Home equity lending is in demand and volumes are growing. Is this different from the second-lien lending business that contributed to the GFC? What does this tell us about US housing?

Our View:

It's Not the GFC – Housing Credit is Not Threatened by Current Home Equity Products
Current home equity lending practices are materially stronger than in the pre-GFC era. Origination processes and targeted credit metrics have been transformed by regulatory change while the demand drivers for home equity products today are a reverse of the prior era. We view the growth of current home equity lending as a positive contributor to housing finance (and consumer health), and we remain constructive on housing credit.

The pre-GFC era was characterized by aggressive lending practices for all types of home loans. Often, second liens were a tool for loan officers to close a transaction and help earn a commission by bridging limited downpayment capacity for prospective subprime homebuyers stretching to purchase a home. The "piggy-back" second was simultaneously originated behind a first lien at home purchase, routinely taking the cumulative LTV on properties with second liens to 95% or higher with limited skin in the game for borrowers.

Today, production is focused on existing homeowners. Pandemic era interest rates facilitated historically low-cost fixed rate first mortgages and robust HPA – alongside amortization – drove the growth of "trapped" home equity behind the first mortgage. Closed-End Seconds (CES) and Home Equity Lines of Credit (HELOCs) are tools for existing homeowners to access their home equity value. Borrowers boast prime FICO scores above 720 and 90% or more are owner-occupiers with CLTVs topping out around 65-75%, leaving most homeowners with material equity value. Loan proceeds are generally used for home improvements, major expenses, or debt consolidation, and not to "stretch" to purchase a home with minimal money down.

Modeling Matters:
The different characteristics of current vintage home equity production places a premium on modeling capabilities as performance data are limited to date. This includes identifying appropriate historical cohort analogs to current production, which impacts both credit and prepayments. We believe this creates an opportunity for investors with sophisticated modeling capabilities. Recent research on emerging prepayment speed differences between products reinforces the role of modeling specific performance curves as the universe of historical data on post-GFC production increases over time.

Fixed Rate HELOCs and HEA Contracts:
Within our constructive view on the sector, we particularly like fixed rate HELOC product as we believe it insulates borrowers from rate-driven credit stress. Borrowers also like the rate certainty (in addition to the line-of-credit flexibility in the product) which creates pricing power for lenders. This in turn yields additional excess spread to the first-loss position, improving both credit support and returns. The greater prepayment sensitivity to rates typically translates into higher market yields versus floating rate HELOCs and CES and re-emphasizes the importance of modeling.

We also note Home Equity Agreement contracts (HEA) which we see as an attractive product for house-rich but FICO-poor existing homeowners. HEA are partial ownership interests directly in the property's equity. We expect investment performance to be positively correlated to positive HPA, which increases the value of the HEA contract. HEA carry no ongoing interest rate burden and are attractive to existing homeowners with limited access to mortgage credit and who may not be able to meet additional interest payment burdens. We view HEA as another example of the post-GFC evolution of the second lien industry.

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