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Freddie Mac's Second Mortgage Proposal Is Consumer Friendly

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On April 22, Freddie Mac proposed to begin purchasing second mortgages. Evidence shows this proposal is worth pursuing: it's a simple, consumer-friendly addition to the government-sponsored enterprise's (GSE's) toolkit that would allow borrowers to do a cost-effective cash-out refinance.

The need for cash-out refinances is as great as ever. Housing wealth has increased considerably as home prices have increased over the past few years. During the COVID-19 pandemic, many families tapped into their home equity via cash-out refinancing to pay for home improvements, pay off debt, or otherwise improve the quality of their lives.

Today, many borrowers have spent down their savings but still need cash for those same reasons. But doing a cash-out refinance is expensive under high interest rates because the borrower must give up their current, low-interest-rate mortgage.

Freddie Mac's proposal almost exactly mirrors the terms of cash-out refinancing: it would apply only to mortgages where (1) Freddie Mac holds the first lien, (2) the combined loan-to-value ratio is 80 percent or lower (or 65 percent for manufactured housing), and (3) the borrower is required to pay off the second lien when the borrower refinances, sells the house, or otherwise pays off the first lien.

But Freddie Mac's proposal is more borrower friendly because it would allow the borrower to retain their first mortgage, with its attractive rate, while tapping into their home equity.

As the Federal Housing Finance Agency (FHFA) takes comments on the proposal, we offer insights into how the proposal would benefit both borrowers and Freddie Mac, argue that the proposal offers no more risk to Freddie Mac than a cash-out refinance, review the arguments people make against the proposal, and add some thoughts on what the product should include to maximize success, if implemented.

How would borrowers benefit?

Let's look at an example to understand why this proposal benefits borrowers. Consider a borrower who has a 3 percent, $300,000 mortgage taken out in 2020 and would like to make a $100,000 addition to their home. Assume the home's current market value is $500,000, giving the borrower an 80 percent loan-to-value ratio. If the borrower did a cash-out refinance, the new $400,000 mortgage would carry a 7.25 percent interest rate, with a monthly payment of $2,729.

The Freddie Mac proposal, on the other hand, would allow the borrower to retain their 3 percent interest rate, and the corresponding $1,265 monthly payment, and take out a new 20-year mortgage for $100,000. If the rate of this second mortgage were 10 percent, the payment would be $965 per month. Altogether, the borrower would pay $2,130 per month, much lower than the $2,729 per month for the cash-out refinance.

In short, Freddie Mac's proposal allows existing Freddie Mac borrowers to tap into their home equity via a second mortgage without giving up their low-rate mortgage. This second mortgage would be available as an up-to-20-year fixed-rate mortgage, and the borrower would have to qualify for the second mortgage, initially using a manual underwriting process. Freddie Mac will look to automate this process, but we believe automation could take as much as a year.

Does the proposal introduce new or heightened risk for Freddie Mac?

The second mortgage proposal is no more risky to Freddie Mac than cash-out refinances. Similar to the existing limit on the cash-out refinances, the 80 percent loan-to-value ratio limit and ability-to-repay regulations would make the product dramatically safer than the second liens that performed atrociously (PDF) during the 2008 financial crisis. Having a similar loan-to-value ratio limit also ensures the product has the same home equity cushion as Freddie Mac cash-out refinances.

Under the proposal, Freddie Mac would also control the loss mitigation, because it would hold both the first and second liens. The simultaneous repayment requirement would assure that Freddie Mac will never hold only the second lien. Given the proposal's similarities with cash-out refinances, we expect the underwriting standards, capital requirements, and pricing should be similar as well, though those haven't been specified.

In addition, relative to cash-out refinances, borrowers would have a lower monthly payment under the proposal, which means they'd be less likely to default. Lower risks of default would help protect Freddie Mac financially, but that protection would be partially offset by the financial risks Freddie Mac is taking with the product. The GSE is holding these second liens in portfolio until it can establish a performance history and securitize, and the spreads at the time of securitization may be wider or narrower than at origination.

What are the objections to this proposal?

Despite benefits like lower payments for borrowers and minimal risk to Freddie Mac, we've heard three primary objections to this proposal.

1. Some argue the proposal is mission creep on Freddie Mac's part.

   We don't see the mission creep because this product provides a more cost-effective alternative to the cash-out refinance products Freddie Mac already offers.

   Additionally, on legal grounds, Freddie Mac's charter (PDF) explicitly states the GSE can purchase subordinate liens. Congress granted this ability in the 1984 Secondary Market Enhancement Act, which amended Freddie Mac's 1970 charter. Further, Freddie Mac and Fannie Mae both purchased second liens before the 2008 financial crisis.

   Between the economic similarities to cash-out refinances and Freddie Mac's charter explicitly allowing for this product, we don't believe the mission creep argument has merit.

2. Some argue there's no need for a government player in this market, and that Freddie Mac is trying to enter a market that already operates successfully.

   Depository institutions have long offered home equity lines of credit, or HELOCs (though these usually require a high credit score). Additionally, there are several second mortgage products being offered in the market, and most of them have a broader array of options than the Freddie Mac product (which would offer only up-to-20-year fixed-rate second mortgages). Some products allow the borrower to take the funds as needed rather than all up front, similar to a HELOC, and others offer an array of terms (variable and fixed-rate products). Some of these second mortgages are securitized, but the market is very small.

   If Freddie Mac proceeds, borrowers will benefit because they'll have more second-lien options (between a standardized Freddie Mac product or more customizable product offered by the private market). A Freddie Mac second mortgage product would likely increase awareness and use of second mortgages. The product should also diminish the number of relatively more expensive cash-out refinances among borrowers who don't know they have the option of a second mortgage because their lender does not offer the bespoke product.

3. Some argue the proposal would slow prepayment speeds on low-coupon first mortgages (and lower their value as a result) because some of those borrowers would have otherwise done a cash-out refinance.

   This is true, but the actual impact on speeds will be small. The ramp-up on this product will likely be slow, between manual underwriting and the adjustments lenders must make to implement a second lien. Moreover, this loss to investors is more than offset by the benefit to borrowers, similar to streamlined refinances.

What additions would maximize the product's success?

Despite its potential benefits, we believe additional disclosure would make Freddie Mac's second mortgage product more successful because it would give investors more information before these second mortgages are securitized.

The FHFA and Freddie Mac could commit to providing more transparency and metrics around the product, which are not elements in the current proposal. The public needs to see reporting on volumes, interest rates, borrower characteristics, pricing (including loan-level pricing adjustments), lender participation, and denial rates, with more frequent updates during the initial stages of the product. Freddie Mac should include these second mortgages, matched to the first, in their loan-level performance data to allow market participants to more easily observe market behavior. The FHFA and Freddie Mac should also commit to timelines on automating underwriting to ensure progress during any administration transition period.

The evidence we've shared shows that, by offering borrowers a cost-effective alternative to cash-out refinancing that does not introduce significant risk for Freddie Mac or borrowers, Freddie Mac's second mortgage proposal could be a powerful addition to the suite of mortgage offerings, while providing homeowners greater housing and financial stability.

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