obviously has a greater incentive than any other stakeholder to influence the behavior of the regulator.

The flip side of regulatory capture is that managers and owners of highly subsidized and regulated industries are more concerned with pleasing the regulators than with pleasing consumers or investors, since the industries know that investors will believe all is well if the regulator is happy. Thus, the regulator and the regulated industry may form a symbiosis where each looks out for the other's interests while ignoring the concerns of investors.

Furthermore, my colleagues should consider the constitutionality of an `independent regulator.' The Founders provided for three branches of govenment--an executive, a judiciary, and a legislature. Each branch was created as sovereign in its sphere and there were to be clear lines of accountability for each branch. However, independent regulators do not fit comfortably within the three branches; nor are they totally accountable to any branch. Regulators at these independent agencies often make judicial-like decisions, but they are not part of the judiciary. They often make rules, similar to the ones regarding capital requirements, that have the force of law, but independent regulators are not legislative. And, of course, independent regulators enforce the laws in the same way, as do other parts of the executive branch; yet independent regulators lack the day-to-day accountability to the executive that provides a check on other regulators.

Thus, these independent regulators have a concentration of powers of all three branches and lack direct accountability to any of the democratically chosen branches of government. This flies in the face of the Founders' opposition to concentrations of power and government bureaucracies that lack accountability. These concerns are especially relevant considering the remarkable degree of power and autonomy this bill gives to the regulator. For example, in the scheme established by H.R. 1427 the regulator's budget is not subject to appropriations. This removes a powerful mechanism for holding the regulator accountable to Congress. While the regulator is accountable to a board of directors, this board may conduct all deliberations in private because it is not subject to the sunshine act.

Ironically, by transferring the risk of widespread mortgage defaults to the taxpayers through government subsidies and convincing investors that all is well because a `world-class' regulator is ensuring the GSEs' soundness, the government increases the likelihood of a painful crash in the housing market. This is because the special privileges of Fannie and Freddie have distorted the housing market by allowing Fannie and Freddie to attract capital they could not attract under pure market conditions. As a result, capital is diverted from its most productive uses into housing. This reduces the efficacy of the entire market and thus reduces the standard of living of all Americans.

Despite the long-term damage to the economy inflicted by the government's interference in the housing market, the government's policy of diverting capital into housing creates a short-term boom in housing. Like all artificially created bubbles, the boom in housing prices cannot last forever. When housing prices fall, homeowners will experience difficulty as their equity is wiped out. Furthermore, the holders of the mortgage debt will also have a loss. These losses will be greater than they would have been had government policy not actively encouraged over-investment housing.

H.R. 1427 further distorts the housing market by artificially inflating the demand for housing through the creation of a national housing trust fund. This fund further diverts capital to housing that, absent government intervention, would be put to use more closely matching the demands of consumers. Thus, this new housing program will reduce efficiency and create yet another unconstitutional redistribution program.

Perhaps the Federal Reserve can stave off the day of reckoning by purchasing the GSEs' debt and pumping liquidity into the housing market, but this cannot hold off the inevitable drop in the housing market forever. In fact, postponing the necessary and painful market corrections will only deepen the inevitable fall. The more people are invested in the market, the greater the effects across the economy when the bubble bursts.

Instead of addressing government polices encouraging the misallocation of resources to the housing market, H.R. 1427 further introduces distortion into the housing market by expanding the authority of federal regulators to approve the introduction of new products by the GSEs. Such regulation inevitably delays the introduction of new innovations to the market, or even prevents some potentially valuable products from making it to the market. Of Course, these new regulations are justified in part by the GSEs' government subsidies. We once again see how one bad intervention in the market (the GSEs' government subsidies) leads to another (the new regulations).

In conclusion, H.R. 1427 compounds the problems with the GSEs and may increases the damage that will be inflicted by a bursting of the housing bubble. This is because this bill creates a new unaccountable regulator and introduces further distortions into the housing market via increased regulatory power. H.R. 1427 also violates the Constitution by creating yet another unaccountable regulator with quasi-executive, judicial, and legislative powers. Instead of expanding unconstitutional and market distorting government bureaucracies, Congress should act to remove taxpayer support from the housing GSEs before the bubble bursts and taxpayers are once again forced to bail out investors who were misled by foolish government interference in the market.

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