STRUCTURED
FINANCE
ASSOCIATION

May 22, 2024

The Honorable Sandra Thompson
Director
Federal Housing Finance Agency
400 7th Street, SW
Washington, DC 20024

Dear FHFA,

The Structured Finance Association (SFA) writes in response to the proposal by Freddie Mac to begin purchasing closed-end second loans ("the Proposal"). We welcome the opportunity to provide comments from our members, which include agency and non-agency mortgage-backed securities investors, issuers, banks, non-bank mortgage lenders, and other securitization market participants. We especially appreciate that the FHFA has sought public comment under its recently promulgated New Product Rule.[1]

Introduction

SFA has solicited feedback from its members. Based on that feedback, SFA encourages FHFA not to approve Freddie Mac's proposal to purchase closed-end second mortgages. The Proposal raises serious concerns about the appropriate role of the government-sponsored enterprises (GSEs) in the housing finance market, risks crowding out private capital, may exacerbate current housing affordability challenges, and ultimately expands the GSEs footprint—a footprint that already dominates our nation's housing finance system.[2] We understand that there may be some ancillary benefits to the Proposal, but it is our view that the hazards posed outweigh any potential benefits that may materialize.

In this letter, we begin describing the dominance of the GSEs in the mortgage market, and then summarize the Proposal and its prospective benefits and risks to taxpayers. We then describe the role that private capital plays in providing home equity loans, and highlight some potential adverse macroeconomic consequences of a large-scale increase in home equity extraction via the GSEs. We then offer responses to the specific questions posed by FHFA in the Proposal. Finally, we offer suggestions for how the Proposal might be refined to at least marginally improve mission alignment, reduce taxpayer risk, and lessen its effect on private markets.

[1] See: https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Prior-Approval-for-Enterprise-Products-Final-Rule.aspx
[2] Note that we presume that, if approved, Fannie Mae would implement a similar program.

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The GSEs Dominate the Mortgage Market and Have Competitive Advantages

Fannie Mae and Freddie Mac have long dominated the U.S. housing finance system. As of year-end 2023, the GSEs managed the credit risk on $6.7 trillion in 1-4 family mortgages (48% of the $14.0 trillion outstanding).[3] At the same time, the federal government held $2.4 trillion of this risk through its primary mortgage insurance programs and depository institutions collectively held $3.6 trillion. The remaining outstanding mortgages were held by other investors, including through private securitization.

The GSEs can achieve such scale primarily because of their Congressional charters, which include preferential regulatory and tax treatments.[4] As a result, investors perceive that the GSEs had implied federal backing which, in turn, substantially reduces financing costs and provides a material competitive advantage. The GSEs were placed into federal conservatorship in 2008 and subsequently entered into preferred stock purchase agreements with the U.S. Treasury to absorb mounting losses. These agreements, which remain in place today, hardened market expectations that GSE obligations are guaranteed by U.S. taxpayers.

Private Capital Finances Home Equity Lending

The Federal Reserve estimates that, as of year-end 2023, there were $512.3 billion in home equity loans outstanding.[5] These loans, which take the form of either home equity lines of credit (generally floating rate) or closed end second liens (generally fixed rate), are predominately held by depository institutions (87% of the outstanding balance). Of the $445.7 billion held by banks and credit unions, closed end second liens totaled $81.0 billion.[6]

Private securitization of home equity loans, while modest, recently have picked up. There have been seven closed-end second lien deals totaling $2.3 billion through April 2024, exceeding the six deals totaling $1.9 billion issued in 2023. Moreover, secondary market spreads for AAA-rated tranches of these securitizations have tightened over the past year, suggesting that increased investor interest and familiarity has improved pricing.

A recent report from Deutsche Bank highlights aspects of five recent closed-end second lien securitizations in 2024.[7] Key provisions of these deals include:

- Weighted average FICO scores between 723-741,
- Weighted average (combined) LTV from 68-74%,
- Average loan balances from $72,640 to $91,710.

These pool characteristics are consistent with the Proposal. As a result, the Proposal would squarely target borrowers that are already served by the private market. Allowing the GSEs to enter and leverage their competitive advantages would risk cannibalizing private market activity.

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[3] Inside Mortgage Finance (March 15, 2024).
[4] The Charter Acts for each institution can be found at:
https://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/About-Fannie-Mae---Freddie-Mac.aspx
[5] Financial Accounts of the United States Table L.218.
See: https://www.federalreserve.gov/releases/z1/20240307/z1.pdf
[6] Inside Mortgage Finance (March 22, 2024).
[7] "The Outlook: The Closed End Second and HELOC Handbook" available at http://research.db.com/research/TinyUrl/46VJT

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The Proposal: Consumer Benefits and Risks to Taxpayers and Investors

Freddie Mac is proposing to purchase closed-end second lien mortgage loans from approved primary market lenders and for which they hold the first lien. The loans would have fixed rates, terms of up to 20 years and would fully amortize, with a maximum combined loan-to-value ratio of 80%. Initially these loans would be purchased through Freddie Mac's cash window at spot prices. The intention is that these loans would be held on Freddie Mac's balance sheet until a secondary market can be later established.

One motivation for the Proposal seems to be a view that the only existing option for borrowers to access their home equity is to do a cash-out refinance. This is a false comparison, as currently the most economic transaction for a borrower is to take out a home equity loan in the existing $500 billion private market. Cash out refinance activity is now extremely low by historical standards.[8]

A recent Bank of America research report quantifies the combined "opportunity set" for the GSEs in the home equity lending market at $1.85 trillion.[9] The analysis is based on current loan-to-value ratios that account for past home price appreciation and focuses on existing mortgages with interest rates below 4% and assuming a combined loan-to-value of no more than 75%.

By establishing a large-scale closed-end second lien program, the GSEs would likely expand the availability of this product, reduce the cost of such credit, and act as a stabilizing secondary market bid. Of course, the GSEs' ability to do this arises from their competitive advantages, including taxpayer support. Notwithstanding such potential benefits, and for the reasons detailed below, we believe the costs of the Proposal outweigh the benefits.

When a borrower extracts home equity with a private lender, the subordinate exposure acts as a buffer against loss to a GSE that holds the first lien risk. Under the Proposal, however, a GSE would simply increase its risk exposure to the borrower. In the event of a housing market downturn, taxpayers would be exposed to significantly higher losses than would otherwise be the case. We believe this is inconsistent with the FHFA's statutory mandate as conservator to preserve and conserve GSE assets.

Home equity borrowing also has implications for investors in GSE-issued mortgage-backed securities (MBS) and credit risk transfer (CRT) securities. For MBS investors, subsequent second lien exposure will tend to reduce the likelihood of mortgage termination through home sale and hence extend the expected life of the loan. For CRT investors, new second liens increase the likelihood of default in adverse macroeconomic environments. These dynamics exist irrespective of the second lien provider, although the GSEs ability to facilitate significant home equity extraction at a scale only they can accomplish would have an outsized negative effect on MBS and CRT investors.

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[8] Alexi Alexandrov, Noah Cohen-Harding, and Patrick Lipid (2023) "A Look at Cash-Oujt Refinance Mortgages and their Borrowers Between 2013 to 2023." Available at: https://www.consumerfinance.gov/about-us/blog/office-of-research-blog-a-look-at-cash-out-refinance-mortgages-and-their-borrowers-between-2013-to-2023/

[9] See: https://rsch.baml.com/r?q=mcPrfIISKp!EgchqpCYnYA&e=yuli.yin%40bofa.com&h=38d-7Q

The Program Could Have Macroeconomic Consequences

The introduction of large-scale closed-end second lien programs by the GSEs could exacerbate the current "rate lock" effect limiting home inventory for sale and act as inflationary economic stimulus.

Exacerbating the "Rate Lock" Effect. The FHFA recently published a working paper titled "The Lock-In Effect of Rising Mortgage Rates," which examines the impact of rising mortgage rates on borrowers, sellers, and the broader housing market. The executive summary states:

This mortgage rate lock-in led to a 57% reduction in home sales with fixed-rate mortgages in 2023Q4 and prevented 1.33 million sales between 2022Q2 and 2023Q4. The supply reduction increased home prices by 5.7%, outweighing the direct impact of elevated rates, which decreased prices by 3.3%. These findings underscore how mortgage rate lock-in restricts mobility, results in people not living in homes they would prefer, inflates prices, and worsens affordability. Certain borrower groups with lower wealth accumulation are less able to strategically time their sales, worsening inequality.[10]

Allowing the GSEs to purchase closed-end second mortgages, if sufficiently scaled, could exacerbate the housing rate lock effect. Prospective homeowners would see fewer homes available for sale, which puts upward pressure on home prices and reduces housing affordability. Rising home prices have been an important component of elevated inflation in recent years.[11]

Stimulus Could be Inflationary. The impact of rising home prices is not limited to the housing market. Indeed, large-scale equity extraction for home improvements and consumption would increase overall demand in the economy and increase inflation. This would work at cross-purposes with the Federal Reserve's efforts to tame inflation through higher interest rates and thus may lead to higher rates and for a longer period.

In short, FHFA should be mindful of the unintended consequences of borrowers unlocking a significant amount of home equity through the GSEs.

The 30-day Timeframe for Evaluating New Products is Too Short

We appreciate that the FHFA has published the Proposal for public comment under its New Product Rule. However, many of our members noted that the timeline for submitting and reviewing comments (a 30-day public comment period and the 30-day review period) is inadequate for a change of this potential magnitude. Recognizing that the 30-day time periods are statutorily mandated, one idea looking forward is that FHFA provide an "advance notice" ahead of new product proposals which are complex or that could have an outsized impact on the market. At a higher level, we believe that the statutorily mandated 30-day review period is a clear indication of Congressional intent as it relates to the scale and scope of new products that should be considered.

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[10] Ross M. Batzer, Jonah R. Coste, William M. Doerner, and Michael J. Seiler (2024) "The Lock-In Effect of Rising Mortgage Rates." Available at: https://www.fhfa.gov/PolicyProgramsResearch/Research/Pages/wp2403.aspx

[11] W. Scott Frame and Kristopher Gerardi (2023) "Recent Trends in U.S. Home Prices and Mortgage Interest Rates". Available at: https://structuredfinance.org/recent-trends-in-u-s-home-prices-and-mortgage-interest-rates/

Responses to FHFA Questions

1. To what degree might the proposed new product advance any of the purposes set forth in Freddie Mac's charter act?

Freddie Mac's charter articulates four public policy purposes:
(1) to provide stability in the secondary market for residential mortgages;
(2) to respond appropriately to the private capital market;
(3) 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) **by increasing the liquidity of mortgage investments** and improving the distribution of investment capital available for residential mortgage financing; and
(4) to promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) **by increasing the liquidity of mortgage investments** and improving the distribution of investment capital available for residential mortgage financing.

The Proposal refers to the charter's mandate to provide mortgage market liquidity, stating:
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.[12]

Importantly, increasing liquidity is not itself a public policy purpose of the GSEs. Instead, the "increasing liquidity of mortgage investments" is done in furtherance of the goals of "providing assistance to secondary market" and "promoting access to credit." This suggests that in instances where assistance is not needed, or where access to credit already exists, there is no rationale for increasing liquidity. As discussed above, there is no identified need for assistance or obstacles to credit access in the existing market for closed-end second mortgages. The Proposal does not represent an appropriate response to the private capital market.

Freddie Mac's public policy purposes reference specific populations and geographies (i.e., low- and moderate-income families, as well as central cities, rural areas, and underserved areas) that merit particular focus. However, the Proposal does not seek to remedy any identified obstacle to mortgage credit for borrower populations that may be currently underserved by the existing closed-end second market.

2. To what degree might the proposed new product advance Freddie Mac's Duty to Serve Underserved Markets activities and support Freddie Mac in meeting its housing goals?

The Proposal does not advance Freddie Mac's Duty to Serve Underserved Markets or support Freddie Mac in meeting its housing goals. There is nothing in the Proposal that indicates any benefit targeting underserved markets. In fact, to the degree that widescale equity extraction is facilitated by the GSEs, this could exacerbate the existing housing rate lock effect that limits

[12] https://www.federalregister.gov/documents/2024/04/22/2024-08479/freddie-mac-proposed-purchase-of-single-family-closed-end-second-mortgages-comment-request#footnote-14-p29330

housing supply, increases housing prices, and worsens housing affordability. In short, the Proposal does nothing to advance GSE housing goals and may, in fact, be a hindrance.

3. To what degree might the proposed new product already be supplied by other market participants?

As discussed above, over $500 billion in home equity loan balances is currently outstanding, and about 20% of that balance results from closed-end second mortgages. This market is primarily funded by depository institutions, but private securitization activity has been expanding.

4. To what degree might the proposed new product promote or lessen competition in the marketplace?

As previously noted, there exists a well-functioning market for home equity loans, including closed-end second mortgages. Allowing the GSEs to enter and leverage their competitive advantages risks stifling the competitive landscape and displacing existing market participants, including private securitization investors and ancillary service providers[13].

5. To what degree might the proposed new product overcome natural market barriers or inefficiencies?

We believe that the burden of demonstrating the existence and size of natural market barriers or inefficiencies lies with the GSE proposing a new product. Deliberations with our members also did not identify any existing market barrier or inefficiency, as creditworthy borrowers can readily access second lien credit at market-driven rates.

6. To what degree might the proposed new product raise or mitigate risks to the mortgage finance or financial system?

The Proposal would result in the Freddie Mac – and by extension taxpayers -- increasing its risk exposure to their existing borrowers. Hence, in the event of a housing market downturn, taxpayers would be exposed to significantly higher losses than would otherwise be the case.
It would be helpful to see historical analysis of the performance of this product through the housing crash and Great Recession and how this informs the calibration of regulatory capital charges.

7. To what degree might the proposed new product further fair housing and fair lending?

The Proposal makes no mention of how it would further fair housing and fair lending and we do not believe that it would.

[13] Our members have specifically mentioned that private investors have increased adoption of streamlined and lower-cost property appraisal processes in the closed-end second market.

8. To what degree might borrowers benefit from or be adversely affected by the proposed new product?

Borrowers will likely benefit from lower interest rates, the extent to which will determine how much additional homeowner equity will be extracted. The GSEs' ability to offer lower interest rates is a result of their funding advantage.

9. Are there any other factors that the Director should take into consideration concerning the proposed new product?

Suggested Refinements to the Proposal

While we believe the FHFA should deny the Proposal in its current form, we share some suggested refinements for the FHFA to consider before permitting the GSEs to enter this market. We believe these changes will, on the margin, improve mission alignment, reduce taxpayer risk, and lessen the effect on private markets.

1.) Establish aggregate limits on program size. Such limits, which would be consistent with those set for the GSEs multifamily mortgage programs, could limit GSE risk from the program and allow private capital to continue participating in the closed-end second lien market.

2.) Establish second lien loan balance limits. This would be analogous to the conforming loan limits for first lien mortgages and provide for continued private-sector participation in the closed-end second market. One place to look for a balance limit could be the Qualified Mortgage Rule.[14] Subordinate lien covered transactions may be qualified mortgage loans based upon their loan amount if they have APRs that do not exceed certain thresholds above APOR. The smallest of those categories is for subordinate liens covered transactions with loan amounts of less than $66,156 (indexed for inflation) that have APRs within 6.5% of APOR for a comparable transaction on the date the interest rate is set. Currently, the 2024 balance adjusted for inflation in 2024 is $78,277. Beyond this, a prohibition on the second lien having a larger balance than the existing first lien should be considered.

3.) Limit to owner-occupied properties. Loans secured by second or vacation homes, or investment properties should be prohibited.

[14] See 12 CFR 1026.43(e)(2)(vi)(E).

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Conclusion

The SFA believes that the FHFA should not approve Freddie Mac's proposal to purchase closed-end second mortgages. The Proposal raises concerns about the appropriate role of the GSEs in the housing finance market, risks crowding out private capital, and may exacerbate current housing affordability challenges.

We appreciate the opportunity to comment on the Proposal and would be glad to provide additional information and feedback.

Sincerely,

Michael Bright
CEO
Structured Finance Association