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Statement by

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before the

Subcommittee on Consumer Affairs

of the

Committee on Banking, Housing and Urban Affairs

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I appreciate the opportunity to appear before this subcommittee to discuss home equity lines of credit, a subject that has received increased attention lately. There has been a substantial growth in this type of credit since 1984, with outstanding balances totaling approximately $40 billion at the end of 1986. We believe that the total may now be as high as $70 billion and could reach $80 billion by year-end.

This rapid expansion in home equity lines is probably attributable to several factors. For example, the plans have provided consumers convenient access to credit at interest rates that are relatively low compared to other means of financing consumer spending. Tax laws phasing out the deductibility of interest for nonmortgage consumer debt have made home equity loans more desirable to tax conscious borrowers. In addition, competition among financial institutions to offer diverse financial services to their customers has resulted in vigorous marketing of home equity lines, often at low introductory interest rates and discounted fees.

Recently, the Board and other bank regulatory agencies changed the reporting requirements for credit secured by real estate to provide more complete and accurate information on household borrowing through home equity lines of credit. This change should provide more accurate information for an important segment of the market, and enable us to better gauge the growth of this type of credit and the effect it is having on other consumer borrowing.

In addition, the Board has conducted consumer surveys this year to gather information that will allow us to better understand consumer usage of home equity lines of credit. These surveys, which were conducted in March and April of this year, included 1300 families, 930 of whom were homeowners. As of April 1987, 6 percent of the homeowners surveyed had established home equity lines of credit, and an additional 1 percent had applied for these credit lines. The surveys indicated that consumer awareness of home equity lines of credit is high. Eighty percent of all the homeowners surveyed stated that they were aware of the existence of such credit plans, although a majority of the respondents who had not yet opened such credit accounts indicated no interest in establishing a home equity credit line in the future.

The surveys also revealed that those homeowners who had established home equity lines tended to have higher family incomes, more equity in their homes, and were younger and better educated than the average homeowner. In addition to these findings, the surveys showed that, relative to other types of credit lines, home equity accounts tended to be for larger amounts, with the median size of an account approximately $25,000. The most common reasons given for using home equity accounts were to pay off other debts and to finance home improvements. Forty-five percent of accountholders had no balances outstanding on their home equity lines, while the median

amount outstanding for accountholders with unpaid balances was $14,800.

During the past year, the Board has received inquiries from financial institutions, trade associations, consumer groups, and the Congress concerning home equity lines of credit. Much of the discussion has focused on the current disclosure requirements for these loans, and whether these requirements are adequate. In response to these inquiries, the Board has been reviewing its current regulatory requirements, with the goal of ensuring that consumers receive sufficient information prior to contracting for this type of credit.

Possible Regulatory Action

Since home equity programs are more complex than other types of open-end credit plans, and pose a greater risk to consumers if they fail to understand the terms and conditions of the plan, the Board, like the Congress, is concerned about whether the existing disclosure requirements under the Truth in Lending Act and Regulation Z ensure that consumers receive adequate information about these types of loans when they contract for a particular plan.

During the past year, Board staff has been considering the issue of home equity lending within the context of Truth in Lending disclosure requirements. The staff's analysis indicates that the current regulatory requirements for open-end credit may not adequately reflect the complexities that are present in most

home equity programs. Specifically, the staff has focused on the content, timing, and format of the disclosures required under Regulation Z as possible candidates for regulatory change. At this time, our staff is preparing a proposal that would amend Regulation Z to address these issues and expects to present their recommendations to the Board within a few weeks. Although the review is still in process, and neither the staff nor the Board has made any firm decisions about what can and should be done, I would like to share with you some of the particular issues we have been considering.

Under current requirements, when a home equity plan is opened, a creditor need only give general disclosures about how the finance charge will be determined, what other charges will be imposed, the security interest being taken, and the consumer's billing rights. Creditors are not required to disclose certain items, such as their right to unilaterally change the terms and conditions of the plan, or the possibility that a balloon payment may be required as part of the plan. It is conceivable that Regulation Z could be amended to require disclosure of these features. There also may be a need to require more disclosures in home equity line advertisements. A question raised in this regard is whether disclosing a payment term in an advertisement should require disclosure of other material terms, such as the annual percentage rate or fees to be charged under the plan. In considering any additional disclosure requirements, however, the Board is guided by the principle that disclosures should provide

consumers with essential information, without overloading them with less important information or unnecessarily raising creditors' compliance costs.

Another area we have identified as one to look into concerns the timing of disclosures. Regulation Z currently permits open-end credit disclosures to be given anytime prior to the first transaction. In the case of home equity lines of credit, therefore, consumers may not receive disclosures about the terms and conditions of the plan until closing. Since many home equity credit plans involve large application fees and tend to be more complex than other types of open-end credit, an argument can be made for requiring disclosure of the fees, terms, and conditions of such plans at an earlier time in the credit process.

Finally, concern has been expressed that consumers may not fully understand the terms and conditions of the programs. This concern may be due, in part, to the complexity of these plans and the fact that the underlying contracts could run several pages in length. Currently, Regulation Z does not require any special format for open-end disclosures. As a result, in most cases, the disclosures given for these plans are not segregated from the contractual provisions or highlighted in any standard manner. We believe that consumers should be alerted to the most important terms and conditions of the plans for which they contract. To the extent that the current regulatory requirements fail to meet this goal, it might be necessary to

require that disclosures about these plans be segregated from other information.

At this point I would like to mention that at its meeting in October 1987, the Board's Consumer Advisory Council generally endorsed the idea of requiring additional disclosures for home equity lines in advertisements and in initial account disclosure statements. The Council also supported the idea of requiring creditors to provide disclosures for these loans at an earlier stage of the credit-granting process than is currently required. In addition, Council members saw the need to have these disclosures highlighted in a manner that would alert consumers to material information about the terms and conditions of these programs.

Legislative Proposals

The subcommittee has asked that we comment on legislation concerning home equity lines that was introduced in the House. H.R. 3011, which was introduced by Congressman Price, would amend the Truth in Lending Act to establish additional disclosure and advertising requirements for open-end credit plans secured by the consumer's dwelling. The bill would change the requirements concerning the content, timing, and format of the Truth in Lending disclosures that are now required for home equity lines of credit. Currently, the Truth in Lending Act and Regulation Z treat home equity lines of credit like other types

of open-end credit plans. As a result, creditors only are required to give the disclosures that I previously outlined. H.R. 3011 would require creditors to give more extensive and detailed disclosures about home equity loans. For example, it would require more disclosures concerning the annual percentage rate, including disclosure of the maximum amount that the rate could change in a one-year period, and, if no limit exists on annual rate increases, a statement to that effect. The bill would also add an example, based on a $10,000 amount outstanding, showing the payment terms under the plan, and would require creditors to disclose their ability to unilaterally change the terms and conditions of the plan. These disclosures, among others, would generally have to be given at the time of application, which is earlier than current requirements, and would have to be segregated from other disclosures, which is also a departure from current requirements. H.R. 3011 would also add a new advertising section to the Truth in Lending Act for home equity lines.

The Board generally supports the approach taken in H.R. 3011 to require additional disclosures for home equity plans at an earlier stage of the credit-granting process. The Board also believes that material information about these plans should be presented in a manner that will alert consumers to the most important information about the cost of their credit transaction. To the extent that H.R. 3011 addresses these concerns about the

content, timing, and format of disclosures given to consumers, the Board generally favors the bill's intent.

H.R. 3468, which was introduced by Congressman Schumer, would also amend the Truth in Lending Act to require additional disclosure and advertising requirements for home equity loans. The bill would require certain disclosures to be given with each home equity application. For example, creditors would have to disclose more information about the annual percentage rate and fees charged under a particular plan, as well as provide more information about a plan's payment terms. Creditors would also have to give an example of the periodic payments that would have been required under the plan over a fifteen-year period. The bill would also impose additional disclosure requirements for advertisements of home equity loans. Perhaps the most significant feature of H.R. 3468, however, is the fact that it would impose additional substantive requirements on home equity loans, such as prohibiting the establishment of rate floors and payment schedules that would permit interest-only payments, and prohibiting credit extensions in excess of 75 percent of a dwelling's fair market value.

As I indicated in my comments on H.R. 3011, the Board generally supports the idea of increased disclosures for home equity loans. To the extent that H.R. 3468 would require creditors to provide consumers with more information about the cost of a credit transaction, the Board would generally support this goal. The Board, however, generally opposes the imposition

of substantive restrictions on a particular loan product absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices. At this time, we are unaware of any evidence that such practices exist. Moreover, to the extent that imposing substantive restrictions could affect a creditor's ability to offer this type of loan product, consumers who might otherwise enjoy the advantages that such a product offers could be adversely affected. For example, H.R. 3468 would prohibit plans that allow interest-only payments, a feature that might be attractive to consumers who prefer the lower monthly payments offered by these plans and who fully understand that a balloon payment may result. In addition, the bill would prohibit rate floors for home equity loans with a variable-rate feature. Such a restriction could adversely affect a creditor's ability to offer a home equity product, since creditors have fixed operating costs that may necessitate their placing limits on the minimum rate that can be offered to consumers. Moreover, prohibiting creditors from setting rate floors may be ineffective since creditors may be obliged to seek alternative sources of revenue through increased fees and transaction charges, or through the imposition of higher maximum interest rates or greater interest rate margins. The Board, therefore, urges Congress not to adopt legislation that might unnecessarily restrict the offering of products that, in many cases, benefit consumers, particularly absent sufficient evidence that such restrictions are necessary to prevent misleading or abusive practices.

Conclusion

I can assure you that the Federal Reserve Board shares the goal that consumers receive adequate information at a relevant stage of the credit-granting process when they contract for home equity loans. We believe that it is particularly important that consumers understand these programs since they may pose a greater risk because of their complexity, the large credit lines generally involved, and the possibility of losing one's home. On the other hand, I want to urge the Congress not to restrict the terms and conditions of home equity programs without sufficient evidence of a clear and unequivocal need for such action.

We look forward to working with you on this important subject.