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Report to the Chairman, Subcommittee on Financial Institutions and Regulatory Relief, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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HIGH-LOAN-TO-VALUE LENDING

Information on Loans Exceeding Home Value

GAO

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The Honorable Lauch Faircloth
Chairman, Subcommittee on Financial
Institutions and Regulatory Relief
Committee on Banking, Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

This report responds to your request that we provide information on high-loan-to-value (HLTV) loans. Since 1995, a segment of the financial services industry has offered loans that are tied to the value of a borrower's house but that, in combination with preexisting first mortgages, exceed this value. The loans, referred to as HLTV loans, provide for a combined loan-to-value ratio that could reach 125 percent or even more of a home's value.

As agreed with your office, this report provides information regarding (1) the characteristics of HLTV loans; (2) the major organizations that provided HLTV lending; (3) the volume of HLTV lending in 1995, 1996, and 1997, and the expected volume in 1998; and (4) the benefits and risks of HLTV lending for borrowers, lenders,[1] investors, and regulated depository institutions.

To compile this information, we interviewed officials representing federal regulatory agencies, lending institutions, industry associations, a rating agency, investment banks, and a consumer advocacy group. We also reviewed publicly available information, including published reports, prospectuses associated with the selling of HLTV-related securities, and academic studies. Comprehensive industry data on HLTV loans were not maintained by any single entity. Therefore, in addition to interviews with officials, we relied on the limited industry data that were available at various institutions. Although we did not independently verify these data, we corroborated evidence with other independent sources whenever possible. To ensure that its contents were factually accurate, we provided draft copies of this report to public sector and private sector officials. We incorporated their technical comments where appropriate. We conducted our work between January and June 1998 in accordance with generally accepted government auditing standards. For more detailed information concerning our scope and methodology, see appendix I.

[1]We use the term lender in this report to cover all businesses that either originate these loans themselves or acquire these loans from correspondents or other financial institutions.

Results in Brief

HLTV loans are considered "hybrid" loans because they have characteristics of both mortgage loans and unsecured consumer loans. Like mortgages, HLTV loans are secured by a lien[2] on a house. However, the lien itself may have less financial value than the amount of the loan in the event of a borrower's defaulting, because the value of the HLTV loan and the original mortgage (which would have first claim on the value of the house in the event of a default) may exceed the value of the house. Thus, as with unsecured consumer loans, HLTV lenders rely more heavily on borrowers' creditworthiness—that is, the borrowers' likelihood of making timely and complete payments—in making loans. According to industry officials, most borrowers use HLTV loans primarily to consolidate credit card debt. In addition, some borrowers used HLTV loans to make home improvements. While comprehensive industry data were not available, data provided by a lender responsible for about one-third of HLTV lending showed that, in 1997, HLTV loans averaged about $30,000. The data also showed that the average contract interest rate was between 13 and 14 percent, with an average loan term of 25 years.[3] The average combined indebtedness of the first mortgage and the HLTV loan represented about 110 percent of the borrower's property value, although in some cases the combined loans reached or exceeded 125 percent of value.

According to industry officials and our review of the limited available industry data, from 1995 to 1997, HLTV loans were made or managed primarily by 10 institutions. Often, these 10 institutions obtained loans originally made by correspondents—that is, institutions that dealt directly with the borrower and then transferred the loans to one of the 10 institutions. According to public and private sector officials, regulated depository institutions were not heavily involved in originating HLTV loans. The involvement of these institutions would be important to any assessment of the potential exposure of federal deposit insurance funds to defaults of HLTV loans. One nondepository institution—FirstPlus Financial Group, Incorporated (FirstPlus), of Dallas, Texas—has had about one-third of the market since 1995.

Available data indicate that HLTV lending has grown since its introduction in 1995 but that it remains small relative to other consumer lending. Data on the volume of HLTV loans were limited to those loans that were

[2]A lien is a legal claim in the event of default on a loan that gives the lender claim to the value of a property used as security for the loan.

[3]We use the term contract interest rate to refer to the interest rate stated in the loan agreement. If origination fees or points were charged on the loan, its effective interest rate would exceed the contract interest rate.

subsequently packaged into loan pools used to back securities sold to investors. Lenders and securities firms involved in this process of securitization said that about 95 percent of HLTV loans were sold as securities to investors. The volume of securitized HLTV lending has more than doubled from year to year from 1995, the year it was introduced, through 1997. According to industry representatives, about $1 billion worth of these loans were made in 1995; $3 billion in 1996; and $8 billion in 1997. Industry and securities firm representatives expected HLTV lending to increase again in 1998 to $12 billion or higher. Although this has been a growing market, total HLTV lending was small compared with other types of consumer lending. For example, even if no HLTV loans had been repaid, the total amount of outstanding HLTV loans would only have been about $12 billion at the end of 1997. In contrast, total outstanding residential mortgage debt reached $3.8 trillion in 1997, and total outstanding consumer debt (other than mortgages) reached $1.3 trillion in the same year.

While only limited data were available for documenting the performance of HLTV loans, public and private sector officials pointed to several benefits and risks associated with HLTV lending to the borrower, lender, and investors. For example, while some of these officials said that HLTV lending provided borrowers with a quick way to consolidate credit card debt and lessen their monthly debt payments, others noted that HLTV loans could make it more difficult for homeowners to sell or refinance their houses. Also, while lenders and investors have benefited from the high rate of return on these loans, it is uncertain how these loans would perform during any future economic downturn. If defaults were to increase, the rate of return would decrease. In addition, officials representing the two largest government-sponsored enterprises in the secondary market for residential mortgages[4] did not believe that HLTV lending, at its current level, posed substantially greater risks to their portfolios than did the existing credit card lending that the HLTV lending generally refinances. The risks to the portfolios exist because a high total debt burden could increase the risk of default on the mortgages that comprise the portfolios of these government-sponsored enterprises.

Background

According to industry officials, HLTV lenders used credit scoring models as the primary basis for identifying creditworthy borrowers and thus for

[4]Government-sponsored enterprises are federally chartered, privately owned corporations designed to provide a continuing source of credit nationwide to specific economic sectors. The nation's two largest government sponsored enterprises are the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

approving HLTV loans. Generally speaking, lenders used credit scoring models to evaluate credit risk—the possibility that borrowers would be (1) delinquent (i.e., make late loan payments) or (2) in default (i.e., cease to make loan payments). In general, credit scores have been developed by assessing various types of information from a large pool of borrowers, including borrowers with good payment histories and others with poor payment histories. Statistical analyses identifying the characteristics of borrowers who were most likely to make loan payments have been used to create a weight or score associated with each of the characteristics. For instance, borrowers who did not have a history of delinquent payments receive a higher credit score than borrowers who had many delinquent payments. Most widely used credit scoring systems have a range of scores from 350 to 900. Borrowers with higher scores are usually considered more creditworthy because they would be more likely to pay the loan on time, and in full, than would borrowers with lower scores.[5]

According to an official familiar with these proprietary models, a key variable associated with higher credit scores is home ownership. Homeowners tend to have better payment histories than borrowers with otherwise similar characteristics. Industry officials told us that homeowners acted as if they had a vested interest or "psychological drive" to make prompt loan payments in an effort to keep the homes in which they lived.

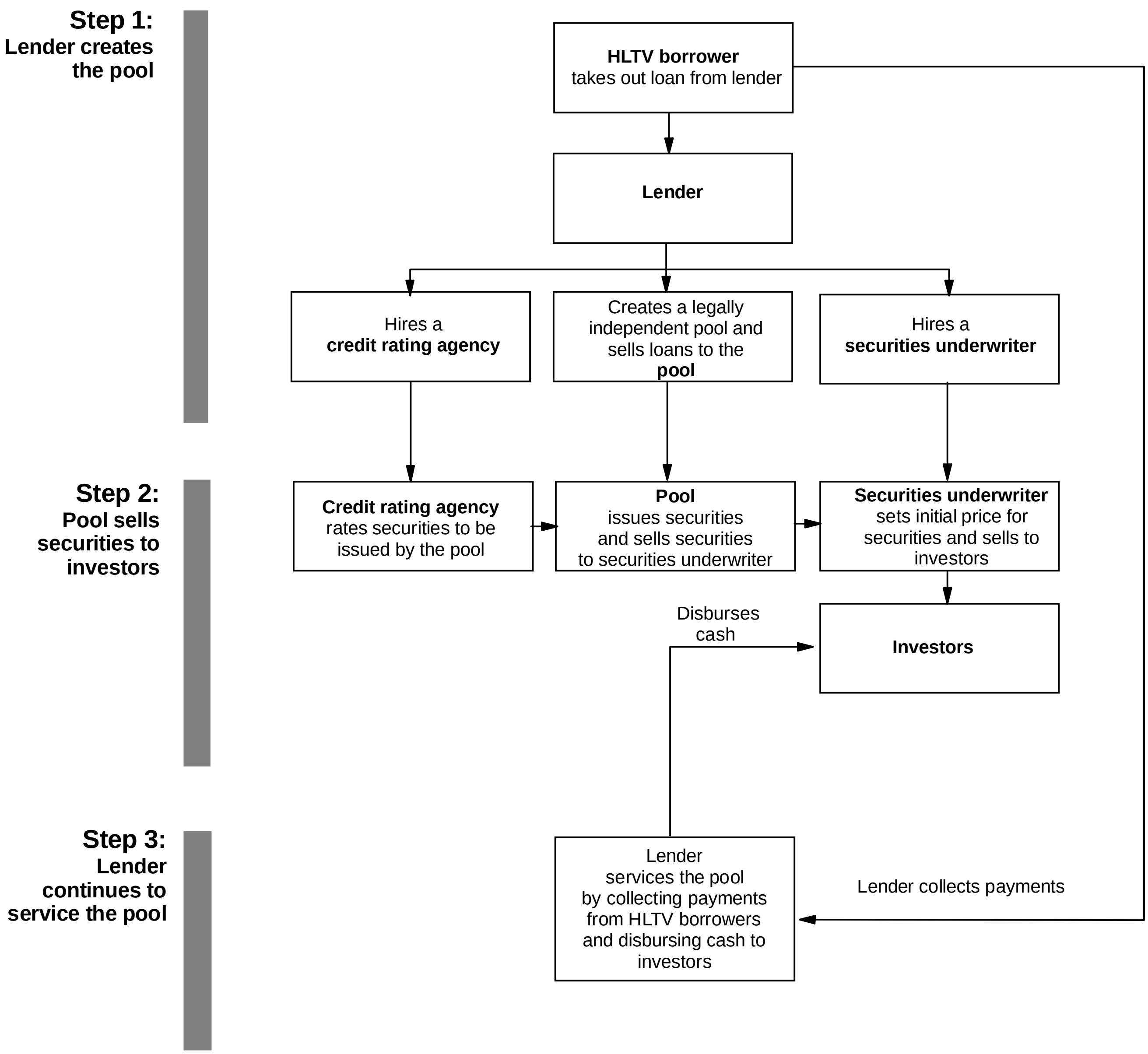
In general, in making HLTV loans, lenders sought to assemble the HLTV loans into pools of loans, which then were used to back securities sold to investors. According to securities firm officials, about 95 percent of HLTV loans were combined into pools and securitized. In general, securitization involves a lender's packaging financial assets—typically loans—into pools, the creation of securities based on the cash flows from the pools, and the sale of these securities to investors. Securitization is commonly done for a wide range of financial assets, including mortgages, car loans, and other forms of consumer debt.

The process of HLTV securitization has three major steps. In the first step, the borrowers take out loans from the lender, and the lender organizes the pool and sells the HLTV loans to the pool. In addition, the lender hires a credit rating agency and a securities underwriter. The pool is established as a legal entity that is independent of the lender. Second, the credit rating

[5]Even though some borrowers with higher scores could become delinquent or default and some borrowers with lower scores could pay the loan as required, statistics showed that borrowers with higher scores would be more likely to pay the loan on time, and in full, than would borrowers with lower scores.

agency rates the securities that will be issued by the pool and the securities underwriter sets initial prices for the securities, buys the securities from the pool, and immediately sells the securities to investors. Third, the lender services the pool by collecting payments from HLTV borrowers and disbursing payments to investors. This securitization process is depicted in figure 1.

Figure 1 : Steps in a HLTV Securitization



Note: In this diagram, the lender both originates the loans and creates the pool.

Source: GAO

Since the pool is a separate legal entity, its credit quality is considered to be separate from that of the lender that formed the pool. The credit quality of the pool depends on the credit quality of the loans in the pool. In addition, the credit quality of the assets in the pool may also be enhanced, either internally or externally. One form of internal credit enhancement occurs if the value of loans in the pool exceeds the value of the securities sold; this is a form of over-collateralization. Common forms of external credit enhancements include insurance policies that pay in the event of loan defaults.

HLTV Loans Have Unique Characteristics

HLTV loans have often been referred to as "hybrid" loans because they have characteristics of both mortgage loans and unsecured consumer loans. According to lenders, borrowers have used HLTV loans primarily to consolidate credit card debt or to make home improvements. Although industrywide data were not available, FirstPlus officials had compiled an "average HLTV loan profile" that identified the average amount of an approved HLTV loan, the interest rate charged, the duration of the loan, and the percent of property value the loan represented. Further, FirstPlus officials identified the "average HLTV borrower profile," which was a creditworthy borrower (based on credit scores) who had a stable income. Officials representing federal regulators and a consumer advocacy group were not aware of any borrowers' complaints about the disclosure of the terms and conditions of HLTV loans.

HLTV Loans Are Hybrid Loans

HLTV loans have characteristics of both mortgage loans and unsecured consumer loans. On the one hand, HLTV loans share characteristics with mortgage loans in that both types of loans are secured with a lien on the property in the event of borrower default. On the other hand, HLTV loans are like unsecured consumer loans because, in both cases, the lending decisions are based primarily on the creditworthiness of the borrower. Creditworthiness is the primary basis for the lending decision because, in the event of a default, there might be little or no value in the house left to pay off the HLTV loan, once the first mortgage loan is covered by the sale of the house.

Average HLTV Loan Profile

Although industrywide data were not available, FirstPlus—which accounted for about one-third of the HLTV loan volume in 1997—provided us with information on its average HLTV loan profile. According to FirstPlus officials, the average HLTV loan they made in 1997 was for about $30,000 with a 25-year term. Also, in the same year, FirstPlus charged an average contract interest rate of 13 to 14 percent on its HLTV loans, but any origination fees or "points charged" would raise the effective interest rate of the loan. A FirstPlus official told us that FirstPlus charged an average of five "points."[6] Thus, a 25-year loan with a 13.5 percent contract rate and 5 points would have an effective interest rate of 14.3 percent. In addition, the average combined debt of a first mortgage and a FirstPlus HLTV loan with a second lien generally represented about 110 percent of a borrower's property value, although some reached as high as 125 percent of value.

Average HLTV Borrower Profile

Although there were no comprehensive industry data, FirstPlus provided us with information on its borrowers. Generally speaking, FirstPlus made HLTV loans to borrowers with a stable average annual income of $60,000. These borrowers had, on average, at least 5 years of job tenure and were in their late thirties. Also, while the borrower had an average of about $20,000 in outstanding nonmortgage debt, as previously mentioned, the HLTV loans were on average about $30,000. Virtually all of these borrowers occupied the house they were using as collateral. The borrower owed an average of about $110,000 on a first mortgage, backed by property worth about $130,000. However, a key FirstPlus official told us that approval of a HLTV loan was not strongly tied to the amount of equity the borrower had in the house; rather, it was primarily tied to the borrowers' creditworthiness, as measured by a credit score.[7] In addition, FirstPlus officials told us that they review the borrower's credit histories, debt-to-income ratios, and disposable-income levels.

Public and private sector officials—including representatives of FirstPlus—told us that credit scores for HLTV borrowers were, on average, about 680 and that this score was considered to be "high." According to the leading provider of credit scoring models, a score of 700 predicts the odds of 30 to 1 that the borrower will be current on the loan payments.[8] An official with a government-sponsored enterprise active in the secondary mortgage market told us that 85 percent of all mortgage borrowers have credit scores of 620 or higher.

[6] OTS officials told us that some lenders have charged as many as 12 points.

[7] HLTV lending differed from subprime lending, which is lending to less creditworthy borrowers. HLTV lending primarily depended on the borrowers' creditworthiness, not on the value of equity in their collateral. Subprime lending, on the other hand, heavily depended on collateral equity and, to a lesser extent, borrower creditworthiness.

[8] The precise definition of being current on the loan payments that this provider used was that the borrower would not be over 60 days delinquent in payments.

The Survey of Consumer Finances, a triennial survey of family finances sponsored by the Federal Reserve with the cooperation of the Department of the Treasury, provides a basis to compare the profile of the HLTV borrower with the broader U.S. population. In 1995, the most recent Survey at the time of our review, average family income was estimated to be $44,300 for all families and $54,600 for homeowners. The Survey also found that 64.7 percent of families were homeowners, with the median value of the house being $90,000. Further, 41.1 percent of the homeowners in the Survey had mortgages or home equity loans, the median total loan amount being $51,000. Credit cards were held by 47.8 percent of the homeowners in the Survey, who owed a median amount of about $1,500.

A comprehensive comparison of the HLTV and Survey profiles was not possible because some Survey data on families are reported as medians, while the HLTV data are based on averages. Further, available data we obtained on HLTV borrowers were from the FirstPlus borrower profile; other lenders' borrower profiles may be different. With these cautions in mind, however, some general similarities and differences between the HLTV and Survey profiles can be delineated. The HLTV borrower had a slightly higher average income: the FirstPlus borrower had an average annual income of about $60,000, while the average homeowner in the Survey had an income of $51,000. The average value of housing in the HLTV profile ($130,000) is higher than the median value of housing in the Survey ($90,000), although this comparison of an average and a median is inherently limited. Since housing values do not have an upper limit, the mean or average value would increase more than the median with the inclusion of high-valued houses. HLTV borrowers appear to have had higher mortgage balances even before taking on the HLTV loans: the FirstPlus profile reported an average first mortgage of $110,000, while the median mortgage and home equity balance for homeowners in the Survey was $51,000.

HLTV Loan Disclosure of Requirements to Borrowers

Federal law and regulations set forth requirements concerning the information on a loan that must be disclosed to a borrower. In addition, state law may require disclosure to borrowers. Specifically, to promote the informed use of consumer credit, the Truth in Lending Act[9] requires that creditors disclose credit terms and the cost of credit as an annual percentage rate (APR). For loans secured by a consumer's home, additional disclosures are required, and the act permits consumers to cancel certain

[9]Truth in Lending Act, 15 U.S.C. 1601 et seq. The act is implemented by the Federal Reserve Board's Regulation Z, 12 CFR part 226.

transactions that involve a lien on their principal dwelling. The Home Ownership and Equity Protection Act of 1994[10] added new disclosure requirements for home equity loans that have credit terms in excess of a certain amount. To be covered by these new disclosure requirements, the loan must meet either of the following tests: (1) the APR must be more than 10 percentage points over the yield on Treasury securities with a maturity comparable to the loan, or (2) total points and fees payable by the borrower must exceed the greater of either 8 percent of the total loan amount or $435.[11] A special early disclosure is required at least 3 days before the loan closing. This disclosure generally includes (1) a warning that the house may be lost in the event of a default, (2) the APR, and (3) the amount of payments. The Home Ownership and Equity Protection Act also limits the use of certain contract terms and other practices in loan transactions covered by the act. These limitations address, among other things, rebates, prepayment penalties, advance payments, and negative amortization. Moreover, the Real Estate Settlement Procedures Act[12] requires use of a standard form for the statement of settlement costs, as prescribed by the Secretary of Housing and Urban Development, in all transactions involving federally related mortgage loans.[13]

Officials representing banking and thrift regulators, the Federal Trade Commission, and a consumer advocacy group told us that they were not aware of any complaints regarding disclosure of HLTV loan terms to the borrower. We reviewed a standard, blank package of settlement papers provided by FirstPlus. While we did not determine compliance with applicable disclosure requirements, our review found that the papers contained information that appeared to address these requirements. Also, our review of these settlement papers indicated that some of the HLTV loans may be covered by the Home Ownership and Equity Protection Act.

[10]The Home Ownership and Equity Protection Act of 1994, Subtitle B of the Riegle Community Development and Regulatory Improvement Act of 1994, P.L. 103-325, 108 Stat. 2106 (1994).

[11]The $435 figure applies to 1998. The Federal Reserve Board adjusts the amount annually based on changes to the consumer price index.

[12]12 U.S.C. 2601 et seq. The act is designed to, among other things, provide for more effective advance disclosure to home buyers and sellers of settlement costs.

[13]Federally related mortgage loans include first or subordinate mortgages on residential homes made by depository institutions or by certain creditors who make more than $1,000,000 in residential loans per year, or which are intended to be sold to Fannie Mae or Freddie Mac.

While Hundreds of Institutions Originated HLTV Loans, 10 Institutions Collectively Served Most of the HLTV Market

According to industry officials, hundreds of institutions originated HLTV loans. There is no comprehensive, publicly available information regarding the identity of these institutions or their HLTV activity, and they are not tracked by regulatory agencies or industry associations. However, many of the institutions acted as correspondents, generally transferring the loans to other institutions that in turn securitized the loans.

According to interviews with numerous industry officials and our review of limited available industry data, 10 institutions have collectively led the HLTV market since 1995. The 10 institutions either received HLTV loans originated by correspondent institutions or originated HLTV loans themselves. One institution in particular—FirstPlus—has made about one-third of all HLTV loans since 1995, either directly or through correspondent relationships with other lenders. The following are the 10 institutions that led the market, in order of the volume of HLTV loans they provided in 1997.

- FirstPlus,
- Cityscape,
- Empire Funding,
- Master Financial,
- PSB Lending Corporation,[14]
- Life Financial,[15]
- First Keystone,
- The Money Store,[16]
- Mego Mortgage, and
- Preferred Mortgage.

According to public and private sector officials, regulated depository institutions were not heavily involved in originating HLTV loans from 1995 to 1997. The degree of involvement of these institutions would be important to assess any potential exposure of federal deposit insurance funds to defaults on HLTV loans. For instance, of the 10 institutions that led the market, only one—Life Financial—was a regulated depository institution. Other institutions were affiliated with depository institutions.

[14]In June 1998, PSB Lending Corporation was in the process of being purchased by Bay View Capital Corporation. However, the acquisition was put on temporary hold pending review of possible federal regulatory guidelines affecting HLTV lending.

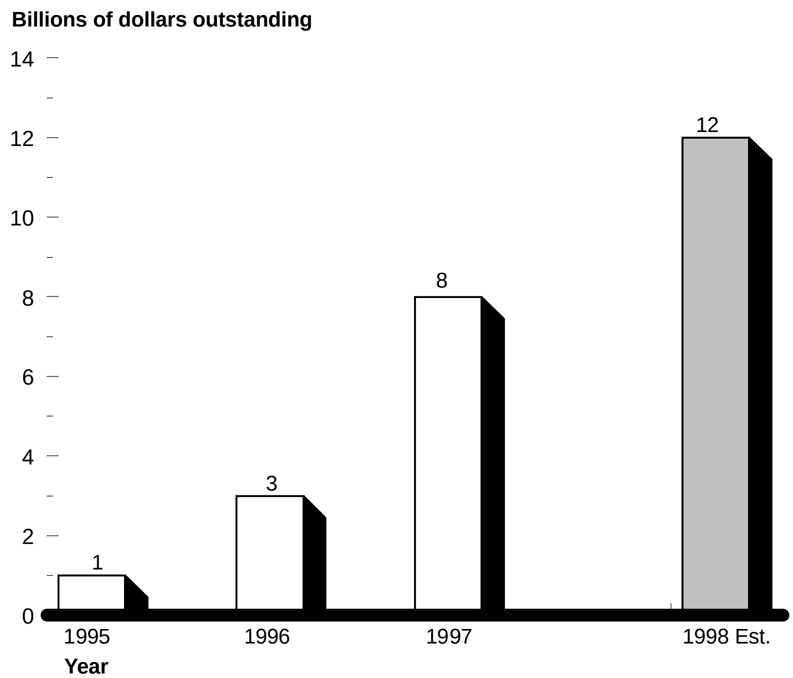
[15]As of June 1998, FirstPlus had applied to acquire Life Financial, a thrift holding company. According to OTS officials, this application is subject to regulatory review.

[16]The Money Store was purchased by First Union Corporation in June 1998.

HLTV Lending Is Growing but Still Represents Only a Small Percentage of the Total Mortgage and Unsecured Lending Markets

Data on the volume of HLTV loans are limited to those loans that were subsequently sold to investors as securities. Lenders and securities firms involved in this process of securitization agreed that about 95 percent of HLTV loans were sold as securities. According to private sector officials, the total securitized volume of HLTV lending has more than doubled from year to year from 1995, the year it was introduced, through 1997. The officials also expected total securitized HLTV lending to increase in 1998, with estimates of total volume of $12 billion or higher. (See figure 2.)

Figure 2: Available Data Show Total Industry Volume of HLTV Lending Has Continued to Grow



Note: 1998 estimates include $12 billion and higher estimates.

Source: GAO review of reports from an investment bank and the Home Improvement Lenders Association (HILA), interviews with private sector officials, and various published articles.

While available data show that HLTV lending has continued to grow, the total outstanding debt represents a small percentage of the total debt outstanding for all consumer-oriented lending. Even if no loans were repaid, total debt outstanding for HLTV loans would be almost $12 billion in 1997. In contrast, total residential mortgage debt outstanding reached about $3.8 trillion in 1997, and total unsecured consumer debt outstanding reached about $1.3 trillion in 1997, according to Federal Reserve statistics.

Estimated Securitized Volume of Major Organizations

Industry officials we interviewed agreed that the 10 institutions shown in table 1 have provided almost all HLTV loans since their introduction in 1995. As shown, FirstPlus has provided a significant part of the HLTV lending—offering about one-third of HLTV loans since 1995.

Table 1: HLTV Loan Volumes by the 10 Leading Lenders, 1995-1997

Dollars in billions

Lender	1995	1996	1997
FirstPlus[a]	$0.30	$1.10	$3.10
Cityscape	0	0	0.80
Empire Funding	0	0	0.90
Master Financial	0	0	0.70
PSB Lending Corporation	n/a	n/a	0.70
Life Financial[b]	n/a	n/a	0.40
First Keystone	0.50	0.80	0.40
Money Store	0	0	0.40
Mego Mortgage	0	0.03	0.30
Preferred Mortgage[b]	n/a	n/a	0.20
Estimated Total[c]	**$1.0 billion**	**$3.0 billion**	**$8.0 billion**

Note: n/a = not available.

[a]According to a key company official, in 1997, FirstPlus provided $3.10 billion in HLTV loans in 42 states; about 27 percent of these loans were made to borrowers in California.

[b]Volume data for 1995 and 1996 for these institutions were not readily available because they were not members of HILA as of May 1998, when the Executive Director sent questionnaires to industry officials.

[c]Totals represent estimates made by industry officials and estimates reported in various published articles. The data in the columns may not add up to the estimated totals because of rounding or because not all data were available.

Source: Compiled by GAO from industry responses to a HILA questionnaire and other industry data.

Benefits and Risks Associated With HLTV Lending

There were limited data on the losses resulting from HLTV lending. However, based on the characteristics of the loans and available performance data on HLTV loans, public and private sector officials identified many inherent trade-offs between the benefits and the risks associated with HLTV lending that face borrowers, lenders, and investors. These officials told us that regulated depository institutions have not made many HLTV loans, but that the practice appears to be growing.

Limited Data Available to Identify Losses on HLTV Loans

Public and private sector officials told us that data on losses from HLTV loans experienced by institutions making loans were limited for a variety of reasons, such as that the loans (1) were a recent lending practice adopted in 1995 (and losses are usually experienced over longer periods of time); (2) were offered during a period of strong economic growth; and (3) were not specifically tracked by regulators because HLTV loans were generally made by unregulated, nondepository institutions.

A recent academic study[17] concluded that there is "no credible economic argument" to suggest that HLTV lending would increase consumer default risk or destabilize the economy. The study noted, however, that several HLTV lenders had substantial losses in 1997. According to the study, some lenders experienced problems due to unrealistic assumptions on how rapidly the loans would be repaid, inadequate underwriting standards, and poor management.

In addition, one securities firm reported on possible HLTV loan losses by comparing them to losses expected in mortgage and credit card lending. The firm noted that possible HLTV losses might be higher than losses experienced in the mortgage lending market. First, the delinquency and default rates on HLTV loans might be higher than those rates on mortgages. Second, in the event of a default and subsequent sale of the house securing the loan, the proceeds of the sale may not be sufficient to pay off both the first mortgage and the HLTV loan. Because first mortgages have first claim on the house sale proceeds, there may be little or nothing left to pay off the HLTV loan. On the other hand, the securities firm also noted that possible HLTV charge-off rates (i.e., the percentage of total loan value that would be written off because no further payments were expected) would compare favorably with losses on "higher quality credit card pools." For instance, the HLTV charge-off rates were estimated to peak at a 4.7 percent annualized rate for recently originated pools. By comparison, the

[17]Charles W. Calomiris and Joseph R. Mason, "High Loan-to-Value Mortgage Lending: Problem or Cure?" July 10, 1998, unpublished working paper, American Enterprise Institute.

charge-off rate on Moody's aggregate credit card index was reported as 6.65 percent in December 1997.

Borrowers With HLTV Loans Experienced Benefits and Risks

Lenders and independent analysts agreed that most borrowers decreased their monthly debt burden payments by using HLTV loans to consolidate their credit card debts, for two reasons. First, because borrowers rescheduled their debts over a longer period of time, the monthly debt burden would decrease even if they paid the same interest rates they were paying on the credit cards. Second, to the extent that the interest rate was lower than the credit card rates, the monthly debt service would be further decreased.[18] In 1997, the average contract HLTV loan charged 13 to 14 percent interest, while the average interest rate on credit cards was 16 percent. However, any advantages of a HLTV loan relative to credit card debt would depend on the terms and conditions of the credit card debt agreement, and these vary across the industry. In addition, as previously mentioned, the effective interest rate on an HLTV loan would vary depending on the number of points charged on the loan. Finally, some industry officials said that HLTV loans might allow borrowers some tax deductions for interest expenses that would not be available for credit card interest expenses.[19]

Public and private sector officials pointed out that HLTV lending involves three primary risks on the part of the borrower. First, officials questioned whether borrowers would have the ability to make HLTV loan payments in the future if they encountered economic difficulties, such as job losses or unemployment. While borrowers might have benefited from restructuring debt by using HLTV loans during good economic conditions, officials pointed out that there were no data on how well the borrowers could make loan payments during any future economic downturn. Default rates on all loans generally increase during economic downturns.

Second, some analysts expressed concern that HLTV borrowers could increase their credit card debt after taking out an HLTV loan because they could retain their credit cards and/or be approved for new credit cards. Given lower monthly debt service, once credit card debt was restructured as an HLTV loan, it is possible that borrowers' credit scores could rise. For

[18]Conversely, the credit card monthly debt service would decrease over time if no new debt was added to the credit cards and at least minimum payments were being made regularly. The monthly debt service on the HLTV loan would remain unchanged for the full term of the mortgage if payments were made regularly.

[19]The Internal Revenue Code provides that interest paid can only be deducted to the extent that the amount of the home equity loan plus the first mortgage does not exceed the market value of the house.

instance, Brittain Associates, a marketing research firm, reported in 1998 that some HLTV borrowers had already begun to build up sizable credit card debt soon after getting the previous debt paid off with a home equity loan.

Finally, some officials believed that HLTV loans might decrease borrowers' financial flexibility by limiting their ability to sell their houses or to refinance first mortgages. The combined value of the HLTV loan and first mortgage often exceeds the value of the house. Upon sale, the borrower would usually need to pay off both loans. If sufficient funds were not available, either from the sale or from other sources, the borrower might not be able to sell. In addition, officials at a government-sponsored enterprise noted that the presence of second loans secured by the value of houses generally made it more complicated to refinance first mortgages.

In addition, housing prices can be particularly sensitive to changes in economic conditions. In some cases, this sensitivity can affect loan payments by borrowers. For example, when the price of oil fell during the mid 1980s, residential housing values in Houston, Texas, fell 23 percent. Similarly, when the California economy went into a recession in the early 1990s, average housing prices declined by 21.1 percent in Southern California and 9.6 percent in Northern California. During these times, defaults on mortgages increased because borrowers lost jobs and, in some cases, were unwilling to pay on mortgages whose balances far exceeded the current market values of their houses.

Lenders of HLTV Loans Experienced Benefits and Some Risks

HLTV loans offered several benefits to HLTV lenders. For example, when the loans were securitized, the lender could continue to service the loans, which would generate service fee income for the lender. A securities industry study noted that several securitization offerings during 1997 provided for service fees of 0.75 to 1.0 percent of the loan amount. On a $30,000 loan, this fee would equal between $225 and $300.

More generally, officials representing securities firms told us that HLTV loans could be profitable for lenders because these loans could be sold at a premium over the face value of the loan to the pools, which subsequently would be securitized. As noted earlier, the lenders organize the pools of assets in the securitization process, but the pools are established as separate legal entities. The lenders sell the HLTV loans to the pool. Under current accounting rules, any such profits must be immediately recognized on those sales where certain equity interests are maintained by the seller as part of the deal and recorded as an asset. The estimated fair value of the asset is added to sales proceeds when calculating profit.

Officials representing securities firms also noted several ways in which the lenders would retain some risk. First of all, some HLTV loans were not securitized and were held on the lenders' books. The officials we talked with estimated that 5 percent of the HLTV loans were not securitized, but there is no way to reliably know how many loans were not securitized or to identify their value. In addition, even when the HLTV loans were securitized (about 95 percent), the officials said the lenders often retained a stake in the retained assets pools. The lender might hold a class of securities that was designed to absorb credit risk to protect investors, for example. By taking on the credit risk with these securities, the lender provides an internal credit enhancement to the other investors in the pool. In addition, by absorbing these credit risks, the lender may protect the pool and its reputation as a securitizer from the consequences of securities that do not perform. In cases where the seller retains an equity interest as part of the securitization, the retained asset carries risk for the lender because the value of the asset is based on assumptions about the future performance of the loans sold and assumptions about future cash flows. If these assumptions do not hold and the value of the retained asset decreases, previously recognized accrued income will not be realized in cash.

Investors of HLTV Loans Experienced a Trade-off Between Benefits and Risks

Several classes of securities were created from each pool of HLTV loans and sold to investors. Different securities classes offered different mixes of expected returns, credit risk, and interest rate risk (the risk that cash flows will vary as interest rates change in the future) to investors. In general, classes with higher risks were designed to pay higher expected returns. Although it is difficult to identify investors of HLTV lending pools because of a lack of data, officials from a securities firm told us that investors were mainly large insurance companies.

To protect investors, securitization redistributes credit risks so that one class of securities is designed to absorb all or much of the credit risk in return for a higher expected return. Such structuring is a common internal credit enhancement. Another common internal credit enhancement is over-collateralization, where the difference between the interest paid on the loans and interest paid to investors (the "excess spread") absorbs losses. In addition, to improve the liquidity or marketability of certain securities, lenders can also provide external credit enhancements to protect the owners of these securities from losses from loan defaults. These external credit enhancements can include insurance policies that protect a pool's securities against default losses on the loans in the pool. Private sector officials told us that external credit enhancements were a popular technique in the securitization of HLTV loans in 1995 and 1996 but that during 1997 and 1998 internal credit enhancements were more prevalent.

Different classes in the securitization would be attractive to investors taking different approaches to managing interest rate risk because each class of securities would receive different parts of the pool's interest and principal payments over different time periods. For example, investors can manage interest rate risk by buying securities with specific payoff periods.

Nevertheless, there is always some intrinsic risk in any investment, and this is increased in the case of securities only recently introduced in the market. Investment bank and government-sponsored enterprise officials noted several risks associated with the securities based on the HLTV loans. While these securities were designed to mitigate risks to the investors, there were risks associated with the underlying loans. For instance, the rate at which defaults are expected to occur on HLTV loans is a crucial factor in putting together the pools and the resulting securities. The expected average default rate on HLTV loans, with an average term of maturity of 25 years, is based on the creditworthiness of the borrower as predicted by credit scoring models. According to the leading provider of credit scoring models, the models are designed to optimize their predictive power over a 2-year period. Although the models will rank borrowers over longer periods, the separation between good and bad borrowers will degrade over a longer time horizon (for instance, 10 years).

Similarly, the likelihood that HLTV loans will be paid before they are due has only been estimated based on the prepayment rate of other forms of consumer debt. If the actual rate of prepayment differs from the predicted rate, the cash flow from the pool of loans will not match the predicted cash flow that would yield the expected payments to investors. This, in turn, would change the realized rate of return on pools of mortgages and on those securities sensitive to interest rate risk created by prepayments.

Regulated Depository Institutions Were Not Heavily Involved in Originating HLTV Loans

It does not appear that regulated depository institutions have experienced many benefits or risks because these institutions did not originate many HLTV loans or invest in the securitized pools. Their minimal benefits, however, might have included service fee income from any HLTV loans that banks originated and sold.

Officials at Fannie Mae and Freddie Mac told us that HLTV lending, at current levels, did not pose a greater risk to their portfolios of first mortgages than did the credit card debt HLTV loans generally refinanced. The risks to the portfolios exist because a high total debt burden on consumers could increase the risk of default on the mortgages that comprise the portfolios of these government-sponsored enterprises. HILA's executive director said, however, that HLTV loans might reduce the possibility of defaults on first mortgages because HLTV loans allowed borrowers to lower their monthly payments on debt. In any event, Fannie Mae and Freddie Mac officials noted that they, as first mortgage holders, would maintain their equity position and be the first to obtain the proceeds from the sale of a house in the event of default.

Moreover, because the data available at the time of our review show that most institutions making HLTV loans were not regulated depository institutions and did not have federally insured deposits, a failure of these institutions was unlikely to impose any direct costs on the government. This condition could change, however, in the event that (1) the size of the HLTV market were to increase and (2) regulated depository institutions were to become substantially involved in making HLTV loans and carrying them on their books. Federal banking and thrift regulatory officials have recognized this possibility, and some have begun efforts to identify and monitor HLTV lending done by regulated financial institutions. In addition, officials from the Office of Thrift Supervision told us that they are clarifying their regulatory guidelines as they affect HLTV lending.

As agreed with you, unless you publicly release its contents earlier, we plan no further distribution of this report until 30 days from its issue date. At that time, we will provide copies to the Ranking Minority Member of your Subcommittee, the Chairman and Ranking Minority Member of other congressional committees with jurisdiction over financial issues, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, the Chairman of the Federal Deposit Insurance Corporation, the Chief Executive Officer of the Federal National Mortgage Association, the Chief Executive Officer of the Federal Home Loan Mortgage Corporation, the chief executive officers of various HLTV lenders, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of James McDermott, Assistant Director, Financial Institutions and Markets Issues. Other major contributors include Becky Kennedy, Evaluator-in-Charge; Mitchell Rachlis, Senior Economist; and Edwin Lane, Evaluator. If you have any questions about this report, please call me on (202) 512-8678.

Sincerely yours,

Susan S. Westin

Susan S. Westin
Associate Director, Financial Institutions
and Markets Issues

Objectives, Scope, and Methodology

This report was prepared in response to a request from the Chairman, Senate Subcommittee on Financial Institutions and Regulatory Relief, Committee on Banking, Housing, and Urban Affairs. Our objectives were to provide information regarding (1) the characteristics of HLTV loans; (2) the major organizations that provided HLTV lending; (3) the volume of HLTV lending in 1995, 1996, and 1997, and the expected volume in 1998; and (4) the benefits and risks of HLTV lending for borrowers, lenders, investors, and regulated depository institutions.

To determine the characteristics of HLTV loans, we gathered background information on various aspects of individual loans by interviewing officials representing FirstPlus (the institution that provided about one-third of total HLTV lending from 1995 through 1997), industry associations, a rating agency, and investment banks, as well as by reviewing publicly available information, including published articles that reported such characteristics. To identify the average loan profile and the average borrower profile of HLTV loans, we obtained data on HLTV loans made by FirstPlus. We interviewed company officials and reviewed their literature as well as other published reports. Although we did not independently verify this—or any—industry data, we corroborated evidence with other independent sources whenever possible.

To identify the major organizations that provided HLTV lending, we interviewed numerous officials representing the private sector. We selected officials to talk to, in part, on the basis of industry recommendations of knowledgeable people. We also conducted a literature search and reviewed selected articles that reported on HLTV lenders and their activities. Moreover, we collected and reviewed numerous mail solicitations sent to GAO staff from many different lenders advertising HLTV loans. We compiled a list of the top 10 HLTV lenders by corroborating information we collected. The Executive Director of the Home Improvement Lenders Association (HILA) confirmed that we had identified the top 10 HLTV lenders.

We obtained the industry volume of HLTV lending in 1995, 1996, and 1997, as well as the expected volume in 1998, by interviewing various officials representing HLTV lending institutions, industry associations, and investment banks and by reviewing published information, such as company prospectuses and relevant articles obtained through our literature searches. We obtained volume amounts—for the same years—for individual HLTV lenders from the Executive Director of HILA. For our review, the Executive Director surveyed individual lenders that were members of HILA and provided us with the survey responses. In addition, we contacted officials representing another selected lender to obtain additional volume data. We did not independently verify this industry data.

To identify the benefits and risks of HLTV lending for borrowers, lenders, investors, and regulated depository institutions, we interviewed public sector officials representing federal banking and thrift regulatory agencies and the Federal Trade Commission, as well as private sector representatives from First Plus, industry associations, a rating agency, investment banks, and a consumer advocacy group. We also reviewed numerous published journal articles, academic and industry studies, and congressional testimonies that reported benefits and risks associated with HLTV lending and investing. In addition, we reviewed published literature to generally denote the securitization process as well as the common accounting treatment of profits. Finally, we interviewed public and private sector officials and reviewed selected federal and state regulations and laws to gain an understanding of lender protection laws relevant to HLTV lending.

We conducted our work between January and June 1998 in accordance with generally accepted government auditing standards. To ensure that its contents were factually accurate, we provided a draft of this report to officials at federal banking and thrift regulatory agencies, the Federal Trade Commission, Fannie Mae, and Freddie Mac. We also provided a draft of the relevant sections of this report to the officials representing FirstPlus for their review. In addition, to ensure that we accurately reported volume data, we contacted officials representing the other nine institutions that collectively served most of the HLTV market. We incorporated their technical comments where appropriate.

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