Federal Housing Finance Agency
Office of Inspector General

Recent Trends in Enterprise Cash-Out Refinances

White Paper • WPR-2021-008 • September 27, 2021

WPR-2021-008

September 27, 2021

Executive Summary

Fannie Mae and Freddie Mac (the Enterprises) acquire single-family mortgage loans that are generally either for purchasing a home or refinancing an existing mortgage. A mortgage refinance pays off an existing loan and replaces it with a new one. In a cash-out refinance, a borrower refinances for a new loan amount that is greater than the balance of the existing loan and receives the difference in a cash payment. A cash-out refinance borrows against equity in a home and, according to the Enterprises, there are no restrictions on how the funds are used.

The Enterprises publicly report that cash-out refinances have a higher risk of default than purchase loans or other refinances. For this report, the Federal Housing Finance Agency (FHFA or Agency) clarified for us that cash-out refinances have a higher risk of default if all other attributes of the loan are the same. According to FHFA, cash-out refinances can pose increased credit risk to the Enterprises when layered with other risk factors such as a high debt-to-income (DTI) ratio or low credit score.

In 2020, in line with general single-family volume, Enterprise acquisitions of cash-out refinances more than doubled to $454 billion, compared to $207 billion in 2019. However, the share of cash-out refinances remained relatively stable at 19%. According to Enterprise reporting and our analysis of data from FHFA, the share of Enterprise cash-out refinances with additional risk layers grew between 2017 and 2019 but has since decreased.

Like the housing boom of the early to mid-2000s, the recent increase in refinances occurs amid declining interest rates and increasing home prices. However, the types of loans the Enterprises have acquired recently are different from those they acquired in the early to mid-2000s. Certain higher risk loan products that were widespread in the early to mid-2000s are no longer accepted by the Enterprises. Additionally, FHFA reports it has been working with the Enterprises to reduce acquisitions with multiple risk factors. FHFA officials recently highlighted to us that in their reviews, cash-out refinances are performing better than purchase loans for a certain measure of default. While cash-out refinance volumes have remained high in 2021, FHFA and both Enterprises report no material concerns with the directionality of related risk.

This white paper provides background information on Enterprise single-family cash-out refinances, discusses trends in Enterprise single-family cash-out refinances, describes FHFA and Enterprise views of risk related to cash-out refinances, and summarizes how FHFA and the Enterprises mitigate risk.

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ABBREVIATIONS

DTI	Debt-to-income
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
LTV	Loan-to-value
OIG	Federal Housing Finance Agency Office of Inspector General

BACKGROUND

The Enterprises acquire single-family mortgage loans that are generally either for purchasing a home or refinancing an existing mortgage. A mortgage refinance pays off an existing loan and replaces it with a new one. The new loan typically has a new term, interest rate, and monthly payment. Common reasons borrowers refinance include lowering their mortgage interest rate, changing terms (e.g., from a 30-year loan to a 15-year loan), or getting cash-out, among others. In a cash-out refinance, a borrower refinances for a new loan amount that is greater than the balance of the existing loan and receives the difference in a cash payment.[1] A cash-out refinance borrows against **equity** in a home and, according to the Enterprises, there are no restrictions on how the funds are used.

> **Home equity** is the dollar-value difference between the balance owed on a mortgage and the value of the property.

In 2020, historically low interest rates contributed to a high volume of refinances. According to data from Freddie Mac's Primary Mortgage Market Survey, 30-year fixed rate mortgage rates in 2020 were the lowest on record. The Enterprise reported that with record low interest rates, mortgage refinance activity was the highest annual total since 2003. As reported by FHFA, approximately 70% of Enterprise single-family acquisitions in 2020 were refinances.

During the fourth quarter of 2020, house prices increased 10.9% over the past year, according to FHFA's House Price Index. The Agency stated in its 2020 Annual Report to Congress that this was the "largest year-over-year gain on record." As reported by Freddie Mac, the rapid increase in house prices also impacted refinance trends in 2020. With increasing house prices came increased homeowner equity. Freddie Mac reported in March 2021 that homeowners took advantage of these trends by using cash-out refinances to extract equity. The Enterprise estimates that borrowers nationwide cashed out over $150 billion in home equity last year.

Fannie Mae and Freddie Mac publicly report that cash-out refinances generally have a higher risk of default than purchase loans or other refinances. For this report, FHFA clarified for us that cash-out refinances have a higher risk of default if all other attributes of the loan are the same. According to FHFA, cash-out refinances can pose increased credit risk to the Enterprises when layered with other risk factors such as a high DTI ratio or low credit score. This white paper will provide background information on Enterprise single-family cash-out refinances, discuss recent trends in Enterprise single-family cash-out refinances, describe

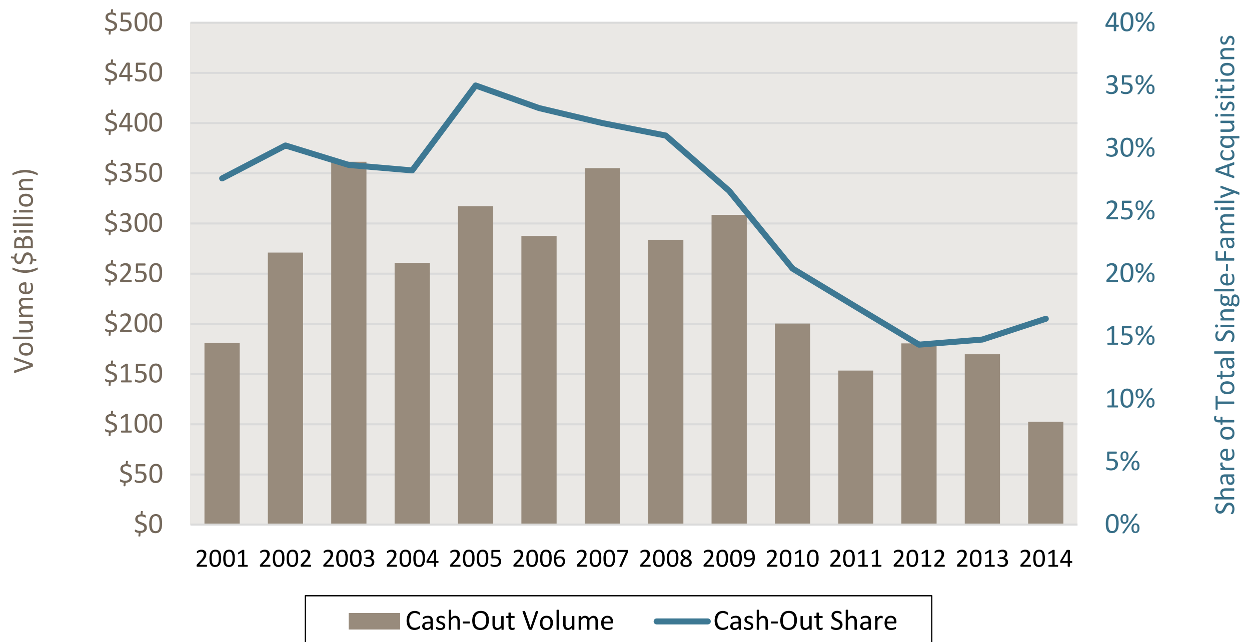
[1] Both Enterprises also offer refinance transactions with limitations on funds disbursed to the borrower. Fannie Mae's "Limited Cash-Out Refinance" restricts cash back to the borrower to the lesser of 2% of the new refinance loan amount or $2,000, in addition to other financing limitations. Freddie Mac's "No Cash-Out Refinance" allows cash back to the borrower up to the greater of 1% of the new mortgage or $2,000. For this report, these limited cash back refinance offerings are not considered cash-out refinances.

FHFA and Enterprise views of risk related to cash-out refinances, and summarize how FHFA and the Enterprises mitigate the risk.

Historic Trends in Enterprise Cash-Out Refinances, 2001 to 2014

The annual cash-out refinance share of the Enterprises' total single-family acquisitions increased from 28% in 2001 to a peak of 35% in 2005. The annual share remained above 30% through 2008 and continuously declined to a low of about 14% in 2012. See Figure 1.

FIGURE 1. ENTERPRISE CASH-OUT VOLUME AND SHARE OF SINGLE-FAMILY ACQUISITIONS, 2001-2014



Source: OIG analysis of Fannie Mae and Freddie Mac annual financial results.

2001-2007: Cash-Out Refinances Increase and Stay Relatively High During Housing Boom

The early to mid-2000s was a period of rapid increases in house prices and is commonly referred to as a housing boom. According to FHFA's House Price Index, nationwide home price appreciation peaked during this period in 2005, when prices increased at an annual rate of about 10.6%. That year, the cash-out refinance share of Enterprise acquisitions also peaked, as illustrated above in Figure 1. During this period, the annual cash-out refinance volume peaked in 2003, when the Enterprises acquired a combined $361 billion in single-family cash-out refinances.

Also during this period, as previously reported by FHFA, the Enterprises operated under expanded mortgage eligibility requirements to include higher-risk nontraditional mortgages.

The Enterprises reported increased levels of mortgages with multiple risk factors and mortgages that lacked full documentation of borrower income. Fannie Mae recently explained to us that, controlling for underlying market conditions and other factors, cash-out refinances during this time were particularly higher risk.

2008-2014: Share of Cash-Out Refinances Declines Amidst Financial Crisis and Tightened Underwriting Standards

The housing market began to deteriorate notably in 2007 as house prices declined and loan delinquencies and defaults increased. By the fourth quarter of 2008, home prices had depreciated by 10.1% on an annual basis, according to FHFA House Price Index data.

In line with market-wide conditions, the Enterprises implemented tightened underwriting standards after the 2008 crisis. As reported in their financial disclosures, the Enterprises discontinued their purchases of many higher-risk loans. For example, Fannie Mae reported to us that for cash-out refinance loans acquired during 2004-2007, over 60% had three or more risk factors. That percentage was reportedly cut in half for cash-out refinances acquired during 2009-2012. As illustrated in Figure 1, cash-out refinance acquisitions declined significantly after 2009. According to a 2014 Freddie Mac report, annual cash-out volumes during 2010 through 2013 were the smallest since 1997.

After declining for seven years straight, the cash-out refinance share of the Enterprises' combined single-family mortgage acquisitions slightly increased in 2013 and 2014.

RECENT TRENDS IN ENTERPRISE CASH-OUT REFINANCES

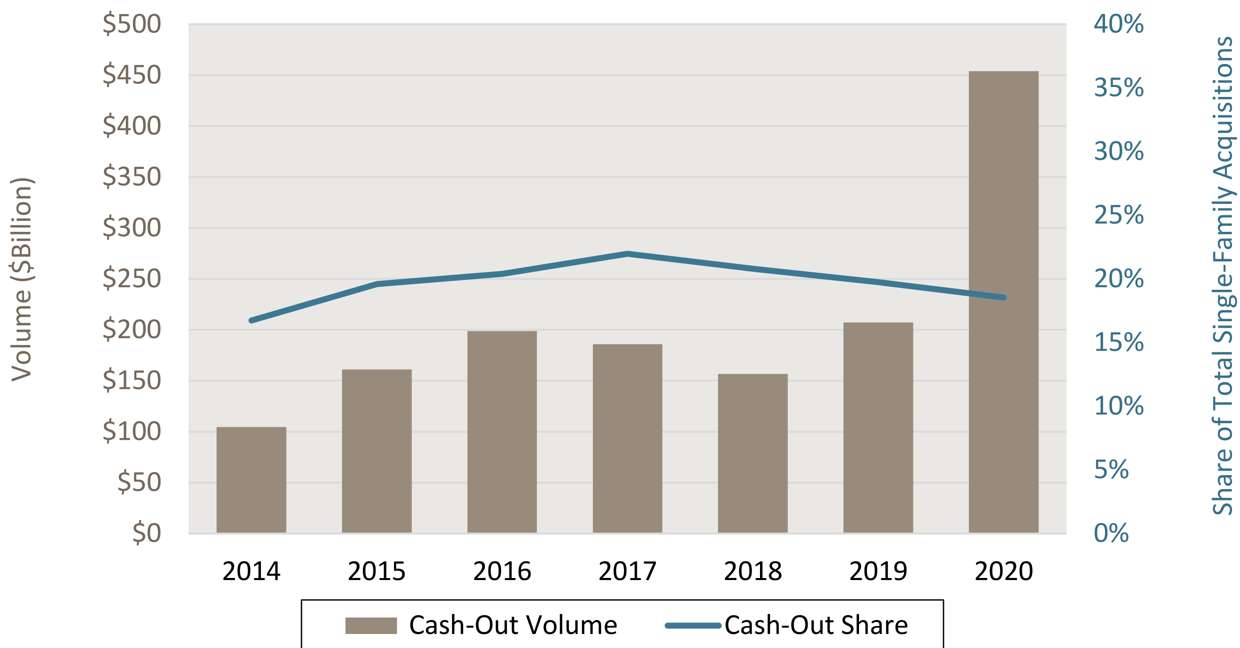
To examine recent trends in Enterprise cash-out refinances, OIG analyzed loan-level data of Fannie Mae and Freddie Mac cash-out refinances acquired between 2014 and the end of the first quarter of 2021. This data was provided to us by FHFA. We discuss results of our analyses below.

2015-2020: Cash-Out Share Remains Relatively Stable while Volume More than Doubles in 2020

Since 2014, the cash-out refinance share of the Enterprises' single-family acquisitions increased to about 20% in 2015 and remained in the range of 19% to 22% through 2020. See Figure 2. At its highest, the share during this period was still 13 percentage points below the peak of the housing boom in the 2000s.

The volume of cash-out refinances, however, increased notably in 2020, in line with the general pace of Enterprise single-family acquisitions. Combined, the Enterprises acquired about $2.45 trillion in single-family mortgages last year, compared to $1.05 trillion in 2019. Cash-out refinances accounted for about 19% of 2020 acquisitions, totaling $454 billion. The Enterprise's annual cash-out acquisition volume had remained around or under $200 billion in the prior ten years.

FIGURE 2. ENTERPRISE CASH-OUT VOLUME AND SHARE OF SINGLE-FAMILY ACQUISITIONS, 2014-2020



Source: OIG analysis of information provided by FHFA.

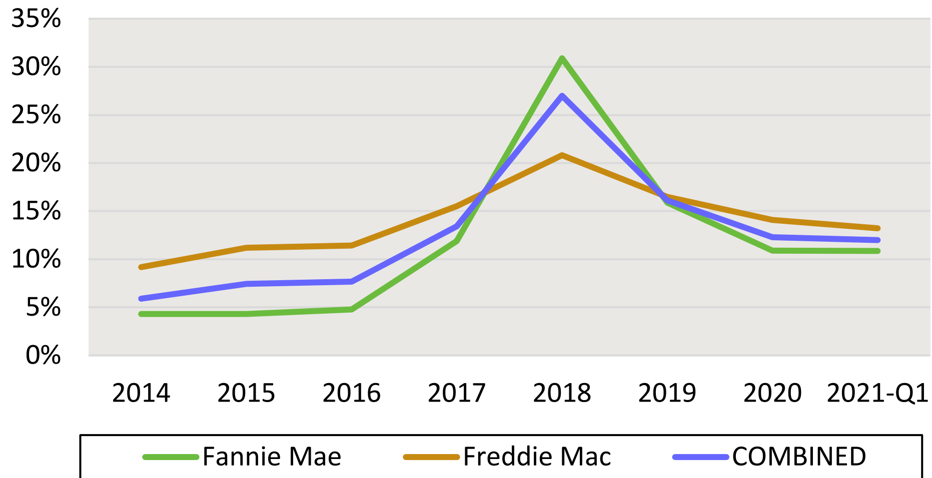
Shifts in Credit Risk

While the Enterprises' cash-out refinance acquisition share remained relatively stable during this time period, the risk profile shifted. For example, FHFA has reported that a DTI ratio greater than 45% (high DTI) is an elevated risk factor. Combined, the share of the Enterprises' cash-out refinances with a high DTI stayed between 6% and 8% between 2014 and 2016 and then increased rapidly to a peak of 27% in 2018. See Figure 3. Although, as OIG has previously reported, the share of loans with a high DTI increased for all Enterprise acquisitions during this time,[2] cash-out refinances experienced higher levels. For Fannie

[2] In April 2017, FHFA issued a directive on Enterprise underwriting of loans with a DTI ratio up to 50%. After implementing the directive, Enterprise acquisitions of single-family loans with a DTI ratio greater than 45% notably increased beginning in late 2017. For more information, see OIG, *An Overview of Enterprise Debt-to-Income Ratios* (Mar. 27, 2019) (WPR-2019-002) (online at www.fhfaoig.gov/sites/default/files/WPR-2019-002.pdf).

Mae, 31% of cash-out refinance loans acquired in 2018 had a high DTI, compared to 25% of its single-family acquisitions as a whole. For Freddie Mac, the levels were 21% and 18%, respectively.

FIGURE 3. SHARE OF ENTERPRISE CASH-OUT REFINANCES WITH DTI > 45%



Source: OIG analysis of information provided by FHFA.

The share of Enterprise cash-out refinance acquisitions layered with high DTI began to decline in 2019. Around this time, as discussed later, FHFA worked to update Enterprise standards for high DTI loans. In addition to a notable decrease in the high DTI share, the share of cash-out refinance loans with lower credit scores also decreased. In 2018, about 18% of the Enterprises' cash-out refinance acquisitions had a credit score less than 680. In 2020, it was about 7%.

The Enterprises also use the loan-to-value (LTV) ratio to measure credit risk. Requirements from both Enterprises generally limit cash-out refinance acquisitions to a maximum LTV ratio of 80%.[3] Fannie Mae explained to us that this limit has been in place "since 2015." Our analysis of loan-level data showed that after 2015, the annual share of Fannie Mae cash-out refinance acquisitions with LTV ratios above 80% has been near zero. For Freddie Mac, however, our analysis showed that between 2017 and 2019, up to 3% of the Enterprise's annual cash-out refinance acquisitions had LTV ratios above 80%. FHFA officials explained to us that, in certain circumstances, Freddie Mac granted exemptions to the LTV requirements and FHFA has worked with the Enterprise to generally discontinue the exemptions. In 2020, the share of Freddie Mac cash-out refinance acquisitions with LTV ratios above 80% declined to near zero.

In response to the COVID-19 pandemic, the Enterprises implemented flexibilities in underwriting standards, among other things. Broadly speaking, FHFA reported in its 2020 Annual Report to Congress that its COVID-19 policies "were built on the lessons learned

[3] This requirement applies to single-unit primary residences.

from the failures of the 2008 financial crisis." The Agency reported that, during the flexibilities, recent Enterprise acquisitions generally had improved with regard to certain credit characteristics (including DTI and credit scores). However, overall asset quality worsened significantly due to "a sharp increase in delinquencies in the immediate aftermath of the pandemic." Specific to cash-out refinances, Freddie Mac reported to us its view that credit quality was "very strong" during the pandemic.

Risk in Cash-Out Refinances Still Below Boom of 2000s

Both Enterprises reported to us that they had no material concerns with the recent spike in cash-out refinances. Fannie Mae told us that while its cash-out refinances grew "increasingly risky" between 2017 and 2019, it believes that the risk profiles have since improved. The Enterprise added that risk in cash-out refinances during 2017-2019 was still "substantially lower" than pre-2009 acquisitions. Similarly, Freddie Mac explained that the share of cash-out refinance loans is below historical levels and the related risk is within its risk appetite. Referencing its March 2021 report on refinance trends in 2020,[4] the Enterprise noted that in 2006, during the housing boom, "borrowers cashed out at least three times as much debt as a proportion of equity than they did in 2020."

FHFA and the Enterprises explained to us their views of the similarities and differences between recent trends and trends during the early to mid-2000s. An FHFA official explained to us that both periods experienced significant declines in interest rates, which drove refinance activity. And Fannie Mae noted that during both time periods, the rapid increase in home prices resulted in an equity increase. However, the risk landscape is different as certain higher risk loan products that were widely accepted in the early to mid-2000s—such as interest-only loans and loans that lacked full documentation—are no longer accepted by the Enterprises. Additionally, FHFA reports it has been working with the Enterprises to reduce acquisitions with multiple risk factors. According to a Fannie Mae report to us, for cash-out refinances acquired in 2020 through June 2021, the share with four or more risk factors is over seven times less than the share during the mid-2000s.

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[4] *See* Freddie Mac, *Refinance Trends in 2020* (Mar. 5, 2021) (online at www.freddiemac.com/research/insight/20210305_refinance_trends.page).

FHFA and Enterprise Risk Monitoring and Mitigation

Generally, the Enterprises manage their exposure to single-family mortgage credit risk in various ways. For example, both Enterprises transfer credit risk to third-party investors and maintain underwriting standards aimed at managing changing risk.[5]

FHFA

In an August 2021 meeting, Agency officials explained to us the types of reports that examination staff use to monitor risk in Enterprise cash-out refinances. Agency staff regularly review credit risk metrics as well as ongoing performance of cash-out loans compared with other Enterprise loans. Though the Enterprises report cash-out refinances have an increased risk of default, FHFA officials highlighted that their reviews revealed cash-out refinances were performing better than purchase loans for a certain measure of default.

FHFA officials also described for us work it has done with the Enterprises to manage risk related to cash-out refinances. For example, in 2018, during the time of increased levels of high DTI cash-out refinances, FHFA worked with Fannie Mae to implement a requirement that borrowers for high DTI cash-out refinances have at least six months of reserves. The Agency also worked with Freddie Mac to address risk related to DTI in the Enterprise's cash-out refinances, including tightening underwriting standards in response to the economic stress presented by the COVID pandemic. An Agency official explained that the Agency's response to the COVID pandemic also accounted for collateral risk, as certain appraisal flexibilities offered during the time were not extended to cash-out refinance transactions.

Fannie Mae

Fannie Mae reported to us that, to mitigate increased risk associated with cash-out refinances, it generally limits the LTV ratio to a maximum of 80%. As previously mentioned, the Enterprise's automated underwriting system also requires at least six months of reserves for high DTI cash-out refinances.

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[5] The Preferred Stock Purchase Agreements may also impact how the Enterprises manage risk in their acquisitions of cash-out refinances, among other things. In January 2021, terms of the Preferred Stock Purchase Agreements, which govern the U.S. Department of Treasury's support of the Enterprises, were amended. Under the amendment, a maximum of 3% of refinance acquisitions, over a 52-week period, can have two or more higher risk characteristics at origination. Higher risk characteristics include: LTV ratio greater than 90%, DTI ratio greater than 45%, and credit score less than 680. As discussed in this report, Enterprise cash-out refinances already are generally limited to a maximum 80% LTV ratio. On September 14, 2021, FHFA announced it would be suspending this and certain other provisions added in the January 2021 amendment, pending further review. FHFA's announcement of the suspension is available online at www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-and-Treasury-Suspending-Certain-Portions-of-the-2021-Preferred-Stock-Purchase-Agreements.aspx.

Fannie Mae also provided us with two reports that it maintains to monitor risk in acquisitions, including for cash-out refinances. In monitoring single-family acquisition risk factors, the Enterprise treats a cash-out refinance itself as a risk factor. Fannie Mae also noted that for loans acquired in recent years, the Enterprise tracks performance on various early delinquency measures. A tracking report Fannie Mae shared with us in August 2021 showed that cash-out refinances were performing at or better than Enterprise expectations.

Freddie Mac

To mitigate risk, Freddie Mac also generally limits cash-out refinances to a maximum 80% LTV ratio. The Enterprise reported to us that it performs monthly evaluations to assure acquired loans are within Freddie Mac's risk limits. Freddie Mac also noted that it conducts quality control on loans to assess compliance to underwriting requirements and escalates emerging risks appropriately.

Refinances Expected to Remain Elevated through 2021

Low interest rates and house price increases have continued into 2021. FHFA reported that in the first quarter of 2021, house prices rose 12.6% year-over-year. In March 2021, Freddie Mac reported that with interest rates remaining low, it forecasts that the "refinance volume will remain strong in 2021." Specifically for cash-out refinances, the Enterprises acquired a combined total of about $153 billion in cash-out refinance mortgages during the first quarter of 2021, more than any quarter during 2020. Freddie Mac recently reported to us that its volume declined through July 2021 and increased again in August 2021. The Enterprise clarified that the cash-out refinance share continued to increase.

FHFA and both Enterprises reported to us that they have no heightened concerns with how the risk related to cash-out refinances is trending. An FHFA official explained that the risk is stable, citing that the cash-out shares are low relative to historic measures and layered risk is also low. Fannie Mae told us that the directionality of the risk related to single-family cash-out refinances is not that different than other acquisitions. Freddie Mac stated that it considers risk related to single-family cash-out refinance loans as "stable but increasing."

CONCLUSION

Cash-out refinances allow borrowers to extract equity from mortgaged properties with no restriction on how to use the funds. Both Enterprises publicly report that cash-out refinances have a higher risk of default than purchase loans or other refinances. For this report, FHFA clarified for us that cash-out refinances have a higher risk of default if all other attributes of the loan are the same. According to FHFA, cash-out refinances can pose increased credit risk

to the Enterprises when layered with other risk factors such as high DTI ratio or low credit score. In 2020, in line with general single-family volume, Enterprise acquisitions of cash-out refinances more than doubled to $454 billion, compared to $207 billion in 2019. However, the share of cash-out refinances remained relatively stable at 19%. According to Enterprise reporting and our analysis of data from FHFA, the share of Enterprise cash-out refinances with additional risk layers grew between 2017 and 2019 but has since decreased.

Like the housing boom of the early to mid-2000s, the recent increase in refinances occurs amid declining interest rates and increasing home prices. However, the types of loans the Enterprises have acquired recently are different from those they acquired in the early to mid-2000s. Certain higher risk loan products that were widespread in the early to mid-2000s are no longer accepted by the Enterprises. Additionally, FHFA reports it has been working with the Enterprises to reduce acquisitions with multiple risk factors. FHFA officials recently highlighted to us that in their reviews, cash-out refinances are performing better than purchase loans for a certain measure of default. While cash-out refinance volumes have remained high in 2021, FHFA and both Enterprises report no material concerns with the directionality of related risk.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide information on Fannie Mae and Freddie Mac acquisitions of single-family cash-out refinance mortgages, FHFA and Enterprise views on the risk associated with cash-out refinances, and how FHFA and the Enterprises mitigate the risk. To achieve this objective, we reviewed internal FHFA and Enterprise documents as well as publicly available documents. We interviewed FHFA officials and requested and reviewed information from the Enterprises. We also requested and analyzed Enterprise loan data provided by FHFA. We did not independently test the reliability of the data.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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