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 backdrop 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 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 a month 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 deferrals 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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The paradox of recent indications of consumer financial distress and the need for additional credit helps to explain the popularity of HELs among lenders. Experience shows that several of the HELs had an initial growth faster than other consumer loans. In addition, a survey conducted by the National Secondary Mortgage Association and the American Financial Services Association of all consumer loan originators who offered HELs found that default losses, net of legal fees and other write-off costs, were less than 0.5 percent of all HEL assets. This is an indication of the shift toward consumer lending toward HELs, when loan default and bankruptcy rates are low. However, it is difficult to gauge the magnitude of consumer lending toward HELs, because credit is classified in the debt market. Thus. HELs at commercial banks then amounted to about $50 billion.

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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, monthly HELOCs may be reduced. About 47 percent of total nonmortgage debt was held by households for whom the median household income is $57,000. This is 72 percent of the median house value in 1986.

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Another reason for the popularity of HELs among consumers is that HELs are currently lower than rates on other nonmortgage consumer credit.

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The paradox of recent indications of consumer financial distress and the need for mortgage credit helps to explain the popularity of HELs among lenders. Experience shows that some of the funds had been used for other than consumer loans. In addition, a survey conducted by the National Secondary Mortgage Association and the American Financial Services Association of all consumer loan originators who offered HELs found that delinquency rates, net of legal fees and other write-off costs, were less than 0.5 percent of HEL assets. Thus, shifting the composition of consumer lending toward HELs, when loan default and bankruptcy losses are seen as a way of guarding against large loan losses.

Moreover, the ongoing evolution of the financial services industry makes HELs attractive to lenders as effective marketing tools. This is because of the way HELs can be used 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 by the substantial benefit of reducing the cost per dollar of consumer lending. This "lock-in" effect is likely to continue in the recent past because many lenders have waived closing costs. However, this trend does not appear to take on greater importance in the future.

How Important Are HELs to Consumer Lending?

There are no hard data on the total value of HEL credit lines nationwide. Moreover, because it is impossible to determine the magnitude of home equity lending because currently published national credit flows do not include funds among first mortgages, second mortgages, and HELs. There are some rough indications of the importance of HELs. The Federal Home Loan Mortgage Corporation estimates that all second-mortgage balances totaled $150 billion in 1985, up from $100 billion in 1983 and $54 billion in 1980. Thus, HELs are not on a growth curve.

In March 1986, all second mortgages held by thrifts amounted to only $1.1 billion between December 1985 and February 1986. These changes anticipate the introduction of the new tax law on January 1. Consumer installment debt nationwide increased only $353 million on average between November 1985 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 quarter of 1986 show a relatively large increase in home mortgage debt held by households—$257.1 billion, after $228.8 billion in the third quarter and $187.2 billion in the second quarter. Moreover, tax reform may reduce the number of mortgage 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, the effect is likely to have only a "marginal" impact on the aggregate consumer spending stream.

Limited 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, MBA estimates of both chartered commercial banks increased $9.4 billion in December 1986, $10.0 billion in January 1987, and $9.6 billion in February 1987. The change in loans to individuals at these same banks, how- ever, was only $1.1 billion amid the storm. The Federal Home Loan Mortgage Corporation estimates that all second-mortgage balances totaled $150 billion in 1985, up from $100 billion in 1983 and $54 billion in 1980. Thus, HELs are not on a growth curve.

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 nonmortgage credit contributed to only about $5.7 million, or 0.5 percent of assets. During the fourth quarter of 1986, 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 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 U.S., 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 statistical by the underlying collateral, not necessarily by the items purchased with it. Thus, HEL balances are not continuously included in mortgage debt, even though they may be used to buy consumer goods and services.

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Limited evidence suggests that, initially, few consumers are using second mortgages and HELs to capture the tax advantage. A poll of households conducted between January 14 and 16, 1987, by Louis Harris and Associates for Business Week found that of the households who either took out a second mortgage or used an "HE" card, 54 percent doing so in the past year, only 24 percent said that they did or would repay other loan with the proceeds. Finally, this category includes debt consolidation for tax reasons. The remaining unknown factor is whether consumers will use their HELs to repay their first mortgage or to repay a credit card balance. Moreover, 56 percent of these consumers said they would use their HELs to repay their spending if they did not or would not take out a HEL.
Conclusions

Home equity lines are mortgages combined with revolving credit lines. To lenders, they offer the advantages of higher interest rates, economies of scale in loan administration, and the opportunity to build ongoing relationships with customers. To consumers, they offer the advantages of having access to large sums of money which can be lent or used at any time, as credit lines typically have no minimum amount for withdrawals. A major shift to HELs thus implies that consumer spending will grow more slowly in periods of high interest rates than it otherwise might.

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Against this apparently risky background for consumer lending, consumers are being offered additional borrowing opportunities. Many lenders are advertising their credit lines, though many lenders are utilizing them to attract additional customers. Lenders are being asked to provide evidence that they are servicing home equity lines (HELs) in great numbers.

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