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ECONOMIC COMMENTARY

Home Equity Lines: Characteristics and Consequences

by K. J. Kowalewski

Three traditional indicators of consumer financial distress have sent up warning flags in the past year. The rapid growth of consumer installment debt relative to that of disposable personal income pushed the debt-to-income ratio to new highs in 1986; delinquency rates on installment and mortgage debt continued to increase last year; and personal bankruptcies grew about 30 percent to reach a record high.

Against this apparently risky background for consumer lending, consumers are being offered additional borrowing opportunities. Many lenders are giving consumers credit lines of many thousands of dollars based on the equity in their homes. Available evidence suggests that consumers are acquiring these home equity lines (HELs) in great numbers.

What are HELs? Why are they so popular? What is their probable impact on the quantity of consumer borrowing and on the economy? This *Economic Commentary* attempts to answer these questions.

What Are HELs?

HELs are basically mortgages because they are collateralized with real estate, typically a first home. Like traditional mortgages, HELs place liens on the home. Unlike traditional mortgages, HELs are *prearranged* and *revolving credit lines* that may be accessed by check, telephone transfer, or credit card, depending on the lender. The HEL credit line can be drawn down at any time and for any reason, and as the HEL principal is repaid, it can be borrowed again until the maturity date of the HEL is reached. Usually, there is a minimum amount for withdrawals.

HEL pricing varies considerably among lenders. Interest rates on HELs are almost always variable, and may change monthly or even more frequently without an upper limit or ceiling. There also may be a floor below which contracted HEL rates cannot fall. Most lenders use their prime rate or *The Wall Street Journal* prime, plus one to three points. Some lenders add points to a U.S. Treasury bill interest rate or to some average of that rate. In many cases, the point spread above these base rates depends on the amount of the HEL credit line, with smaller spreads for larger credit lines, as is true in commercial lending.

As with first and second mortgages, appraisal and other closing costs for HELs are assessed, though many lenders waived these costs in late 1986 and early 1987 for competitive reasons. It is important to note that these fees are based on the size of the credit line even if the full credit line is never borrowed. An annual fee of about $30 also is required by most lenders.

The maximum amount of a HEL credit line may be limited to typically 75 to 85 percent of the equity (market value minus outstanding mortgage debt) in the home or, more restrictively, to 75 to 85 percent of the home's market value minus the outstanding mortgage debt. Unlike most credit cards, HELs have a fixed maturity, or a maximum amount of time consumers can take to repay the balance, which typically varies between 10 and 20 years. There are no penalties for early repayment of the HEL.

Principal and interest can be repaid in one of two ways, depending on the lender. Fixed-percentage HELs calculate minimum monthly payments as a percentage, usually between 2 and 5 percent, of the outstanding principal. Interest-only HELs require only interest payments for the duration of the loan and one principal payment or "balloon" when the loan matures. The advantages of balloon HELs are greater interest deductions over the life of the loan and lower monthly payments. On the other hand, balloon HELS imply a greater risk that the consumer will be unable to repay the balloon when the loan matures.

It is also possible that the fixed-percentage HEL will not be completely repaid at maturity, either because a large loan was taken out near the maturity date or because interest rates rose to high levels over the course of the loan. If the consumer must refinance the unpaid principal of the fixed-percentage HEL or the balloon using the home as collateral, closing costs and other fees must be paid again, even if the original lender is used.

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Why Are HELs So Popular?

HELs are not new. Although there is some dispute over this point, Beneficial Corporation, the nationwide finance company, is believed to have originated the HEL in California during the late 1960s.[1] Merrill Lynch & Co. conducted a pilot HEL program in 1978 that became a permanent part of its lending portfolio in 1982; Shearson/American Express introduced a HEL in 1981; and State Savings in Stockton, California, was the first savings and loan association to offer a HEL in 1978.[2]

These and other early HELs were not widely popular because they were restricted by the Truth in Lending Act. Before Congress changed the law in 1982, consumers had the right to rescind credit transactions that were secured by a lien on their homes within three days after the credit was extended, and lenders were required to notify consumers of this right every time such credit was extended. These restrictions made convenient access to the HEL by credit card or check prohibitively expensive to lenders.

A number of possible reasons can explain the recent frenzy of interest in HELs. The most important reason from the consumer's point of view is the Tax Reform Act of 1986. The Act phases out the deductibility of interest on nonmortgage consumer debt by 1991; interest on debt secured by first and second homes remains deductible as long as the amount of the debt is less than the purchase price of the home plus the cost of any improvements.[3] Thus, homeowners may be able to retain the tax deductibility of their consumer interest payments by shifting their current credit card, automobile, and other nonmortgage debt to a HEL. If the HEL can be accessed by credit card, then the homeowner has the same tax-deductible and convenient transactions medium as under the old law.

Another reason for the popularity of HELs among consumers is that HEL interest rates, even before taxes, are currently lower than rates on other nonmortgage consumer credit.

The paradox of recent indications of consumer financial distress and the new availability of home equity credit helps to explain the popularity of HELs among lenders. Experience shows that second mortgages have been less risky than other consumer loans. In addition, a survey conducted by the National Second Mortgage Association and the American Financial Services Association of all consumer loan originators who offered HELs found that delinquency losses, net of legal fees and other write-off costs, were less than 0.5 percent of HEL assets in 1985. Thus, shifting the composition of consumer lending toward HELs, when loan defaults and bankruptcies are rising, is seen as a way of guarding against large loan losses.[4]

The ongoing evolution of the financial services industry makes HELs attractive to lenders as effective marketing tools. Thrifts view HEL lending as a cost-effective entry into consumer lending because these institutions have considerable experience in making real estate loans. Moreover, the high initial costs of HELs are seen as locking consumers into one lender, with the side benefit of reducing the cost per dollar of consumer lending. This "lock-in" argument has had less merit in the recent past because many lenders have waived closing costs. However, this reason should take on greater importance in the future.

How Important Are HELs in Total Consumer Lending?

There are no hard data on the total value of HEL credit lines nationwide. Moreover, it is impossible to know the magnitude of home equity lending because currently published national credit statistics do not distinguish among first mortgages, second mortgages, and HELs. There are some rough indications of HEL activity, however. The Federal Home Loan Mortgage Corporation estimates that all second mortgages totaled $150 billion in 1985, up from $100 billion in 1983 and $34 billion in 1980.[5] Thus, HELs are no greater than these amounts.

In March 1986, all second mortgages held by thrifts amounted to only 2.3 percent of total assets, and second mortgages accessed via credit cards and other open-ended agreements amounted to only about $5.7 million, or 0.5 percent of assets.[6]

David Olson, a recognized authority on second-mortgage lending at SMR Research, Inc., estimates that the total amount of debt under home equity lines at year-end 1986 was $40 billion to $50 billion, or 20 to 25 percent of all second-mortgage credit and about 2.5 to 3 percent of all home mortgage credit outstanding.

The commercial banks participating in the November 1986 Senior Loan Officer Opinion Survey conducted by the Board of Governors of the Federal Reserve System reported that, on average, HEL credit represented 11 percent of their total home mortgage credit in September 1986. If this number is taken to be representative of all commercial banks in the United States, HELs at commercial banks then amounted to about $50 billion.

It is also difficult to calculate the magnitude of HEL loans outstanding because credit is classified in the debt statistics by the underlying collateral, not necessarily by the items purchased with the loan. Thus, HELS are anonymously included in mortgage debt, even though they may be used to buy consumer goods and services.

Recognizing this fact, some weak evidence suggests that HELs have made an impact on the nominal composition, though not necessarily the total amount, of household borrowing at year-end 1986 and early 1987. After increasing on average $4.8 billion between February 1986 and November 1986, real estate loans at domestically chartered commercial banks increased $9.4 billion in December 1986, $10.0 billion in January 1987, and $5.6 billion in February 1987. The change in loans to individuals at these same banks, however, averaged $1.6 billion between February 1986 and November 1986, but only $1.1 billion between December 1986 and February 1987. These changes anticipate the introduction of the new tax law on January 1.

1. Katz, Jane W. "Home Equity Loans Are Good Business," *Outlook of the Federal Home Loan Bank System,* vol. 2, no. 6 (November/December 1986), p. 13.

2. "Credit Card Taps Unused Home Equity," *Savings and Loan News,* vol. 103, no. 6 (June 1982), p. 84.

3. Second mortgages or HELs made before August 16, 1986, are exempt from this restriction. After that date, interest remains deductible on all types of mortgage debt as long as the debt is used for educational or medical expenses.

4. It is quite possible that this advantage will be reduced if many homeowners shift to HELs.

5. "Big Comeback for Home Equity Credit," *Bankers Monthly,* vol. 103, no. 5 (May 1986), p. 30.

6. Katz, p. 14.

Consumer installment debt nationwide increased only $533 million on average between November 1986 and March 1987, after increasing $5.5 billion on average between November 1985 and October 1986.

Finally, the flow-of-funds statistics compiled by the Board of Governors of the Federal Reserve System for the fourth quarter of 1986 show a relatively large increase in home mortgage debt held by households—$257.1 billion, after $226.8 billion in the third quarter and $187.2 billion in the second quarter—and a very small increase in consumer debt—$43.4 billion, after $78.9 billion in the third quarter and $86.9 billion in the second quarter.[7]

What Is the Potential Growth of Home Equity Lending?

Many estimates suggest a substantial growth potential for HELs. First, Beneficial Management Corp., a major second-mortgage lender, estimates that untapped home equity amounts to about $3.5 trillion.[8]

Second, Charlene Sullivan, of Purdue University's Krannert Graduate School, told the 1986 National Consumer Lending Conference that the median value of equity in dwellings is currently $41,261. This is 72 percent of the median house value of $57,500, suggesting that much equity remains to be tapped.[9]

Third, the 1983 *Survey of Consumer Finances* shows that about 63 percent of total nonmortgage debt among households in the sample was owed by households having available home equity—market value minus outstanding mortgage debt in excess of 20 percent of the home's value—of $10,000 or more. About 47 percent of total nonmortgage debt was held by households for whom tax considerations may be relevant. Finally, among households with credit card debt outstanding, about 20 percent have both substantial home equity and a customary practice of paying less than the full amount billed.[10]

Will HELs Affect Total Consumer Spending and Borrowing?

Most lenders and analysts agree that tax reform is the major reason for the current popularity of HELs among consumers. If this is true, then HELs should not greatly affect the total amount of consumer borrowing or purchases. Consumers will simply shift all of their once tax-deductible, nonmortgage debt over to a HEL to maintain the tax advantage. As long as the after-tax interest costs are equal, consumers using HELs should not increase their spending. Indeed, consumers with sufficient home equity already had access to the second-mortgage market, which entails the same closing costs and interest rates, and would have used a second mortgage had they so desired.

Nevertheless, HEL interest rates are currently lower than interest rates on most credit cards and other consumer loans, and many lenders offered very low "teaser" interest rates on initial HEL balances as a marketing tactic. Lower borrowing interest rates mean lower monthly debt payments and greater consumer discretionary income. Even if all of this extra income is spent, it is unlikely that this added spending is great enough to have a measurable impact on the aggregate consumer spending statistics.

Limited evidence suggests that, initially, few consumers are using second mortgages and HELs solely to capture the tax advantage. A poll of households conducted between January 14-18, 1986, by Louis Harris & Associates for *Business Week* found that of the households who either took out a second mortgage (or HEL) or considered doing so in the past year, only 24 percent said that they did or would repay other debts with the loan. Presumably, this category includes debt consolidation for tax reasons. The remaining uses for the loan were to make purchases or to repay a first mortgage. Moreover, 56 percent of these consumers said that they would have to cut back their spending if they did not or would not take out a HEL.

Society National Bank in Cleveland, Ohio, surveyed its HEL customers and found that only 17 percent used HELs to either consolidate debts or repay credit card balances. The largest single category of HEL usage was "cash with unknown purpose," 29 percent; all other consumers used the loan proceeds to make purchases or to pay taxes. HEL borrowings averaged 52.5 percent of the committed credit line, or about $10,200.[11]

This albeit casual and possibly dated information suggests that most HEL borrowings have been used to support, though not necessarily to increase, spending, and not solely to consolidate debts for tax purposes. This raises the question of why consumer interest in HELs was so strong near the end of 1986, when the new tax law was about to be effective. These consumers presumably had the option of obtaining a second mortgage before the end of 1986, but did not. Perhaps many of these consumers did not, or thought they did not, have access to the second-mortgage market. If this is true, these consumers are likely to use HELs to support their consumption spending.

Might consumers simply be responding to the massive HEL advertising campaign of the past year? Or were they influenced by misleading advertising? Advertisements and consumer lenders say HELs help consumers to get money out of their houses or to use the money in their houses. This line of reasoning is deceptive and incorrect because consumers do not sell some of the equity to the lender. The house simply serves as collateral. The HEL must be repaid from the borrower's income. The only way to get money out of the house is to sell the house. Indeed, using a HEL to support spending reduces the amount of savings a consumer can place in other, more liquid assets. If advertising has played a large role, then there will be a temporary increase in spending, but as the HEL repayment amounts accumulate, consumers may need to reduce their spending.[12]

7. These debt flows are admittedly weak evidence about the impact of HELs because consumer spending, particularly automobile purchases, fell in both the fourth quarter of 1986 and the first quarter of 1987, while home purchases grew, though at slower rates than during the previous three quarters of 1986. The lags involved in mortgage loan processing also make these timing arguments somewhat speculative.

8. Weinstein, Michael. "Home Equity Credit Lines Expected to Boom," *American Banker*, August 5, 1986, p. 14.

9. Katz, p. 15.

10. These indicators of the potential growth of HELs may be somewhat optimistic, because only between 30 and 40 percent of all taxpayers itemize deductions, and not all itemizers own homes. Moreover, tax reform may reduce the number of itemizers.

11. "Bank Says Average Borrower is Almost Identical Throughout Ohio," *The Plain Dealer*, Cleveland, Ohio, February 23, 1987, p. 2-C.

Or do these consumers place a great deal of value on flexibility, on having credit ready and waiting when necessary? This seems unlikely, because lenders report that HELs are used soon after they are opened. First Fidelity Bancorp in New Jersey, for example, reports that its average HEL credit line is $36,000, with an average loan balance of $16,000 within the first 12 months.[13]

Conclusions

Home equity lines are mortgages combined with revolving credit lines. To lenders, they offer the advantages of lower risk, variable interest rates, economies of scale in loan administration, and the opportunity to build ongoing relationships with customers. To consumers, they offer currently lower before-tax interest rates, longer maturities, borrowing flexibility, and tax advantages. To date, there is very little information about the magnitudes and purposes of HEL borrowing. However, the currently favorable terms of HEL borrowing and casual evidence suggest that consumers are using HELs at least to maintain spending.

Whether HELs will increase the variability of spending is not clear. Because interest rates on HELs are variable without a cap, the shifting of conventional, fixed-rate consumer credit to HELs shifts the interest-rate risk from lenders to consumers. It may be argued that consumers are less able than lenders to manage this risk, because lenders have more opportunities to diversify their portfolios and generally command greater financial resources. When interest rates rise, personal incomes tend to grow more slowly, but monthly debt repayments will increase on variable-rate loans. A major shift to HELs thus implies that consumer spending may grow more slowly in periods of high interest rates than it otherwise might. Conversely, when interest rates fall, spending may increase more rapidly than it otherwise might.[14]

This additional variability may be offset by greater credit supply during periods of high interest rates. Lenders tend to restrict consumer credit when interest rates are high, not only because high interest rates slow consumer income growth, but also because consumer lending is relatively less profitable when market interest rates are above usury ceiling rates. The apparently greater propensity among lenders to offer HELs may imply that consumer credit may be less severely restricted during periods of high interest rates. However, if lenders closely match HEL credit lines to home market values, then credit supply may not increase, because home values tend to fall during periods of high interest rates. Only time will tell about the impact of HELs.

12. An alternative explanation is that the advertising late last year simply reminded many consumers that they had the option of obtaining a second mortgage.

13. *Bank Rate Monitor*, vol. 5, no. 2 (December 22, 1986), p. 8.

14. Variable interest rates also mean that consumer lenders' earnings are more stable, implying a more stable supply of credit.

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