Home Equity Lending Would Benefit Texas

“For Texas bankers, home equity loans represent a potential source of lending growth.”

Texas is the only state that does not permit general home equity loans. Texas' Homestead Act, which originated in the Republic of Texas in 1839, forbids foreclosure on a Texan's homestead for any debts other than first mortgage and property improvement loan defaults and unpaid property taxes. As a result, banks make second loans on equity in Texas homes only if the loan proceeds are for home improvements.

In other states, home equity loans provide consumers with an additional source of credit for a variety of purposes. Consumers use home equity loans not only for home improvements, but also for repayment of other debts, education, real estate purchases, business financing, vacations, medical expenses and other purposes.

Critics of home equity loans in Texas are concerned that consumers who borrow on the equity in their homes often become overburdened with debt. The recent performance of home equity loans elsewhere in the country can shed light on these concerns. If home equity loans tend to cause consumers to take on excessive debt, then such loans would be expected to perform poorly compared with other types of loans in regions experiencing adverse economic conditions.

In general, U.S. banks have recovered from the credit difficulties of the recent past. For both Eleventh District banks and banks in the rest of the nation, the ratio of troubled assets to total assets has decreased in each of the past six quarters. In some regions, however, credit difficulties persist. The available data on loan defaults and charge-off rates at banks operating in regions with pervasive credit difficulties do not support the view that home equity loans are associated with excessive risk. These findings suggest that many of the concerns expressed by the critics of home equity lending in Texas are unfounded.

Industry Performance

Profitability. Bank profitability during the third quarter of 1993 remained strong in the Eleventh District, which includes northern Louisiana, southern New Mexico and Texas. Chart 1 shows that banks in both the District and elsewhere in the United States have generated a sustained improve-
ment in profitability since the end of 1991. District banks reported a return on assets of 1.25 percent for the third quarter, making it the seventh consecutive quarter in which they earned a return on assets of 1 percent or greater. The performance of banks in the rest of the nation also remained strong, with a 1.29-percent return on assets in the third quarter.

Asset quality. Improvements in asset quality have contributed to the positive trend in bank profitability. Chart 2 shows that the troubled asset ratio continued to decline in the third quarter of 1993, both in the Eleventh District and in the rest of the nation. Among District banks, troubled assets made up 1.02 percent of total assets, down from 1.78 percent in third-quarter 1992. Outside the District, troubled assets represented 1.97 percent of total bank assets in third-quarter 1993, down from 2.83 percent a year earlier. The remaining troubled assets at banks both in the District and in the rest of the nation consist primarily of noncurrent real estate loans and other real estate owned.

Despite these positive trends in asset quality and profitability, loan growth has remained relatively sluggish. As a result, bankers are searching for alternative lines of business to enhance the industry’s growth potential. For Texas bankers, home equity loans represent a potential source of lending growth.

Home Equity Loans

Benefits. Home equity loans provide an additional option for obtaining credit for many consumers. Using a home equity loan, a homeowner can borrow against the accumulated equity in his or her home. There are two types of home equity loans: a traditional second mortgage and a home equity line of credit. A second mortgage is a fixed-amount loan that is extended for a specified period of time and generally requires monthly installment payments. A home equity line of credit, on the other hand, is a revolving account that permits borrowing at the account holder's discretion up to the amount of the credit line. A home equity line of credit typically has a more flexible repayment schedule than a second mortgage.

For consumers, a major benefit of home equity loans is the ability to use home equity as collateral. Unlike businesses, which often possess alternative types of collateral, home equity is the only major source of collateral for most consumers. By securing their loans with a junior claim on home equity, consumers can lower their interest payments relative to the payments required on unsecured credits, such as credit cards. While businesses often are able to obtain even lower interest rates by securing their loans with a first lien, that option is not available to most consumers. As a result, consumers often find home equity loans relatively attractive, because they represent the least expensive viable source of financing.

An additional advantage of home equity loans stems from the changes in tax laws initiated by the Tax Reform Act of 1986. The law allows a tax deduction for the interest paid on home mortgage loans but prohibits tax deductions for the interest paid on other consumer loans. This preferential tax treatment gives home equity loans an additional advantage over other consumer loans.

While some anecdotal evidence suggests that home equity loans play an important role in small-business financing, the available data indicate that the majority of home equity loans are used for consumer purposes. Chart 3 shows that, in 1988, 45 percent of those with second mortgages and 38 percent of those with home equity lines of credit initially used the loan proceeds for home improvement. Consolidation of other debts, including credit card debts and auto loans, was cited as a use by 35 percent of those with second mortgages and by 40 percent of those using their home equity line of credit. Individuals cited "business" as a use of the loan proceeds in only 4 percent of the home equity lines of credit and in 6 percent of the second mortgages.

Providers of home equity loans. Consumers may choose from a number of sources for obtaining home equity loans. Chart 4 shows that about one-third of the consumers who use a second mortgage obtain the mortgage from a bank. Other popular choices for second mortgages are thrifts, brokerage firms and mortgage companies. About half the consumers who use a home equity

Chart 2

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>Eleventh District</td>
<td>3.5%</td>
<td>3.2%</td>
<td>2.8%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Rest of the United States</td>
<td>3.4%</td>
<td>3.1%</td>
<td>2.7%</td>
<td>2.4%</td>
</tr>
</tbody>
</table>

*Troubled asset ratio is the ratio of loans past due 90 days or more, nonaccrual loans and other real estate owned to end-of-period gross assets.

DATA SOURCE: Reports of Condition and Income.

Chart 3

Uses of Home Equity Loans, 1988

- Second mortgages
- Home equity lines of credit

NOTE: Multiple uses could be cited for a single loan or drawdown. "Other uses" include medical expenses, vacations, tax payments and purchases of vehicles, furniture and appliances.

Chart 4
Sources of Home Equity Loans

<table>
<thead>
<tr>
<th>Source</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Second mortgages</td>
<td>33%</td>
</tr>
<tr>
<td>Home equity lines of credit</td>
<td>54%</td>
</tr>
<tr>
<td>Thrifts</td>
<td>27%</td>
</tr>
<tr>
<td>Credit unions</td>
<td>8%</td>
</tr>
<tr>
<td>Other</td>
<td>32%</td>
</tr>
</tbody>
</table>


For most banks, home equity loans constitute a moderate portion of total assets. In the third quarter of 1993, home equity loans outstanding made up about 3.5 percent of total assets and 6 percent of total loans at U.S. banks outside of Texas. As a proportion of real estate loans at these banks, home equity loans totaled 14 percent. About 53 percent of the banks offered home equity lines of credit in the third quarter of 1993, up from 48 percent in early 1990.

Performance of home equity loans.
Home equity lending has several distinct risk characteristics. One source of potential risk for lenders is the nature of the claim on collateral. Home equity loans generally are secured by a junior claim on a home and, in a foreclosure, these loans are paid off only after first mortgages. Thus, a home equity loan may have less effective collateral protection than a first mortgage.

In addition, home equity lines of credit frequently include an adjustable rate feature. When interest rates rise, this feature can result in substantial increases in required interest payments, leading potentially to cash flow problems for borrowers and a rising level of defaults. However, to the extent that borrowers are able to make the higher payments associated with rising interest rates, the adjustable rate feature of home equity lines of credit actually can benefit a bank during a period of rising rates.

Finally, the critics of home equity loans in Texas contend that some consumers tend to overburden themselves with debt when they have access to home equity loans. In an economic downturn, this heavy financial burden could cause over extended consumers to default.

To the extent that these factors impart an excessive level of risk to home equity lending, the actual performance of home equity loans would be expected to fall below the performance of other types of credits. The available data indicate, however, that the performance of home equity loans has been similar to, and in many cases better than, the performance of other types of loans.

While separate data on loan performance are not available for the second mortgages held by banks, indicators of asset quality are reported for home equity lines of credit. Chart 5 shows that noncurrent home equity lines of credit accounted for 0.63 percent of total home equity lines of credit outstanding in the third quarter of 1993. This noncurrent rate is lower than the noncurrent rates for consumer loans, commercial and industrial

Chart 5
Noncurrent Loans and Net Charge-Offs,* Third-Quarter 1993

<table>
<thead>
<tr>
<th>Loan type</th>
<th>Percent of loans noncurrent</th>
<th>Percent of loans charged off (net, annualized)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Home equity lines of credit</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>1-4 family</td>
<td>2.0</td>
<td>2.5</td>
</tr>
<tr>
<td>Consumer</td>
<td>3.0</td>
<td>3.5</td>
</tr>
<tr>
<td>Commercial and industrial</td>
<td>3.5</td>
<td>4.0</td>
</tr>
<tr>
<td>Real estate</td>
<td>4.0</td>
<td>4.5</td>
</tr>
<tr>
<td>Total loans</td>
<td>4.0</td>
<td>4.5</td>
</tr>
</tbody>
</table>

*Noncurrent loans rates represent the percentage of loans in each category that are past due 90 days or more or that are in nonaccrual status. Net charge-offs are loan losses for the period less recoveries of previous loan losses.

NOTE: Rates are calculated only for banks with assets of $300 million or more.

DATA SOURCE: Reports of Condition and Income.
loans, and total real estate loans. Furthermore, home equity lines of credit have performed better than other residential real estate loans, as shown by a comparison with the overall noncurrent rate for one- to four-family real estate loans.

Similarly, home equity lines of credit generally have relatively low net charge-off rates, as shown in Chart 5. For the first three quarters of 1993, the rate of net charge-offs for home equity lines of credit was 0.19 percent, significantly lower than the net charge-off rates for the other major loan categories.

Even in regions experiencing economic difficulties, home equity lines of credit have performed well compared with other types of loans. Table 1 highlights the third-quarter 1993 performance of home equity lines of credit by U.S. census region. The West, represented by the Pacific census region, and the Northeast, represented by the Middle Atlantic and New England census regions, have experienced real-estate-sector difficulties, which are reflected in high rates of noncurrent real estate loans. Nonetheless, the noncurrent rates on home equity lines of credit are low relative to other noncurrent loan rates in these regions. These data reflect the generally superior performance of home equity lines of credit over the past several years.

The favorable performance of home equity lines of credit indicates that home equity lending has not been associated with an excessive level of risk. Concerns that consumers with access to home equity loans may become overburdened with debt are not supported by the evidence on the relative performance of home equity loans.

**Conclusion**

The evidence on home equity lending outside Texas suggests that, overall, such loans have been a useful financial service. Consumers view home equity loans as an attractive financing option, and banks have found that the loans have performed well relative to other loans. In the future, the Texas Legislature likely will be asked to reconsider the laws that prevent home equity lending in the state. Changing the laws to allow for general home equity loans would benefit consumers, businesses and the regional financial industry by adding to the array of financial services offered Texans.

—Linda M. Hooks