GSE Activity Report

Wednesday, April 17, 2024

Seconds That Aren't Piggy

Summary

Just as the CFPB readies its assault on cashout-refi discount fees comes FHFA's request for views on a new Freddie Mac product that would give borrowers access to their locked-up equity without a new first lien at a higher rate or a traditional home-equity second riding piggyback atop the first lien. With millions of borrowers facing mounting consumer-debt burdens and banks increasingly unable to offer likekind products on their portfolios, the proposal could prove a boon higher-wealth, to cash-strapped borrowers absent sudden house-price drops that leave them under water. Nonbank mortgage originators also have a brand-new gig.

Impact

The first question we asked as we saw FHFA's announcement is whether these new seconds are successors to the piggyback loans that pushed the GSEs into the LTV stratosphere before the great financial crisis put a costly end to all that. They aren't.

Even though the charter implications of seconds atop existing liens are less explicit than those forcing credit enhancement for over-80 firsts, FHFA indicates that what it calls the "total" LTV – we presume this means combined – would need to be under eighty. This protects Freddie from HLTV credit risk and gives borrowers a buffer against all but severe house-price depreciation.

However, it also limits borrowers to those with lower-LTV existing loans, benefiting older and more affluent borrowers, borrowers who could bear the higher payments associated with twenty-year tenors. Many lower-income, cash-strapped borrowers may have already taken out cash and, even if their rate is low, their equity is sparse. And, only borrowers with first liens sold to Freddie can get closed-end seconds purchased by Freddie, meaning that Freddie owns this secondary market until Fannie comes up with a like-kind offering. FHA borrowers aren't eligible unless Fannie persuades FHFA to let its version of these loans go to borrowers with an FHA first, which will take still more time. Theoretically, a private market for non-Freddie closed-end seconds could follow Freddie's lead, but we think banks are unlikely to enter this arena since they're largely out of FHA and nonbanks haven't the capital or liquidity to build a secondary market on their own.

Could banks offer closed-end seconds on GSE loans or even their own and hold these on portfolio? Not unless the new capital rules are a lot nicer to HLTV paper and seconds than even revised end-game capital rules are likely to prove. FHFA speculates that GSE-purchased closed-end seconds will also lower market prices for likekind loans – likely since this is the usual result of GSE guarantees. However, banks will then stay out of this sector even if they're in it now.

Could closed-end seconds be originated contemporaneously with firsts or does the first have to season prior to borrower eligibility? FHFA's analysis is unclear on this key point, but it seems likely that, at least at first, Freddie will want seasoned loans that give it the insights into borrower behavior it says reduces guarantee risk on closed-end seconds. Still, we wonder how well repayment history will actually predict performance on these seconds given that the principal reason for cashout refis is consumer desire to service household debt, meaning that the borrower's overall debt-service capacity is impaired with the second unless Freddie's underwriting seeks to control for this. We can see that home-purchase borrowers with a low-LTV first might like a closed-end second to cash out some remaining equity and handle renovation or other costs, but this is yet to come.

Outlook

FHFA has to approve this product for Freddie before all these risks, rewards, and market effects materialize. But, we think it will soon be open season on closed-end seconds for Freddie and soon Fannie unless comments to FHFA are a lot more negative than we expect or someone pressures Sandra Thompson on this product when she tomorrow comes before Senate Banking.

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