THE EMERGING HELOC CRISIS

Over the past three decades, the United States real estate market has endured a series of economic Boom and Bust cycles. The most recent cycle has led to serious and significant turmoil in the housing finance market and the banking institutions that supply the monetary fuel to support that market. Recent economic data appears to indicate that we are entering a stage of economic stability; however, developing circumstances within a segment of mortgage-related lending threatens to force the housing market into another economic decline.

A Home Equity Line of Credit ("HELOC") is a loan set up as a line of credit up to a stated maximum draw, rather than for a fixed dollar amount. During the recent housing boom, HELOCs were frequently originated at the same time, or shortly after, the purchase money mortgage and typically are in a second lien position. In recent months, HELOC underwriting practices have received increased regulatory attention and scrutiny. This type of attention is frequently indicative that there is the perception of a potential crisis in the HELOC market. This perception could place increasing pressure on operating results and regulatory capital adequacy for impacted financial institutions.

The HELOC loans that were originated over the past decade are now approaching maturity and the point in time at which these loans will commence repayment of principal, commonly referred to as "reset" or "end-of-draw." Following the "end of draw' period, Borrowers are no longer able to draw against their line of credit. In addition, borrowers will be required to begin repayment principal and interest or repay the entire principal balance. As a result, many borrowers are very likely to face "payment shock" from an increase in combined principal and interest payments, a reduction in home value, and a potential inability to refinance under revised underwriting guidelines; and thus may not have the ability to repay the loan. How lenders deal with the transition in their HELOC portfolios will greatly influence the outcome of this emerging crisis.

BACKGROUND TO THE CRISIS

During the recent Real Estate Boom, banking institutions developed a variety of financial vehicles, including HELOCs, to assist consumers with various financing needs. These vehicles were often structured as multiple loans merged into one, such as a Combined Loan-to-Value (CLTV) loan. A CLTV loan occurs when a first mortgage and simultaneous second mortgage are extended to a borrower. This type of loan structure is frequently referred to as a "piggy back" loan and the combined loan to value often exceeded 100% of a property's purchase price and increased the risk of this already tenuous loan product. HELOC-related funds were advanced to meet consumer need for other expenses, such as college tuition, bill consolidation, vacations, and other luxury goods. Available equity to collateralize the HELOC was further constrained by the fact that funds extended did not add value to the home. Clearly, bankers, and most likely the borrowers, believed that real estate values would continue to rise or at least never decline in value.

These practices led to the expansion of the HELOC market; where borrowers were granted an interest-only line of credit for a pre-determined draw period (generally 5 to 10 years. In addition, HELOC loans were offered to consumers at very attractive interest rates – often less than 3%. At the end of the ten-year

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draw period, the intent was that the debt would either have to be refinanced, liquidated, or reset to fully amortizing status over some remaining period of time. At the same time, a changing dynamic began to emerge in the U.S. housing market. Americans could no longer dispose of their property in exchange for significant capital appreciation. Instead, consumers were faced with severely declining property values and large mortgages, frequently combined with outstanding draws under the line of credit. As the impact of the economic recession spread, many of these borrowers became unable to meet their mortgage obligations.

THE MAGNITUDE OF THE CRISIS

HELOC instruments first emerged in any significant volume during 2003. As of Q1 2003, there were $242 billion in HELOCs outstanding in the United States.[1] Between the first quarter of 2005 and the end of 2007, approximately 10.8 million HELOC loans were originated. By 2009, the outstanding balance had grown to $672 billion[2], representing a 278% increase.

HELOCs originated during this time period are referred to as “bubble-era” HELOCs. The balances reported represent outstanding principal drawn against the credit lines but do not include the unfunded portions. As of the end of 2013, there are approximately 16 million outstanding HELOC loans of which 50% have outstanding principal balances greater than $100,000.[3]

While some of the bubble-era HELOC loans were originated as "piggy-back" second mortgages in conjunction with the purchase of a primary residence, the vast majority of HELOC loans were originated sometime after the home purchase – usually within two years. Whereas traditional second mortgage loans or home improvement loans were amortizing fixed-rate loans used by borrowers to finance improvements to their property, the proceeds of the bubble-era HELOCs were frequently used for intangible or non-real estate purposes.

HELOCs were irresistible to many consumers because the interest-only payment was often only a few hundred dollars per month. Borrowers, and lenders alike, did not demonstrate serious consideration for the fact that at the end of the draw period the loan would become fully amortizing with a commensurate significant increase in the monthly payment requirements to accommodate principal amortization. Borrowers and lenders seemed to find comfort in the assumption that soaring property values would mitigate any repayment shock. The assumption was that the borrower, or the lender, could always liquidate the property at a significantly enhanced value if necessary to meet principal repayment requirements.

The first material wave of HELOC loans was originated during 2003; therefore, the reset dates for these instruments began to arrive in 2013. If prior patterns hold true, then an increase in past dues and defaults is almost certainly on the horizon. Many consumers continue to experience difficulty in balancing income and living costs with financial obligations. More than 35 percent of Americans have debts and unpaid

[1] Per the New York Federal Reserve.
[2] Per Equifax.
[3] TransUnion Study Identifies Framework for Managing HELOC Risk; Up to $79B of $474B in HELOCs May Be at Elevated Risk of Default, http://www.wallstreet-online.de/nachricht/6915736-transunion-study-identifies-framework-for-managing-heloc-risk-up-to-79b-of-474b-helocs-may-be-at-elevated-risk-of-default

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bills that have been reported to collection agencies, according to a study released by the Urban Institute.[4] With regard to HELOCs, "Borrowers are delinquent on about 5.6 percent of loans made in 2003 that have hit their 10-year mark, Equifax data show, a figure that the agency estimates could rise to around 6 percent this year. That's a big jump from 2012, when delinquencies for loans from 2003 were closer to 3 percent."[5] Given these facts, another financial crisis equal in magnitude of the Real Estate Bust of 2008 – 2009 may be looming.

The reset of a significant portion of HELOC loans extended during the Boom era could not be arriving at a worse time. With the onset of the Real Estate Bust in 2008 – 2009, unemployment levels increased dramatically. While recent reports by the Department of Labor appear to present a rosy picture of the jobless rate (now reported below 7%), the fact remains that millions of Americans have simply dropped out of the labor force for inability to find suitable employment. Some estimates indicate that as many as 90 million Americans may have dropped out of the labor force.

Not only has the labor force declined significantly, but the very nature of the workplace is fast changing. Many Americans are now faced with the need to hold down multiple part-time jobs in order to make ends meet. Oftentimes, these part-time opportunities pay substantially less than the traditional full-time positions that Americans came to expect prior to the Real Estate Bust. At the same time, the part-time positions generally do not include employer-paid benefits leaving a larger financial burden on the employee.

The changing dynamics of the workplace will, without question, impact the emerging crisis. Borrowers whose incomes supported the HELOCs at the time of origination with low debt service requirements resulting from the interest-only feature of the credit lines will now find themselves faced with startling payment shock as the loans are reset to fully amortizing status at current market rates.

Additionally, HELOC loans that were originated at maximum Debt-To-Income ("DTI") ratio levels, as established by then-existing underwriting guidelines, are now subject to much tighter underwriting standards. This is evidenced by recent guidelines established by Regulatory Agencies' intent to apply more stringent assessments under the Ability to Repay ("ATR") and Qualifying Mortgages ("QM") programs. The resulting effect will likely require additional risk-based capital to offset the perceived risk of these HELOC portfolios, due in part to the potential for default. Although it is currently unclear the extent to which delinquencies will soar upon reset of the bubble-era HELOCs, it is reasonable to assume that delinquencies will, indeed, soar. A recent Reuter's article cited Bank of America, declaring that 9% of the loans that have reset in their HELOC portfolio are delinquent.[6]

A vast majority (approximately 77%)[7] of HELOC loans are second liens, thereby subordinate to the first lien on the collateral property, which may likely have an outstanding principal balance that exceeds the property value. In such case, the mortgage, and related second, is considered "underwater." When a borrower defaults on a standard mortgage, the mortgage is often "written down" to a more reasonable

[4] AP article dated July 29, 2014 in a study by the Urban Institute
[5] Insight: A new wave of U.S. mortgage trouble threatens, Reuters, November 6, 2013.
[6] Insight: A new wave of U.S. mortgage trouble threatens, Reuters, November 6, 2013.
[7] Feds Lack Options to Help HELOC Borrowers as Resets Loom, National Mortgage News, April 4, 2014 http://www.nationalmortgagenews.com/news/origination/feds-lack-options-to-help-heloc-borrowers-as-resets-loom-1041508-1.html

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amount based upon the current market value of the property. However, a HELOC loan on such a property cannot simply be written down and in most cases must be written off in its entirety.

The Office of the Comptroller of the Currency estimates $23 billion in HELOCs held by the nine largest banks are due to reset in 2014, followed by $41 billion in 2015, $49 billion in 2016, and $54 billion in 2017.[8] The resulting defaults potentially arising from the reset of HELOC loans could lead to millions of dollars in losses, placing severe constraints on the financial institutions' regulatory capital. Reliable estimates of reset volume for the remainder of US Banks are not presently available; however, it is reasonable to expect difficulties for many of the nation's regional and community banks will parallel those of the large banks referenced above.

If the impending wave of resets on HELOCs leaves borrowers struggling to pay their monthly bills and unable to liquidate their debt, they are unlikely to have many options. Programs already in place to help "underwater" borrowers with second liens have had little success. Meanwhile, the Treasury's authority to create and fund new homeowner assistance programs under the Troubled Asset Relief Program expired several years ago.[9] Due to this expiration, it may be difficult for the federal government to respond with meaningful assistance, without intervention from Congress.

THE EMERGING REGULATORY PERSPECTIVE

Recognizing the impending crisis, Governmental Regulatory Agencies ("Agencies") have issued a series of Guidance pronouncements over the past decade that dictate ***stricter reporting requirements*** and ***assessment of the risk inherent in HELOC portfolios***. Further, the Agencies required stress testing to address the growing concern that HELOCs represent as they approach the End-Of-Draw (or reset) periods for years 2014 through 2017.

On July 1, 2014 the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("FRB" or the "Fed"), the Federal Deposit Insurance Corporation ("FDIC"), the National Credit Union Administration ("NCUA") and the Conference of State Bank Supervisors issued guidance entitled '***Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods.***'[10] The guidance succinctly lays out the End-of-Draw Risk Management Principles that financial institutions will have to grapple with as this crisis emerges and develops. Those principles are summarized as:

1. Prudent underwriting for renewals, extensions, and rewrites.
2. Compliance with pertinent existing guidance, including but not limited to the *Credit Risk Management Guidance for Home Equity Lending* and the *Interagency Guidelines for Real Estate Lending Policies*.

[8] Feds Lack Options to Help HELOC Borrowers as Resets Loom, National Mortgage News, April 4, 2014 http://www.responsiblelending.org/tools-resources/headlines/feds-lack-options-to-help-heloc-borrowers-as-resets-loom.html

[9] Feds Lack Options to Help HELOC Borrowers as Resets Loom, National Mortgage News, April 4, 2014 http://www.nationalmortgagenews.com/news/origination/feds-lack-options-to-help-heloc-borrowers-as-resets-loom-1041508-1.html

[10] *Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods,* July 1, 2014, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Conference of State Bank Supervisors.

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3. Use of well-structured and sustainable modification terms.
4. Appropriate accounting, reporting, and disclosure of troubled debt restructurings.
5. Appropriate segmentation and analysis of end-of-draw exposure in Allowance for Loan and Lease Losses (“ALLL”) estimation processes.

The guidance goes on to identify the regulatory expectations of prudent management of the HELOC transition as:

1. Developing a clear picture of scheduled end-of-draw period exposures.
2. Ensuring a full understanding of end-of-draw contract provisions.
3. Evaluating near-term risks.
4. Contacting borrowers through outreach programs.
5. Ensuring that refinancing, renewal, workout, and modification programs are consistent with regulatory guidance and expectations, including consumer protection laws and regulations. ***Note:*** meeting regulatory expectations here will require understanding of and compliance with new consumer lending directives and oversight being implemented by the Consumer Financial Protection Bureau (“CFBP”).
6. Establishing clear internal guidelines, criteria, and processes for end-of-draw actions and alternatives (renewals, extensions, and modifications).
7. Providing practical information to higher-risk borrowers.
8. Establishing end-of-draw reporting that tracks actions taken and subsequent performance.
9. Documenting the link between ALLL methodologies and end-of-draw performance.
10. Ensuring that control systems provide adequate scope and coverage of the full end-of-draw period exposure.

Implementation of the regulatory guidance will have significant impact on the application of underwriting guidelines for the HELOCs at reset date and the reporting requirements that financial institutions must comply with to properly document their analysis and results.

REGULATORY UNDERWRITING REQUIREMENTS

Billions of dollars of HELOCs that were extended a decade ago during the Real Estate Boom could be leading to a new wave of defaults by homeowners creating further turmoil in the financial institutions industry. Because a large number of borrowers may be unable to handle the higher payments, financial institutions may be forced to foreclose, refinance or modify these loans.

Recent regulatory pronouncements have identified specific areas within financial institutions that will require close scrutiny and monitoring, with emphasis on requirements for systems, reporting, risk assessment, required third party data collection/analytics, and pro-active measurements of the institution’s financial profile. Areas such as ALLL, specific reserves, troubled debt restructuring (TDR), regulatory compliance and adherence to recently enacted standards of Fair Lending, ATR, and QM standards pose significant challenges impacting, at a minimum:

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- Personnel and training;
- Interpretation, development, and understanding of risk management procedures;
- Enhancement of internal bank reporting systems;
- Development of policies, procedures and protocols; and
- Compressed deadlines for accomplishment of such tasks.

Further exacerbating the stress upon financial institutions will be the need to coordinate and comply with the pronouncements of the newly created Regulatory Agencies created to oversee these matters and which may constrain the strategic options available, despite the provisions of the original lending document. These Agencies include, but are not limited to:

- Consumer Finance Protection Bureau ("CFPB"); and
- Federal Housing Finance Authority ("FHFA").

COMPLEXITY OF THE NEWLY REQUIRED REPORTING

The newly implemented reporting requirements are complex. Meeting these requirements will require deployment of a knowledgeable, dedicated team of resources. The following represents a broad overview of some of the analysis/reporting requirements that will be necessary to meet regulatory requirements. Portfolios formed through Merger & Acquisition, failed bank purchases, segmented loans within Loss Share portfolios, diverse origination channels for the loans, and possible evaluation of repurchase contracts are only a few of the identified areas of concern that will need evaluation to meet Agency reporting standards:

- Identify, assess and analyze the key risks;
- Monitor risk exposures against the institution-approved risk appetite;
- Provide exception reporting, including the identification of patterns, trends or systemic issues within the portfolio that may impair loan quality or risk mitigation factors;
- Report on the effectiveness of models generated;
- Develop policies and procedures and analytical software necessary for risk bucketing and provisioning;
- Ensure that risks are appropriately controlled and mitigated, and provide assurances to the Board and Senior Management; and
- Ensure policies, procedures and risk mitigation strategies are in compliance with all regulatory directives, including those issued by the bank's direct regulator and by those directives issued by the CFPB and the FHFA, and provide assurances to the Board and Senior Management.

Given the complexity of these impending risk management requirements, financial institutions with HELOC portfolios must prepare for these challenges, but also be in a position to take advantage of opportunities. To properly manage the challenges associated with HELOC portfolios, financial institutions must have the ability: to measure and report on their HELOC exposure; ensure that their

customers adequately understand their obligations and options; train customer service personnel to work with HELOC customers; and establish clear internal policies and reporting procedures.

Financial institutions also have the opportunity to take advantage of current HELOC trends - including "end of draw' period - to expand their HELOC loan portfolios. As the End of Draw period approaches, many eligible homeowners will want to refinance. In order to make the most of this situation, financial intuitions must be prepared to fully support the operational and regulatory requirements.

Mike Block, Executive Managing Director of **Watkins Consulting**, Inc., is well-versed and established in the arena of regulatory compliance and reporting.

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