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OCC Anticipates Nearly Half of Outstanding HELOCs Will Reach End-of-Draw Period by 2017

Heather L. Hansche and Lindsay S. Henry*

The Office of the Comptroller of the Currency predicts that there are $131 billion in home equity line of credit ("HELOC") balances outstanding that are scheduled to transition from draw period to full repayment between 2015 and 2017. The authors of this article discuss considerations for banks holding a significant portion of HELOCs about to reach their end-of-draw period, options to avoid unnecessary defaults, and regulatory compliance issues.

A year ago, the federal banking agencies and the Conference of State Bank Supervisors issued the Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods ("Guidance"). The Guidance identifies the components of an effective program to work with borrowers reaching their HELOC end-of-draw periods to manage risk and avoid unnecessary defaults. The Office of the Comptroller of the Currency ("OCC") raised this issue again in its Spring 2015 Semiannual Risk Perspective, identifying end-of-draw period exposure as one of the largest risks facing national banks. The OCC predicts that there are $131 billion in HELOC balances outstanding that are scheduled to transition from draw period to full repayment between 2015 and 2017. If a significant portion of your bank's HELOC portfolio will reach the end-of-draw period soon, you should review the considerations outlined below and implement a management program including policies and procedures to address these exposures.

END-OF-DRAW PERIOD CONSIDERATIONS

Identifying the characteristics of your bank's HELOC portfolio will help determine the steps needed to effectively manage your program. Most HELOCs require interest-only payments during the draw period, then during the repayment period borrowers can no longer draw against the line of credit and the outstanding principal is either due immediately in a balloon payment

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or is repaid over the remaining term through monthly principal and interest payments, resulting in payment shock.

If a bank has HELOCs in its portfolio with balloon payments, the bank should identify those borrowers who may not be able to repay the balloon. If the value of their home has not increased, these borrowers will likely be unable to refinance their HELOCs with another lender. The OCC estimates that of the $131 billion in HELOC balances that are reaching their end-of-draw periods in the next three years, almost $16 billion have combined loan-to-value ratios above 90 percent. Making refinancing even more difficult for these borrowers is the fact that HELOC delinquencies typically increase during the last year prior to the end-of-draw period.

HELOCs that transition to a repayment phase instead of requiring a balloon payment when the draw period ends may have the same impact on borrowers' ability to repay or refinance. These borrowers will experience payment shock due to the increased amount of monthly payments during the repayment phase, which may be combined with a change in interest rate. Recent delinquencies or their combined loan-to-value ratio may also inhibit borrowers' ability to refinance with another lender.

The Guidance instructs banks to establish programs to proactively manage end-of-draw period exposure by identifying high-risk borrowers. Banks should conduct an inventory of their end-of-draw period contract provisions and review borrowers' line of credit utilization rates, delinquencies, the status of first liens on the secured property and the repayment behavior of borrowers, including whether they make more than the minimum required payment during the draw period.

PROGRAM OPTIONS: REFINANCE, WORKOUT, AND MODIFICATION PROGRAMS

To avoid unnecessary default, the banking regulators encourage banks to establish refinance, workout and modification programs for high-risk HELOC borrowers nearing their end-of-draw periods. Banks must ensure that all applicable regulatory requirements are followed in implementing these programs. Requirements to be considered include disclosures under the Truth-in-Lending Act ("TILA") and Real Estate Settlement Procedures Act ("RESPA"), mortgage servicing rules, right of rescission, higher-priced mortgage loan requirements ("HPML"), and ability to repay requirements ("ATR").

The program options available to a bank and the applicable regulatory requirements will vary based on whether HELOCs have matured or not and whether they are delinquent or not. Generally, there are more options available

and fewer requirements and restrictions if HELOC terms are changed before maturity. Regulatory requirements vary depending on whether the new terms are effected through a refinancing or a modification of the HELOC.

A "refinancing" is defined under Regulation Z and Regulation X as occurring when an existing credit obligation is satisfied and replaced with a new obligation undertaken by the same consumer. Neither Regulation Z nor Regulation X include a definition of the term "modification," yet both regulations use this term in describing a creditor's obligations. Without clearer guidance, the best approach to decide whether a transaction is a refinancing or a modification is to determine whether the existing obligation is replaced with a new obligation and thus is a refinancing, or whether the action is a modification that changes the terms of, but does not replace, an existing obligation.

Prior to HELOC maturity, a bank can control whether a transaction is a refinancing or a modification by the manner in which it is documented. After maturity, modifications are not an option because the underlying credit obligation has already matured and so cannot be modified. A matured HELOC can be replaced with a new credit obligation in a refinancing transaction, or a bank can engage in loss mitigation activities such as workouts or debt repayment plans. Loss mitigation activities are generally outside the scope of both TILA and RESPA except with respect to the CFPB's new mortgage servicing rules, which impose notice and timing requirements related to servicing activities including loss mitigation.

REGULATORY COMPLIANCE ISSUES

Following are some basic regulatory compliance issues to take into consideration in developing your bank's HELOC end-of-draw period management program.

As a general matter, TILA permits certain changes to HELOC terms at or prior to maturity upon the written agreement of the borrower. These changes are subject to the change-in-terms requirements and limitations under Regulation Z. For example, converting a HELOC with a balloon payment from open-end to closed-end credit prior to maturity is permissible but the bank must provide applicable closed-end credit disclosures. In addition, a bank can make certain changes without borrower approval if the change unequivocally benefits the consumer. To establish that a change in HELOC terms is a modification and not a refinancing, it should be documented with a modification agreement rather than a new note. The ATR and HPML requirements do not apply to modifications.

If the change in terms is effected through a refinancing as defined under

TILA, it will be documented with a new note and all new disclosures are required. The change-in-terms limitations and requirements under Regulation Z do not apply to refinances, which gives banks greater flexibility in implementing their program terms. However, disclosure requirements, mortgage or lien priority issues and ATR and HPML issues must be considered if a HELOC is refinanced.

RECOMMENDATIONS

The banking regulators advise banks to adopt an end of draw period management program commensurate with the size and risk characteristics of their HELOC portfolio. This requires a bank to first identify the characteristics of its HELOC portfolio, including the financial condition and ability to pay of its borrowers. Refinance, modification, and loss mitigation options that are consistent with prudent underwriting standards should be implemented and must comply with regulatory requirements, including applicable consumer protection laws.