May 22, 2024

Electronically filed via Provide Input | Federal Housing Finance Agency (fhfa.gov)
The Honorable Sandra Thompson
Director
Federal Housing Finance Agency
Constitution Center
400 7th Street, SW
Washington, D.C. 20219

Re: Freddie Mac Proposed Purchase of Single-Family Closed-End Second Mortgages; Comment Request

Dear Director Thompson:

On behalf of the Center for Responsible Lending,[1] thank you for the opportunity to comment on the proposal by Freddie Mac to purchase certain single-family closed-end second mortgages.[2] We write in support of Freddie Mac's proposal. During periods when the prevailing mortgage rate is well-above the interest rate on outstanding mortgages, using a second mortgage rather than a cash-out refinance to access home equity will have clear borrower benefits, and a Freddie Mac-backed home equity loan will provide borrowers with additional benefits relative to second mortgages from private lenders. In addition, the cross-subsidy generated by Freddie Mac second mortgages will make up for the cross-subsidy lost due to lower refinancing volumes when mortgage rates are elevated, allowing the Enterprise to continue to subsidize mission-oriented loans.

Introduction

Many mortgage lenders are willing to offer cash-out refinances because the Government-Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac, the Federal Housing Administration (FHA), or the Department of Veterans Affairs (VA) bear the credit risk. However, fewer lenders are willing to make home equity loans, especially to borrowers with lower credit scores, given the associated credit risk and the lack of a developed secondary market.[3] As a result, despite the benefits of home equity loans over cash-out refinances described below, many borrowers continue to access their home equity using cash-out refinances or are unable to access it all, particularly, low-wealth, lower credit score, minority, and Veteran borrowers served by FHA and VA.[4] In order to address the needs of these borrowers, Freddie

[1] The Center for Responsible Lending is a non-profit, non-partisan research and policy organization dedicated to protecting homeownership and family wealth by working to eliminate abusive financial practices. CRL's views are informed by its affiliation with Self-Help, one of the nation's largest nonprofit community development financial institutions. Self-Help has provided $6 billion in financing to 70,000 homebuyers, small businesses and nonprofits and serves more than 80,000 mostly low-income families through 30 retail credit union branches in North Carolina, California, and Chicago.
[2] See FRE Closed-End Second Liens Notice for Web.pdf (fhfa.gov).
[3] In 2023, $5.38 billion of home equity loans and home equity lines of credit were securitized (source: https://www.insidemortgagefinance.com/articles/230004-home-equity-securitization-up-sharply-in-2023?v=preview). For context, there is $11 trillion of "tappable" home equity, meaning it could be extracted without increasing the combined loan-to-value ratio above 80% (source: Mortgage Monitor report May 2024 (icemortgagetechnology.com)).
[4] As discussed in responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-cashout-refi-mar2023.pdf.

Mac would have to relax the requirement that they own the first mortgage before purchasing the second. However, even as written, the proposal is a commendable first step toward increasing the availability of second mortgages.

Discussion of Our Support

(1) *Borrower Benefits of Second Mortgages*

Using a home equity loan instead of a cash-out refinance to convert equity into liquidity has clear borrower benefits when mortgage rates are high. For a home equity loan, the higher interest rate is only applied to the equity extracted whereas in a cash-out refinance, it is applied to the equity extracted *and* the borrower's existing loan balance. Therefore, when mortgage rates are well above the note rate on outstanding first mortgages, as they are today, using a home equity loan instead of a cash-out refinance has tangible borrower benefits. In the comment request, Freddie Mac provides a useful comparison of an existing mortgage paired with a home equity loan and a cash-out refinance, and we will use this example to show five tangible borrower benefits of using a home equity loan rather than a cash-out refinance in the current interest rate environment.

First, as noted in the comment request, using the home equity loan will result in a lower combined monthly payment ($912) than a cash-out refinance ($1049), thus saving the borrower $137 per month ($1,644 annually). As a consequence of the more affordable monthly payment, the borrower is less likely to default on the existing mortgage plus home equity loan option than on the cash-out refinance.

Second, as described in the comment request, the combination of the existing loan and the second mortgage has lower lifetime interest costs ($114,779) compared to the cash-out-refinance ($227,576), which means using the second mortgage would save the borrower $112,797 in interest over the life of their loans. However, it is important to note that on a go-forward basis, the interest savings associated with the second mortgage option are even larger. The figures in the Freddie Mac proposal include interest on the existing loan that the borrower has already paid. In some respects, interest already paid is a sunk cost and has no bearing on the choice between a home equity loan and a cash-out refinance. If we instead restrict the comparison to interest the borrower would pay going forward until maturity under the two options, the difference becomes even more stark—under the existing loan plus the second mortgage, total interest costs over the next 21.5 years would be about $80,000, a savings of over $147,000 compared to the cash-out refinance.

The difference in interest costs is also reflected in the effective interest rate of each option. We calculate the effective interest rate on the extracted equity amount using the increase in monthly payment under each option. For the second mortgage, the borrower pays an additional $280 per month on the $30,000 loan balance, so the second mortgage has an effective interest rate of

9.50%, matching the stated interest rate. In contrast, for the cash-out refinance, the borrower will pay an additional $416 per month to extract $30,000 of equity, which results in an effective interest rate of 16.6%, more than double the stated interest rate of 7.50%.

Third, use of the second mortgage will also result in faster equity accumulation compared to the cash-out refinance. The cash-out refinance is a new 30-year mortgage, and therefore resets the amortization schedule for the borrower such that a high proportion of their monthly payment goes towards interest. Using a second mortgage allows the borrower to remain on the original amortization schedule associated with their existing first mortgage and, because the home equity loan matures in 20 years, results in faster equity accumulation. For example, 5 years after extracting equity, using the second mortgage would result in an additional $17,000 of equity compared to the cash-out refinance. Ten years later, the equity advantage would be $35,000.

Fourth, the shorter term of the second mortgage creates a benefit for borrowers who remain in their home until maturity. For the example borrower, should they remain in their home until the home equity loan matures at year 20, their monthly payment will revert back to $632 for the remaining 18 months of their first mortgage. In contrast, with the cash-out refinance, at year 20 they will continue to pay $1,049 per month for the next 10 years.

Fifth, the borrower will pay less in closing costs on the home equity loan than for the cash-out refinance. Closing costs are typically assessed as a percentage of the loan amount. For example, one larger lender's website suggests closing costs on a home equity loan range from 2% to 6% of loan balance, while a loan comparison website suggests a range of 2% to 5%.[5] Based on these ranges, for the example loan a borrower would pay closing costs of between $600 and $1,800. Data collected on conventional cash-out refinances completed in 2021 indicate the typical borrower paid closing costs of 2.2% of the loan amount, which would amount to $3,300 in the cash-out refinance example.[6]

(2) *Borrower Benefits Specific to Freddie Mac Second Mortgages*

While the borrower benefits described above are intrinsic to home equity loans in the current interest rate environment, there will be two additional borrower benefits that are specific to second mortgages backed by Freddie Mac. Because Freddie will own the credit and collateral risk of both the first and second liens, they will be better able to offer holistic loss mitigation options to borrowers who default due to financial hardship as compared to a private lender who only owns the risk on the second lien. Freddie Mac can extend their loss mitigation approach to both the first and second mortgage, including streamlined options for payment forbearance, payment deferrals, and modifications that produce lower monthly payments, thereby likely generating fewer defaults and foreclosures than a loss mitigation approach that addresses each loan separately.

[5] Sources: A Guide To Home Equity Loan Closing Costs | Rocket Mortgage and Home Equity Loan Closing Costs: How Much You'll Pay | LendingTree.
[6] Calculated as the median total loan cost divided by the median loan amount for conventional cash-out refinance transactions. Source: HMDA 2021.

The entrance of Freddie Mac into the second mortgage market is likely to result in lower interest rates for borrowers. The GSEs, along with Ginnie Mae, have standardized the parameters for first mortgage securitization, and the GSE guarantee removes the credit and collateral risk, leaving mortgage-backed securities (MBS) with only interest rate exposure and thereby creating a deep market for MBS with a broad set of investors. Over time, Freddie Mac's entry into second mortgages could have a similar effect, as Freddie Mac will promote data and process standardization and increase operational efficiency. These improvements will in turn encourage participation by lenders who might not otherwise enter the market for second mortgages, and increased competition will lead to lower interest rates on second mortgages for borrowers.

(3) *Cross-Subsidization of Mission Loans*

Freddie Mac second mortgages would provide the enterprise with a valuable source of cross-subsidy for mission lending in periods when rate/term and cash-out refinance volumes are low. Freddie Mac's charter act mission is to "provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities)…" and to "promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas)…"

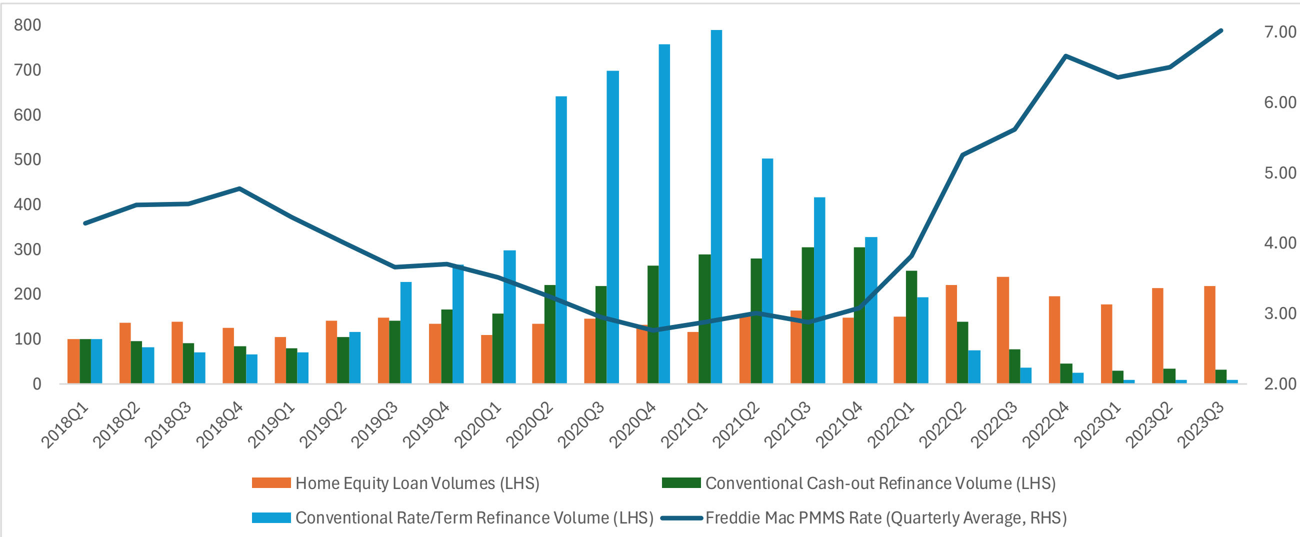
To meet their mission and their return on equity targets, Freddie Mac generates a cross-subsidy by charging higher fees (and therefore generating an above-market return on equity) on less-mission-central products, including rate/term refinances, cash-out refinances, investor loans, and loans for second homes.

During periods of high interest rates, origination volumes for rate/term and cash-out refinances, investor loans, and loans for second homes typically fall, reducing the amount of cross-subsidy generated and available for mission loans. Rate/term and cash-out refinance volumes are particularly sensitive to the level of mortgage rates in relation to the interest rate on outstanding loans. When mortgage rates are elevated, rate/term refinances no longer reduce the borrower's monthly payment and cash-out refinances become a costly equity extraction option for borrowers, as described above.

As shown in the Figure below, rate/term and cash-out refinance volumes peaked in 2021 when the mortgage rate was around 3%, but, over the course of 2022, quickly dropped off as the mortgage rate more than doubled. Meanwhile, home equity loan volumes increased along with mortgage rates beginning in 2022Q2, which is particularly notable given that many lenders did not offer the product and have just begun to roll out their offerings. As of the end of 2023, rate/term refinances and cash-out refinances had fallen to about 10% and 30% of their 2018Q1 level respectively, reducing the cross-subsidy generated for mission loans. In contrast, home equity loan volumes remained robust at 220% of 2018Q1 volumes and, if the proposed new product is approved, provide the opportunity for Freddie Mac to recapture cross-subsidy under the current interest rate environment.

By pricing second mortgages to generate an above-market return on equity, as is the case with cash-out refinances, Freddie Mac can continue to generate a cross-subsidy from less-mission-related equity extraction products that can be used for mission loans under all market conditions.

Figure: Quarterly Conventional Rate/Term Refinance, Cash-out Refinance, and Home Equity Loan Volumes (indexed to 2018Q1) and the Freddie Mac 30-Year PMMS Rate.



Sources: Cash-out refinance volume sourced from Data Point: 2022 Mortgage Market Activity and Trends | Consumer Financial Protection Bureau (consumerfinance.gov), https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/FPRR_4Q2023.pdf and author's calculations. Home equity loan volumes sourced from TransUnion Home Equity Reports (PowerPoint Presentation (transunion.com), PowerPoint Presentation (transunion.com), PowerPoint Presentation (transunion.com), and PowerPoint Presentation (transunion.com)). Freddie Mac PMMS Rate sourced from Mortgage Rates - Freddie Mac.

(4) *Extending Availability of Second Mortgages to Further Equitable Access to Home Equity*

Once Freddie Mac has successfully developed the market for second mortgages, securitized the loans, and successfully managed the resulting risk, the Enterprise should consider relaxing the restriction that second mortgages only be purchased when Freddie Mac owns the first mortgage. By doing so, the low-to-moderate income (LMI), Black and Latino, and Veteran borrowers disproportionately served by the FHA and VA programs may be able to obtain a second mortgage through Freddie Mac rather than using a more costly cash-out refinance to access their home equity.[7] As an alternative, to the extent the success of the Freddie Mac's second mortgage program is predicated on a single entity owning the credit risk on both the first and second mortgage and a holistic loss mitigation program, then FHA may want to consider expanding the size and scope of their second mortgage program.

[7] Research indicates that in 2022, FHA cash-out refinances were disproportionately used by borrowers with lower credit scores and borrowers in neighborhoods with higher shares of Black residents, as described in responsiblelending.org/sites/default/files/nodes/files/research-publication/crl-cashout-refi-mar2023.pdf.

FHA and VA first mortgages are assumable. Access to home equity loans would allow some of the first-time, LMI, Black and Latino, and Veteran homebuyers who use these mortgage programs to create a more affordable monthly payment by assuming an existing mortgage with a below market interest rate combined with a Freddie Mac second mortgage.[8]

Conclusion

The Center for Responsible Lending thanks FHFA for providing the opportunity for public input on the Freddie Mac proposal to purchase certain single-family closed-end second mortgages. A Freddie Mac second mortgage program would have substantial benefits for borrowers and generate a cross-subsidy for Freddie Mac mission loans when the volumes of traditional cross-subsidy sources are reduced. For these reasons, we support the Freddie Mac proposal. Once the product is proven, we suggest consideration be given to how second mortgages can be made more available to FHA and VA borrowers. Thank you again for the opportunity to share our support for the proposal and its positive impact on mortgage borrowers.

Sincerely,

The Center for Responsible Lending

[8] The ability of FHA and VA borrowers to use Freddie Mac second mortgages paired with an existing loan with a below-market interest rate to create a more affordable monthly payment may be limited by the Freddie Mac requirement that the combined loan-to-value ratio of the first and second mortgage not exceed 80%.