Whalen Global Advisors LLC

May 20, 2024

The Honorable
Sandra L. Thompson
Director
Federal Housing Finance Agency.
Washington, DC
Email: RegComments@fhfa.gov

Re: "Proposed Enterprise New Product; Comment Request 'Freddie Mac Single-Family Closed-End Second Mortgages,' (No. 2024-N-5)

Dear Director Thompson:

Freddie Mac proposes to create a new, subprime market for close-end second lien mortgages. Below we provide responses to the substantive questions in the request, but we ignore the portions of the request regarding "mission." This proposal continues the unfortunate direction of housing policy under the Biden Administration, which often disregards the realities of the mortgage market in favor of progressive aspiration. Freddie Mac states in its proposal:

> "Freddie Mac believes the proposed new product may advance its charter act purposes by providing liquidity and stability in the secondary mortgage market. Freddie Mac also believes it could provide a foundation for more consistent liquidity in the secondary mortgage market because of its credit guarantee and experience securitizing mortgage loans."

We submit that this statement is untrue. In fact, Freddie Mac is proposing to create a new, subprime market for second lien mortgages. More, we submit that the proposal will be harmful to low-income borrowers as well as create new risks for the Treasury.

The market for second lien mortgages is a prime market dominated by depositories. Banks typically originate the loans at a loss and retain the servicing. Prime closed-end second liens have significantly higher coupons than first liens and offer attractive risk-adjusted returns to banks. There may be subprime portions of the mortgage market that are underserved in terms of second mortgage financing, yet overall, the market appears to be well served, very liquid and stable. The second lien market, in fact, has significant excess capacity and plentiful available credit.

Looking at the data, it is hard to escape the conclusion that specific social and/or economic factors including demographics, tax policy, and Basel III are depressing demand for subprime second liens. This may not be a bad thing. Farrel, Grieg and Zhao (2020) suggest that consumers using cash-out refinance had better economic outcomes than consumers using HELOCs to tap home equity.[1] Some

[1] Farrell, Diana and Greig, Fiona and Zhao, Chen, Tapping Home Equity: Income and Spending Trends Around Cash-Out Refinances and HELOCs (December 3, 2020). https://ssrn.com/abstract=3742341

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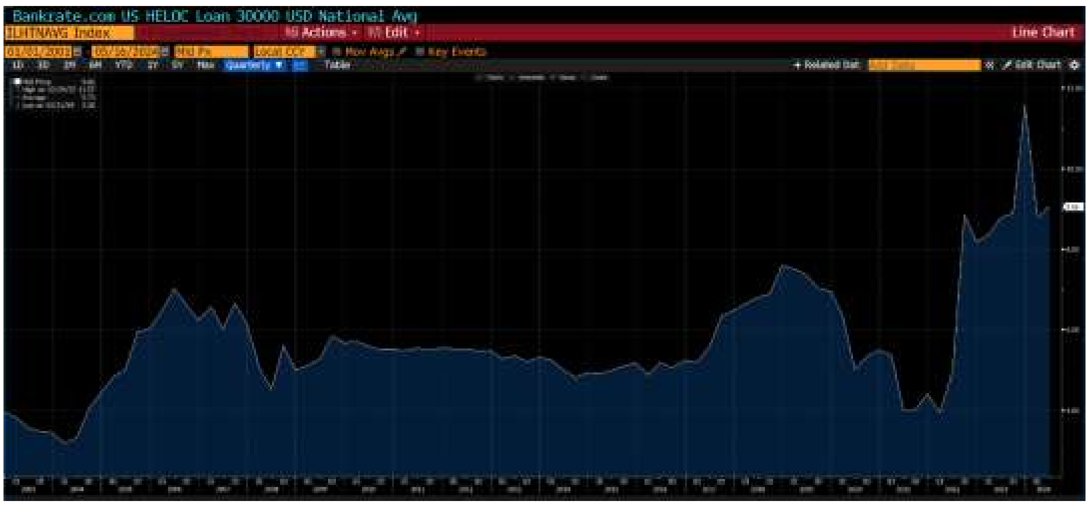
observers claim that "trillions" in new closed-end second liens could be unlocked by this proposal.[2] Goodman, Kaul and Tozer (2023) have called for creation of a subprime second lien market in government-insured loans.[3]

We think this proposal is reckless and ignores the public record regarding the credit performance of subprime second liens over the past 30 years. The total market for closed-end second liens is less than $50 billion in UPB today, in large part because of subprime credit losses following 2008. Although second liens as an asset class have typically been seen as products for a rising interest rate environment, volumes actually fell 20% in 2023. The chart below shows the Bankrate HELOC index.



Source: Bloomberg (05/17/24)

"An estimated $49.30 billion of new commitments for home equity lines of credit and closed-end second liens were originated during the quarter, down 7.3% from the third quarter," reports *Inside Mortgage Finance*.[4] We suggest to our colleagues at the FHFA that interest rates have not been high enough long enough to truly stimulate interest in the entire sector of second liens and HELOCs. But this does not mean that the FHA or Freddie Mac should start to guarantee subprime closed-end seconds. Through this proposal, Freddie Mac risks becoming the "patsy" in the next down cycle in US home prices.

Freddie Mac indicates that the primary goal of this proposed new product is "to provide borrowers a lower cost alternative to a cash-out refinance in higher interest rate environments." But is that really true? A cash-out refinance into a 15-year floating rate first lien may be a better trade for many low-income consumers today vs a second lien with a double-digit coupon. Subprime seconds have coupons in low to mid-teens depending on the credit and LTV. We believe that the illustrations used by Freddie Mac in this proposal are misleading. A loan officer acting in the best interest of a low-income consumer might recommend the 15-year refinance loan vs a second lien so as to eliminate the mortgage debt faster.

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[2] Whitney, Meredith "The mortgage reform that could unleash the next big US stimulus," *Financial Times*, May 3, 2024

[3] Goodman, Laurie, Kaul, Karen, and Tozer, Ted, "Second-Lien Securitization Could Be Key to Accessing Home Equity in a High-Rate Environment," *Urban Institute*, January 2023.

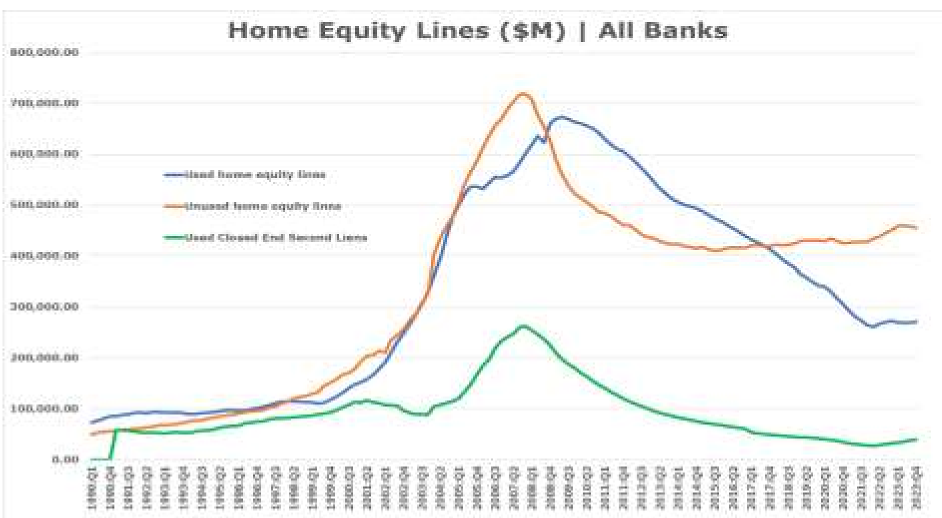
[4] *Inside Mortgage Finance*, March 22, 2024

The Freddie Mac proposal should make clear that the target is subprime borrowers and that the consumer is likely to pay a significantly *higher annual percentage rate (APR)* on the second lien, say +300-400bp, than on a new first lien mortgage.[5] Given the inferior credit of the subprime borrower, the coupons on these subprime second liens should be even higher than the Bankrate average for HELOCs. Given where we are in the housing cycle, we submit that deliberately putting a subprime borrower into a second-lien mortgage in 2024 violates the established legal concept of providing a “net tangible benefit” to the borrower and could be a path to disaster for the consumer.

In questions 1 & 2, we can stipulate that the proposed activity is allowed under current law, although we think that the prospective harm to consumers may contradict this view, as we discuss below. In question 3, you ask “To what degree might the proposed new product already be supplied by other market participants?” This is the core issued raised by the subject proposal.

Freddie Mac is proposing a solution to a problem that does not really exist. The non-bank market for seconds is limited to a few nonbank issuers that sell the assets to private investors. Over the past two years, there have been several dozen private securitizations totaling single-digit billions, but the subprime component of these deals is unknown. Since the margins in conventional lending are non-existent, some lenders are pushing into HELOCs and non-QM loans.

This proposal will greatly increase risk to the enterprises and the taxpayer, and hurt private markets and lenders. The market for prime second liens is arguably over-served by private lenders, which today have unused credit available to lend that is in excess of current exposures by over 100%. Just to make the point, despite tough Basel III capital weights on second liens, existing lenders, who are predominantly banks and credit unions, would more than double current exposures from where they stand today, as shown in the chart below. Unused credit lines on HELOCs totaled almost $450 billion at the end of 2023.



Source: FDIC

As you can see in the chart, bank owned second liens (green line) comprise about 20% of the market or $50 billion in UPB, while revolving home equity lines of credit (HELOCS) take up the rest. It is significant that for both second liens and HELOCS, banks are the predominant producers and

[5] The price differential between first and second liens reflects the inferior security of the second and the higher loss severity in the event of default.

also tend to hold these subordinate notes in portfolio. Banks have about 90% market share in closed-end second liens and credit unions have the remainder.[6] The data from the FDIC is a significant subset of the total market, with the remainder held by nonbank lenders, insurance companies and hard money investors. The average FICO score for these exposures is reported to be north of 750.

In question 4, you ask "To what degree might the proposed new product promote or lessen competition in the marketplace?" The proposal threatens to create a government-subsidized market for subprime seconds and take away cash-out refinance business from conventional lenders, a strikingly insensitive proposal at a time when lenders are struggling with profitability and even survival. The proposal would cannibalize cash-out refinance loans offered by nonbank issuers, which currently comprise almost 10% of total mortgage lending volumes and represent some of the more profitable loans.[7]

In question 5 you ask, "To what degree might the proposed new product overcome natural market barriers or inefficiencies?" The new product for Freddie Mac is unneeded, thus there are no barriers or inefficiencies to address. Note please that there is no real secondary market in prime second liens because retaining these prime credit loans in bank portfolio is the most efficient way to fund them. The market for private subprime second liens is very limited because of the elevated credit risk.

Nonbank issuers have no comparative advantage originating prime close-end seconds vs a bank, which have a 300-400bp funding advantage. Is there money to be made in originating and selling subprime second liens? Some nonbanks are trying, but first lien non-QM loans are far more profitable. Compare the vibrant secondary market for non-QM jumbo first lien mortgages with the tiny market for subprime second liens.

In question 6, you ask: "To what degree might the proposed new product raise or mitigate risks to the mortgage finance or financial system?"

After the question of taking profitable business away from private lenders, the issue of increased risk to the enterprises is significant and not addressed by the proposal. Freddie Mac is essentially asking for authority to increase subprime credit exposures on existing borrowers up to 80% LTV. Freddie Mac is proposing to do this at the top of the housing market, after a decade-long upward surge in home prices. In a home price correction later in the decade, many of second lien notes written since 2020 will become worthless and illiquid, forcing banks and the GSEs to write them down.

The chart below shows the credit performance of bank-owned seconds since 1990. Notice in the chart that the net loss rate on bank-owned HELOCs is currently negative, as is the case with first liens. The huge volatility in interest rates since 2019 and the related downward skew in loss rates, which reflects strong home prices, is a blazing red flag for the FHFA and financial regulators. During the 2008 crisis, bank losses on seconds were significantly higher than on first liens. Frankly, if Freddie Mac takes on these subprime exposures at this stage of the housing market, as a matter of prudence we'd encourage the FHFA to require Freddie Mac to write-off the seconds entirely.

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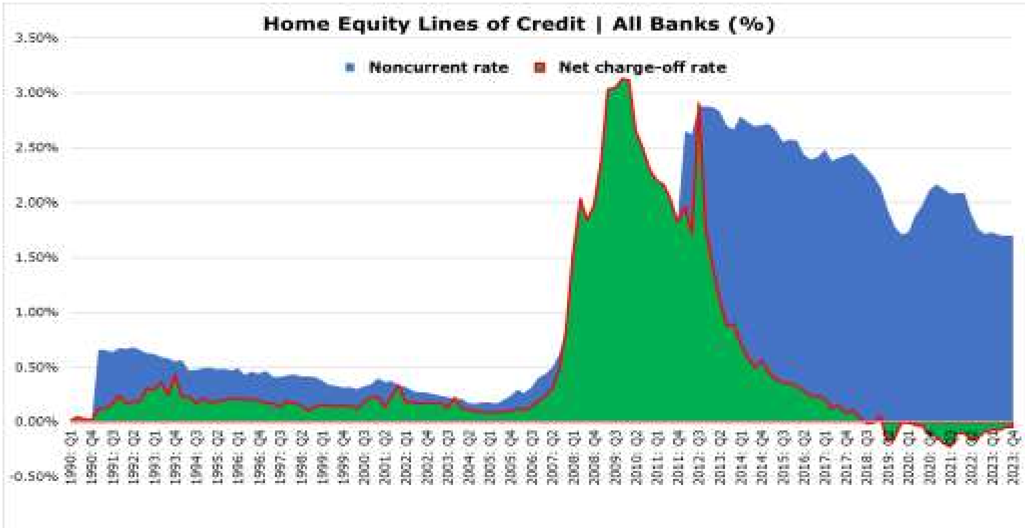
[6] Most states allow independent mortgage banks (IMBs) to originate both second liens and HELOCs, but as a practical matter due to funding most of the loans end up being owned and serviced by banks. *Inside Mortgage Finance*, March 22, 2024

[7] Adelberg, Erica "GSE Second Lien Mortgages Could Dampen Prepays, Supply," *Bloomberg Intelligence*, May 14, 2024



Source: FDIC

At some point in the future, we will see mean reversion and a large home price reset like the early 1990s and the 2010s. Our view within WGA, which is informed by our work with a number of large issuers, is that home prices will rise sharply as and when short-term interest rates fall, followed by a significant correction possibly back down to near 2020 levels. Higher long-term interest rates will cause net loss rates to revert to the average ~ 70% of the UPB of the loan. All seconds created since before COVID and many first liens will be underwater.

Finally, in response to question 9 of the proposal, we submit that this notice is incomplete. It does not discuss or evaluate the possible harm to consumers that can arise when the federal government promotes a subprime loan product over other products that are priced for the risk, especially when these home equity products have such a checkered and well-documented history. Patterson & Rogers (1994) note:

> "While home equity loans carry a risk to the borrowers of losing their homes, homeowners cannot properly assess this risk due to their tendency to underestimate the probability of default and foreclosure. Homeowners who do lose their homes to foreclosure may be devastated, both financially and psychologically." [8]

While there have been a number of changes since the 1990s to make home equity products less attractive for unscrupulous lenders, there is no discussion in this proposal as to how Freddie Mac will monitor this risk to low-income borrowers and prevent lenders from using the price advantage conferred by the GSE guarantee to engage in deceptive and abusive behavior in originating closed-end seconds. But the bigger risk to consumers is taking on more mortgage debt just when home prices may decline for the first time in a decade.

When either of the GSEs leans in favor of one product or another in the name of the "mission," then we are injecting dangerous subjective political judgments into the credit process that may harm consumers and the enterprises. What could be worse for a consumer than taking on new debt at the top of the home market at a double-digit APR? Is it really worth gambling with the financial future

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[8] Rogers, Forrester, Patterson, Julia, "Mortgaging the American Dream: A Critical Evaluation of the Federal Government's Promotion of the Home Equity Financing (1994)." *Tulane Law Review*, Vol. 69, No. 2, 1994, Available at SSRN: https://ssrn.com/abstract=2712870

of American consumers just so that President Joe Biden can make soundbites about “helping consumers” with the rising cost of housing during his reelection campaign?

We will be happy to answer any questions regarding these comments.

Yours sincerely,

Christopher Whalen
Chairman