Exotic Loans Behind Taxpayer 'Payment Shock'

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By Robert Freedman, senior editor, REALTOR® Magazine

Cato Institute analyst Mark Calabria in his piece, Housing Market Will Be Fine Without 30-Year Fixed Loans (Investor's Business Daily, March 17), argues that the stability provided to households from the 30-year, fixed-rate mortgage comes with a big contingent liability: the bailout of Fannie Mae and Freddie Mac.

As Calabria puts it, although the 30-year fixed-rate mortgage 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."

But surely Calabria knows that it wasn't the 30-year, fixed-rate mortgage that forced the two secondary mortgage market companies to need a bailout; it was their dabbling in subprime, stated-income, Alt-A, and other exotic loans while they were playing catch-up to Wall Street players in the private-label mortgage securities market. The Obama administration, in its white paper on reforming Fannie and Freddie, makes this clear:

"Fannie Mae and Freddie Mac were largely on the sidelines while private markets generated increasingly risky mortgages. Between 2001 and 2005, private-label securitizations of Alt-A and subprime mortgages grew fivefold, yet Fannie Mae and Freddie Mac continued to primarily guarantee fully documented, high-quality mortgages. But **as their combined market share declined—from nearly 70 percent of new originations in 2003 to 40 percent in 2006—Fannie Mae and Freddie Mac pursued riskier business to raise their market share and increase profits. Not only did they expand their guarantees to new and riskier products, but they also increased their holdings of some of these riskier mortgages on their own balance sheets."**

Calabria says that as long as the federal government guarantees the 30-year, fixed rate mortgage, someone will have to pay for that subsidy. But it wasn't until the two government-sponsored enterprises strayed from their role backing the 30-year, fixed rate mortgage that taxpayers got hit with a bill to pay for the subsidy to those two companies. On that basis, if the concern is over reducing taxpayer exposure to bad loans that cost taxpayers money, then ensuring the government retains a role supporting the 30-year, fixed rate mortgage is arguably what we should be encouraging.

And to be clear: consumers—i.e., taxpayers—have been unambiguous in their preference for long-term, fixed-rate mortgage financing. About 90 percent of those that finance their purchase choose that type of loan.