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Statement by

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Member, Board of Governors of the Federal Reserve System

before the

Subcommittee on Consumer Affairs and Coinage

of the

Committee on Banking, Finance and Urban Affairs

United States House of Representatives

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I appreciate the opportunity to appear before this subcommittee to discuss home equity lines of credit and H.R. 3011. The proposed bill would amend the Truth in Lending Act to require creditors to provide consumers with more information about home equity programs in advertisements and in initial account disclosure statements.

The information that we have regarding home equity lines of credit shows that 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 $65 billion and could reach $75 to $80 billion by year-end.

This rapid expansion 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.

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 debate has focused on the current disclosure requirements for these loans, and whether these requirements are adequate. The sponsors of H.R. 3011 have sought to address some of these concerns by introducing legislation to require additional disclosures for home equity loans. At the same time, 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.

Legislative Proposal

H.R. 3011 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. 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 are required to disclose how the finance charge will be determined under the plan, what other charges will be imposed, the security interest being taken, and the consumer's billing rights.

The proposed bill would require creditors to give more extensive and detailed disclosures. For example, it would require more disclosures concerning the annual percentage rate, including, if applicable, a statement that no limit on annual rate increases exists. The bill would also add an example, based on a $10,000 amount outstanding, showing the payment terms under the plan and how changes in the annual percentage rate could affect payments under the plan. In addition, the proposed bill would call for disclosure of the creditor's ability to unilaterally change the terms and conditions of the plan, a statement that the consumer risks losing his or her home in the event of any default, and a disclosure that interest-only payments increase the cost of the loan since they do not reduce the principal owed. Creditors would also be required to give consumers a pamphlet that is to be prepared by the Board. These additional disclosures 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 information, which is once again a departure from current Truth in Lending requirements for open-end credit.

The proposed legislation would also add a new advertising section to the Truth in Lending Act for home equity lines. Currently, a creditor is required to make certain cost disclosures in advertisements only when "any specific terms of the plan" are included in the advertisement. Regulation Z limits "specific terms" to items that are required to be disclosed in the initial disclosures. The bill would add a reference to a periodic payment amount as a term that requires the advertisement to include additional disclosures. The bill also would require, under certain circumstances, a disclosure regarding the tax-deductibility of interest paid on home equity lines, and would prohibit creditors from referring to home equity loans as "free money" or a "loan at prime."

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. In our review of H.R. 3011, we find that the Congress has identified many of the issues that we ourselves have targeted as major areas of concern that possibly could be addressed through regulatory action.

During the past year, Board staff has been considering the issue of home equity lending within the context of Truth in

Lending disclosure requirements. In addition, the Board's Consumer Advisory Council formed a subcommittee at the beginning of this year to look into the issue and has discussed it at its past two meetings. 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, Board staff is preparing a proposal that would amend Regulation Z to address these issues and expects to present their recommendations to the Board sometime next month. 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 those general disclosures that I previously outlined. 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. Some questions raised in this regard include whether "teaser" rates are adequately disclosed as only lasting for a limited time period and 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, in many cases, do not receive disclosures about the terms and conditions of the plan until closing. Since most home equity credit plans involve large up-front 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.

The Federal Reserve Board shares the goal that consumers receive adequate information at a relevant stage of the credit process when they contract for home equity loans. We believe that it is particularly important that consumers understand these programs since they arguably pose a greater risk because of their complexity, the large credit lines generally involved, and the possibility of losing one's home. Therefore, we look forward to working with you on this important subject.