Response to FHFA's Request for Comment on Freddie's New Loan Product

The new closed-end second lien mortgage program proposed by Freddie Mac is a step forward in the direction of addressing the issues faced by the consumer because of the unusual housing market conditions. We believe that more needs to be done to stem the downward affordability spiral that consumers are being subject to because of the severe supply-demand imbalance in the housing market.

Given that Freddie Mac's charter is to "promote access to mortgage credit", we recommend that the new proposed closed-end second lien mortgages be combined with "selective assumability" (by refraining from exercising the "due-on-sale" clause) for homes being purchased by first-time homebuyers to help restore normalcy to home sale transactions and thereby increase their access to mortgage credit.

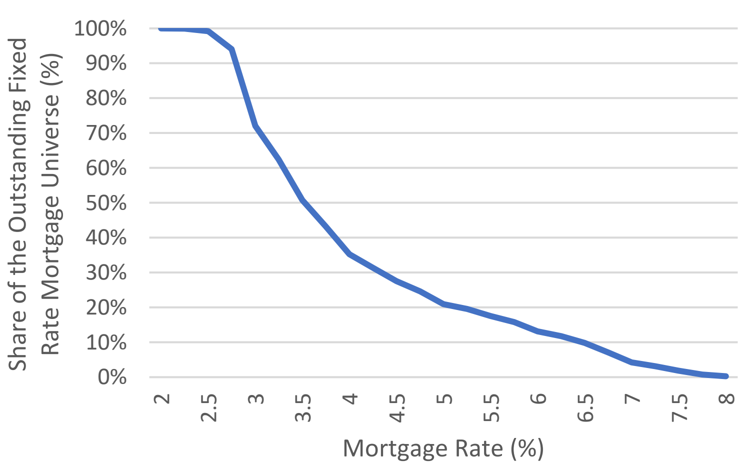
Unusual Housing Market

The housing market today feels unusual in many ways. The Fed raising rates by more than 500bps and mortgage rates around 7% (levels only seen prior to the GFC) has caused affordability to drop to all-time lows. However, home prices have been resilient because of the severe imbalance in housing demand and supply. The supply of homes remains severely constrained partly because the ultra-low mortgage rates on the outstanding mortgage debt (Figure 1) has disrupted the typical cycle of home sale transactions. Typically, a first-time home buyer begins with a starter home, then upsizes based on the growing family needs and eventually downsizes on retirement.

The average mortgage rate on the outstanding universe of mortgages is 3.5%, around 350bp lower than current mortgage rates, imposing a significant friction on borrower mobility. The average mortgage payment increase that a borrower would face while moving is around 48%.

The severe shock to affordability, because of both higher mortgage rates and higher home prices, has made it difficult for borrowers to both upsize and downsize, and the resulting constraints on borrower mobility have exacerbated the lack of housing supply. We propose easing the strict enforcement of the "due-on-sale" clause by providing "selective assumability", which, when combined with the new proposed closed-end second lien mortgage, would likely help address the lack of supply in the housing market.

Figure 1: Share of the Outstanding Mortgages with Rates at or Above Various Mortgage Rates



Source: EMBS, Metacapital

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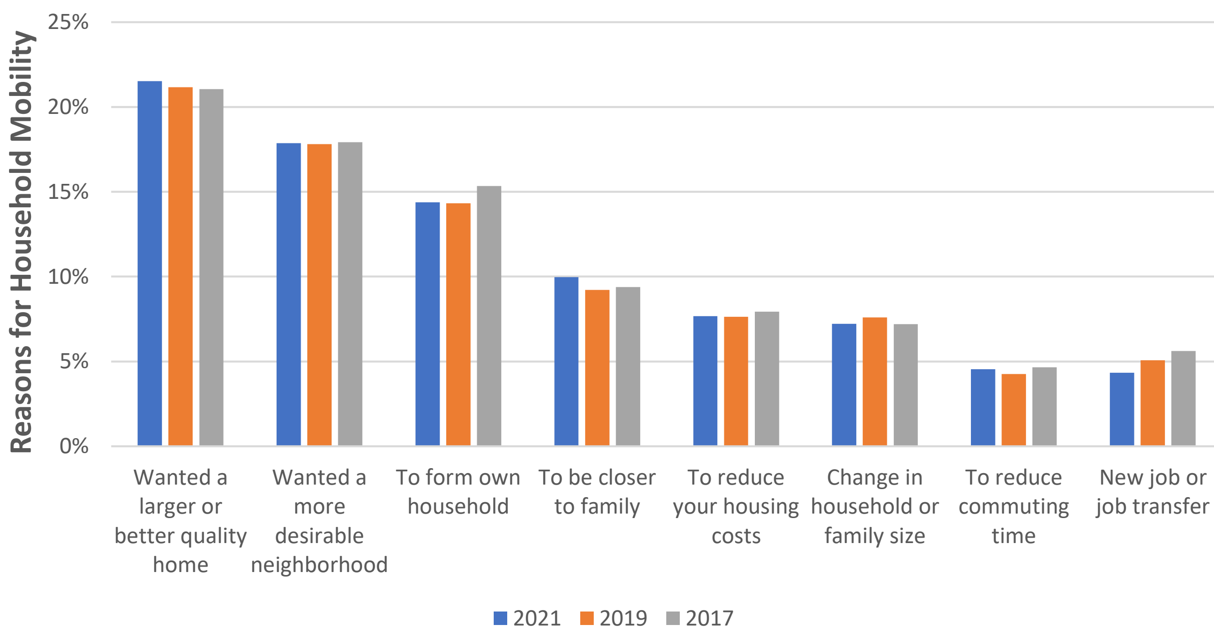
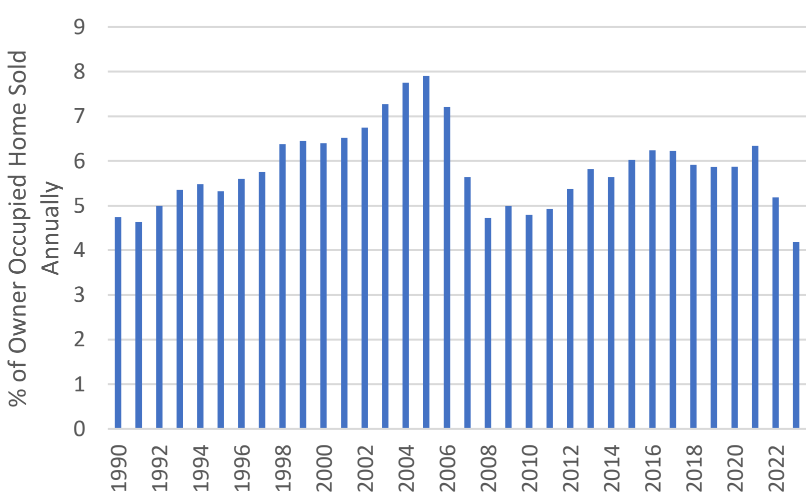
The American Housing Survey, which tracks borrower mobility over a two-year period, was last conducted in 2021, which may have been too soon to capture the full impact of higher mortgage rates on household migration. However, looking at the main reasons for borrower mobility (Figure 2), it is rather intuitive that a 48% increase in mortgage debt payment alone (ignoring the home price increase seen during the same period) would pose a significant economic challenge for borrower mobility. Not surprisingly, we have noticed a sharp decline in the number of homes turning over in a year (Figure 3). A recent working paper published by FHFA estimates that the lock-in effect of rising mortgage rates led to a 57% reduction in home sales with fixed-rate mortgages in Q4 2023 and prevented 1.33 million sales between Q2 2022 and Q4 2023[1].

Figure 2: Top Reasons for Household Mobility



Source: AHS, Metacapital

Figure 3: Share of Owner-Occupied Home being Turned Over (i.e. sold) in a Year



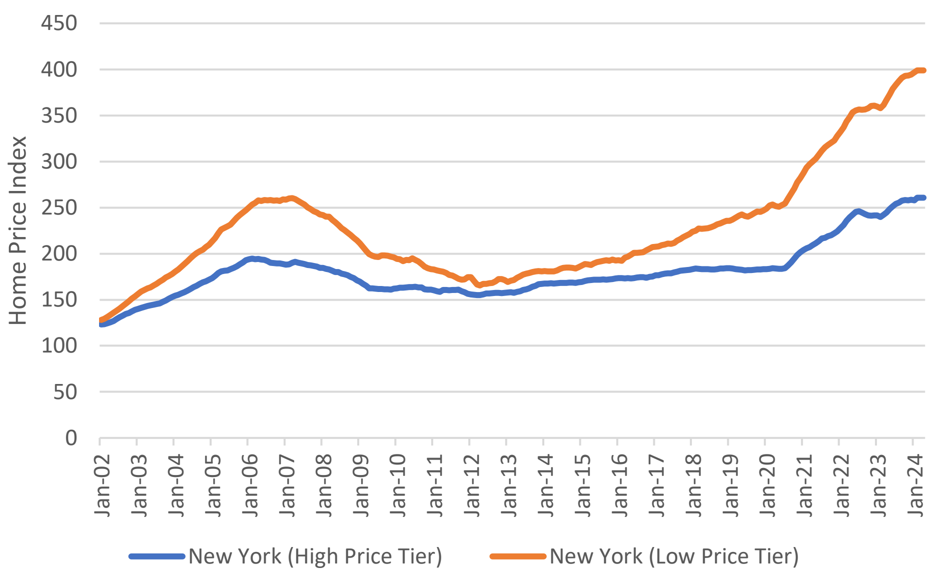
Source: NAR, Metacapital

[1] https://www.fhfa.gov/PolicyProgramsResearch/Research/Pages/wp2403.aspx

Housing Shortage Props Up Home Prices Despite Historic Low Affordability

The reduced household mobility not only has reduced housing demand but also deprived the market of the necessary housing supply. For example, the starter homes that would have been made available by borrowers looking to move to a larger/better home are now unavailable because of the mortgage rate lock-in effect. Given that household formations have continued to hold steady, the supply demand imbalance for first-time home buyers has become severe. This has resulted in outsized home price increases for starter homes (Low Price Tier Index, Figure 4), thereby exacerbating the affordability crisis for first-time home buyers. This downward affordability spiral, resulting from higher mortgage rates and increasing home prices (in a supply constrained housing market), is unlikely to ease anytime soon without intervention. The FHFA working paper estimates that supply reductions increased home prices by 5.7%, outweighing the direct impact of elevated rates which decreased prices by 3.3%[2].

Figure 4: Home Price Increase for Different Price Tiers in New York



Source: Corelogic, Metacapital

Record High Home Equity

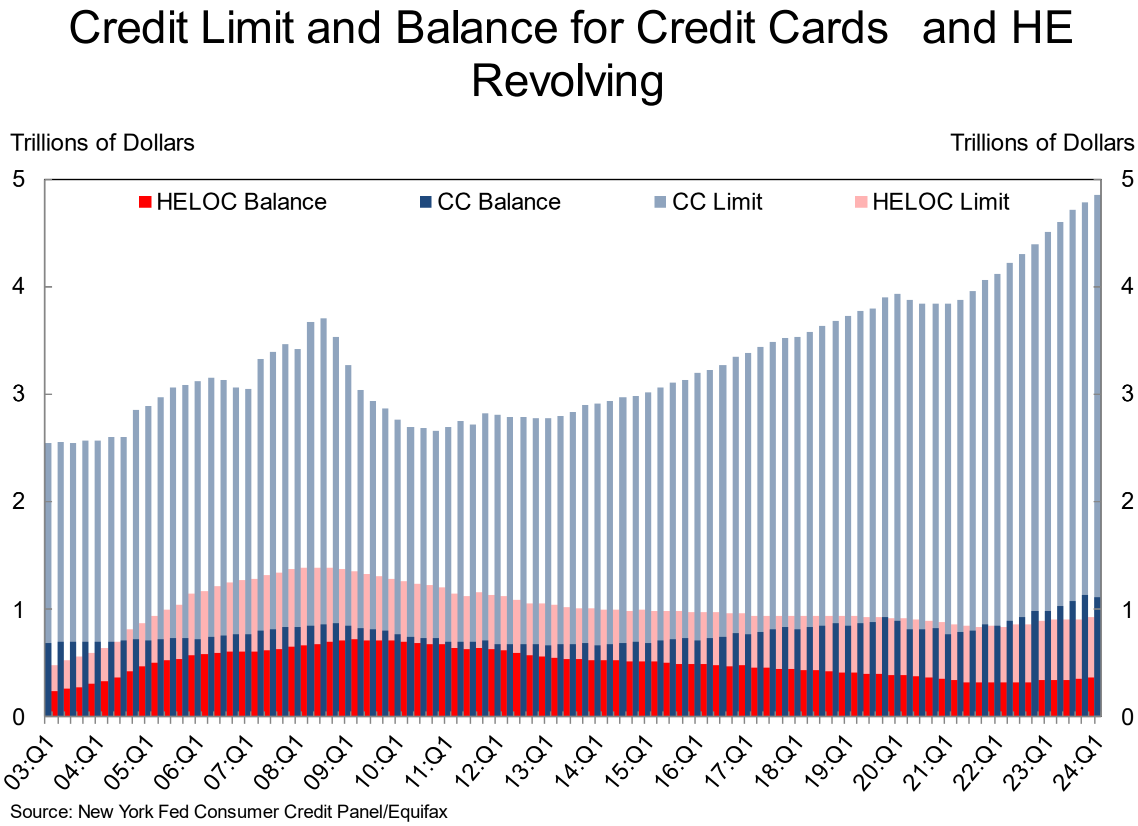
This supply demand imbalance in the housing market has caused home prices to continue to increase despite affordability being at all-time lows. While current homeowners have seen equity in their homes balloon, they have not been able to benefit from it. For the universe of homes with mortgages, Black Knight[3] estimates that borrowers have $11 trillion of tappable equity – an all-time high, equating to approximately $206K per borrower.

With persistent high inflation, it is not surprising that certain households are looking to access more credit. With mortgages rates around 7%, not many are looking to tap into their home equity through the most often used route of a cashout refinance. Instead, consumers have been tapping expensive credit card debt (Figure 5). Consequently, households' inability to tap the home equity has unnecessarily burdened household balance sheets. The new proposed closed-end second lien mortgage program will help borrowers access credit at more affordable rates.

[2] https://www.fhfa.gov/PolicyProgramsResearch/Research/Pages/wp2403.aspx

[3] https://www.icemortgagetechnology.com/resources/data-reports/may-2024-mortgage-monitor

Figure 5:



Improving Access to Mortgage Credit for First-Time Home Buyers

While a stand-alone second lien program is likely to allow existing homeowners to tap equity in their homes at relatively attractive rates, first-time home buyers are less likely to benefit from it. Currently, the GSEs choose to not exercise the "due-on-sale" clause for certain mortgages they guarantee, provided certain conditions are met[4]. Extending a similar exception to homes being sold to first- time home buyers ("selective assumability") along with a second lien mortgage can improve mortgage affordability. Improved mortgage affordability through "selective assumability" combined with second liens will provide the much-needed relief to the current supply demand imbalance in the housing market. As seen in Figure 6, the first-time homebuyer saved 18% on their monthly mortgage payments when combining assumability along with a closed-end second lien.

In fact, FHA, VA and Fannie should align with Freddie and look to launch a similar second lien program. Although all FHA/VA loans are assumable there are currently very few loans being assumed because borrowers lack the large upfront funds needed to assume mortgages on homes with huge home equity. A second lien program launched by FHA/VA would go a long way to help address the affordability issue faced by first-time home buyers; the main constituent of FHA/VA portfolio.

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[4] For example, servicers can follow the procedures for requesting approval for the assumption of a delinquent conventional mortgage loan to determine whether Fannie Mae is willing to forego enforcement of the due-on-sale provision.

Figure 6: Impact of "selective assumability" combined with closed-end second lien mortgage for a first-time homebuyer.

	Option A	Option B
Scenario	• Assume Current First Mortgage UPB of $160,000 • Obtain a Second Mortgage for $40,000 • Borrower brings 20% downpayment of $50,000	• New Purchase First Mortgage for $200,000 • Borrower brings 20% downpayment of $50,000
First Mortgage Terms	• UPB: $160,000 • 3% Fixed Rate originated in 2021 • 324 remaining payments	• UPB: $200,000 • 7% Fixed Rate originated in 2024 • 360 payments
First Mortgage Payment	$721.12	$1,330.60
Second Mortgage Terms	• UPB: $40,000 • 9.5% Fixed Rate originated in 2024 • 240 payments	N/A
Second Mortgage Payment	$372.85	N/A
Total Monthly Mortgage Payment	**$1,093.97**	**$1,330.60**

Source: Metacapital

Conclusion

Freddie Mac's new closed-end second lien mortgage product is a step in the right direction, as it does improve borrower balance sheets by allowing them to tap into their home equity more efficiently. However, it does not go far enough to help address the current broken state of the housing market which has sidelined many first-time home buyers. The proposed second lien program can be combined with "selective assumability" to stop the downward spiral of affordability and make mortgage credit more accessible to first-time homebuyers. We strongly urge all government agencies to consider a similar program.