CoreLogic®

WHITE PAPER ▸ February 2016

Home Equity Lending Landscape

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Introduction

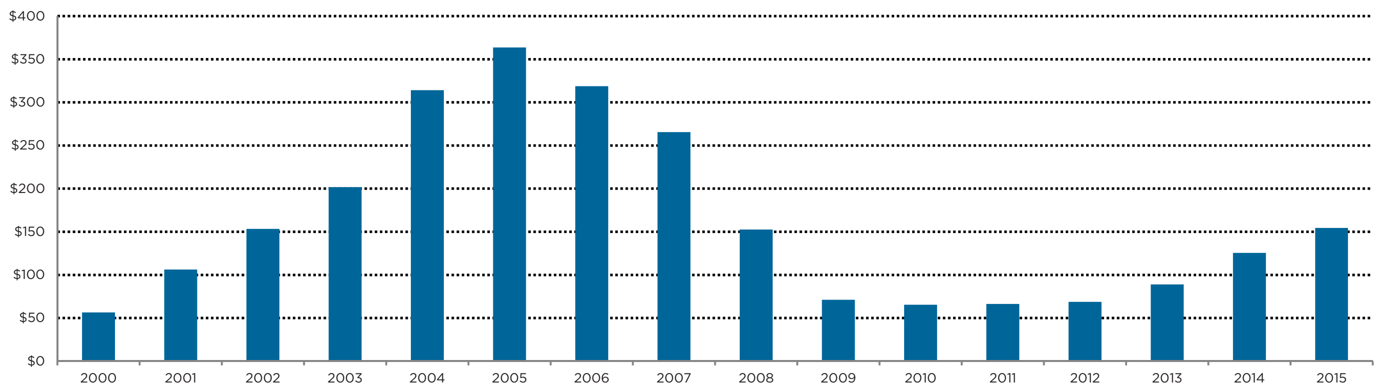
After years of being out of favor, home equity lending is making a comeback.

For the past two years, origination volumes have been trending sharply higher as more homeowners benefit from home price appreciation and more lenders regain confidence in the category.

During the first three quarters of 2015, lenders originated nearly 976,000 new home equity lines of credit (HELOCs) with combined limits in excess of $115.8 billion. Both of these figures were the highest for the January-through-September period since 2008 and represented year-over-year gains of 21 percent and 31 percent, respectively.

APPROVED HELOCS

Billions



Source: CoreLogic

Despite the pick-up, the HELOC market is still below its peak in 2005, when originations totaled nearly $364 billion. But there are clear signs that a continually improving real estate market, a strengthening economy and better loan performance are converging to increase the lending community's comfort level with home equity products.

The lines of credit being originated today are being underwritten more conservatively than in the "good old days" of 100 percent combined loan-to-values (CLTVs), and streamlined "coffee-cup" loan decisions.

All of which suggests that the industry has learned its lesson from the mortgage crisis, and is adapting to the new more regulatory-focused environment.

What hasn't changed, however, are the challenges of finding profitable customers, and originating no-cost products in a manner that improves, rather than impedes, relationship building.

This paper will examine:

- **The forces driving renewed demand for home equity lending.**
- **The quality and performance on recent vs. legacy home equity loans.**
- **What home equity lending looks like circa 2015.**
- **Home equity risk scenarios that haven't played out—yet.**
- **New approaches to target profitable customers, reduce risk and create market differentiation.**

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Equity Distribution

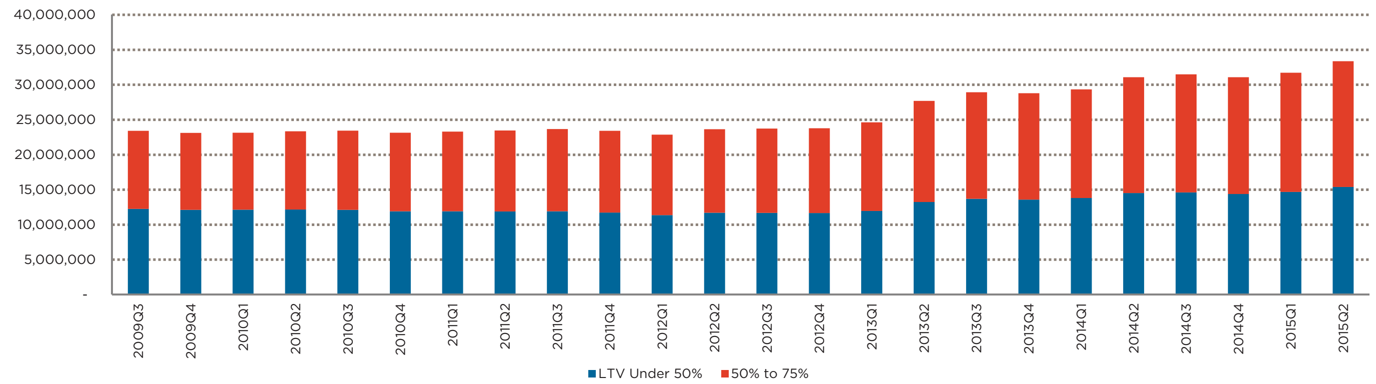
The two macro-economic drivers behind home equity demand are house price appreciation and job growth, which boosts consumer confidence.

Strong home price appreciation in most markets has significantly reduced negative equity at the bottom of the market and created more than $6 trillion of equity since the trough of Q1 2009, according to the Federal Reserve. To put it another way, as of the end of Q3 2015, there were more than 15.6 million borrowers with LTVs below 50 percent, and another 18.3 million with LTVs between 50 percent and 75 percent.

In addition, there are approximately 30 million homeowners who own their homes free and clear, and who are potential candidates for HELOCs and cash-out refinances.

EQUITY GROWTH

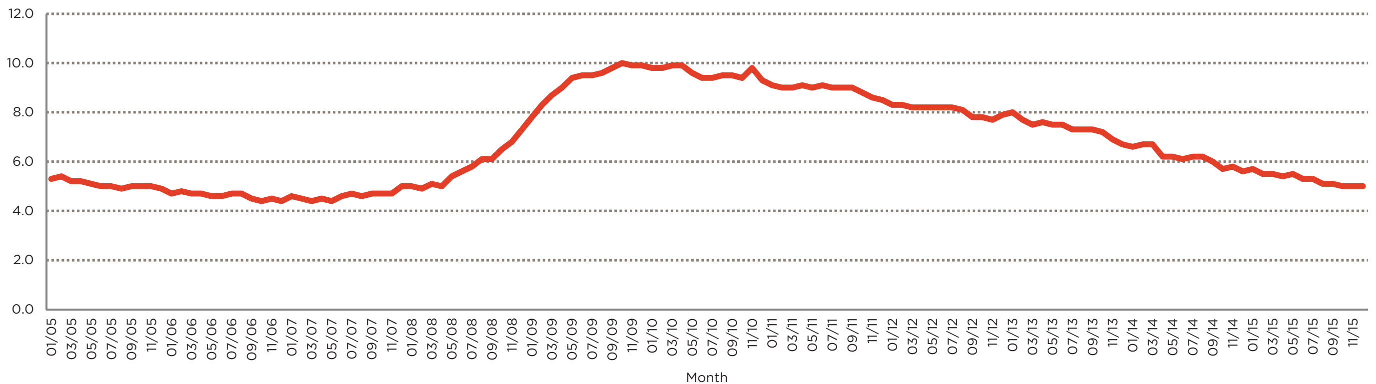
Number of Homeowners



Source: CoreLogic

Home price appreciation is only part of the picture; the other part is job growth and, with it, greater consumer confidence. Over the past six years, more than 13.5 million new jobs have been added, reducing the unemployment rate from its high of 10 percent in 2009 to 5 percent at the end of 2015.

UNEMPLOYMENT RATE



Source: Bureau of Labor Statistics

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Behavioral Changes

In the recent past, homeowners looking to tap the equity in their homes might have additionally considered a cash-out refinance. Over the past three years, however, the vast majority of the most creditworthy borrowers have already been able to refinance into generationally low first mortgage rates.

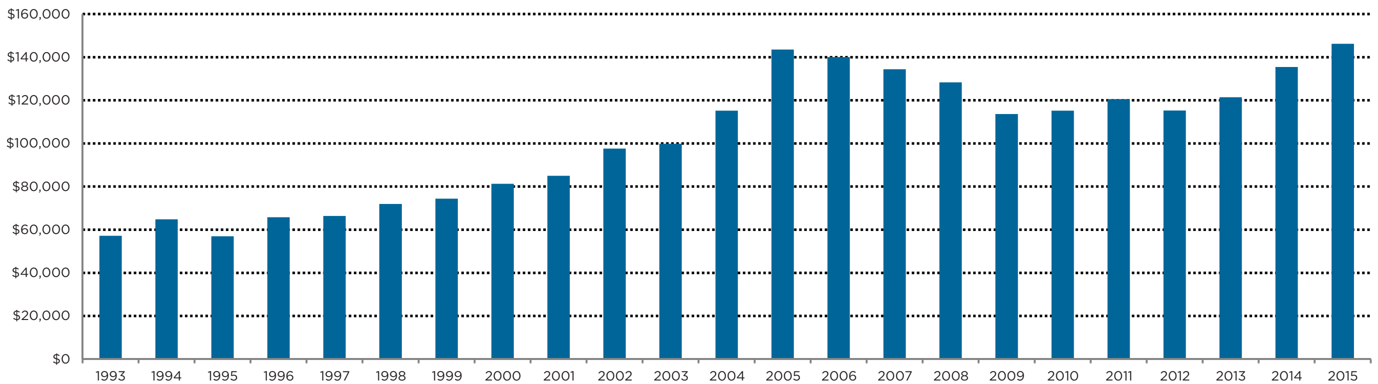
As of October 2015, nearly three quarters of all homeowners with a mortgage have first mortgage rates below 5.0 percent, and the average interest rate on outstanding mortgage debt is now 3.8 percent. Some observers believe that these low rates may change homeowner behavior going forward. How, for example, will these owners finance major expenses: college tuition, a new car or large medical bills? What about debt consolidation? Will they be willing to give up their low first mortgages and refinance into higher rates or will they instead tap equity via HELs and HELOCs?

Similarly, when they need more space or want better amenities will they be as quick to sell and move up to a larger home (and a larger first mortgage at a higher rate) as they have been in the past? Or will they consider remodeling instead, and use home equity products to finance it?

The recent resurgence in home remodeling suggests that behavior is changing. The National Association of Home Builders recently reported that its Remodeling Market Index (RMI) posted its 10th consecutive quarter in which the index stayed above the key breakeven mark of 50: the point at which remodelers feel confident about the market.

REMODELING

Dollars in Millions



Source: U.S. Census Bureau

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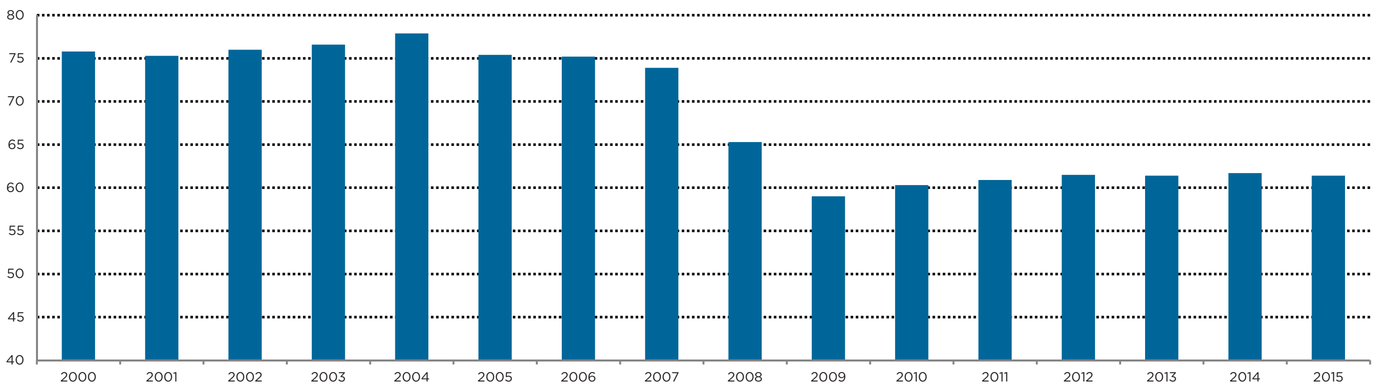
Not the HELOCs of Yesteryear

Pre-crisis, HELOCs were popular cross-sell and add-on products: soon after a client would get a first mortgage, their lender would almost automatically follow up with a HELOC. It wasn't uncommon to see CLTVs of 100 percent, and pricing at below prime. Similarly, borrowers with small down payments were often presented with piggyback first and seconds as a way of avoiding mortgage insurance.

Once the crisis hit, borrowers in negative equity positions saw their lines "blocked" by lenders. The presence of home equity seconds also slowed modification and short sale efforts, in many instances. Eventually many of the homes backing these liens went into foreclosure.

Today, however, most lenders are more conservative in their underwriting. A new analysis of HELOCs originated in 2015 shows the average CLTV was about 61 percent.

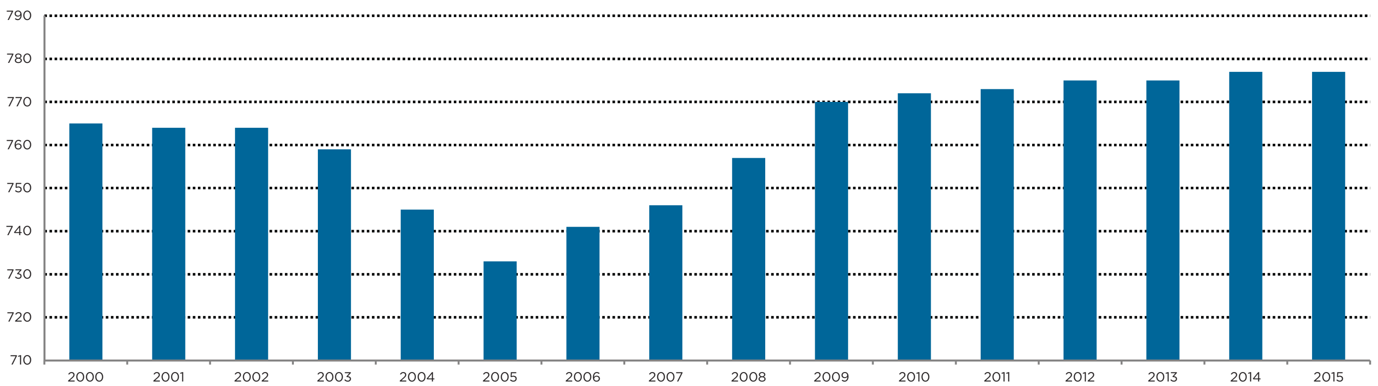
AVERAGE CLTV OF ORIGINATIONS



Source: CoreLogic

The average credit score at origination in 2015 was a relatively pristine 774, more than 30 points higher than the average credit score for loans originated a decade ago.

AVERAGE FICO SCORE



Source: CoreLogic

Debt-to-income ratios (DTIs) continue to be in the 35 percent range, roughly where they have been since 2009. Interestingly, closed-end home equity loans fall under the Qualified Mortgage (QM) / Ability-to-Repay (ATR) standard with its 43 percent ceiling, while HELOCs do not.

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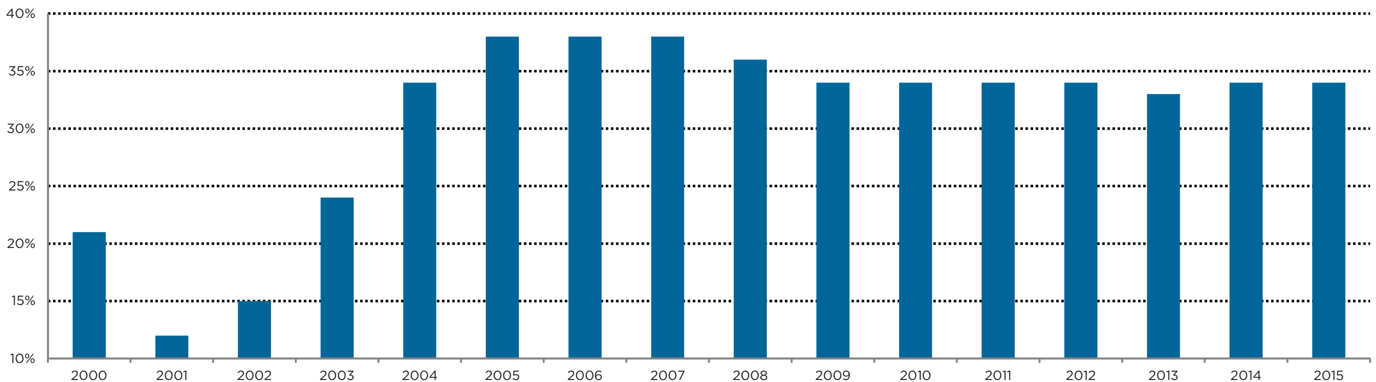
AVERAGE DTI

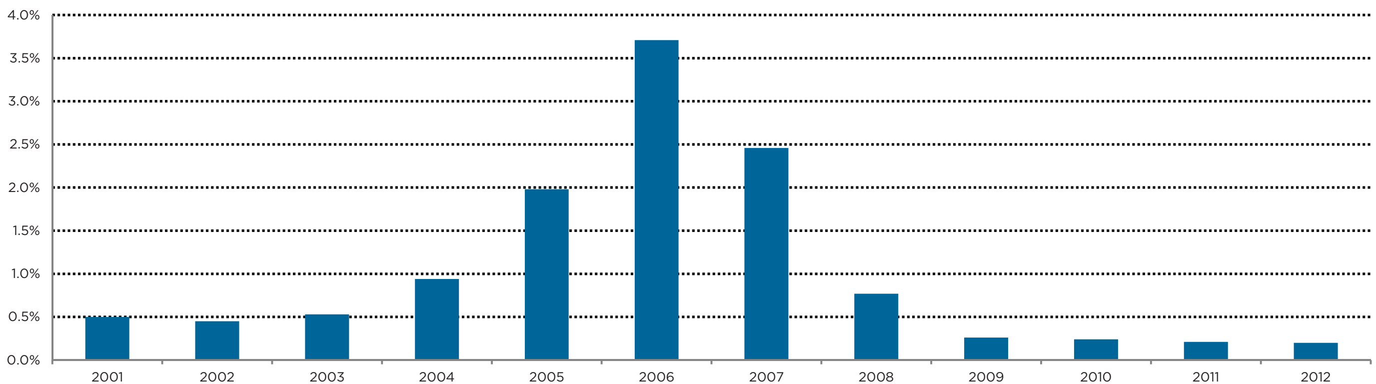


Source: CoreLogic

Not surprisingly, the performance of recently originated home equity is exceptionally good. Since 2009, the typical 60+ day delinquency rate at 36 months after origination was apparently 25 basis points, about half of the rate in the very early 2000s.

HELOC 60 DAY DELINQUENCY

Vintage Performance 36 Months After Originations



Source: CoreLogic

The average size of a HELOC (i.e. the line's limit at origination) during the first three quarters of 2015 was $118,694, up from $108,960 during the same period in 2014. During the 2004-2007 period, HELOCs averaged $103,016.

In 2015, the monthly HELOC utilization rate (combined outstanding HELOC balances divided by the sum of their limits) averaged about 65 percent, compared with 71 percent during the 2008-2011 period. Over the past 15 years, the utilization rate was highest in 2010, when the monthly rate averaged about 72 percent.[1]

As has been the case in the past, revolving HELOCs continue to outnumber closed-end loans (HELs) by approximately 4 to 1.

[1] The analysis excludes HELOCs without an outstanding balance.

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Evaluating the Collateral

Although industry-wide the average CLTV for home equity products overall never quite broke the 80 percent barrier, even in the heyday of home equity lending, a significant number of legacy loans, particularly those originated as simultaneous seconds, had very high CLTVs.

For the past eight years, the 80 percent CLTV mark has become a hard ceiling for home equity lenders and a barrier that most have been reluctant to cross.

Historically, automated valuation models (AVMs) had been the valuation tool of choice for the property and equity backing home equity products. The relatively low cost of AVMs and their speed of response aligned well with the no-cost, no-hassle approach that was prevalent during the housing boom.

The performance of legacy HELs and HELOCs prompted many institutions and their regulators to re-think how the collateral was evaluated. Some banks initially took the stance that they would go to full appraisals.

In 2010, new federal guidelines required regulated institutions to perform an onsite inspection and photograph the property, if they are using AVMs for lending purposes. These, in turn, led to new AVM products that include additional information and are now widely used within the industry.

It is fairly common today to see lenders using an escalating scale of valuation tools—from enhanced AVMs to hybrids to full appraisals—depending on the perceived risk involved in the loan.

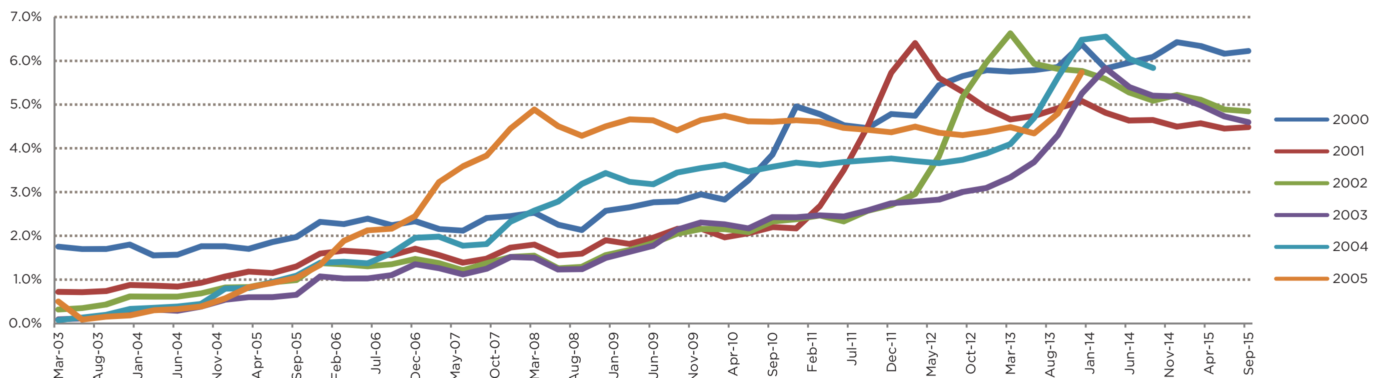
Legacy Lines Not That Big a Problem—After All

Between 2004 and 2007, more than 12.2 million HELOCs were originated, often using relatively loose underwriting criteria. While a significant portion of the riskiest loans went into default and were wiped out by foreclosure, millions are still active today.

Of the 4.1 million homes that were underwater as of Q3 2015, for example, 39 percent, or 1.6 million properties, had both first and second liens. The average mortgage balance in this group was $307,000 and the average underwater amount was $83,000 (versus $58,000 for underwater borrowers with just first liens.)

In addition to negative equity, the other risk associated with legacy HELOCs is potential for payment shock when older legacy lines hit their 10-year mark and convert from interest-only to fully amortizing payments.

PERCENTAGE OF TOTAL OUTSTANDING BALANCE IN DELINQUENCY



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Some observers have warned that the large number of HELOCs originated in 2004 through 2007 could create another round of losses, particularly for large commercial banks over the next few years.

While there has been some increase in late payments and delinquencies tied to conversions, so far the problem appears to be manageable. The average monthly delinquency rate (30+ days overdue) for HELOCs was 2.0 percent in 2015 through November—the lowest level in eight years.

A number of lenders have proactively offered HELOC “refinance” programs that allow borrowers to extend their interest only periods, and simply pay the current HELOC interest rate.

Also, many of the older lines have been extinguished by first mortgage refinances that incorporated the outstanding home equity debt.

As a result, the number of active legacy HELOCS has significantly declined. Having said that, the smaller cohort of active legacy HELOCs that haven’t been refinanced because of equity, credit or income issues will be very susceptible to default in the event of payment shock.

The Challenge of Profitability

Unlike first liens, home equity is typically marketed to the consumer as a no-cost product. As a result, pricing and the cost of origination—valuation, credit, lien and title search and filings—take on increased importance.

For lenders, pricing can be a double-edged sword. They need to price for the risk that they are taking yet not price themselves out of the market and lose not only a loan, but also potentially a customer. In addition, higher pricing alone won’t protect against adverse selection.

As we have seen in the discussion of valuation choices, there is a need to continually balance the cost of products and services used to underwrite the loans with the perceived risks.

Similarly, lenders need to target profitable customers who will access these lines early.

Small balance borrowers—less than $50,000—and consumers who take lines just in case, but don’t use them, tend to be unprofitable. Typically, lenders are targeting prospects that have enough equity to justify a reasonably sized line of credit and the potential to draw against that line quickly, creating interest income for the lender.

Companies, like CoreLogic, have created propensity models that help lenders identify the best prospects for home equity and purchase offers within their portfolio or their market footprints. For example, our propensity model can identify prospects that have equity and are most likely (i.e. highest scoring 10% of prospects are two times as likely) to be in the market for a home equity product in the next 6 months. If the borrowers are current customers, then CoreLogic can also append credit information. With this information, these institutions are often able to add an income estimate and have enough confidence to make a pre-approved offer while making the most of marketing dollars and optimizing return on investment.

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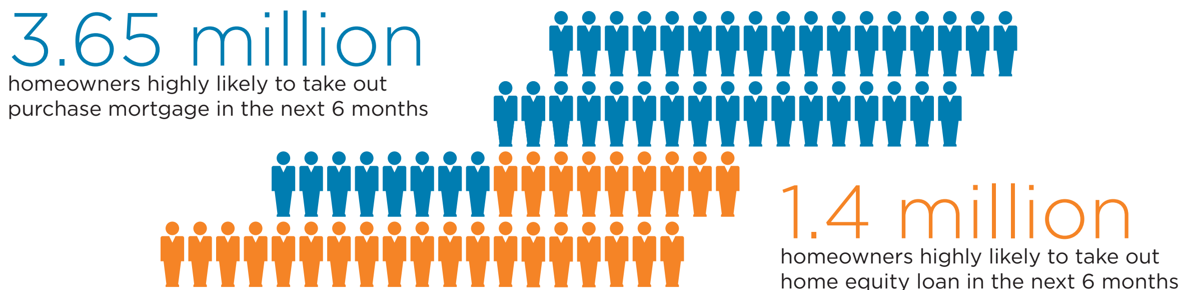
Another approach, often used to prospect for new customers, is an Invitation to Apply (ITA). An ITA allows a lender to use publicly available data outside of a credit bureau. ITAs are designed to make consumers aware of available home equity programs, and how they can be used, but stop short of pre-approved offers. If the consumer responds, the lender can then pull credit determine home value and available equity, then use the home equity propensity model to confidently select the top scoring homeowners who are most likely to take out a home equity loan in the next 6 months.

IDENTIFY PROSPECTS FOR HOME EQUITY AND PURCHASE OFFERS USING A CORELOGIC PROPENSITY MODEL



Finding a Competitive Edge

At the end of the day, there are a number of ways that lenders can differentiate themselves in the home equity market. These include:

- Competitive pricing, including interest rate discounts for customer loyalty and multiple product usage.
- Product innovation: shorter and customizable terms and draw periods, for example.
- Flexible underwriting, such as higher CLTVs and streamlined documentation programs (remember ATR doesn't apply to HELOCs).
- Aggressive life-cycle marketing to create awareness and highlight product features and advantages. Tactically, this can take a number of forms: measured media; digital and mobile marketing; in-branch / ATM; statement-insert promotions; keyword search and social media opportunities.
- Cross-selling a lender's current first lien portfolio to determine lendable equity for use in an ITA campaign.
- Identification of a lender's high balance savings/investments customers to identify their lendable equity in real estate holdings through property data analysis.
- Leverage property data and analytics; develop advanced targeting to identify non-customers they want to build relationships with.
- Speed. While the days of "coffee cup" decisions are gone—at least for the foreseeable future—fast decisions and ease of applying online vs. in branch can be important differentiators. Although the average turn time on a HELOC decision is probably still about 30 days, a number of lenders are working to reduce this significantly. Their goal: give good customers decisions as fast as one day.

Lenders that are rethinking their approach to home equity might want to familiarize themselves with the enhanced underwriting, valuation and portfolio and market analysis tools that are now available.

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New Rules

One final thought as banks get back into the home equity market, there are new rules and regulations regarding home equity products, depending on whether they're a HELOC or a closed-end second. Under the QM rule, closed-end seconds need to pass the ATR test; however, this is not the case with HELOCS. As of October 3, 2015, the "Know Before You Owe" / TRID rule now applies to closed-end seconds, but not to HELOCs.

Home Equity Resources

CoreLogic has a broad array of data, analytics and product offerings for home equity lending, including:

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CoreLogic (NYSE: CLGX) is a leading global property information, analytics and data-enabled services provider. The company's combined data from public, contributory and proprietary sources includes over 4.5 billion records spanning more than 50 years, providing detailed coverage of property, mortgages and other encumbrances, consumer credit, tenancy, location, hazard risk and related performance information. The markets CoreLogic serves include real estate and mortgage finance, insurance, capital markets, and the public sector. CoreLogic delivers value to clients through unique data, analytics, workflow technology, advisory and managed services. Clients rely on CoreLogic to help identify and manage growth opportunities, improve performance and mitigate risk. Headquartered in Irvine, Calif., CoreLogic operates in North America, Western Europe and Asia Pacific. For more information, please visit corelogic.com.

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