

Issues

Will Texas Voters See Equity in Home Equity Lending?

On November 4, 1997, Texans will have the opportunity to liberalize the state's long-standing restrictions on home equity lending.

More than 150 years after the Homestead Act of 1839 originally prohibited most forms of home equity lending in Texas, the state's homeowners remain virtually sealed off from the wealth stored up in their homes. But on November 4, 1997, Texans will have the opportunity to liberalize the state's long-standing restrictions on home equity lending. House Joint Resolution 31 (HJR 31), a proposed amendment to the state's constitution appearing as Proposition 8 on the upcoming November ballot, would permit Texans to use the wealth stored up in their homes in any way they see fit. With a few exceptions, the Homestead Act currently prevents Texans from taking out a loan secured by the wealth in their homes. The only change to the Homestead Act under HJR 31 is the insertion of a clause allowing Texans to borrow voluntarily against the equity in their homes. Home equity then could be pledged as collateral to finance education, acquire working capital for a small business, pay for medical expenses, consolidate debt or use in any other way borrowers see fit.

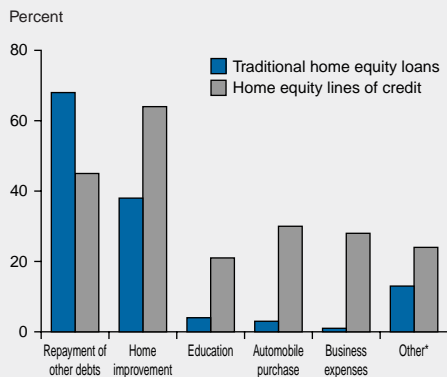
Passage of this measure holds the promises of lower interest payments on consumer debt and, because the interest paid on home equity loans is tax-deductible, lower federal income tax payments as well. The resulting savings could boost the purchasing power of the average Texas homeowner and stimulate the state's economy. A close examination of the arguments against home equity lending suggests that any perceived costs of allowing this activity in Texas are small in comparison with the benefits.

Home Equity Loans: An Overview

Home equity is defined as the market value of a homestead minus any outstanding debt secured by the homestead. Home equity credit takes one of three forms. The traditional home equity loan, or closed-end loan, is extended for a specific period with the entire loan proceeds disbursed in one lump-sum payment. The loan is then repaid through regular payments of principal and interest. The second type, the home equity line of credit, is a revolving account, similar to a credit card, that permits borrowing from time to time, at the homeowner's discretion, up to the limit of the credit line. Finally, the reverse mortgage is a home equity loan in which the borrower receives monthly payments from the lender and the loan is paid in full when the home is sold. Reverse mortgages are typically used by house-rich but cash-poor homeowners, such as senior citizens, who have a great deal of equity in their homes but live on fixed incomes. Monthly payments usually help cover living expenses and home repair costs. The lending institution then has a valid claim on the property, which is repaid by the borrower's heirs after the homeowner dies and the property is sold. HJR 31 would allow only traditional, closed-end home equity loans and reverse mortgages; home equity lines of credit would continue to be prohibited in Texas.

Chart 1 illustrates how the proceeds of traditional home equity loans and home equity lines of credit typically are used. Homeowners use traditional home equity loans to consolidate high-cost unsecured

Chart 1
Uses of Home Equity Loans



* Other includes real estate purchase, medical expenses and vacations.

NOTE: Data have been weighted to ensure the representativeness of the sample. Percentages sum to more than 100 percent because respondents were allowed to cite multiple uses for their home equity loan.

DATA SOURCE: Thomas Durkin, Glenn Canner and Charles Luckett, "Home Equity Lending: Evidence from Recent Surveys," *Federal Reserve Bulletin*, July 1994.

Texas is unique in its current prohibition of home equity lending, as the other 49 states allow both the closed-end and open-end types of home equity lending.

consumer loans into a lower cost loan secured by a second mortgage on their homestead; they also use these loans to make improvements to their property. With home equity lines of credit, uses of the funds are more varied. Home improvements, debt consolidation, automobile purchases and business expenses are among the most frequently cited uses for these loans.

Texas' Proposed Home Equity Law

In 1839, Stephen F. Austin spearheaded a Homestead Act to protect Texas colonists from losing their land grants. This Homestead Act, and its prohibition of home equity lending, originated as a reaction to a bank panic in 1837 and was included in the state constitution in 1845 when Texas joined the United States. Under the Homestead Act, households can have a lien placed against their property only when securing the following types of debt: a loan to buy the house, a home improvement loan, a loan to pay property taxes, a loan to pay off a federal tax lien and a loan ordered by a court in the settlement of a divorce or inheritance. The only proposed change to this law is to allow Texans to place a lien on their property as security for a closed-end loan or reverse mortgage. Texas is unique in its current prohibition of home equity lending, as the other 49 states allow both the closed-end and open-end types of home equity lending.

The proposed change to the Homestead Act contains several clauses designed to protect consumers from unscrupulous lending practices and safeguard against an

excessive accumulation of debt. Table 1 lists the consumer protections included in HJR 31. One of the major provisions is an 80 percent aggregate loan-to-value limitation on all debt secured by the homestead. For example, for a house with an appraised value of \$100,000, up to \$80,000 in debt could be secured by the homestead, including both the home equity loan and any mortgage debt. If the outstanding balance of the mortgage debt by itself exceeded 80 percent of the homestead's value, then no equity would be available to secure a home equity loan. There is also a cap of 3 percent of the equity loan value on all fees charged by the lender in connection with the equity loan. Furthermore, involuntary liens would not be authorized against a homestead for any purpose; no lender could place a lien on a homestead unless the homeowner allowed it. There would also be a 15-day waiting period before a home equity loan could be finalized: 12 days for finalizing the application, and three days after closing during which the borrower could rescind the loan.

Home Equity Lending: Good for Borrowers and Lenders

The recent proposal to allow home equity lending in Texas represents a win-win situation, in that both borrowers and their lenders would benefit.

Borrowers win. Advocates of home equity lending point out the irony inherent in Texas' prohibition on home equity loans. Originally, the Homestead Act and its limits on the use of equity in the homestead were meant to protect Texans from foreclosure on their homesteads. Today, this prohibition forces Texans to take on alternative consumer debt at dramatically higher costs. Compared with an unsecured loan, a home equity loan is less risky for a lender because an asset with a fairly predictable value stands behind the loan. Hence, by pledging their home equity as collateral, homeowners can borrow at lower interest rates. In addition, interest payments on home equity loans are deductible on federal tax returns, making home equity loans even more advantageous than other types of consumer loans for taxpayers who itemize their deductions.

A special finance report by the Texas State Comptroller's Office estimates that legalized home equity lending would lead to annual statewide interest cost savings of \$120 million.¹ This would come as Texans replace higher interest rate consumer debt with lower interest rate home equity loans.

Table 1

HJR 31: Consumer Protections and Provisions

Lines of Credit Prohibited	Open-end home equity loans are not allowed.
Loan-to-Value Cap	The amount of the equity loan plus the total of all other debt against the homestead cannot exceed 80 percent of the market value of the property.
Notice	The lender is required to give the borrower a written notice that the homestead will be pledged as collateral when the borrower applies for an equity loan.
Additional Collateral	No collateral other than the homestead can secure an equity loan.
Waiting Period	Equity loans may not be closed until 12 days after an application is received. In addition, the borrower has 3 days after closing to rescind the loan.
Authorized Lender	Equity loans can only be made by federally authorized lenders (for example, FHA-approved lenders) or state-licensed lenders, as defined in the Texas Constitution.
Fees	There is an aggregate cap of 3 percent of the equity loan value on all fees charged by the lender in connection with the equity loan.
Location of Closing	An equity loan cannot be closed in a borrower's home; closings are limited to the office of a lender, a title company or an attorney.
Voluntary Liens	Equity loans are voluntary; the Homestead Act is not being repealed and involuntary liens are not authorized against a homestead for any purpose.
Nonrecourse Loans	All loans will be nonrecourse (that is, no personal liability for the homeowner beyond the homestead property) unless the loan was obtained through fraud.
Judicial Foreclosure	No home equity loan may be foreclosed upon without a court order.
Cross-Default	The lender may not demand payment because of a default on another debt. Also, the lender may not require the borrower to apply the proceeds of an equity loan to repay another debt to the lender.
Prepayment Penalty	Prepayment penalties are prohibited.
Agricultural Property Exemption	Property designated as "agricultural use" property cannot be used as collateral for an equity loan unless the property is primarily used for the production of milk.
Decrease in Market Value	The lender may not demand payment if there is a decrease in the market value of the homestead.
Stacking of Loans	The borrower may have only one equity loan at a time.
Mandatory Counseling for Reverse Mortgages	Counseling regarding the availability and advisability of reverse mortgages and other financial alternatives is required for all reverse mortgage applicants.

Additionally, assuming the average Texan pays a marginal federal income tax rate of 28 percent, the tax deductibility of the interest could lead to further savings of up to \$88 million annually, to the extent that homeowners itemize deductions. However, based on the profile of federal taxpayers in Texas who would likely utilize home equity loans, the Comptroller estimates that only about 60 percent would take advantage of this savings. As a result, the Comptroller suggests that aggregate annual homeowner savings from the tax deductibility of home equity loans would be \$53 million (60 percent of the \$88 million in potential savings).

For the average homeowner in Texas who currently itemizes deductions on his or her federal income tax return, the Comptroller's report suggests that substituting the average home equity loan for existing consumer credit would generate an estimated annual savings of \$850. Table 2 illustrates the advantages that home equity loans have over other consumer credit alternatives. A typical consumer could save nearly \$230

annually for four years by financing a \$30,000 educational loan as a home equity loan, even if the interest rate on the educational loan were 82 basis points lower than the rate on the home equity loan (the educational loan is assumed to be cheaper in this example because most student loans are backed by the federal government). These savings come from the tax advantages available through home equity lending. Home equity loans can generate even more substantial savings over other types of consumer debt through lower interest rate loans to homeowners, as illustrated by the other examples given in Table 2.

The benefits of home equity loans to borrowers are perhaps summed up best by the users of home equity credit themselves. As shown in Table 3, consumers cite low interest rates, accessibility, convenience and tax advantages as major benefits of home equity loans.

In addition to generating savings for individual Texas homeowners, home equity lending also has the potential to serve as a catalyst for overall economic activity in the

Table 2
An Example of Typical Home Equity Loan Savings

Loan type	Interest rate (percent)	Deductible from federal income tax?	Average annual after-tax interest payments	Annual home equity loan advantage
Home equity	8.25	yes	\$ 922.18	—
Educational	7.43	no	1,152.15	\$ 229.96
New car	8.41	no	1,305.94	383.76
Consumer	13.33	no	2,082.82	1,160.64
Credit card	16.25	no	2,546.86	1,624.68

Assumptions: \$30,000 initial loan value repaid over four years, marginal tax rate of 28 percent.
DATA SOURCE: Texas State Comptroller's Office, *Home Equity Report*, April 1996.

The savings for consumers associated with home equity loans could boost the purchasing power of the average Texas homeowner, thereby stimulating the state's economy.

state. The savings for consumers associated with home equity loans could boost the purchasing power of the average Texas homeowner, thereby stimulating the state's economy. Moreover, to the extent that small business owners avail themselves of the advantages of home equity loans, economic activity could be expanded further through both greater credit availability and a lower cost of funds for entrepreneurial activity.

Lenders win. Accumulated equity in homes is one of the largest components of wealth in Texas. Census Bureau estimates from 1990 place the total market value of owner-occupied housing in Texas at around \$220.4 billion, with approximately \$123.4 billion representing equity. This equity represents a loan market for lenders that has been largely untapped, save for home improvement loans. In the *Home Equity Report*, the Comptroller, making the assumption that Texans' use of this equity would parallel national trends and using the seven-year-old Census Bureau estimate of available home equity, expects Texans to take out

roughly \$3.8 billion in traditional home equity loans. An equity research report released earlier this year by the Robinson-Humphrey Company estimates that Texans currently have about \$200 billion in untapped home equity. In this report, the market potential for home equity lenders in Texas is estimated at \$10 billion annually.

Consistent with the view that home equity lending represents an important opportunity for financial institutions in Texas, home equity loans continue to show solid growth at banks in other areas of the country. Chart 2 shows that home equity loans have been the fastest growing loan segment for insured commercial banks since 1996. The growth in home equity lending has occurred even as consumers have refinanced their mortgages at low interest rates. This refinancing activity has tended to curtail the growth in home equity loans, as consumers typically roll the outstanding balances on all their home equity obligations into a single new loan. The strong growth in home equity lending may be partly attributable to lenders' response to rising default rates on consumer loans. According to the February 1997 Federal Reserve Board survey of senior loan offi-

Table 3
Advantages of Home Equity Loans Cited by Borrowers

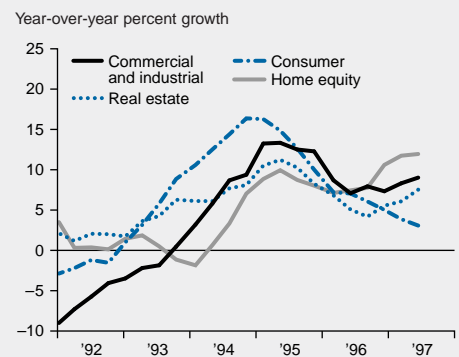
Advantage	Home equity line of credit	Traditional home equity loan
Low interest rate	35	51
Easy to get	21	32
Tax advantage	31	28
Convenient	57	5
Other ¹	5	26

¹ Includes ability to borrow a large amount, absence of closing costs, ability to consolidate debts and other similar responses.

NOTE: Percentages sum to over 100 percent because respondents were allowed to choose two advantages for each type of credit.

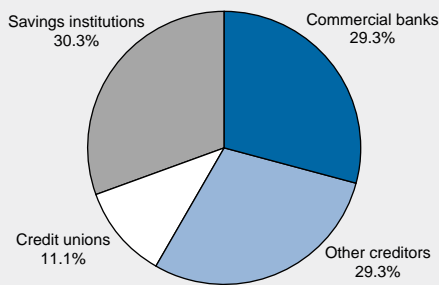
DATA SOURCE: Thomas Durkin, Glenn Canner and Charles Luckett, "Home Equity Lending: Evidence from Recent Surveys," *Federal Reserve Bulletin*, July 1994.

Chart 2
Loan Growth at U.S. Insured Commercial Banks



DATA SOURCE: Report of Condition and Income.

Chart 3
Sources for Traditional Home Equity Loans



DATA SOURCE: Thomas Durkin, Glenn Canner and Charles Luckett, "Home Equity Lending: Evidence from Recent Surveys," *Federal Reserve Bulletin*, July 1994.

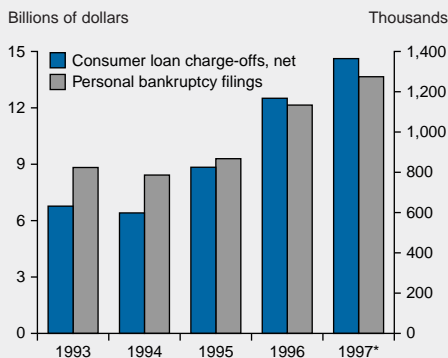
cers, banks have been encouraging borrowers to transfer unsecured debt to home equity lines by reducing the fees and rates associated with home equity credit.

Chart 3 shows the relative importance of the existing sources of home equity loans in other areas of the country. Based on this distribution, savings institutions, commercial banks and credit unions all would benefit significantly from the move to allow home equity lending in Texas.

Misconceptions About Home Equity Lending

The drive to expand home equity lending into Texas comes as Americans continue to go deeper into debt. Chart 4 shows the trends in consumer loan charge-offs and personal bankruptcy filings since 1993. Both the level of outstanding consumer debt and the delinquency rate of this debt

Chart 4
Consumer Loan Charge-Offs and Personal Bankruptcy Filings

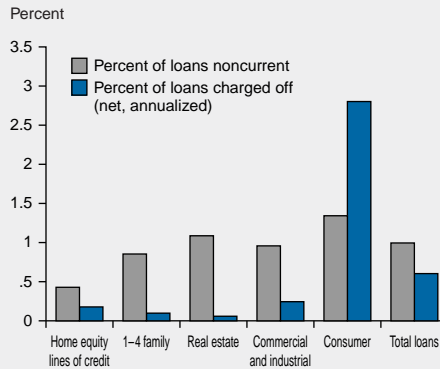


* 1997 data are as of June 30. Net charge-offs are annualized, and June 30, 1997, personal bankruptcy filings are for the 12-month period ending on June 30.

NOTE: Net charge-offs are loan losses for the period less recoveries of previous loan losses.

DATA SOURCE: Report of Condition and Income; Administrative Office, U.S. Court System.

Chart 5
Noncurrent Loans and Net Charge-offs* at Insured Commercial Banks
As of June 30, 1997



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

NOTE: Closed-end home equity loans are included in loans secured by 1-4 family residential properties, consistent with bank loan reporting requirements.

DATA SOURCE: Report of Condition and Income.

have been increasing recently. Given these trends, some have argued that now is not the time to allow Texans greater access to credit. In the event of an economic downturn, increasing the debt secured by property through home equity lending could increase loan defaults and property foreclosures.

In this regard, one of the main advantages of home equity loans—accessibility—has also been viewed as a drawback. Because home equity loans are backed by an asset with a fairly reliable, consistent value, the exact purpose of the loan is not as important to the lender. Critics of home equity lending argue that the ease with which home equity loans can be obtained may cause consumers to become overextended, ultimately resulting in default on their home equity loans and foreclosure on their homesteads.

However, these arguments against home equity lending are not borne out by the data on the performance of home equity loans in the other 49 states. For insured commercial banks, home equity loans consistently outperform other types of loans. Chart 5 shows the noncurrent and charge-off rates reported by U.S. commercial banks as of June 30, 1997. Traditional home equity loans are included with all loans secured by 1-4 family residences, consistent with loan reporting requirements. However, separate data are available for home equity lines of credit, and the noncurrent rate for this category of loans is well below the noncurrent rates for the other loan categories. Similarly, the charge-off rate for home equity lines of

Freer home equity lending would add to the array of services offered by Texas financial institutions and has the potential to boost the purchasing power of Texas homeowners.

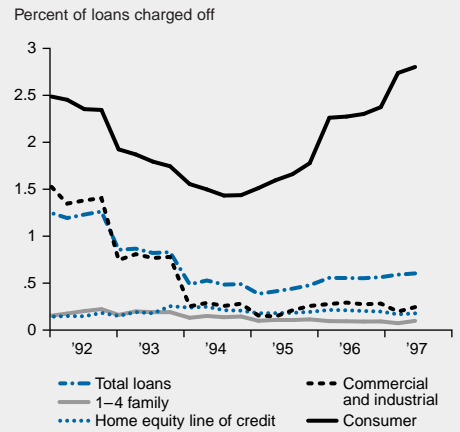
credit compares favorably with the charge-off rates for consumer and total loans.

Charts 6 and 7 show the historical performance of the different loan categories, highlighting noncurrent rates and charge-off rates, respectively. Home equity lines of credit have consistently been one of the best performing loan categories for U.S. insured commercial banks since 1992. 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. These data come from states that do not have many of the restrictions included in Texas' proposed constitutional amendment.

A primary reason for the superior loss performance of home equity loans is that they tend to be used wisely by borrowers in good financial standing. Home equity borrowers tend to be 43 to 51 years old, have a household income of \$46,000 to \$61,000 and own a house valued between \$113,000 and \$165,000.² Hence, the main effect of the current prohibition on home equity lending in Texas most likely is not to protect unwitting consumers, but rather to prevent homeowners from enjoying the advantages of secured debt.

Similarly, arguments that restrictions on home equity lending are necessary to protect small business owners from foreclosure on their residences also ignore the primary effect of home equity lending in reducing financing costs and enhancing the availa-

Chart 7
Net Loan Charge-offs* at
U.S. Insured Commercial Banks



* Net charge-offs are loan losses for the period less recoveries of previous loan losses.

DATA SOURCE: Report of Condition and Income.

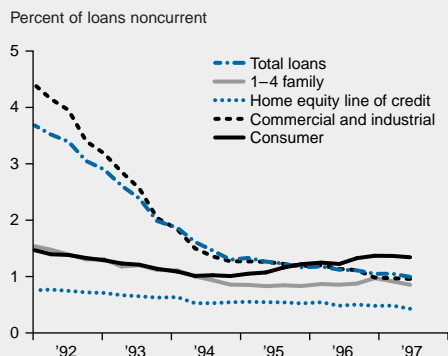
bility of credit. The Comptroller's report on home equity lending estimates that small businesses in Texas could save \$58 million annually and gain access to \$375 million in loans to expand entrepreneurial activity if the state's prohibition on general home equity lending were removed. It is for this reason that small business owners themselves support legalization of home equity lending.

Conclusion

Many Texans have faithfully made house payments over time, building equity in their homesteads. Yet, they have been unable to access this enormous store of wealth. Proposition 8 is poised to change that. Passage of this proposed amendment to the Texas Constitution would give Texans control over the wealth they have accrued in their homes. Freer home equity lending would add to the array of services offered by Texas financial institutions and has the potential to boost the purchasing power of Texas homeowners. The vote on November 4, 1997, will determine whether, after more than 150 years, Texans have come to see equity in home equity lending.

—Edward C. Skelton

Chart 6
Noncurrent Loans* at
U.S. Insured Commercial Banks



* Noncurrent loans are loans that are past due 90 or more days or are in nonaccrual status.

DATA SOURCE: Report of Condition and Income.

Note

¹ Texas State Comptroller's Office, *Home Equity Report*, April 1996. The Comptroller's figures are adjusted here to exclude home equity lines of credit, since they are prohibited in HJR 31.

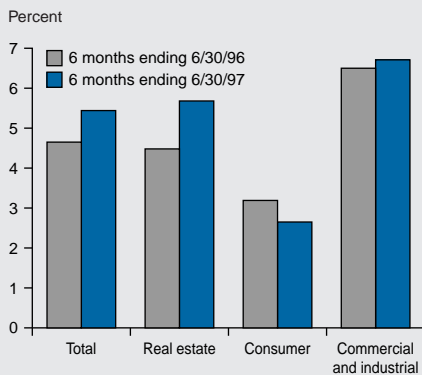
² These survey results are from "Home Equity Lending: Evidence from Recent Surveys," by Thomas Durkin, Glenn Canner and Charles Luckett, *Federal Reserve Bulletin*, July 1994.

11K Bank Notes

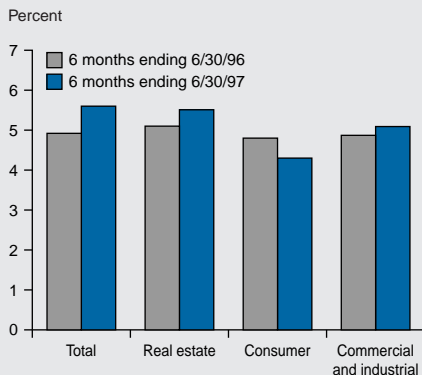
Through June 30, 1997, loan growth at U.S. commercial banks exceeded the pace set in the first half of 1996. The median loan growth rate for U.S. banks was 5.44 percent for the six months ending June 30, 1997, up from 4.65 percent for the same period a year ago. Real estate lending accelerated, offsetting a slowdown in consumer lending. The median real estate loan growth rate rose to 5.68 percent from 4.48 percent, while the median growth rate for consumer loans was just 2.65 percent, down from 3.19 percent. Commercial and industrial loans continued to be the fastest growing segment of U.S. banks' loan portfolios, as the median growth rate rose to 6.71 percent from last year's 6.50 percent.

Loan growth at Eleventh District banks remained slightly ahead of the national pace. The median loan growth rate for District banks through the first six months of 1997 was 5.60 percent, versus 4.92 percent through the first half of 1996. Growth rates for real estate and business lending strengthened, while the growth rate for consumer lending was subdued. The median real estate loan growth rate was 5.51 percent, up from 5.10 percent. The median consumer loan growth rate of 4.30 percent trailed last year's 4.80 percent. For commercial and industrial loans, the median growth rate rose to 5.09 percent from 4.87 percent.

Median Loan Growth at U.S. Insured Commercial Banks



Median Loan Growth at Eleventh District Insured Commercial Banks



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The Regional Financial Industry in Review

Financial Industry Trends, an annual publication by the Dallas Fed, provides an overview of the structure and performance of commercial banks, bank holding companies, foreign banking operations, credit unions and thrifts.

By many measures, the performance of financial institutions based in Louisiana, New Mexico and Texas exceeded that of their counterparts in the rest of the country during 1996. For the most part, the regional financial industry experienced stable earnings, steady loan growth and an increase in equity capital levels over 1995.

In early 1996, slight but broad-based increases in loan delinquencies and charge-offs became apparent. Lenders responded by adjusting their underwriting and monitoring procedures and increasing provision expenses. At year-end, asset quality indicators remained satisfactory overall, and high levels of equity capital, generated by retained earnings, lent strength to balance sheets.

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