May 22, 2024

The Honorable Sandra Thompson
Director
Federal Housing Finance Agency
Constitution Center
400 7th Street SW
Washington, DC 20219

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

Dear Director Thompson:

U.S. Mortgage Insurers ("USMI")[1] appreciates the opportunity to provide the Federal Housing Finance Agency ("FHFA") with comments on the proposed "Freddie Mac Single-Family Closed-End Second Mortgages" new product pursuant to the FHFA's Prior Approval for Enterprise Products Final Rule.[2] To best ensure that innovations do not disintermediate market participants while keeping consumers well served, USMI has consistently supported the faithful implementation of a transparent and objective process for evaluating new products at Fannie Mae and Freddie Mac (together "the Enterprises").

USMI commended[3] FHFA's Prior Approval for Enterprise Products Final Rule and believes it is appropriate to put Freddie Mac's proposal out for notice and comment to provide stakeholders and the public with the opportunity to provide meaningful input on the proposed product. This process is integral to promoting the safety and soundness of the Enterprises and ensuring that innovations do not unnecessarily crowd out other market participants.[4] As an industry focused on managing long-term mortgage credit risk and serving first-time, low- and moderate-income ("LMI"), and minority homebuyers who lack the resources for large down payments, we are committed to policies that appropriately balance safety and soundness with access to affordable and sustainable homeownership.

After careful consideration, USMI recommends that FHFA disapprove Freddie Mac's proposal to purchase closed-end second mortgages because the proposed product is not aligned with

[1] USMI membership comprises the following private mortgage insurers: Enact Mortgage Insurance Corporation; Essent Guaranty, Inc.; Mortgage Guaranty Insurance Corporation; National Mortgage Insurance Corporation; and Radian Guaranty Inc.
[2] 12 C.F.R. § 1253.
[3] https://www.usmi.org/press-release-private-mortgage-insurers-statement-on-fhfas-final-rule-for-new-gse-products-and-activities/.
[4] See Section 1321 of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, as amended by Section 1123 of the Housing and Economic Recovery Act of 2008.

Freddie Mac's explicit statutory mission, creates additional risk for Freddie Mac and, ultimately, taxpayers, lacks sufficient detail, and is duplicative of an active private market.

In addition, there are critical clarifications necessary to fully understand and comment on the proposed product. First, product eligibility should be limited to loans with an original loan-to-value ("OLTV") of 80% or below, in addition to being subject to prudential combined LTV limitations based on a new appraisal. Second, FHFA should define restrictions for the product, including debt-to-income ("DTI") limitations, caps on allowable loan amounts, and exclusions for certain loan types. It would not be prudent as a risk and policy matter for Freddie Mac, and Fannie Mae, which is sure to follow, to encourage equity extraction among borrowers who were unable to make large down payments upfront, thereby increasing the default risks of a higher risk and more vulnerable population of borrowers. This risk is particularly heightened now given the extraordinary run up in home prices since 2019. Third, capital requirements and pricing for the proposed product should be specified and articulated. Fourth, any approval should be strictly limited to the original proposed product parameters (e.g., credit and eligibility criteria). Any material expansion should be considered a "new product" and subject to further public comment facilitated by public reporting on all relevant information on the loans originated under the new product, including which borrowers were served, what savings (if any) were realized by the borrowers, risk management actions taken by Freddie Mac (such as credit risk transfer on these higher risk exposures) and the statutory and public policy rationale for any further expansion. If FHFA does not disapprove the proposed product, USMI encourages FHFA to clarify the open questions and re-submit the proposal for further input.

I. Public Interest Considerations

FHFA's Prior Approval for Enterprise Products Final Rule requires the Director to determine if a proposed new product is in the public interest based upon certain factors, including: (1) the degree to which the new product might advance any of the purposes of the Enterprise; (2) the degree to which the new product serves underserved markets and housing goals; (3) the degree to which the new product is being or could be supplied by other market participants; and (4) the degree to which the new product might raise or mitigate risks to the mortgage finance or financial system. The Prior Approval for Enterprise Products Final Rule requires the submission of a new product to specifically address the public interest factors and such considerations have not been detailed in the notice for public comment.[5] The proposed product fails to meet each of these tests; it is not consistent with Freddie Mac's mission, introduces increased risks for borrowers and the mortgage finance system, and seeks to enter a market already well served by private sector participants.

[5] 12 C.F.R. § 1253.9.

A. Freddie Mac's Single-Family Closed-End Second Mortgage Proposed Product is Not Consistent with its Mission.

Freddie Mac's statutory purpose is:

> "(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."[6]

Congress did not intend these objectives to include ongoing access to second lien products for borrowers who have already secured residential mortgage credit and achieved homeownership. The Enterprises remain in conservatorship and this proposed product does not increase Freddie Mac's safety and soundness, capitalization, or work of making home possible. The upfront affordability of achieving homeownership has been a persistent barrier for aspiring homeowners and is a paramount issue in today's economy. While a closed-end second lien product may serve some existing homeowners, the proposed product does not further access to affordable and sustainable mortgage credit for prospective homeowners.

B. History Cautions Against the Use of Second Lien Products Without Proper Guardrails, Particularly During Times of High Home Price Appreciation.

Inevitably, there is increased risk for all parties when additional debt is secured with the same collateral as a first mortgage. Much research has been conducted following the Great Financial Crisis on the role of second liens in the mortgage crisis. The prevalence of second liens made a bad situation worse.[7] FHFA itself has studied the nuanced performance of second liens and a 2014 working paper concluded, "The second-lien-associated increase in the relative odds of a negative outcome is in essence *multiplicative*, meaning that the increases have larger absolute effects for years in which defaults were generally high, in effect, magnifying mortgage risk."[8]

Following years of constrained housing supply and low interest rates, home prices nationwide appreciated by 40% in 2021 and 2022, and, today, prices remain near the historic high in many

[6] 12 U.S.C. § 1451 *et seq.*
[7] The Relationship Between Second Liens, First Mortgage Outcomes, and Borrower Credit: 1996-2010 (fhfa.gov)
[8] *Id.*

markets.[9] The proposed product allows existing homeowners to extract equity from their homes, and creates additional risk for Freddie Mac and borrowers who will be more leveraged, and may, ultimately, increase costs on these borrowers and the taxpayers who stand behind Freddie Mac. The proposal does not address any requirements related to payment history or seasoning of the first lien. Limited seasoning could exacerbate the additional risk to the borrower, Freddie Mac, and taxpayers in a home price environment that may not be stable. The soundness of the proposed product hinges on continued home price appreciation in a hot market and, without the ability to limit the purpose of the second lien, may support additional consumer spending, debt, and inflationary pressure.

There is also a distinction to be made among second lien mortgage products, including "piggyback" mortgages, home equity loans, and home equity lines of credit ("HELOCs"). Piggyback mortgages began as niche products but were increasingly designed to avoid traditional private MI protection. This loan structure typically involves a first lien mortgage equal to 80% of the purchase price of the home and a simultaneous second lien for purposes of reducing the down payment. Studies conducted by the Federal Reserve,[10] Joint Center for Housing Studies of Harvard University,[11] and Promontory Financial Group[12] have all concluded that piggyback mortgages carry increased risk that performed poorly during the Great Financial Crisis and "have historically experienced higher lifetime rates of severe delinquency than insured mortgages."[13] Since piggyback loans are not protected by private MI and expose Freddie Mac to undue credit risk, these loans should be specifically excluded from the proposal.

In addition, FHFA's Enterprise Regulatory Capital Framework ("ERCF") recognizes the heightened risk associated with second liens and applies a significant multiplier for subordination in recognition of the additional risk.[14]

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[9] FHFA Home Price Index Monthly – April 2024 [U.S. House Price Index - April 2024 | Federal Housing Finance Agency (fhfa.gov)]

[10] CHRISTOPHER J. MAYER, KARREN M. PENCE, AND SHANE M. SHERLUND, FEDERAL RESERVE BOARD, DIVISION OF RESEARCH & STATISTICS AND MONETARY AFFAIRS, FINANCE AND ECONOMICS DISCUSSION SERIES, THE RISE IN MORTGAGE DEFAULTS (November 2008), https://www.federalreserve.gov/pubs/feds/2008/200859/200859pap.pdf.

[11] Eric S. Belsky and Nela Richardson, J. Center for Housing Studies of Harv. U., *Understanding the Boom and Bust in Nonprime Mortgage Lending* (September 2010), https://www.jchs.harvard.edu/sites/default/files/ubb10-1.pdf.

[12] Promontory Financial Group, Assessing the Delinquency and Default Risk of Insured and Non-Insured High LTV Mortgages (July 15, 2011), https://www.promontory.com/uploadedFiles/Articles/Insights/Larson%20-%20Assessing%20the%20Delinquency%20and%20Default%20Risk%20of%20Insured%20and%20Non-Insured%20High%20LTV%20Mortgages.pdf.

[13] *Id.* at 17.

[14] 12 C.F.R. § 1240.

TABLE 6 TO PARAGRAPH (d)(2): RISK MULTIPLIERS

Risk Factor	Value or Range	Single-family Segment			
		Performing Loan	Non-Modified RPL	Modified RPL	NPL
Loan Purpose	Purchase	1.0	1.0	1.0	
	Cashout refinance	1.4	1.4	1.4	
	Rate/term refinance	1.3	1.2	1.3	
Occupancy Type	Owner-occupied or second home	1.0	1.0	1.0	1.0
	Investment	1.2	1.5	1.3	1.2
Property Type	1-unit	1.0	1.0	1.0	1.0
	2-4 unit	1.4	1.4	1.3	1.1
	Condominium	1.1	1.0	1.0	1.0
	Manufactured home	1.3	1.8	1.6	1.2
Origination Channel	Retail	1.0	1.0	1.0	1.0
	TPO	1.1	1.1	1.1	1.0
DTI	DTI <= 25%	0.8	0.9	0.9	
	25% < DTI <= 40%	1.0	1.0	1.0	
	DTI > 40%	1.2	1.2	1.1	
Product Type	FRM30	1.0	1.0	1.0	1.0
	ARM1/1	1.7	1.1	1.0	1.1
	FRM15	0.3	0.3	0.5	0.5
	FRM20	0.6	0.6	0.5	0.8
Subordination	No subordination	1.0	1.0	1.0	
	30% < OLTV <= 60% and 0% < subordination <= 5%	1.1	0.8	1.0	
	30% < OLTV<= 60% and subordination > 5%	1.5	1.1	1.2	
	OLTV > 60% and 0% < subordination <= 5%	1.1	1.2	1.1	
	OLTV > 60% and subordination > 5%	1.4	1.5	1.3	

Further, a two-loan structure complicates refinancing and loss mitigation options for distressed borrowers since there could be two investors/holders of the mortgages and two servicers. Traditionally, first and second lien holders each have different rights when it comes to loss mitigation options. Generally, when a borrower defaults, the second lien holder will have no right to recovery of proceeds until the first lien holder's claim has been paid.[15] While Freddie Mac would hold both the first and second liens, borrowers who are in default may face procedural obstacles to loss mitigation options and refinances as a result of the additional lien and if the two loans have different servicers.

[15] RESTATEMENT (THIRD) OF PROP.: MORTGAGES § 7.4.

C. Consumers Are Well-Served by Banks, Credit Unions, Independent Mortgage Banks, and the Private Label Security Market Without Additional Risk to Taxpayers.

According to Equifax, $53 billion in closed-end second liens were originated between January and August of 2022, representing a 50% increase over the prior year.[16] Kroll Bond Rating Agency, LLC ("KBRA") recently reported from 2020 through 1Q2024 there were $4.5 billion in cumulative closed-end second mortgages collateralized in second lien private label security ("PLS") transactions[17] in addition to portfolio lending by other institutions. This market has been growing, increasing from six deals totaling $1.9 billion in 2023 to already nine transactions totaling nearly $3.5 billion for January 2024 through mid-May 2024.[18] KBRA predicts that if both Enterprises were purchasing second liens, nearly 60% of the private market would have been eligible for the proposed product.[19] Consumers already have many choices to access home equity including closed and open-end products from banks, credit unions, and independent mortgage banks, and this inappropriate competition could displace the private market. There is not an excess of demand for closed-end second mortgages or securitization of second mortgages that the private market is not currently meeting. Furthermore, Freddie Mac's proposal may also promote adverse selection in the marketplace.

II. Requested Clarifications

FHFA's Prior Approval for Enterprise Products Final Rule requires FHFA to evaluate Freddie Mac's request, "to determine if the submission contains sufficient information for FHFA to prepare a public notice such that the public will be able to provide fully informed comments on the new product."[20] There remain several open questions, which impede the public's ability to provide fully informed comments on the proposed product. USMI requests a number of clarifications that would help market participants better understand the impacts and consequences of the product. We encourage FHFA to clarify the open questions and then re-submit for public comment if it does not disapprove the proposed new product.

A. LTV Calculation

The proposal indicates that the total LTV of the combined first and second mortgages would be capped at 80%. However, the notice does not indicate if that percentage is based on original LTV or current mark-to-market LTV. As a prudential matter, it would be important to make sure

[16] Laurie Goodman, Karan Kaul, Ted Tozer, Second-Lien Securitization Could be a Key to Accessing Home Equity in a High Rate Environment, Urban Institute, January 25, 2023.
[17] KBRA Releases Research - FHFA Closed-End Seconds: Effect on PLS?
[18] BRAVO 2024-CES1, GRADE 2024-CES1, J.P. Morgan Mortgage Trust 2024-CES1, RCKT Mortgage Trust 2024-CES1, RCKT Mortgage Trust 2024-CES2, RCKT Mortgage Trust 2024-CES3, Towd Point Mortgage Trust 2024-CES1, Towd Mortgage Trust 2024-CES2, and VSTA 2024-CES1.
[19] *Id.*
[20] 12 C.F.R. § 153.6.

that borrowers are not over-leveraged and Freddie Mac should fully understand the unique risks associated with this product. If FHFA does not disapprove the proposed product, USMI strongly recommends that it be restricted to borrowers with original LTV ratios of no greater than 80% with a corresponding confirmation that the value of the collateral has not declined once a loan meets this initial test.

Freddie Mac's proposal is also silent on valuation requirements if the product uses mark-to-market LTV ratios and does not indicate whether a full appraisal is required or an alternative, such as a broker price opinion ("BPO") or automated valuation model ("AVM"), is permitted. Considering the unique risks associated with a two-lien structure, it is critical that lenders use all information available to underwrite the closed-end second mortgage and capture the most accurate property value. To that end, USMI recommends that Freddie Mac's product, should it not be disapproved, require a full appraisal of the property securing the lien and not rely on a BPO, lender or Freddie Mac AVM, or another appraisal alternative.

B. Limitations and Exclusions for the Proposed Product

Beyond LTV concerns, the proposed new product lacks some details which may improve the safety and soundness of the product. USMI suggests FHFA consider applying guardrails including DTI limitations, allowable maximums, and an exclusion for piggyback loans. These guardrails would help protect borrowers, Freddie Mac, and taxpayers in the event of a market downturn.

C. ERCF Capital Required and Pricing Considerations for the Second Lien

FHFA finalized the ERCF on December 17, 2020, and the final rule contains a risk multiplier for subordination as demonstrated in the chart above.[21] The notice of the proposed new product does not discuss the capital treatment of the product. FHFA should clarify the capital and pricing treatment, including Loan-Level Pricing Adjustments ("LLPAs"), applicable to the proposed product.

D. Process for Potential Future Amendments to the Product

USMI also urges caution on what the approval of the product would mean for future expansions of the Enterprises in the second lien market. The proposal indicates that the total LTV must be at or below 80% LTV at this time, but it is unclear whether future proposals by Freddie Mac to allow for equity extraction of loans with higher total LTVs would require additional notice and comment. Given the risk and problematic history associated with the performance of second liens, FHFA should require additional notice and comment for any future expansions of the product should the current proposal not be disapproved, as the expansion of the product may have additional unintended consequences not identified during the initial comment period.

[21] 12 C.F.R. § 1240.

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USMI and its member companies appreciate the opportunity to provide feedback and recommendations on the Freddie Mac Single-Family Closed-End Second Mortgages proposed product. We look forward to supporting programs that ensure responsible, sustainable access to homeownership and promote safety and soundness in the U.S. housing finance system. Please feel free to reach out to me directly at sappleton@usmi.org or 202-280-1820 if you have any questions or should you need any further information.

Sincerely,

Seth D. Appleton
President, USMI