FRBSF Weekly Letter

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Home Equity Lending: Boon or Bane?

Home equity loans are an increasingly important source of credit for households and a growing component of bank portfolios. Commercial banks are by far the largest providers of home equity credit, with about 40 percent of all outstanding home equity loans. Between 1987 and 1988, banks' home equity loans grew by over 30 percent, from $28.9 billion to $37.5 billion. As a share of total bank assets, home equity loans grew from about one percent to over 1.3 percent. Thrifts, finance companies, and brokerage firms also engage in home equity lending.

Home equity lending is widely considered a low-risk lending activity. Like first mortgage loans, these loans are secured by housing assets, the value of which has performed well historically. Nonetheless, the rapid growth of home equity lending warrants a review of the rationale for and performance of the home equity loan market.

As discussed in this *Letter,* the home equity loan market appears to be developing conservatively. The nature of the instrument, however, makes home equity loans somewhat riskier than they may appear at first glance.

Home equity lending

A home equity loan can be structured in one of two ways. First, it can be structured as a traditional second mortgage, wherein the borrower obtains funds equal to the full loan amount immediately, and commits to a fixed repayment schedule. Alternatively, home equity borrowing can be structured as a line of credit, with check, credit card, or other easy access to the line over its life.

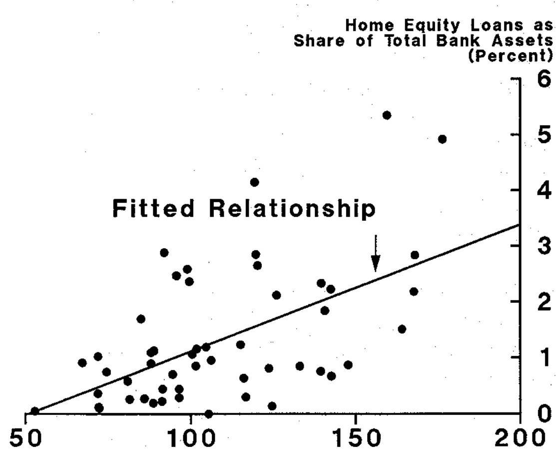
The home equity credit line presently is the dominant form of new home equity lending. The home equity credit line, like other "open-end" or revolving credit facilities, permits the borrower to draw advances against the line whenever needed (up to the limit of the facility). The amount of credit available at a given time depends upon the extent to which the line has been replenished by repayment of outstanding balances.

The available data suggest that the main uses of home equity credit are to consolidate other debt (about 50 percent), finance home improvements (25 percent), and finance automobile purchases (10 percent). Financing medical expenditures and other consumer purchases account for the balance.

Home equity, taxes, and regulation

Apart from the traditional "closed-end" second mortgages that banks and thrifts have always offered, home equity lending is a relatively new line of business for financial institutions. In 1980, fewer than one percent of banking institutions offered home equity lines of credit. Today, 80 percent of commercial banks and 65 percent of thrifts offer such products.

Home Equity Loans and Home Prices 1988, By State



Economic and regulatory developments are responsible for the recent growth of home equity lending by banks and for the growing interest on the part of consumers. Economic forces, in particular, have been important. During the late 1970s and early 1980s, home prices rose sharply, improving the housing equity positions of many households. To the extent households have viewed this appreciation as permanent, they probably have come to consider this equity part of their stock of savings. It is natural, therefore, that the market would seek a means of mobilizing this wealth by providing a home equity credit facility. Indeed, as the chart indicates, home equity lending is most active in states were the level of home values is high.

Moreover, changes in the laws and regulations governing home equity lending facilitated the development of products that could take advantage of this stock of wealth. First, in 1982, the Truth in Lending Act was modified to remove a major impediment to home equity lending. Originally, the Act, as implemented by Federal Reserve Regulation Z, gave consumers three days to change their minds following each, separate drawdown on a line of credit secured by real estate. This stringent "right of rescission" represented a significant cost disadvantage of home equity credit facilities relative to credit card and other revolving debt lines. The 1982 law limited the right of rescission to the initial setup of the loan, thereby making home equity lines of credit more attractive to lenders.

Second, the 1982 Banking Act expanded the authority of national banks to extend flexible, home equity credit, enabling them to make real estate loans primarily on the basis of the creditworthiness and income prospects of the borrower. For federally-chartered thrifts, the Act lifted the restriction that they lend only on the security of "first lien" collateral. Both of these changes facilitated the crafting of home equity credit lines.

The 1986 and 1987 Tax Acts also have influenced the market for home equity lending. The 1986 Act phases out the deductibility of interest payments on most forms of consumer loans, making consumer debt generally more costly to households. The only exception is interest on loans secured by a taxpayer's principal or second residence, which remains deductible, although there are restrictions on the maximum principal amount of a home equity loan that qualifies for an interest deduction. The 1987 tax revisions limit the amount to the lesser of true home equity (that is, the fair market value minus acquisition debt) or $100,000. These reforms make real estate lines of credit relatively less expensive than other forms of consumer credit, and undoubtedly contribute to the strength of the home equity loan market.

Pricing home equity loans

Traditional second mortgages typically are structured like first mortgages, usually with fixed interest rates and a fully-amortizing repayment schedule. Home equity lines of credit, on the other hand, are typically adjustable-rate instruments.

The adjustable-rate feature likely is a consequence of the contingent nature of a line of credit. In essence, a line of credit embodies a series of "options" to obtain credit over the life of the line. If a fixed-rate contract were used, and interest rates rose above the contract rate, borrowers would exercise the option to borrow and profitably invest the funds in the open market at higher rates. From the standpoint of the lender, offering a fixed-rate home equity credit line, thus, is equivalent to selling long-term interest-rate "call" options.

Financial markets in general appear reluctant to offer such long-term options, perhaps because the market doubts the ability of the writer of such options (that is, the lender in the case of fixed-rate home equity lines) to perform on his obligations in an adverse economic environment. Thus, the pricing of home equity lines of credit as adjustable-rate instruments is consistent with the general rarity of pure, long-term interest rate options in the economy. Regulators also discourage lenders from writing pure options.

As with other adjustable-rate instruments, the contract rate is linked to a reference rate (often the prime rate plus about two percentage points). Home equity line rates, however, seldom have restrictive caps, implying that households (rather than banks) are bearing the entirety of interest rate risk. It can be argued that functional caps are likely to become more common as competition in home equity lending grows, since households are less able than banks to accommodate interest rate risk. Hence, as in the first lien adjustable-rate mortgage market, it is likely that capped-rate instruments ultimately will dominate pure, adjustable-rate ones in the home equity loan market.

Risk in home equity loans

One future source of risk in home equity loans, therefore, will be the interest rate risk introduced by the move towards capped-rate products. There are, however, other sources as well. A major source of risk to loans collateralized by housing, of course, is the possibility that local housing values or household purchasing power may decline, stimulating abandonment of the property and default on debt secured by the housing. Certain features of home equity loans make them particularly susceptible to such risks. First, while the adjustable-rate feature of the debt reduces the interest rate risk of the lender, the variable payment size exposes households to greater cash-flow risks than would a fixed-rate instrument, everything else being equal. This, in turn, exposes the lender to greater credit risk.

Ironically, another source of risk is the very fact that such lines employ collateral. Theory suggests that collateral reduces risk, since a general claim on a borrower is augmented by a specific claim on an asset. However, processes of "self-selection" can reverse this relationship. Namely, it is possible that borrowers who choose to pledge collateral are riskier than those who can obtain unsecured credit.

In addition to the risks inherent in self selection, there are risks introduced by the very nature of the home equity loan. They are secured by a lien that generally is junior to that of any primary mortgage debt. Thus, home equity lines of credit of a given size have less effective equity protection than first lien instruments; a decline in the value of the underlying housing results in a much greater than proportional decline in the collateral coverage of a home equity loan. This added leverage makes them correspondingly far riskier than first mortgages. Moreover, the law governing the quality or "perfection" of the lien is quite complicated, and the lien of future advances may be different from that of the initial advance since in the meantime, other events or liens may be interposed. While lenders' counsel try to craft loan agreements that avoid legal pitfalls, the effective riskiness of home equity lending likely varies somewhat with the legal environment. (There are, for example, at least 27 variations in the treatment of lien priority across states.)

This variation in contract characteristics also affects the liquidity of home equity debt. For debt to be easily pooled and sold in the secondary market, it needs to be fairly consistent in its credit- and interest rate-risk characteristics. The complexity of collateral structures, coupled with the inherently uncertain maturity of revolving credit instruments, makes home equity loan assets considerably less liquid than straight, first lien, fixed maturity debt.

Handle with care

Outstanding home equity credit, while growing rapidly, presently represents far less than 10 percent of the outstanding value of home equity, currently estimated at $3 trillion. The continued high level of home values, coupled with favorable tax treatment, likely will spur further growth in this segment of the credit market, making it a significant component of bank and thrift portfolios.

However, adverse-selection processes, legal complexities, and other features of these loans can be important sources of risk. In fact, there is some evidence that delinquency rates are higher for home equity lines than for unsecured lines. In addition, mortgage insurers tend to experience greater difficulties with adjustable-rate instruments than with fixed-rate, first lien mortgage debt. Comprehensive data on comparative rates of nonperformance and charge-offs are not presently available. It is clear, however, that continuing assessment of the risks in home equity lending is important for banks, thrifts, and their regulators.

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