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**PUBLIC INTEREST COMMENT**

# Freddie Mac Proposed Purchase of Single-Family Closed-End Second Mortgages

**THOMAS M. HOENIG**
*Distinguished Senior Fellow, Mercatus Center at George Mason University*

Notice of proposed Enterprise new product; request for comment.
Agency: Federal Housing Finance Agency
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I appreciate this opportunity to respond to the Federal Housing Finance Agency (FHFA) invitation to comment on a proposal by the Federal Home Loan Mortgage Corporation (Freddie Mac) to purchase certain single-family closed-end second mortgages as a new product. The following comment questions the appropriateness and risks of Freddie Mac expanding its activities to include purchases of single-family closed-end second mortgages, the purpose of which is not limited to financing the rehabilitation, renovation, modernization, refurbishment, or improvement of properties. I explain that allowing Freddie Mac to underwrite loans for purposes beyond homeownership

- is inconsistent with its mandate;
- provides subsidized loans for non-housing-consumption purposes to those who already hold a first lien with it, thus favoring this group over renters and other homeowners with no justification for doing so; and
- because its lending is subsidized, incents homeowners to trade home equity for debt, increasing homeowner leverage and industry risk for purposes outside home improvement.

The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge about the effects of regulation on society. This comment, therefore, does not represent the views of any party or special interest group. Rather, it is designed to help the FHFA as it considers Freddie Mac's proposal to expand its operations.

## Freddie Mac's Proposal Is Inconsistent with Its Mandate

Given the appreciated value of US housing since the pandemic, there has been a significant buildup of equity within the housing market. It is understandable that the consumer may wish to unlock that equity for spending on goods and services outside housing. There is a developed market for doing so including HELOC loans, second mortgages, and securitization of second mortgages. There does not appear to be a market failure that would justify the expansion of Freddie Mac's mission to include underwriting second mortgages to fund non-mortgage-related expenditures.

Freddie Mac proposes developing a guaranteed closed-end second mortgage available to its current first-lien borrowers for any purpose, and in doing so, significantly expanding its mission beyond housing. As provided in Sec. 301(a) of the Federal Home Loan Corporation Act (Act), Freddie Mac's mandate is to provide ongoing assistance to the secondary market for residential mortgages, increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing. Also, the Act provides that a mortgage loan may include a second lien for loans **intended to finance the rehabilitation, renovation, modernization, refurbishment, or improvement of properties.** Freddie Mac, through its government sponsorship, has a significant subsidy and advantage over other lenders to influence the flow of capital to housing. Freddie Mac's role is to use this subsidy to promote home ownership—not consumer spending. The effect of allowing Freddie Mac to engage in consumer lending broadly, therefore, is inconsistent with its statutory mandate.

## Competitive and Distributional Effect on Markets

As proposed, Freddie Mac would confine this product to those for whom it has underwritten the first mortgage. But even under this condition, the scope of the proposal is outside Freddie Mac's mandate, and the effect of the proposal on the flow of capital through the economy would be significant. Bank of America Securities estimates that Freddie Mac's potential market for this product could be $850 billion.[1] It goes on to note that if Fannie Mae were also to offer a similar product, the potential market would more than double to $1.8 trillion. While consumers might use part of this amount to refurbish currently owned real estate, they also can use it for other purposes.

There appears to be no market shortage of credit available to procure consumer and second-mortgage loans for non-mortgage-related spending. As of the first quarter of 2024, for example, Federal Deposit Insurance Corporation (FDIC) data show that total bank-held junior liens and home equity loans reached nearly 300 billion dollars, and total outstanding bank consumer and personal loans exceeded two trillion dollars. Even so, Freddie Mac proposes entering this market and using its subsidy to lower the cost of borrowing for the purchase of all consumer goods, not just housing and housing improvement. While it proposes, initially at least, to offer this product to a single class of mortgagees it already finances, Freddie Mac provides no evidence that private lenders are unwilling to offer such loans. Freddie Mac would be giving a significant subsidized advantage to its own borrowers over other mortgage debtors, mortgage-free homeowners, and renters. Over time, Freddie Mac's (and perhaps Fannie Mae's) dominance would deepen within the first and second mortgage markets, and also within the securitization markets as it expands its role in providing subsidized loans to consumers.

## Implications for Financial Stability

In 2008, Freddie Mac's balance sheet leverage and quality of loans and related guarantees threatened its solvency, and the US government found it necessary to take the organization into conservatorship. Since then, the housing market has recovered, and owner equity is at a historically high level. Freddie Mac's financial position also has improved, so much so that it considers itself able to expand its

[1] BofA Global Research, BofA Securities, Non-agency Alert, "Freddie Mac's Proposal to Purchase Closed-End Second Mortgages," April 17, 2024.

operations to include closed-end second mortgage loans to fund consumer purchases unrelated to home ownership. This expansion of activities outside its core mission will have at least two consequences.

First, as with any subsidy, the market will expand the supply of such mortgages to Freddie Mac borrowers. Loan originators, brokers, and services will look forward to the fees and expected earnings this subsidy will provide them as part of the process chain. While the proposal will provide a new revenue stream to these groups, it will raise the risk profile of the industry for a purpose other than expanding homeownership.

Second, following the incentives of easier access to credit and lower rates, homeowners will increase their personal leverage as they exchange equity for debt. Over time, as the offering expands to Fannie Mae and beyond to other government-sponsored enterprises (GSEs), these enterprises and consumers will become increasingly exposed to an ever-possible decline in home values. This occurred prior to the previous housing crisis and led to massive consumer losses that forced the GSEs into their current conservatorship. While such outcomes may appear remote now, expanding Freddie Mac operations as proposed increases the risk of—and taxpayer exposure to—future bailouts in a manner inconsistent with its mandate.

Confirming these concerns, the Financial Stability Oversight Committee (FSOC) in a recent report has noted the rising risk levels as it applies to bank mortgage servicing companies (NMCs).[2] The report notes that any shocks to the mortgage market can lead to significant deterioration to NMC balance sheets and access to credit, which create serious liquidity and solvency issues for this group. Such risk will increase for all parties if this segment of the industry assumes added leverage to fund non-housing-related spending.

## Possible Unintended Consequences

Finally, expanding Freddie Mac's mandate to underwrite and securitize non-housing-related mortgages is difficult to justify when data continue to show a shortage of affordable housing. While there are any number of causes for the shortage,[3] Freddie Mac's role is to facilitate capital markets' providing access to funding for housing. There is no justification for going beyond this mission and providing capital for nonhomeownership consumer lending that will benefit a few at a cost to many.

[2] Financial Stability Oversight Council (FSOC), *Report on Nonbank Mortgage Servicing 2024*, May 10, 2024.

[3] Kevin Erdmann, *Shut Out: How a Housing Shortage Caused the Great Financial Recession*, Mercatus Center at George Mason University (Arlington, VA: Rowan and Littlefield, 2019); Kevin Erdmann, "Flirting with the Last 'No' in Housing," Discourse, April, 26, 2024, https://www.discoursemagazine.com/p/flirting-with-the-last-no-in-housing.