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ECONOMIC COMMENTARY

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-percent 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 financial distress due to the debt 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.

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 potential impact on the quantity of consumer borrowing and on the economy? This Economic Commentary attempts to answer these questions.

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Home Equity Lines: Characteristics and Consequences

by K. J. Kowalewski

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Why Are HELs So Popular?

There are no hard data on the total value of HEL credit lines nationwide. Moreover, it is impossible to estimate the magnitude of home equity lending because currently published national credit reports do not include information on many among first mortgages, second mortgages, and HELs. There are some rough indicators of HEL activity. The Federal Home Loan Mortgage Corporation estimates that all second-mortgage balances held by thrifts amounted to only about $5.7 billion, or 0.5 percent of total assets.

The paradox of recent indications of consumer financial distress and the near-zero interest rate on their credit helps to explain the popularity of HELs among lenders. Experience shows that second-mortgage loans have far fewer delinquencies 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 rates, net of legal fees and other write-off costs, were less than 0.5 percent of outstanding HEL assets. This is a significant shift in the composition of consumer lending toward HELs, when loan delinquency and bankruptcy are on the rise. Before Congress changed the law in 1982, consumers had the right to re-arrange 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 three days after the credit was extended. The change in the law is likely to explain the recent rise in HEL activity. The advantages of making a loan that is used as an add-on to the existing credit card can be seen 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 lending product, possibly a benefit of reducing the cost per dollar of consumer lending. This "lock-in" effect is an added benefit of making HELs at commercial banks rather than at thrifts. However, historically, HELs have been made by thrifts.

Many estimates suggest a substantial growth in the second-mortgage market, which is projected to double or triple by the end of the 1980s.

More recently, polls of consumers suggest that a substantial portion of second-mortgage lending is expected to be HELs. In March 1986, all second mortgages accessed via credit cards and other consumer loans, and many lenders offered very low 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, the increase in income spending is great enough to have a measurable impact on the aggregate consumer spending function.

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, new balances of nonmortgage consumer credit at commercial banks increased $4.1 billion in December 1986, $10.0 billion in January 1987, and $10.7 billion in February 1987. The change in loans to individuals at these same banks, however, was only $2.0 billion in December 1986 and 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.

Some estimates of the total amount of HEL credit held by households-among first mortgages, second mortgages, and HELs—held by thrifts amounted to only about $5.7 billion, or 0.5 percent of total assets, and second mortgages accessed via credit cards and other consumer loans through 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 $228.8 billion in the third quarter and $187.2 billion in the second quarter—had increased $87.9 billion in the third quarter and $69.8 billion in the second quarter.

What Is the Potential Growth of Home Equity Lending?

There are no hard data on the total value of home equity lines nationwide. Moreover, it is impossible to estimate the magnitude of home equity lending because currently published national credit reports do not include information on many among first mortgages, second mortgages, and HELs. There are some rough indicators of HEL activity. The Federal Home Loan Mortgage Corporation estimates that all second-mortgage balances held by thrifts amounted to only about $5.7 billion, or 0.5 percent of total assets. In March 1986, 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 showed 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—had increased $87.9 billion in the third quarter and $69.8 billion in the second quarter.

What Are HELs? Why Are HELs So Popular?

Corporation, the nationwide finance industry makes HELs attractive to lenders as effective market-expanding tools. Third, HELs are used as an add-on to the existing credit card 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 lending product, possibly a benefit of reducing the cost per dollar of consumer lending. This "lock-in" effect is an added benefit of making HELs at commercial banks rather than at thrifts. However, historically, HELs have been made by thrifts.

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