Board of Governors of the Federal Reserve System

Report to the Congress

Rules on Home-Equity Credit under the Truth in Lending Act

November 1996

FEDERAL RESERVE BOARD STUDY ON RULES ON HOME-EQUITY CREDIT UNDER THE TRUTH IN LENDING ACT

INTRODUCTION

The Truth in Lending Act requires lenders to give extensive disclosures when homeowners apply for home-secured credit. Different rules govern depending on whether a lender offers an open-end line of credit or the more traditional closed-end second-mortgage loan.[1] In addition, substantive rules establish certain consumer rights. For example, homeowners have the right to cancel a transaction within three business days when the credit is secured by their principal dwelling.

In 1994, the Congress amended the Truth in Lending Act to require additional disclosures for closed-end home-equity loans in which the borrower is paying rates and fees above a certain percentage or amount. The Home Ownership and Equity Protection Act (HOEPA) amendments were contained in the Riegle Community Development and Regulatory Improvement Act (RCDRIA) and became effective in October 1995.

Under the HOEPA, the rules did not change for open-end home-equity lines of credit, as the congressional hearings that led to enactment of the new rules did not reveal evidence of abusive practices connected with open-end home-equity lending. Instead, the Congress directed the Federal Reserve Board to conduct a study and submit a report on whether the existing Truth in Lending rules provide adequate protections for consumers obtaining home-equity lines of credit. In addition, the Congress directed the Board to address whether a more appropriate interest-rate index should be used in determining the applicability of the HOEPA. Under the 1994 provisions, the HOEPA requirements are triggered when the annual percentage rate at consummation of the loan transaction exceeds by more than 10 percentage points the yield on Treasury securities of comparable maturities or when the fees associated with the loan exceed $400.[2]

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[1] Open-end credit is generally defined as credit in which the creditor reasonably contemplates repeated transactions, a finance charge is imposed on the outstanding balance, and the amount of credit is replenished to the extent the outstanding balance is repaid. Closed-end credit is defined to include all credit that does not meet the definition of open-end credit.

[2] This figure must be adjusted annually on January 1 by the annual percentage change in the Consumer Price Index that was reported for the preceding June 1.

This report describes the regulatory framework that is in place for open-end home-equity lines of credit, compared with the rules for closed-end credit; discusses information drawn from consumer surveys about consumer attitudes toward and use of home-equity plans; and presents the Board's analysis of issues and its findings regarding the adequacy of the open-end rules that are currently in place. Based on its analysis, and given the data available to date, the Board has determined that no additional protections are warranted at this time in regard to home-equity lines of credit.

Consumer advocates have expressed concern that, because different rules apply to closed-end credit and to home-equity lines, creditors may turn to open-end credit to avert the stricter rules of the HOEPA. The HOEPA rules have been in effect for less than a year. The Board believes, therefore, that it would be premature to conclude that the rules for open-end credit will be used to circumvent the HOEPA and, thus, that the stricter rules ought to apply uniformly. As required by the RCDRIA, however, the Federal Reserve will hold one or more hearings on home-equity lending no later than September 1997. At that time, the Board will solicit and will have another opportunity to consider the views of consumers and consumer advocates, lenders, and other interested parties not only on whether the HOEPA is working but also on whether there is evidence that creditors are restructuring loan products into open-end credit to evade the HOEPA.

I. CURRENT RULES FOR OPEN-END AND CLOSED-END HOME-EQUITY LENDING

Open-end home-equity rules under the Truth in Lending Act

The Truth in Lending Act (TILA) contains home-equity rules that govern disclosures at different stages of the credit process. 15 U.S.C. §§ 1601 - 1666j. The Home Equity Loan Consumer Protection Act amendments to the TILA, enacted in November 1988, require creditors to give consumers extensive disclosures and an educational brochure for home-equity plans at the time an application is made. For example, creditors must provide information about payment terms and fees imposed under the plans; and, for variable-rate plans, they must also provide information about the index used to determine the rate together with a fifteen-year history of changes in the index values. Before a consumer becomes obligated on the plan, transaction-specific home-equity disclosures must be given by the creditor. In addition, the law imposes substantive limitations on home-equity plans, such as limiting the right of creditors to terminate a plan and accelerate an outstanding balance or to change the terms of a plan after it has been opened.

The Board's Regulation Z implements the TILA. The Regulation Z requirements for home-equity lines of credit closely mirror the statutory requirements. As the statute sets forth specific provisions that are restrictive in many cases, the rules implementing the statute are similarly restrictive.

The rules for home-equity lines of credit are contained in sections 226.5b, 226.6(e), 226.9(c)(3), and 226.16(d) of Regulation Z and the accompanying official staff commentary. Requirements for home-equity lines of credit apply to all open-end credit plans secured by a consumer's dwelling. The rules require creditors offering home-equity plans (and third-parties in some instances) to give specific disclosures about costs and terms, and limit how creditors may structure programs.

<u>Application disclosures</u>. In most cases, at the time a consumer receives an application for a home-secured line of credit, disclosures must be given. These disclosures must be in writing, grouped together, and segregated from all unrelated information. The consumer must also be given an educational pamphlet prepared by the Board or one that is similar. Creditors must provide information including:

(1) The annual percentage rate (the APR);
(2) The payment terms, including the length of the draw and repayment periods, an explanation of how the minimum periodic payment will be determined and the timing of payments, and an example based on a $10,000 outstanding balance and a recent APR;[3]
(3) Fees imposed by the creditor and third parties;
(4) A statement that negative amortization may occur and that as a result a consumer's equity in a home may decrease;
(5) Several statements about the consequences of home-secured credit, including a statement that loss of the home could occur in the event of default, and
(6) For variable-rate loans, a minimum-payment example based on the maximum APR, and an historical table showing how the APR and the minimum periodic payment would have been affected during the preceding fifteen years by changes in the index.

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[3] The example must show the minimum periodic payment and the time it would take to repay the $10,000 balance if the consumer made only minimum payments and obtained no additional credit extensions.

Account-opening disclosures. Transaction-specific initial disclosures must be given to consumers before the first transaction is made under the plan. These disclosures provide consumers with detailed information on the actual terms of the plan.

Periodic statement disclosures. Creditors are required to give information on periodic statements about account activity--including amounts outstanding, credits to the account, and periodic rates used to calculate the finance charge.

Notice of change in terms. Subject to certain limitations on changes in terms, creditors are generally required to send the consumer a notice fifteen days in advance if a term on the plan is changed. A notice must also be sent if additional extensions of credit are prohibited or if the credit limit is reduced; this notice must be sent no later than three business days after the action is taken.

Advertising disclosures. In advertisements of home-equity plans, creditors generally trigger additional disclosures if they advertise finance charges and other significant charges or the repayment terms for a plan. If an advertisement contains a trigger term, creditors must also state the following:

(1) The periodic rate used to compute the finance charge (expressed as an APR);
(2) Loan fees that are a percentage of the credit limit, along with an estimate of other plan fees; and
(3) The maximum APR that could be imposed in a variable-rate plan.

Other advertising rules specific to home-equity lines of credit. If a minimum payment for the home-equity plan is stated, the advertisement must also state if a balloon payment will result. For a variable-rate plan, an advertisement that states an introductory rate must also state how long the introductory rate will be in effect. The introductory rate and the fully-indexed rate must be disclosed with equal prominence. In addition, creditors cannot advertise home-equity plans as "free money" (or using a similar term) and cannot discuss the tax consequences of interest deductions in a misleading way.

Contract limitations on home-equity plans. The TILA and Regulation Z prescribe substantive limitations on the changes that a creditor can make in the APR, termination of a plan, and other credit terms initially disclosed to the consumer. For example, a creditor cannot terminate a plan and demand repayment of the entire outstanding balance unless the consumer has engaged in fraud or misrepresentation, has failed to meet the repayment terms, or has adversely affected the creditor's security by action or inaction. A creditor generally cannot change a term unless the change was provided for in the initial agreement, the consumer agrees to the change in writing, or the change is insignificant or "unequivocally beneficial" to the consumer throughout the remainder of the plan. The creditor also cannot apply a new index and margin unless the original index becomes unavailable.

Closed-end home-equity rules under the HOEPA

Section 152 of the Home Ownership Equity Protection Act of 1994 amended the TILA to impose additional disclosure requirements and substantive limitations on closed-end home-equity mortgage loans that bear rates or fees above a certain percentage or amount. 15 U.S.C. §§ 1602(aa), 1639. The act responds to anecdotal evidence presented in congressional hearings about abusive lending practices. The cases reported typically involved elderly and often unsophisticated homeowners who used their home as security for loans with high rates or high closing fees, and with repayment terms the homeowners could not possibly meet.

Section 152 applies to consumer installment (closed-end) loans secured by the consumer's principal dwelling (1) if the APR at consummation exceeds by more than 10 percentage points the yield on Treasury securities having comparable maturities at the time the loan is made, or (2) if closing costs exceed 8 percentage points of the loan amount.

Disclosures. The section 152 amendments to the TILA layer disclosure and timing requirements onto the requirements previously in place for consumer credit transactions.[4] Creditors offering HOEPA-covered loans must provide abbreviated disclosures to consumers three days before the loan is closed. The disclosures inform consumers that they are not obligated to complete the agreement and could lose their home if they fail to make payments; and state a few key cost disclosures, including the APR, the regular payment, and, if the loan has a variable rate, a "worst case payment" if rates increase as high and quickly as possible under the loan agreement. But the law does not prohibit creditors from making any home-secured loan, nor does it generally limit the rates that creditors may charge.

Substantive limitations. Creditors making loans subject to section 152 are prohibited from including in their loan agreements, among other provisions, terms calling for: (1) balloon payments in loans with maturities of less than five years, (2) payment schedules that result in negative amortization, (3) higher interest rates after default, and (4) prepayment penalties in most instances. Consumers entering into a HOEPA-covered loan may rescind the transaction for up to three years after closing if creditors failed to provide the early disclosures or included a prohibited term in the loan agreement.

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[4] Generally for closed-end credit, transaction-specific disclosures are given before a consumer becomes obligated on an extension of credit. For variable-rate loans, comprehensive disclosures are given at the time of application.

Reverse mortgages and open-end credit. Some types of home-secured loans are exempt from section 152 of the HOEPA. For example, reverse mortgages--which typically contain payment schedules with negative amortization and a balloon payment--are exempt from the requirements of section 152.[5] The Act provides for an alternative detailed disclosure scheme in section 154. Similarly, open-end lines of credit are exempt. The Conference Report to the HOEPA indicates that the congressional hearings produced insufficient evidence to establish whether there are significant numbers of abusive home-equity loan transactions in the open-end credit market.

II. SURVEY DATA ON USE OF EQUITY LINES OF CREDIT

The equity that has been accumulated in homes is one of the largest components of the wealth of U.S. households.[6] Unlike many other types of assets, home equity is not highly liquid and thus cannot readily be used to purchase goods or services or to repay debt. Home equity is, however, a widely accepted form of collateral for credit, and in recent years homeowners have raised large amounts of spendable funds by borrowing against the equity in their homes. Home equity-lines of credit are the most widely used type of borrowing based on home equity.[7] As of 1995, 7.5 percent of homeowners had a home-equity line of credit.

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[5] A reverse mortgage transaction is a loan secured by the equity in a home. It could be either an installment loan or a line of credit. A reverse mortgage transaction differs from the typical mortgage where a creditor disburses all proceeds at consummation and the consumer repays the loan in monthly installments. In a reverse mortgage, disbursements are made to homeowners--typically on a monthly basis and typically to the elderly--until the homeowner dies, moves permanently, or sells the home. The lender relies on the home's future value for repayment.

[6] At the end of 1995, home equity accounted for about 17 percent of the wealth of U.S. households. (Balance Sheets of the U.S. Economy, Board of Governors of the Federal Reserve System).

[7] The other type of home-equity credit is referred to as the "traditional home-equity loan." These are closed-end loans extended for a specific time period that generally require payment of interest and principal in equal monthly installments. See, Glenn B. Canner, Thomas A. Durkin, and Charles A. Luckett, "Home Equity Lending: Evidence from Recent Surveys," Federal Reserve Bulletin, vol. 80 (July 1994), pp. 571-583.

At the end of 1995, households had outstanding debt of roughly $115 billion under their home-equity lines.[8]

The Federal Reserve helps sponsor surveys seeking information about consumers' financial condition and behavior. The most recent survey, the 1995 Survey of Consumer Finances, collected detailed information pertaining to the income, assets, and liabilities of households and included questions about the use of home-equity lines of credit.[9] An earlier survey, between November 1993 and March 1994, collected information about the characteristics of households having home-equity credit lines and about their experiences with this type of credit.[10] This section of the report draws primarily from these two household surveys, which, taken together, provide extensive information about home-equity lending.

Reasons for Selecting Home-Equity Lines of Credit. Some households reported having established home-equity lines of credit as early as 1982. The popularity of home-equity borrowing--and the use of equity-secured lines of credit, in particular--gained momentum in the mid-1980s.[11] The phaseout of the federal income tax deductions for interest paid on nonmortgage consumer debt, mandated by the Tax Reform Act of 1986, changed the relative cost of borrowing among consumer debt instruments and significantly enhanced the appeal of using debt secured by homes.

The tax advantages of using home-equity lines of credit are only one reason for their popularity, however. Relatively low interest rates on home-equity loans, compared with most other forms of consumer credit, and the convenience of being able to draw as needed against a line of credit have also proved to be particularly attractive features of the

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[8] This estimate is derived by dividing the amount outstanding under home-equity lines of credit at commercial banks as reported on the December 31, 1995, Report of Condition and Income by the share of the home-equity line market accounted for by commercial banks as reported in the 1995 Survey of Consumer Finances.

[9] The survey was conducted by the National Opinion Research Center of the University of Chicago. The survey included a nationally representative sample of 4,250 households. Among homeowners in the survey, about 8.6 percent had a home-equity line of credit.

[10] The survey was conducted by the Survey Research Center of the University of Michigan. The survey included a nationally representative sample of 2,537 households. Among the homeowners interviewed, about 8.6 percent had a home-equity line of credit.

[11] See table 1 at page 17 in Glenn B. Canner, James T. Fergus, and Charles A. Luckett, "Home Equity Lines of Credit," *Federal Reserve Bulletin*, vol. 74 (June 1988), pp. 361-373.

home-equity line of credit. (See table 1 in the appendix, which presents data on homeowner's reasons for using home-secured lines of credit.)

Sources of Home-Equity Lines of Credit. Consumers obtain home-equity lines of credit from a wide range of financial institutions. Depository institutions, particularly commercial banks and savings institutions to a lesser extent, are the main sources. Commercial banks are the single largest source, with about 69 percent of the home-equity lines of credit as of 1995. Finance companies and other non-depository institutions were the source of 12 percent of the accounts. (See table 2 in the appendix.)

The heavy reliance on depository institutions for home-equity lines of credit is not surprising, as these institutions have aggressively marketed this product for many years. Finance companies (except those affiliated with depository institutions) typically do not offer deposit account services. Consequently, they are not as well suited to offer credit accounts, such as home-equity lines of credit, that can be accessed by check, the principal device used to draw on these lines of credit.

Not all commercial banks offer home-equity lines of credit. At the end of 1995, 49 percent of all U.S. commercial banks held outstanding balances on home- equity lines of credit.[12] Large commercial banks were much more likely to offer home-equity lines of credit than small banks. Among commercial banks, about 90 percent of those with assets over $500 million offered home-equity lines at the end of 1995, while only about one-quarter of banks under $50 million did so.

Users of Home-Equity Lines of Credit. Surveys reveal that households having home-equity lines of credit differ significantly from other households. Compared with other homeowners, those with lines of credit have higher incomes and have accumulated substantially more equity in their homes. They also are better educated and somewhat older. For these reasons, home-equity lines of credit have been characterized as an "upscale" product used by financially sophisticated consumers. (See table 3 in the appendix.)

As of 1995, the average income of households with a home-equity line of credit was $81,000. By comparison, the average incomes of other homeowners and of non-homeowning households were $53,000 and $25,000 respectively. Households with home-equity lines of credit had more years of schooling than other households. As of 1995, the typical home-equity line holder had completed 14 years of school, while the other homeowners and the nonhomeowning households had completed 12 years of school.

The distribution of home-equity lines of credit across income and other categories indicates other differences. For example, more than 48 percent of households with a home-

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[12] Estimate derived from the December 31, 1995, Report of Condition and Income.

equity line of credit had incomes above $60,000; by contrast, 27 percent of other homeowners and 7 percent of nonhomeowning households had incomes above this amount. (See table 4 in the appendix.)

Use of Home-Equity Lines of Credit. Most consumers who have home-equity lines of credit owe amounts well below the maximum allowed under their credit line. In 1995, the median credit line available to homeowners with lines of credit was $26,000, roughly 2.2 times the median amount owed under these agreements. In addition, a substantial proportion--42 percent of those with home-equity credit lines--reported that they had no outstanding balance on the line of credit at the time of the survey. Many households reported that they never have used their accounts, suggesting that the lines were established to meet specific needs anticipated in the future or as a standby source of funds.[13]

The surveys indicate that households use their home-equity lines of credit for many purposes. The principal uses of funds derived from home-equity lines of credit have been to finance home improvements, to repay other debts, and to purchase automobiles or trucks. Relatively few households reported using their lines for funding vacations or other types of current consumption. This pattern of account usage suggests that borrowers have used their accounts primarily to maintain or enhance the value of their homes, to restructure their liabilities, or to purchase consumer durables. (See table 5 in the appendix.)

Consumer Knowledge and Satisfaction. The 1993-94 survey asked consumers who have home-equity lines a series of questions to elicit information about their understanding of the product, their shopping for credit, knowledge of consumer protections, and attitudes toward their home-equity accounts. For comparison, similar questions were asked of consumers who were users of other forms of installment credit but who did not have any home-equity debt outstanding.

One series of questions focused on consumers' understanding about creditors' security interest in their residences. Almost all users of home-equity credit (99 percent of credit line holders and 98 percent of traditional home-equity loan borrowers) indicated that the lender had explained, or they had already known, that their home was collateral for the loan. About 90 percent of both groups recalled the lender's informing them that they had the

[13] Because of competition, some lenders waive or reduce closing costs when a homeowner establishes a line of credit. Other institutions rebate these costs if a homeowner uses the account within a specified period of time. As a result, some consumers may find it relatively costless to open a home-equity line of credit and keep it as a standby source of credit.

right to cancel the credit arrangement within three days, or said that they had already known about that protection.[14] (See table 6 in the appendix.)

Consumers with home-equity credit cited many courses of action a creditor might take if they missed several payments, including foreclosing on the home, sending late-payment notices, contacting a collection agency, assessing late-payment fees, and working out a revised payment schedule. When asked about the worst thing a lender could do if several payments were missed, most respondents (78 percent of credit line holders and 87 percent of traditional home-equity loan borrowers) said the lender could foreclose on the loan. Although virtually all home-equity account holders recognized that a lien had been placed on their property, not all believed that foreclosure and loss of the property was the most severe possible outcome, perhaps indicating that some borrowers have substantial other resources available to meet obligations.

Another group of questions concerned consumer efforts to gather information before opening an account. About two-fifths of home-equity credit account holders searched for information about other sources or available terms before opening the account, slightly higher than the proportion of installment-credit users who searched for such information. Most of these searches involved calling or visiting one or more institutions to ask about interest rates. Well over 90 percent of those who sought information said they were able to get all the information they were looking for, and a few more said they were able to obtain at least some of the information they sought.[15] Eighty-nine percent of credit line holders recalled having received a TILA disclosure statement, and 90 percent of that group had saved the statement. The proportion that recalled receiving a TILA statement was slightly lower for users of traditional home-equity loans, although the proportion of this group that had saved the statement, at 93 percent, was slightly higher. About two-thirds of those who recalled receiving a TILA statement said the statement had been helpful to them in some way, but only 6 percent to 12 percent said the TILA statement had affected their decision to use credit.

A final set of questions concerned consumer satisfaction with their home equity or installment credit: 95 percent of home-equity credit line holders were somewhat or very satisfied with the account, a bit higher than for users of traditional home-equity loans or installment credit. Of the percentage of account holders who were dissatisfied, most complaints concerned the interest rate associated with the loan.

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[14] The three-day right to cancel a home-equity loan transaction, known as the right of rescission, is part of the TILA.

[15] These questions were asked only of those who had obtained home-equity credit or installment credit. The survey did not address the experience of any households that might have sought home-equity credit but did not obtain it.

III. PUBLIC COMMENT RELATING TO HOME-EQUITY RULES

The Board published a notice in the Federal Register seeking public comment on whether the rules for open-end home-secured lines of credit provide adequate consumer protections. The Board received approximately 70 comments. The majority of the comments were from financial institutions, and their trade associations. A few comments were received from consumer representatives.

Generally, a majority of commenters believe that the TILA rules for open-end home-secured lines of credit provide consumers with adequate protections. Many of those commenters, however, suggest specific revisions to rules to improve upon the existing disclosure scheme. Some commenters believe that the home-equity rules are the most comprehensive set of rules governing consumer banking products. Others believe the rules are too complex for consumers to understand and too costly for some creditors to implement. Some consumer advocates believe that the home-equity rules (and the open-end credit rules generally) need to be substantially revised in order to provide consumers with more meaningful information about the true cost of credit. A few commenters favor making no changes to the home-equity rules. They believe that the cost to creditors of implementing any change at all outweighs the benefit to the consumer in changing the rules.

A number of commenters urged the Board to adopt a more straightforward disclosure format. Several commenters believed that consumers are not given information in a readily understandable format. Consumer advocates suggested that the Board require a "federal box" similar to the closed-end requirement, making five or six disclosures more conspicuous than other required disclosures, to encourage consumers to focus on key cost information.

Most commenters believe that providing disclosures when a consumer receives an application is consistent with the purpose of the TILA to promote the informed use of credit. Other commenters requested that in lieu of disclosures at application they should be permitted to give disclosures only at closing. Some commenters believe that transaction-specific disclosures should be required at application as well as at closing.

Many commenters raised concerns regarding the fifteen-year historical example, based on a hypothetical $10,000. Several commenters suggested that the Board recommend its elimination to the Congress. They believe the historical example is burdensome and is seldom used to make credit decisions. Some believe that the example is potentially misleading because the rates disclosed are not an accurate indication of future rates. The historical example only alerts consumers to the fact that rates fluctuate. Consumer advocates urged the Board to recommend to the Congress that the historical example be modified; they suggested requiring creditors to base the example on a loan rounded up to the closest $5,000 of the loan commitment rather than a hypothetical $10,000. Commenters raised other concerns about the content of the disclosures, including the need for a mandatory monthly payment disclosure, and the elimination of the periodic statement requirement and the rescission provisions.

The majority of the commenters addressing issues concerning the act's substantive limitations on changes to credit terms believe that the rules are too restrictive. Several of those commenters believe that the limitations create significant burdens for those creditors who acquire accounts through mergers or acquisitions. For example, a creditor acquiring accounts from another institution typically cannot change the terms of that account. They believe the standard that unilateral changes must be unequivocally beneficial should be relaxed in such circumstances. Other commenters believe that although the substantive limitations are restrictive, creditors are adequately protected if a borrower defaults, if the security for a loan is impaired, or if the borrower's capacity to repay changes materially; in such cases, the regulation allows a creditor to act appropriately.

Only a few commenters discussed the advertising provisions. While many commenters found the current provisions adequate, several commenters believe that the home-equity advertising provisions are onerous. They believe that the rules create a disincentive for creditors to engage in home-equity promotions because of the additional cost to comply with the advertising requirements.

Some consumer advocates believe that the exclusion of open-end lines of credit from the HOEPA is likely to encourage evasion of the closed-end rules. They believe that there are similar abusive lending practices in open-end home-secured credit as in closed-end credit. Some commenters believe those lenders which are subject to the HOEPA are precisely the creditors who are most likely to evade the rules by offering open-end credit.

Consumer Advisory Council Views

The Board's Consumer Advisory Council considered in June 1996 the adequacy of the TILA cost disclosures and other rules for home-equity lines of credit. The Council is composed of thirty individuals representing creditors, consumer groups, and other constituencies affected by the Board's consumer financial services, fair lending, and community development laws.

Council members had divergent views, much like the opinions expressed by the public in written comments. There was general agreement that some consumer protection was appropriate. Many Council members believe the current disclosure scheme is overly complex. There was consensus that disclosures could be less complicated, but ideas for simplifying the rules varied. Some members suggested highlighting key disclosures and eliminating others. Members representing the industry and consumer groups agreed that the fifteen-year historical example was not particularly helpful to consumers.

IV. BOARD ANALYSIS OF EXISTING RULES AND POSSIBLE MODIFICATIONS

The HOEPA responds to anecdotal evidence about abusive lending practices where elderly and often unsophisticated homeowners used their home as security for loans with high rates or high closing fees and with repayment terms the homeowners could not possibly have met. The Board has no evidence to date of abusive lending practices in open-end credit involving the elderly, or any other group of individuals. Recent survey data indicate that homeowners with home-equity lines of credit have higher incomes, are better educated, and receive relatively low interest rates. For these reasons, home-equity lines of credit have been characterized as an "upscale" product that is extended to financially sophisticated consumers.

Similarly, there is no evidence at present to support the belief that the exclusion of open-end home-secured lines of credit from the HOEPA encourages creditors to offer open-end home-equity loans as a way of evading the stricter disclosure rules and the prohibitions against balloon payments and negative amortization.

Based on the public comments and its own review, the Board believes that the current disclosure requirements give consumers important information that they generally find helpful.[16] The Board believes that the TILA disclosure scheme for home-secured lines of credit generally provides consumers with adequate information and protection. To the extent that changes could be achieved by regulation--to streamline the current disclosure requirements or to present information to consumers in a more meaningful format--the Board will consider such revisions in an upcoming review of Regulation Z under its Regulatory Planning and Review program.

Format and Timing. The timing requirement of the early disclosures--at the time of application--is especially helpful to consumers. At the time of application consumers may use the disclosure information in comparing home-secured loans. Later, consumers receive

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[16] State member banks examined by the Federal Reserve generally are in compliance with the home-equity rules. For examinations conducted between 1990 and early 1995, violations of the home-equity rules for open-end credit accounted for about 5 percent of all citations for Truth in Lending violations. Violations associated with the fifteen-year historical example were the most frequent citation. These data correspond to an analysis of the consumer complaints received by the Federal Reserve from 1994 through midyear 1996, which reveals that home-equity concerns are about 8 percent of the complaints under the TILA. Data from the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation suggest that the volume of home-equity violations and complaints is not significant relative to creditors' overall compliance with the TILA.

transaction-specific disclosures before becoming obligated. Nevertheless, the format for presenting early disclosures could be revised to highlight key disclosures. Currently, consumers receive disclosure of between 20 and 30 items at the time of application. In its 1997 review, the Board will consider revising the format to highlight key disclosures, similar to the disclosure format used in closed-end credit. This could include highlighting of the APR, the maximum-rate and the payment example based on a $10,000 line of credit, the good-faith estimate of third-party fees, fees to open and maintain the line of credit, and the minimum draw and balance requirements.

Content. The home-equity rules, as set forth in clarifying remarks on H.R. 3011, appear to have been enacted in response to the Tax Reform Act of 1986, which phased-out the federal income tax deductions for interest paid on nonmortage consumer debt. There were concerns that borrowers would switch to home-secured credit to take advantage of the tax benefits without realizing the consequences of putting their home at risk. The remarks stated in pertinent part:

> Home equity loans offer advantages to consumers. To a large part, the interest on these loans is tax deductible while the deduction for other forms of consumer interest is being phased out .... At the same time, home-equity loans can present potential problems. Many of these loans have variable rates and are often offered with an initial attractive low rate. These rates can then go up, taking payments up with them. Consumers may be unaware of the potential for escalating rates and their impact on their monthly payments.[17]

While all of the existing early disclosures provide important and useful information to consumers, a few disclosures may not be as critical today in providing adequate protection to consumers. The Congress could perhaps attempt to streamline--that is, simplify and clarify--those disclosures required to be given at the time of application. For example, elimination of the following disclosures would reduce the number of disclosures given at the time of application:

- Statement that the consumer should retain a copy of the application. (§127A(a)(6)(C))
- Statement that a consumer should contact a tax consultant for deductibility information. (§127A(a)(13)
- Statement that under certain conditions the creditor may terminate the line and require immediate repayment, prohibit additional extensions, or reduce the credit limit (a disclosure that is also provided in the transaction-specific disclosures).

[17] Remarks by Representative Annunzio, the floor manager of the bill enacted, 134 Cong. Rec. 15277 (1988).

But although certain disclosures could be eliminated without diminishing consumer protections, modifying the disclosure format to highlight key disclosures and to present disclosures in a more meaningful sequence may better accomplish the task of streamlining the existing disclosure scheme.

A number of commenters suggested that the historical example be eliminated or substantially revised. The intent of the historical example, as suggested by the legislative history quoted above, was to put consumers applying for variable-rate loans on notice that substantial rate changes may result in substantial changes in monthly payments. Because the loans are secured by the consumers' dwelling, it is important for consumers to realize that rate increases may also change payment obligations. The historical example shows how the APR and the minimum periodic payment would have been affected during the preceding fifteen-year period by changes in the index used to compute the rate. Based on the public comment and its own analysis, the Board believes that consideration of concerns expressed about the historical example is warranted. A number of commenters believe that the historical example is confusing and often misleading to consumers. Commenters state that many consumers may not understand that previous rates are no indication of future rates. Furthermore, the intent of the early disclosure is to provide consumers useful information in comparing credit terms. Previous rate information does not necessarily help consumers to compare credit terms.

Commenters suggested that the historical example be replaced with a recent APR and a statement alerting consumers that the APR and the corresponding periodic [monthly] payments may change as rates change. A recent APR is necessary because under the current regulatory scheme the historical table is the only place consumers receive rate information. The existing home-equity rules for open-end credit require a creditor to provide an example of the minimum monthly payment using the maximum rate. This maximum rate example is akin to a worse-case scenario and alerts the consumer that their monthly payment obligation may change as corresponding rates change. Thus, a recent APR, a statement alerting consumers about the fact that rates may fluctuate, and an example of the minimum monthly payment using the maximum APR could put consumers on notice that substantial rates changes may result in substantial increase in the minimum monthly payments and provide better assurance that consumers understand the consequences of using their home to secure credit.[18]

Advertising. The Board submitted a report to the Congress on credit advertising in September 1995. The report addressed how existing credit advertising rules could be modified to increase consumer benefit and decrease creditor costs, and how the rules could

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[18] An amendment to TILA, enacted on September 30, 1996, gives creditors offering closed-end variable rate loans the option of disclosing a fifteen-year historical table or a statement that rates and periodic payments may increase or decrease substantially.

be modified for radio advertisements without diminishing consumer protection. In that report, the Board made general recommendations that the Congress simplify the advertising rules as well as make them consistent with other consumer laws. The Board also made specific recommendations, one of which was the elimination of the requirement that the creditor state the highest APR that may be imposed on a home-secured credit line. The recommendation was based on comments that detailed disclosures for many pricing options can result in consumer overload or in a decision by the creditor not to advertise the wide variety of choices available to consumers. The latter is particularly likely where creditors wish to engage in multistate advertising with as few changes to the advertisement as possible.

V. TREASURY SECURITIES AS INTEREST RATE INDEX FOR TRIGGERING RULES FOR CERTAIN MARGINS

The HOEPA responds to anecdotal evidence about abusive lending practices where elderly and often unsophisticated homeowners used their home as security for loans with high rates or high closing fees and with repayment terms the homeowners could not possibly meet. The HOEPA does not generally limit rates that creditors may charge. Instead, the law draws a rate-based line for providing special protections to consumers who are considering certain home-secured loans. The rate-based test for a HOEPA-covered loan is met if the APR at the time of consummation exceeds by more than 10 percentage points the yield on Treasury securities having comparable maturities at the time the loan is made.[19] Section 157 of the HOEPA asks the Board to address whether a more appropriate interest rate index should be used. Based on its own analysis, the Board believes the current statutory rate standard for HOEPA-covered mortgages has a sound economic basis and is an appropriate gauge.

Direct debts of the U.S. government, such as Treasury notes and bonds, are perceived in financial markets as bearing little or no risk of default. Consequently, the interest rates on these securities factor in a rate of return which varies with maturities and other economic conditions but reflects an absence of default risk. On the other hand, debt instruments other than direct debts of the federal government have some degree of default risk. The risk for home mortgage loans, including home-equity loans, varies with the specific purpose of the loan, the financial strength of the borrower, the quality of the collateral securing the debt, and with general economic conditions.

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[19] The Board is authorized to adjust the 10 percent trigger between 8 percent and 12 percent, starting two years after the final rule and no more frequently than every two years subsequently, in consultation with lender and consumer (including low-income consumer) representatives.

The HOEPA uses a 10 percentage point margin to identify mortgages that are covered by its rules. Differences in economic environments may influence the effectiveness of the margin. The situation would be exacerbated by changes in the measure of default risk reflected in debt yields on instruments other than direct U. S. government debt, if such an instrument served as the base line for determining coverage under the HOEPA. The timing of these changes may not correspond to changes to the default risk in mortgage lending in general, or on various types of high-rate mortgages in particular. By using risk-free Treasury debt as the base index, the margin is not further affected by possibly contrary movements in measures of default risk on mortgages intended to be captured by the HOEPA rules and other types of risky debt.

In addition to default risk, debt instruments--both government and nongovernment--include in their yield a component or margin reflecting expectations of inflation over the term of the loan. This margin accounts for the possible erosion in the real purchasing power of money due to the effects of inflation.

In general, yields on shorter-term debt include a smaller premium to account for inflationary expectations than debt with longer maturities. Using a debt-based index with maturities similar to the mortgage loan helps ensure that inflationary expectations or interest rate risk will not be a factor in applying the ten percentage point margin to determine which mortgages are identified as high-rate mortgages covered by the HOEPA.

APPENDIX A

Table 1. Percentage of home equity lines of credit users citing advantages of home equity credit over other types of credit

Advantage cited	Percentage of Users
Convenience[1]	57
Low interest rate	35
Tax advantage	31
Easy to get	21
Ability to defer repaying principal	7
Other[2]	5

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 up to two advantages for each type of credit.

1. Includes immediate access to funds and other responses indicating that convenience was an advantage.
2. Includes ability to borrow a large amount, absence of closing costs, ability to consolidate debts, and miscellaneous other responses.

SOURCE. 1993-94 Surveys of Consumers.

Table 2. Percent distribution of sources of home equity lines of credit, 1995

Source	Home equity lines of credit
Commercial banks	69
Savings institutions[1]	12
Credit unions	7
Other creditors[2]	12
Total	100

NOTE. Percentages are based on numbers of loans or lines of credit. Data have been weighted to ensure the representativeness of the sample. In this and subsequent tables, components may not sum to totals because of rounding.

1. Includes savings banks and savings and loan associations.
2. Includes finance and loan companies, brokerage firms, mortgage companies, and individuals.

SOURCE. 1995 Survey of Consumers Finances.

Table 3. Characteristics of households, 1995

Type of household	Market value of home (dollars, in thousands)		Home equity[1] (dollars, in thousands)		1995 family income (dollars, in thousands)		Age[2] (median years)	Education[2] (median grade completed)
	Mean	Median	Mean	Median	Mean	Median		
Have equity line of credit	167	145	102	84	81	57	48	14
Other homeowner	137	86	97	48	53	38	50	12
Non-homeowner	n.a.	n.a.	n.a.	n.a.	25	18	37	12

NOTE. Data have been weighted to ensure the representativeness of the sample.
n.a. Not applicable.

1. Market value of home less all debts secured by home, including balances outstanding on home equity credit lines and traditional home equity loans.

2. Characteristic of head of household.

SOURCE. 1995 Survey of Consumer Finances.

Table 4. Percentage of households by characteristic

Household characteristic	Have equity line of credit	Other homeowners	Nonhomeowners
Age (head of household)			
18-34	0.9	1.7	12.0
35-44	35.4	35.9	54.7
45-54	28.8	20.2	12.2
55-64	18.3	15.6	6.5
65 or older	16.6	26.7	14.6
Total	100.0	100.0	100.0
Annual family income, in dollars			
Less than 15,000	3.1	17.5	40.4
15,000-24,999	5.4	17.0	22.6
25,000-34,999	9.1	11.7	13.2
35,000-44,999	18.6	15.9	11.5
45,000-59,999	16.3	11.1	5.1
60,000 or more	47.5	26.9	7.2
Total	100.0	100.0	100.0

NOTE. Data have been weighted to ensure the representativeness of the sample.
n.a. Not applicable.
* Less than 0.5 percent.

SOURCE. 1995 Survey of Consumer Finances, preliminary estimates.

Table 4. Percentage of households by characteristic--Continued

Household characteristic	Have equity line of credit	Other homeowners	Nonhomeowners
Home equity, in dollars [1]			
Less than 50,000	32.4	51.2	n.a.
50,000-99,999	25.2	27.9	n.a.
100,000 or more	42.4	20.9	n.a.
Total	100.0	100.0	n.a.
Market value of home, in dollars [2]			
Less than 50,000	6.6	23.1	n.a.
50,000-99,999	24.0	34.2	n.a.
100,000-149,999	21.3	20.4	n.a.
150,000-199,999	22.3	10.8	n.a.
200,000 or more	25.9	11.5	n.a.
Total	100.0	100.0	n.a.

NOTE. Data have been weighted to ensure the representativeness of the sample.
n.a. Not applicable. * Less than 0.5 percent.

1. Market value of home less all debts secured by home, including balances outstanding on home equity credit lines and traditional home equity loans.
2. Estimated by respondent.

SOURCE. 1995 Survey of Consumer Finances, preliminary estimates.

Table 5. Percentage of borrowers citing purpose for use of funds borrowed

Purpose	Percentage of borrowers
Home improvement	64
Repayment of other debts	45
Education	21
Real estate	12
Auto or truck	30
Medical expenses	5
Business expenses	28
Vacation	6
Other[1]	1

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 a single loan or drawdown and more than one draw for one line of credit.

1. Includes purchase of furniture or appliance, purchase of boat or other recreational vehicle, payment of taxes, and personal financial investments.

SOURCE. 1993-94 Surveys of Consumers.

Table 6. Consumers' knowledge of and attitudes toward home equity credit and installment credit, 1993-94, by type of credit (percentage of account holders in each group)

Consumer knowledge or attitude	Home equity line of credit	Home equity loan	Installment credit
Knew or learned there was lien on home	99	98	. . .
Knew or learned there was right to cancel	90	89	. . .
Searched for information[1]	40	44	37
Obtained the information sought[2]	93	97	95
Recalled receiving TIL statement	89	85	68
Saved TIL statement[3]	90	93	91
Found TIL statement helpful[3]	67	63	63
Said TIL statement affected credit decision[3]	8	6	12
Indicated satisfaction with account[4]	95	89	88

NOTE. Data have been weighted to ensure the representativeness of the sample.

1. Searched for information about other creditors or credit terms before obtaining credit.
2. Proportion of those who "searched for information."
3. Proportion of those who "recalled receiving Truth in Lending statement."
4. Includes respondents who said they were "very satisfied" or "somewhat satisfied" with account.

SOURCE. 1993-94 Surveys of Consumers.