

SUBJECT: Allowing home equity loans, extensions of credit loans

COMMITTEE: Financial Institutions— committee substitute recommended

VOTE: 8 ayes — Marchant, Gutierrez, Ehrhardt, Elkins, Grusenforf, Patterson,
Smith, Solomons

0 nays

1 absent — Giddings

WITNESSES: *(On original versions of HJR 31 and HB 1188):*
For — Rob Norcross, Jr. and Fredrick M. Smith, Texas Conference for Homeowners' Rights; David Pinkus, Small Business United of Texas; Colin G. Haza, Bank of America, Texas; Eric Sandberg, Texas Savings and Community Bankers Association; Tim Bunger, Texas Credit Union League; Michael White; Greater Houston Partnership; Robert Howden, National Federation of Independent Business/Texas; Peggy Venable, Texas Citizens for a Sound Economy; Al Black, Jr., Greater Dallas Chamber; Owen Sieperda, Texas Association of Dairyman; Everett Ives, Texas Association of Mortgage Brokers; David A. Sampson, The Arlington Chamber of Commerce; and 15 individuals

Against — Gary Joiner, Texas Farm Bureau; Peggy Gordon, Texas Retired Teachers Association; Tom Smith, Mark Manthey, Public Citizen; Felix Nigh, John W. Holtermann, Texas Silver Haired Legislature; Eric Sandberg, Texas Savings and Community Bankers Association; Randy Neugebauer, Texas Association of Builders; Walter Hinojosa, Texas AFL-CIO; and eight individuals

On — Rob Schneider, Consumers Union; Leslie L. Pettijohn, Office of Consumer Credit Commissioner; Catherine Ghiglieri, Texas Department of Banking

BACKGROUND : The Texas Constitution prohibits the forced sale of a person's homestead to repay debts, except for a debt for the purchase price of a home; to finance improvements to the home; for local property taxes and homeowner's federal taxes; and a court-ordered partition of the property, called an owelty of

partition. Equity is the difference between a home's market value and what is owed on the home.

DIGEST: HJR 31 would allow encumbrances to be placed on homesteads for equity loans and extensions of credit and would establish rules and guidelines for these loans.

If approved, the constitutional amendment would take effect January 1, 1998.

The proposal would be presented to voters at an election on November 4, 1997. The ballot proposal would read: "The constitutional amendment extending homeowners rights to borrow voluntarily against the equity in, and establish a valid lien on, their homesteads according to specific guidelines for purposes in addition to those presently provided for under state law, without affecting homestead tax exemptions or eliminating existing homestead protections against involuntary liens and judgment creditors. "

Equity loans. HJR 31 would define equity loans as extensions of credit that are secured by a voluntary lien on a homestead or other consensual security interest in a homestead.

A home owner could have only one home equity loan at a time and the loan would have to be secured only by the homestead and not by any additional real or personal property, except for a manufactured home or rents to be derived from the homestead. Equity loans would have to be secured only by the homestead property.

The principal amount of an equity loan plus the total outstanding debt secured by the homestead could not exceed 75 percent of the property's fair market value on the date the loan was closed.

Lenders and holders of equity loans would be prohibited from:

- demanding payment, accelerating the payments or foreclosing because of a decrease in the fair market value of the homestead, unless the decrease was caused by substantial damage or destruction to the property,

including a condemnation or other taking;

- demanding payment or accelerating payments or foreclosing because of a borrower's default on any other debt not secured by a previous encumbrance on the homestead;
- requiring the borrower to apply equity loan proceeds to repay another debt;
- requiring or accepting a borrower's homestead as collateral on any other loan;
- establishing a form of open-ended account or other loan with a nondetermined principal amount or indefinite term that could be drawn upon or that allowed credit to be extended from time to time;
- closing the loan before the 12th day after receiving a completed loan application;
- charging a penalty or other charge for advance payments on the loan;
- requiring borrowers to pay, other than interest, fees to the lender or anyone else to process the loan that exceeded in total 3 percent of the original principal of the loan;
- accepting an assignment of wages as loan security;
- allowing borrowers to give their legal rights relating to a judicial proceeding to a lender or anyone else; and
- accepting a financial instrument in which blanks are left to be filled in by the borrower.

Lenders or holders of equity loans would have to:

- give the borrower a copy of the promissory note and all other documents signed by the borrower that relate to the equity loan;
- disclose in any mortgage, deed of trust or security instrument that the loan was an equity loan; and
- within a reasonable time after the loan was paid off, cancel and return the note to the borrower and give the borrower a release from the loan or endorse the note and assign the loan to a lender that is refinancing the loan and paying off the debt at the borrower's request.

The consent of each owner and their spouse would be needed to create a

home equity loan.

The loans could be made only by banks, savings and loan associations, savings banks, credit unions, federally chartered lending instrumentalities, federally approved mortgagees that can make federally insured loans or persons licensed to make regulated loans.

Equity loans could be closed only at the lender's office, a title company, or an attorney's office. Property owners or their spouses could rescind an equity loan without penalty within three days after closing the loan.

The loan would have to be scheduled to be repaid in substantially equal monthly payments, beginning no later than two months after the loan was made. The payments would have to equal the amount of interest and principal scheduled to accrue as of the payment date or that would accrue as of the payment date if the loan and interest were to be fully amortized.

If a borrower defaulted, loan holders could seek recourse against the assets of the borrower, other than the property securing the loan, only if the loan holder obtained a judicial foreclosure of the lien in district court.

Upon default, if loan holders elected to sell the property, they would have to send the borrower written notice of the default by certified mail. The lien holder could not give the borrower the standard notice required under the Property Code about the sale of property under a contract lien until the borrower was given at least 30 days to cure the default after receiving the written notice.

When a homeowner first requested a lender to make an equity loan, the lender would be required to give the homeowner a typed written notice detailing the law governing equity loans. The notice would have to be signed by the lender and the borrower at the loan closing and would have to include a statement of the fair market value of the homestead at the closing.

Lenders or holders of equity loans would forfeit all principal and interest of the loan and pay reasonable attorney's fees and other costs of the borrower if the lender failed to comply with any of the requirements of HJR 31 within a reasonable time of receiving notice of the failure to comply.

Extensions of credit. HJR 31 would allow encumbrances on homestead for extensions of credit. Extensions of credit would have to be the only debt secured by a homestead. Prior debt on the homestead must be paid in full or refinanced as part of an extension of credit. Lenders could not require that an extension of credit be used for a particular purpose.

SUPPORTERS
SAY:

Allowing home equity lending would give Texas homeowners the right and freedom to use their home as they see fit, including as collateral for secondary loans. Texas should not continue, alone among the states, to limit a legitimate use of property in transactions between homeowners and lenders. The state has no right to restrict Texans' use of their own property as loan security. The Constitution's homestead provisions are paternalistic, outdated and rooted in the needs of a different era. Why should the state dictate that a homeowner may borrow against their home equity to build a swimming pool but not to send a child to college or to pay for medical care?

The inability to get home equity loans is costing Texans substantial sums because to use the equity they have built up in their homes they must either sell their home or seek high-interest unsecured loans that do not even offer a break at income-tax filing time. Since interest on loans secured by a home is tax deductible and also is lower than the interest on other loans, home equity loans offer borrowers a double benefit.

Fears of borrowers losing their homes as a result of a default on a home equity loan are overblown and unfounded. Home equity loan defaults in other states are rare, perhaps because borrowers will go to great lengths to make payments since the loan is secured by their home. Borrowers who get home equity loans and second mortgages are typically more financially sound than consumers in general, since they must have accumulated a substantial amount of equity in a home.

Unsecured credit would not dry up if home equity loans became available in Texas. As long as borrowers want unsecured loans, lenders will offer them. Lenders would continue to offer all types of credit to satisfy potential borrowers who do not own homes, who do not choose to use their home as collateral for a loan, or who need amounts too small to justify a home equity loan.

The possibility of using a homestead as collateral for a loan would greatly expand the number of people able to borrow the money to start a new business and thereby expand the Texas economy and create new jobs. One estimate puts untapped home equity at about \$124 billion.

It would be unfair and could raise constitutional questions to exempt agricultural property from being used for equity loans or extensions of credit. Farmers and ranchers should have the same rights as other Texans to borrow against their equity.

HJR 31 and CSHB 1188, the enabling legislation, would be a prudent, reasonable way to allow home equity loans in Texas. Home equity loans and extensions of credit would have to be voluntary, and involuntary liens against homesteads would still be prohibited.

It is important that rules governing equity lending be in the Constitution where they cannot be easily altered. This would ensure that both consumers and lenders are protected.

Equity loans. HJR 31 would cap the amount of debt that could be borrowed against a homestead to ensure that homeowners retain some ownership in their homes, have some cushion in case the value of the home drops, and have an incentive to not default on the loan. The home equity loan and all other debt against a property could not exceed 75 percent of the market value of the property. In addition, persons could have only one equity loan at a time.

Home equity loans would have to stand alone. Only a person's house, and nothing else, could be used to secure a home equity loan. Lenders could not force persons to pay off their equity loan because of default on another debt.

Other provisions would ensure that borrowers are not taken advantage of. Balloon payments would be prohibited because monthly payments would have to fully amortize the principal and interest. Fees would be capped, and there could be no penalties for pre-paying a loan. Lenders would be penalized for not complying with laws concerning equity loans. Lines of credit would be specifically prohibited to prevent abuse of this type of debt where it is easy for borrowers to forget that the money they draw at their

leisure is secured by their home.

Procedural safeguards governing home equity loans would ensure that borrowers were treated fairly and that they understood their responsibilities. Borrowers would have to be given a written notice outlining the home equity law. In addition, there would be a mandatory cooling-off period after a lender received a loan application, and a borrower would have the right to rescind a loan. Equity loans could be made only by standard, licensed financial institutions, not by other lending-type establishments like pawnshops or check-cashing businesses.

Foreclosures and recourse against borrowers. HJR 31 would protect both borrowers and lenders in a foreclosure. If a lender wanted to foreclose and sell the property through the standard, non-judicial procedures, HJR 31 would require them to give borrowers a chance to make good on their debt and to give borrowers notice that is in addition to the current notice requirements in the Property Code. However, HJR 31 would balance this with the option for lenders to go through a judicial foreclosure and have recourse against borrowers' other assets. The rights of both borrowers and lenders would be protected in a judicial foreclosure.

Home equity lenders would rarely use judicial foreclosure, for several reasons. First, their lien would be a second lien, behind the home's original mortgage, and the first lien holder would probably take the lead in selling the home and repaying the loans. Second, if the property was valued high enough to pay off a loan, a lender would prefer to sell the property under the standard non-judicial foreclosure procedures because it could be quicker and easier than judicial foreclosure. Third, if the property had dropped in value, a lender would likely elect to use judicial foreclosure only in limited situations in which a borrower was wealthy because most likely only wealthy owners would have assets that could be obtained by the equity lender in a judicial foreclosure. In addition, in a judicial foreclosure lenders would take the chance that a judge might deny their request for a borrower's assets.

Although obtaining a lender's other assets might be used rarely, it is an important option that should be retained, and equity loans should not be made totally nonrecourse. Lenders are more interested in borrowers' ability

to make loan repayments than in loan collateral so they need to be able to look at a person's overall ability to pay the loan, including their assets. If lenders have no recourse against borrowers, they would be more cautious about making loans, thereby restricting consumer credit. Also, small lenders and mortgage bankers that may not be able to hold home equity loans for long periods need the ability to sell the loans on the secondary market, and this market could pay less for loans that had an outright prohibition against recourse against a borrower's assets. This could put small banks and mortgage companies at a competitive disadvantage to large banks that might not need to sell the loans. California has a law similar to the recourse provisions in HJR 31, and lenders there are able to sell their notes in the secondary market, so Texas loans should also be marketable under HJR 31.

It would be unwise to amend HJR 31 to allow only judicial foreclosures because this costly process can add many months to the foreclosure process, allowing borrowers to live rent-free in a home and possibly damage the property and cause lenders to lose money.

Extensions of credit, reverse mortgages. HJR 31 also would allow extensions of credit loans for persons who have no debt on their homes, such as persons who have paid off their mortgages, paid cash for a home or inherited a house. This would allow a homeowner to refinance a home, and receive cash as part of the deal. Extensions of credit would include reverse mortgages, under which lenders pay borrowers an amount, usually monthly, for a fixed term or until the borrower moves from the home. Allowing extensions of credit would ensure that all homeowners are able to tap their home equity.

Extensions of credit do not need the same constitutional protections as equity loans because they are governed by existing state and federal law concerning first liens. Also, the market would work to set necessary parameters on these loans. Detailed, constitutional restrictions could hurt lenders' ability to sell these loans in the secondary market. In addition, one type of extensions of credit, reverse mortgages, are fundamentally different from equity loans. For example, with a reverse mortgage borrowers are receiving payments, not making them, so they do not need protections against loan payments being accelerated. Borrowers do not need protections against foreclosure because property secured by a reverse mortgage cannot

foreclosed on in the traditional sense since the loan is not due until the house is vacated, usually because the borrower has died, or the house is sold.

OPPONENTS
SAY:

Texans should not be able to risk losing their homesteads because they default on a loan for purposes unrelated to the homestead, and the state should not dilute its long-standing protection for homeowners. These homeowner protections are even more important today than when they were enacted in the 1800s, because of rising pressures on consumers to incur debt. An economic downturn such as the one that hit Texas in the 1980s could result in many more foreclosures, forcing persons out of their homes for defaulting on debt unrelated to the homestead itself.

Home equity loans may have hidden drawbacks for consumers and may turn out to be less than the “great deal” portrayed by lenders. Interest rate increases and other hidden costs can make home equity borrowing expensive and risky.

Dropping the Constitution's homestead exemption could lead to substantial numbers of Texans losing their homes to banks and other lenders. Home equity lending could lead to Texans taking on additional debt, backed by their home, to finance routine consumption spending. The need to protect the homestead has not diminished since many Texans still face personal economic pressure.

If lenders are allowed to secure loans with a homestead, they would stop making unsecured personal loans. Lenders prefer to make loans backed by a tangible asset and would force homeowners to risk their homes to obtain credit. Other avenues exist for consumers to finance real needs such as college costs and medical expenses.

The best stimulant to a strong economy is home ownership and increasing home equity. Allowing debt to finance consumer spending might create a short-term burst of economic activity, but a decline would follow — the period of remorse and depression after the binge. Texans should be increasing their savings, not inflating their debt burden. It is proper for the state to regulate home equity loans because these transactions turn an asset into a debt, something that should be regulated by government.

Agricultural property should be exempt from being used as security for an extension of credit or an equity loan. Agricultural property represents both a person's home and their livelihood, and it would be inappropriate to allow this property to be foreclosed on because of an equity loan or extension of credit. Agricultural property has always been subject to unique treatment under the law, so it would not be an aberration to exempt it from equity loans. In addition, farmers and ranchers can turn to numerous lending programs for funds in lieu of an equity loan.

Equity loans. HJR 31 does not contain some key provisions for consumers and lenders. For example, consumers should be given the right to sue dishonest lenders under the Deceptive Trade Practices Act, and they should be given the right to renegotiate their loan before a foreclosure.

Foreclosure and recourse against borrowers. HJR 31 would unfairly give lenders the ability to go after a borrower's other assets for the debt. This would be inappropriate because a home equity loan should be based on the property and its value, not a borrower's other assets. Home equity loans should be completely non-recourse, and lenders should not be able to use a borrower's other assets for the debt.

The secondary loan market is so large and diverse that Texas lenders, including small banks and mortgage companies, would have no trouble selling equity loans at a competitive rate, even if they were totally non-recourse

At a minimum, borrowers, not just lenders, should be given the option for judicial foreclosure. HJR 31 would allow lenders to choose judicial foreclosure instead of selling a property but does not give this same option to borrowers. In addition, HJR 31 fails to require court orders for evictions, unless the lender choose to go through judicial foreclosure.

Extensions of credit, reverse mortgages. HJR 31 would fail to give borrowers who receive extensions of credit the same protections that would be given to home equity borrowers. Borrowers who take out these loans, which include reverse mortgages or first-lien refinances in which the borrower receives some cash, should be given the same protections as equity borrowers, and lenders should be held to the same standards. Persons taking

out reverse mortgages deserve special protections because these are often elderly homeowners who are vulnerable targets for unscrupulous scam artists.

Bringing reverse mortgages under the constitutional protections given to equity loans would not harm the ability of lenders to make these loans or restrict borrowers from obtaining them because the enabling legislation, CSHB 1188, would exempt them from other, conflicting law.

OTHER
OPPONENTS
SAY:

HJR 31 should restrict equity loans and extensions of credit to a limited number of essential uses, such as medical or educational purposes, to ensure that they are not abused.

HJR 31 should not contain detailed regulation of equity lending. The Constitution should be amended only to authorize the practice with the regulations placed in the statutes.

HJR 31 should not include a debt-to-value ratio. Homeowners should be able to tap all of their equity, not just some arbitrary portion.

HJR 31 should allow lines of credit. This would allow borrowers to borrow money and accrue interest as they need it. For example, a person could borrow money every month to help pay expenses in sending a child to college.

NOTES:

CSHB 1188, the enabling legislation for HJR 31 is also on today's calendar.

The original version of HJR 31 only would have allowed encumbrances to be placed on homesteads for extensions of credit.

SJR 12 and SB 173 by Patterson et al. which would authorize home equity loans, were approved by the Senate, both by 25-6 (Barrientos, Luna, Madla, Nixon, Ogden, Truan), 1 present, not voting (Fraser), on April 2 and have been referred to the House Financial Institutions Committee. SJR 12 would authorize equity loans, reverse mortgages, and blended equity loans to refinance mortgage and other encumbrances. The loans could not exceed 90 percent of the fair market value of the homestead. Equity loans would be barred on homesteads designated for agricultural use.