Insight

The Freddie Mac Second Mortgage Proposal

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Executive Summary

- Freddie Mac sought approval from the Federal Housing Finance Agency (FHFA) to begin purchasing and guaranteeing closed-end home equity loans for borrowers where Freddie already owns the first mortgage.
- This new product would be inconsistent with Freddie Mac's mission, replicate services available in the private sector, risk exacerbating inflation pressures, increase inequality, and worsen the credit risks in private-sector lending.
- The FHFA should deny Freddie Mac's requested approval.

Introduction

On April 16, Freddie Mac sought approval from the Federal Housing Finance Agency (FHFA) to begin purchasing and guaranteeing closed-end home equity loans for borrowers where Freddie already owns the first mortgage. The filing indicates that the proposal's primary goal is to provide borrowers with a lower-cost alternative to a cash-out refinance. As detailed below, this has nothing to do with the core housing mission of Freddie Mac. In addition, the proposal has several other defects and downsides that should lead the FHFA to deny approval.

The Product Is Inconsistent With Freddie Mac's Mission

Congress created Freddie Mac to serve four public purposes, as the Federal Home Loan Mortgage Corporation Act specifies:

> (1) provide stability in the secondary market for residential mortgages;
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> (2) respond appropriately to the private capital market;
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> (3) 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
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> (4) 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.

Home equity loans – also referred to as second mortgages – allow homeowners to turn into cash some of the equity that has built up in their homes. As proposed, it would take the form of a 20-year fixed-rate loan. Allowing existing homeowners to spend a portion of their housing equity does not advance any of the four

purposes of Freddie Mac.

There Is No Market Failure or Need for Government Intervention

These home equity loans meet a need already served by private markets. Similar products are offered by private lenders, funded by private capital, and used to finance home-improvement projects and other major expenses. Freddie Mac is in conservatorship and functionally an agency of the federal government. The first test of a potential government intervention is whether there is a private-sector market failure. Freddie Mac argues that it would offer a cheaper way to provide access to equity, but there is no obligation for the government to subsidize every private activity. There is no compelling rationale for this proposal.

Timing Is Especially Poor and Risks Exacerbating Inflation

FHFA should reject the Freddie Mac proposal, especially in light of historically high inflation, as the consumer spending that would be enabled by the proposal would provide a counterproductive demand stimulus. A variety of sources ranging from advocates to analysts have estimated that there is between $800 billion and $1.5 trillion in potential home equity loans. This assumes that Fannie Mae follows Freddie Mac's lead, but if the Freddie Mac proposal is approved, it seems quite likely that Fannie Mae will follow suit.

It is somewhat uncertain exactly how large the stimulus would be. The upper bound is the $1.5 trillion estimate, which would rival the detrimental impact of the Biden Administration's 2021 American Rescue Plan that totaled $1.9 trillion – one part of the policy errors that caused inflation to jump from 1.4 percent to 9.1 percent. Of course, some of the home equity may be cashed-out using private sector loans, so a lower bound is given by the additional equity cashed-out using the proposed product.

In any event, the risk is for either an acceleration of inflation or a more draconian Federal Reserve policy to offset the demand. At this juncture, higher interest rates would be actively detrimental to Freddie Mac's housing mission.

The Proposal Is Inequitable

It is surprising that Freddie Mac would pursue an initiative at odds with housing equity. The target clientele for these loans is affluent owners with large housing equity and a low credit risk. (Of course, taking out so much housing equity would generate additional risk.)

The Proposal Would Damage Private Credit Pools

Finally, the flip side of the policy will be broad strain in credit markets. Private lenders cannot compete with the terms offered by a 20-year, fixed-rate product. All the best risks will migrate away from private consumer lenders to Freddie and Fannie, and the banking sector and other lenders will be saddled with a riskier book of business. The risk will have to be offset with higher interest rates on private-sector products, reflecting the basic inequity of the proposal.

This is a quantitatively important issue. Compass Point Research estimates that, in the 4th quarter of 2023, consumer debt – excluding student loans – totaled $3.6 trillion. Thus, the upper-bound estimate constitutes roughly one-half of consumer borrowing. Even a smaller displacement of consumer credit would have a dramatic impact on the composition of private credit risks.

Conclusion

Freddie Mac ‘s proposed new product would be inconsistent with its mission, replicate services available in the private sector, risk exacerbating inflation pressures, increase inequality, and worsen the credit risks in private sector lending. The FHFA should deny the requested approval.