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Special Commentary

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Is HELOC EOD a Serious Issue?

Executive Summary

Over the past several years, many analysts and reporters have called attention to the ominous future the economy is facing as home equity lines of credit (HELOC) reach the end-of-draw (EOD) period and borrowers must start paying off the principal of their loans.[1] The concern is that individuals who took HELOC loans during or prior to the Great Recession will suffer a "payment shock," which could threaten the lending industry and affect these individuals' ability to consume. In this report, we look at the recent history of HELOCs and try to gauge how serious of a problem this could be for the overall U.S. economy, in particular for future growth of personal consumption expenditures (PCE).

Pre-emption and Pre-payment Trump HELOC EOD

Regulators have already helped financial institutions prepare for the wave of HELOCs reaching EOD.

One of the characteristics of recent commentary regarding HELOCs is that regulatory institutions have already moved forward with their recommendations to the industry on how to deal with the potential stress of this EOD period. This is perhaps the first sign that it may not be as serious an issue for the industry and/or for the U.S. economy as some have predicted. U.S. financial regulatory institutions, including the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency (OCC) released a document on July 1, 2014 called "Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods."[2] In this document, they described the steps financial institutions should follow to mitigate any potential problems stemming from this EOD period on their HELOC portfolios. Within the document, the regulatory institutions go as far as to give recommendations on how to help individuals that may confront issues as the EOD period approaches, including proactive measures to contact such individuals ahead of time to offer alternative solutions.

This suggests that financial institutions have been working on this issue for several years now and so far the problem, if it exists, seems to have been contained. It is also possible that PCE has already been affected by the expected "payment shock" because the largest effects of this potential shock have already occurred. In other words, if there was any payment shock affecting PCE we should have already seen it being reflected in economic activity.

In order to better understand the issue, we analyze data on HELOC balances by origination vintage as reported by TransUnion.[3] According to TransUnion, 2003 saw HELOC originations of $16 billion, while 2004 balances were an impressive $40 billion, an annual increase of 150 percent. It is estimated that the draw period on a traditional HELOC lasts about 10 years.[4] Thus, the first payment shock, or the start of the EOD period for holders of HELOCS, started in

[1] The "end-of-draw" period for HELOCs typically occurs after 5-10 years, depending on the loan. Leading up to the EOD, individuals can draw from the line of credit and only have to pay interest on those balances (known as the "borrowing period"). However, the EOD period ends this process and the individual needs to start paying the HELOC as if it were a "normal" loan, that is, interest plus principal payment (known as the "repayment period").
[2] The institutions also included the National Credit Union Administration and the Conference of State Bank Supervisors.
[3] Becker, E. "Understanding HELOCs: Facts vs. fear," (August 2014). TransUnion Insights.
[4] According to TransUnion, 96 percent of all HELOCs draw periods were less than 10 years.

2014. However, there is little evidence that such an increase in HELOC originations have had an impact on the industry or on PCE. Of course, the effect on PCE could be masked by the strong increase in employment during the past several years, so it is difficult to know if there was a payment shock that affected consumption.

Figure 1

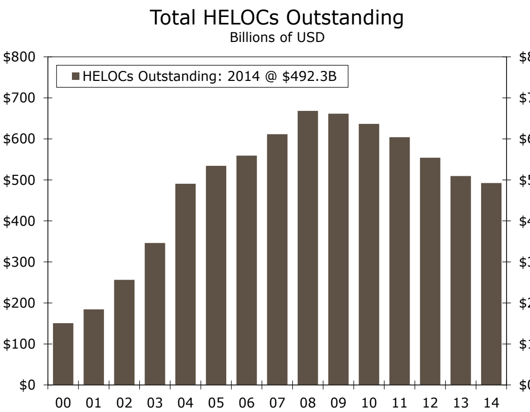
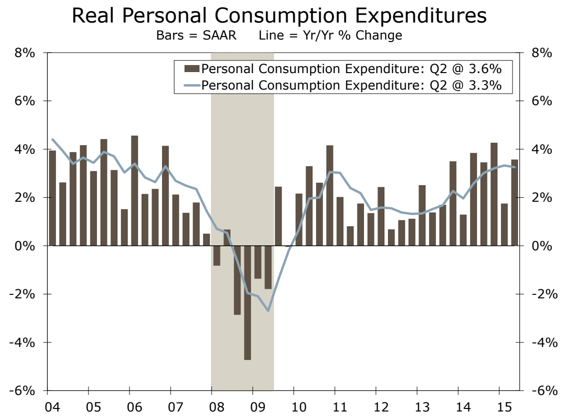


Figure 2



Source: Bloomberg LP, U.S. Department of Commerce and Wells Fargo Securities, LLC

In 2005, there were $65.7 billion in HELOC originations, an increase of 65.3 percent from the previous year, which makes 2015 an even higher-risk year for the industry and for consumers facing a potential payment shock. However, once again, the industry seems to have mitigated this impact and as 2015 is coming to a close there is also very little evidence that consumption has been negatively affected by this payment shock. Furthermore, the cumulative effects of the past two years of EOD periods for different vintages should have been evident if the issue was truly as significant as some have feared. For 2006, HELOC originations were an impressive $74.7 billion, which also means that 2016 should be another year with significant EOD periods.

We have not yet seen any measurable effect on PCE.

In 2007, there were $80 billion in HELOC originations, which increases 2017 risks for both the financial industry as well as consumers. However, if what has happened in 2014 and 2015 is any guide, we do not believe that we will see any measurable impact on PCE. However, it is true that risks will likely be higher in 2016 and 2017 due not only to the larger number of HELOCs reaching EOD, but also because HELOC loans are given based on the price of a home and home prices peaked in 2006.

Figure 3

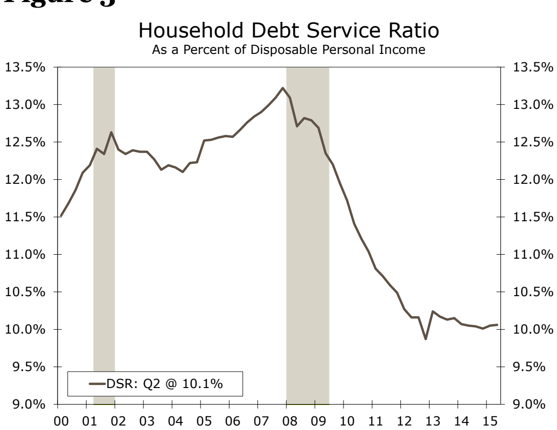
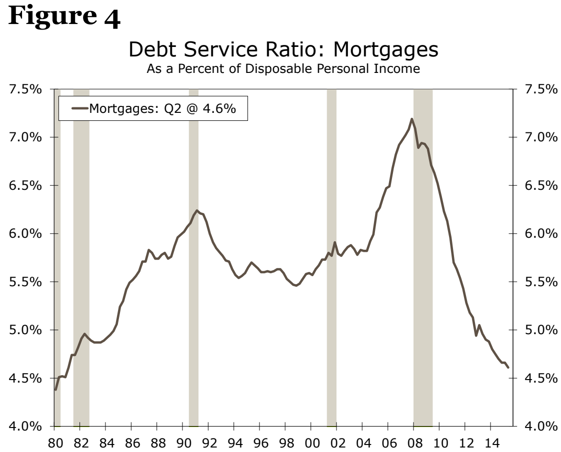


Figure 4



Source: Federal Reserve Board and Wells Fargo Securities, LLC

According to an estimate by TransUnion, the estimated payment shock is not insignificant. They estimate that, for a HELOC with a balance of $80,000 at an annual percentage rate (APR) of

7.0 percent, the interest payment before the EOD period would be $467 per month (interest only). However, after the EOD period, a consumer with a 15-year repayment period would now have a monthly payment of $719 (principal plus interest)—a payment shock of $252 per month.

No Payment Shock on the Radar

Although TransUnion's estimate of a potential payment shock is not trivial, there has been no indication that any payment shock has occurred during 2014 and 2015, the first two years when the bulk of HELOCs originated in 2004 and 2005 should start to reach the EOD period. Just looking at PCE, it is almost impossible to see if there has been a payment shock affecting the U.S. consumer over the past two years.

Debt service ratios have shown no evidence of significant effects from EODs.

Another place where we could look to see if a payment shock has been affecting households is the household debt service ratio and the debt service ratio for mortgages, which includes HELOC payments. However, as Figures 5 and 6 shows there are no signs that higher HELOC payments, or a payment shock, have affected these ratios. In fact, the mortgage debt service ratio has actually continued to decline unabated during the past several years.

The reason for this could be simple, according to reports. According to Moody's Analytics, "…prepayment rates also spike dramatically around the time that HELOCs come to the end of their draw periods…clearly some borrowers have the means to pay off their HELOCs but are rationally taking advantage of the cheap, tax-deductible financing that a HELOC may provide during its draw period. For post-2005 vintages, we expect a similar pattern of payoff to continue with the potential for payoff rates to reach as high as 80% of the number of outstanding accounts and 70% of the outstanding balances."[5] This probably explains why we have not seen any measurable reaction to the "payment shock" many were expecting due to the HELOC EOD period and we are probably not going to see any significant reaction in the future either.

Figure 5

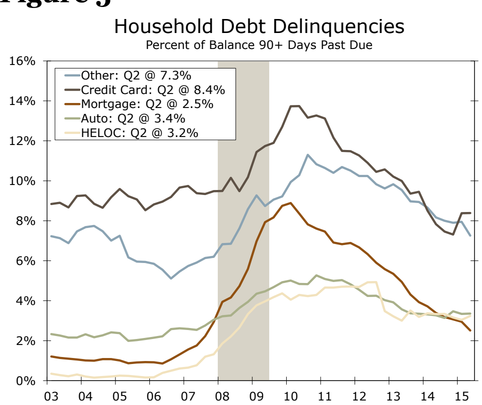
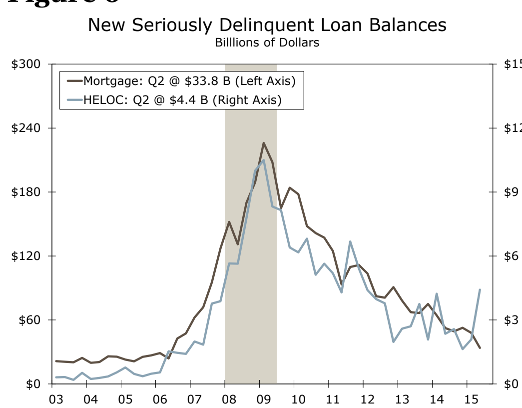


Figure 6



Source: Federal Reserve Bank of New York and Wells Fargo Securities, LLC

Furthermore, according to TransUnion, the financial industry is concerned that individuals would choose to default on their HELOC payments if confronted to a payment shock generated by the EOD. However, looking at Figure 5 and according to the Federal Reserve Bank of New York what we have seen is actually a decrease in the percent of balances 90+ days delinquent for HELOCs rather than an increase. The share of HELOC balances 90+ days delinquent increased to 4.9 percent in Q3 2012 but has since dropped to about 3.2 percent and has remained close to that rate during the past several years. Although Figure 6 shows an increase in the level of those balances for HELOCs, to $4.4 billion in Q2 2015 from a low of $2.1 billion in Q1 2015, the new seriously delinquent balances for mortgages have continued to decline.

[5] Tudor, D. and Deritis, C. "Unlocking the HELOC Threat," (June 2015). Economic & Consumer Credit Analytics, Moody's Analytics. Regional Financial Review.

A significant number of HELOCs will reach EOD next year, but we do not envision any major issues.

Perhaps the strategy put forward by the regulatory institutions has helped minimize the impact of the expected payment shock, or perhaps still historically-low interest rates have allowed consumers to refinance and combine first mortgages with HELOC or second mortgages into one payment with a consolidated payment that is no higher than the previous payment. Or perhaps home price appreciation and strong employment growth have also helped consumers in the process of refinancing their mortgages. Most likely, a combination of all these effects has probably minimized the potential effects of EOD over the financial industry as well as over households and PCE.

Nevertheless, 2016 and 2017 will probably be test years for EOD HELOCs as 2006 and 2007 saw some of the strongest HELOCs originations. However, if what has happened in the 2014-2015 period is any indication of what is coming in 2016 and 2017, we do not envision any major disruption from the start of the EOD period for the HELOCs vintages of 2006 and 2007.

Conclusion

Although on paper there was a potential for HELOCs to become an issue for both the financial industry as well as for the U.S. economy, we have seen no measurable effect of any potential disruption due to the EOD from the large HELOC origination binge just before the Great Recession. The industry, as well as the industry's regulators, has moved to pre-empt some of its potential negative effects, and the characteristics of HELOCs are such that many individuals with HELOCs pre-pay as the EOD period comes near or choose to refinance. It is true that EOD periods corresponding to the two largest years for HELOC originations are still ahead of us, but if the past two years are any indication, then the next two years will not produce any measurable effects of this EOD either on the financial industry or on the U.S. economy, particularly on PCE.

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