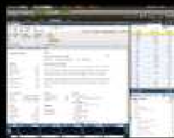
FLIP SEAMLESSLY FROM FUNDAMENTALS



StreetSmart edge

INVESTORS.com
POWERED BY INVESTOR'S BUSINESS DAILY

IBD EDITORIALS

Housing Market Will Be Fine Without 30-Year Fixed Loans

By MARK A. CALABRIA
Posted 03/16/2011 06:08 PM ET

As Congress begins debating the future of Fannie Mae and Freddie Mac, proponents of keeping the taxpayer on the hook for the mortgage market argue that without such support the 30-year fixed-rate mortgage would disappear. The advantages of the 30-year mortgage have, however, been grossly exaggerated. Subsidizing it should not serve as an excuse for continuing to put the taxpayer at significant risk.

First, we should recognize that the 30-year fixed isn't going anywhere. The "jumbo" mortgage market offers a 30-year fixed without a government guarantee. In fact, fixed-rate mortgages have historically been around half of the jumbo market.

Of course it is more expensive — but more expensive to the borrower does not mean more expensive to society. After all, someone has to pay for a subsidy. In all likelihood, it is that same homeowner who will pay for the subsidy in their role as taxpayer.

The difference between 30-year jumbo and conforming loans has been about 30 to 40 basis points. There are lots of reasons for this spread; the existence of a federal guarantee is only one of them.

In the absence of a federal guarantee, rates would likely go up somewhere between 10 and 30 basis points. That smallish jump would not have any impact on homeownership rates and is hardly an amount worth putting our entire financial system at risk.

The Obama administration is likely to propose that this guarantee be priced. If the pricing is actuarially fair and the fee is passed along to the consumer, then the spread between guaranteed and non-guaranteed loans will narrow even more — again raising the question: Why the need for a guarantee?

Some would argue that the 30-year fixed is worth subsidizing because it provides certainty to the borrower. But if borrowers do value that certainty, they should be willing to pay its true cost. More importantly, the certainty provided has proved to be false.

While the current system has given borrowers some stability in their monthly mortgage payment, it has done so by exposing households, as taxpayers, to massive, hard-to-predict contingent liabilities. There's been no bigger "hidden fees" or "payment shock" in the mortgage market than the cost of the bailout of Fannie Mae and Freddie Mac.

The typical borrower is also unlikely to require certainty on a 30-year time horizon. The typical mortgage today has a life of about five years, while the typical homeowner has been in their house less than 10.

Given that 10-year fixed-rate financing for autos is readily available without a government guarantee, we can be reasonably certain that private markets would provide consumers with fixed-rate mortgage financing long enough to meet the needs of most, if not all, borrowers.

Reducing the reliance on the 30-year fixed would also improve the performance of our economy. As interest rates tend to fall in a recession and rise in an expansion, adjustable-rate mortgages would give consumers' pocketbooks a boost when they need it the most, while also helping to constraint an overheating economy when that is needed most.

Some might complain that increasing monthly mortgage payments during an expansion is an unfair way to constrain consumption. Spreading the pain across consumers, however, is far more fair than our current system of having interest rate-sensitive sectors, like construction, bear the brunt of inevitable Federal Reserve interest-rate hikes.

Greater reliance on floating-rate mortgages would also likely reduce the cost and frequency of financial crises. Contrary to popular belief, adjustable-rate mortgages did not cause the current crisis. Lack of borrower equity, poor credit and a weak job market explain almost all the recent defaults.

On the other hand, we know for certain that the widespread use of the 30-year fixed mortgage contributed to the savings and loan crisis. Prior to the crisis, it was often argued that concentrating interest rate risk into a handful of entities, such as Fannie and Freddie, made that risk easier and cheaper to manage. The truth was far from that.

If financial institutions are indeed better than consumers at managing interest risk, then those companies should be able to offer consumers attractive terms for doing so — without the moral hazard of an enormous taxpayer backstop. This would allow consumers to actually have some choice.

Today, families — in their role as taxpayers — are forced to bear uncertain financial risks that they have not freely contracted for, hardly a "pro-consumer" outcome.

• Calabria, formerly a senior aide to the Senate Committee on Banking, Housing and Urban Affairs, is director of financial regulation studies at the Cato Institute.

© 2011 Investor's Business Daily, Inc. All rights reserved. Investor's Business Daily, IBD and CAN SLIM and their corresponding logos are registered trademarks of Data Analysis Inc. Copyright and Trademark Notice | Privacy Statement Terms | Conditions of Use