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Managing HELOCs

A Home Equity Line of Credit (*"HELOC"*) is a dwelling-secured line of credit that generally provides a draw period with interest-only payments followed by a repayment period. The repayment period may include a balloon payment with the balance due immediately, or repayment may be made through higher monthly payments over the remaining loan term. This article discusses a financial institution's obligation to manage risks of its HELOC portfolio, focusing on the applicable regulatory requirements and restrictions on the ability to freeze or reduce HELOCs during the draw period.

Agency Guidance

In 2005, the federal financial institution regulatory agencies published the Home Equity Lending: Credit Risk Management Guidance (the *"Guidance"*). In the Guidance, the agencies recommend that financial institutions apply risk management techniques to identify higher-risk accounts and adverse changes in individual accounts, "enabling management to implement timely preventive action (*e.g.,* freezing or reducing lines)." Although issued over a decade ago, the Guidance remains applicable and financial institutions with HELOC programs must consider it when implementing loss mitigation programs for their HELOC portfolios.

The Guidance provides the following list of risk management activities financial institutions should perform with respect to their HELOC portfolios:

- Periodically refreshing credit risk scores on all borrowers;
- Using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
- Periodically assessing utilization rates;
- Periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who draw upon their HELOC to make the monthly payments;
- Monitoring home values by geographic area; and
- Obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be based on the level of risk in the portfolio.

Financial institutions should have established policies and procedures for loss mitigation and problem loan workouts and are advised, where appropriate and as permitted under the Truth in Lending Act (*"TILA"*) and Regulation Z, to take steps to mitigate credit risks, including refusing to extend more credit or reducing the borrower's credit limit.

In addition to these principles that apply to HELOC risk management generally, in 2014 the federal financial institution regulatory agencies and the Conference of State Bank Supervisors adopted the Interagency Guidance on Home Equity Lines of Credit Nearing Their End-of-Draw Periods (the *"2014 Guidance"*), providing further guidance on managing HELOCs as their draw periods end. The 2014 Guidance instructs financial institutions to proactively manage end-of-draw period exposure by identifying high-risk borrowers. Specifically, financial institutions are advised to 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. The 2014 Guidance encourages financial institutions to avoid unnecessary defaults by establishing refinance, workout, and modification programs for high-risk HELOC borrowers nearing their end-of-draw periods.

TILA and Regulation Z Limitations

The requirements for HELOCs are contained in Section 1026.40 of Regulation Z. Regulation Z limits a creditor's ability to suspend or reduce a HELOC credit limit. A creditor may only prohibit additional extensions of credit or reduce the credit limit applicable to a HELOC during a period in which one of the following conditions exists:

- The value of the dwelling declines significantly below the dwelling's appraised value for purposes of the HELOC;
- The creditor reasonably believes that the borrower will be unable to fulfill the repayment obligations under the HELOC because of a material change in the borrower's financial circumstances; or
- The borrower is in default of any material obligation under the agreement.[1]

Regulation Z prohibits creditors from imposing a fee to reinstate the HELOC when the condition no longer exists. Further, the creditor may not reduce the credit limit below the amount of the outstanding balance if this would require the borrower to make a higher payment. In addition to the limitations in Regulation Z, the terms of the HELOC agreement will control and must provide for a right to reduce the credit limit or suspend the HELOC if these conditions exist.

Property Valuation

A creditor can suspend a HELOC or reduce the credit limit "during any period in which the value of the dwelling that secures the plan declines significantly below the dwelling's appraised value for purposes of the plan."[2] This applies even if the borrower is current on his or her payments. What qualifies as a "significant decline" in value will vary according to the circumstances. The Regulation Z commentary includes as an example of a "significant decline" a 50 percent decline in the appraised value, which serves as a safe harbor for creditors.[3] The safe harbor requires the creditor to compare the amount of equity the borrower had in the house when the credit line was established against the current available equity, rather than being based on changes in the property value alone.

The safe harbor does not require the creditor to obtain an appraisal to determine the property's value.[4] Instead of an appraisal, some creditors will use an alternate valuation model (*"AVM"*) to determine the property value. Creditors that want to use AVMs should familiarize themselves with the applicable regulatory guidance such as the Guidance, which discusses collateral valuation management, and the Interagency Appraisal and Evaluation Guidelines issued in 2010.[5] There has been class action litigation challenging the accuracy of AVMs when used as the basis to suspend or reduce credit limits.[6] If an AVM is used, it must be reasonable and must be periodically tested for accuracy.

Material Change in Financial Circumstances

Regulation Z permits a creditor to suspend or reduce a borrower's credit limit during any period when there is a deterioration in the borrower's financial circumstances.[7] This right to suspend the credit limit under such condition applies even if the borrower is current on his or her payments. Two conditions must be met in order to reduce the credit limit or suspend a HELOC credit line on this basis: (1) there must be a "material" deterioration or change in the borrower's financial circumstances, and (2) as a result of this deterioration or change, the creditor must have a reasonable belief that the borrower will be unable to fulfill his or her repayment obligations.[8] The Regulation Z commentary includes filing bankruptcy or being placed into bankruptcy as a safe harbor permitting suspension or reduction of the credit limit on this basis.[9]

A significant decrease in the borrower's income is the only example given in the commentary of a factor that satisfies the first requirement, that there must be a material change in the borrower's financial circumstances.[10] A decrease in FICO scores, an increase in debt, and an increase in debt-to-income ratio have also been cited by creditors as material changes in the borrower's financial circumstances.

Note, however, a change in any of these factors only satisfies the first part of the two-part test. The creditor must also establish that as a result of this change, the creditor has a reasonable belief that the borrower will be unable to fulfill the repayment terms. This requires the creditor to assess a borrower's future repayment behavior and so is inherently difficult to prove, particularly if the borrower continues to make regular payments while the material change exists. Factors such as a creditor's historic information about change in circumstances related to other borrowers' repayment defaults, how recent the adverse condition is, or how significant the change is are considerations that may be helpful to establish a sound basis for a determination that the creditor has a reasonable belief that the borrower will not continue to repay the HELOC. A failure to pay other debts is the only example given in the commentary of a factor that satisfies the requirement that the creditor has a "reasonable belief" that the borrower will be unable to fulfill the payment obligations under the HELOC agreement.[11]

Default of a Material Obligation

A creditor can reduce the credit limit or suspend a HELOC credit line if the borrower is in default of any material obligation in the HELOC agreement. The creditor must specify the events that are material obligations in the HELOC agreement and is bound by the terms of the HELOC agreement that provide the right to terminate. For example, failure to meet repayment terms is a typical HELOC agreement provision allowing the right to accelerate and terminate. However, if the borrower has a grace period the creditor must be certain that it does not act until the grace period expires, and the creditor must follow any other conditions of the agreement specifying when the right to terminate applies. The commentary provides the following examples of events that would qualify as material obligations (if

designated as such in the HELOC agreement): the borrower (i) moves out of the home, or (ii) permits an intervening lien to be filed that would take priority over future advances of the creditor.[12] A creditor may not specify a "triggering event" in the HELOC agreement that would result in an action different from that permitted in Regulation Z. For example, a creditor cannot include a provision in a HELOC agreement allowing "the creditor to freeze a line due to an insignificant decline in property value since the regulation allows that response only for a significant decline."[13]

Regulation Z

Notice of Suspension or Reduction in Credit Limit, Monitoring and Reinstatement Requirements

The creditor must mail or deliver written notice to the consumer within three (3) business days after suspending or reducing the line of credit.[14] The notice must contain the "specific reasons" for the action. The regulation does not, however, provide any guidance on how to meet the standard of "specific reasons" and there are no Model Forms. If the HELOC agreement requires different timing for the notice of a change, the creditor must follow that requirement.

The creditor is required to restore credit privileges as soon as reasonably possible after the conditions that resulted in the suspension or reduction in the line of credit cease to exist.[15] This can be accomplished in one of two ways. The first option is for the creditor to monitor each account on an ongoing basis to determine when the condition ceases to exist. The frequency of this review depends on the condition permitting the reduction in the credit limit or suspension of the line of credit.

As an alternative, the creditor may shift this duty to the borrower and ask the borrower to request reinstatement of credit privileges by informing the borrower of this responsibility in its notice of reduction in the credit limit or suspension of the line of credit.[16] The creditor can also require a reinstatement request to be in writing, if its notice contains this requirement. Once a borrower requests reinstatement, the creditor must promptly investigate to determine whether the condition allowing the suspension or reduction continues to exist or not. Under this option, the creditor has an affirmative duty to investigate only upon the borrower's request.

The creditor can impose on the borrower bona fide and reasonable appraisal fees actually incurred in investigating whether the condition permitting the line of credit freeze or reduction still exists, unless prohibited under state law.[17]

If the condition no longer exists, the creditor must reinstate the existing account under the former terms and is prohibited from charging a fee for reinstatement.[18]

Adverse Action

Equal Credit Opportunity Act and Regulation B

An adverse action notice is required when a creditor takes "adverse action" on an account as defined in Regulation B. The regulation has three rules that must be considered when determining whether adverse action has occurred. First, the regulation broadly defines adverse action to include "an unfavorable change in the terms of an account that does not affect all or substantially all of a class of the creditor's accounts."[19] Accordingly, if a creditor suspends a HELOC or reduces the credit limit based on a condition permitted under Regulation Z, the creditor has taken adverse action. Second, the regulation excludes from the definition of adverse action "a change in the terms of an account expressly agreed to by an applicant."[20] Since the HELOC agreement must include the conditions permitting the creditor to exercise the right to suspend or reduce the credit limit, a suspension or reduction may be viewed as "terms of an account expressly agreed to by an applicant." As a result, if a creditor suspends a HELOC or reduces the credit limit based on the terms provided in the HELOC agreement, the creditor has not taken adverse action. Finally, the regulation informs creditors that when a creditor's action appears to satisfy both the definition of adverse action and the definition of what is *not* adverse action, adverse action has not occurred.[21] Based on the foregoing, it does not appear that a Regulation B adverse action notice would be required when suspending the line or reducing the credit limit.

Fair Credit Reporting Act

The FCRA has a broader definition of "adverse action" than the ECOA and Regulation B. It includes within the definition any action:

- that would be an "adverse action" under the ECOA;
- taken or determination made in connection with an application or transaction initiated by the consumer that is adverse to the interests of the consumer; and
- taken in connection with a review of an account to determine whether the consumer continues to meet the terms of the account, and which is adverse to the interests of the consumer.[22]

The FCRA imposes disclosure requirements in connection with adverse action when:

- adverse action is taken based on information in a consumer report;

- consumer credit is denied or a charge for credit is increased based on information obtained from third parties other than consumer reporting agencies bearing upon the consumer's creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living; or
- adverse action is taken based on information furnished by a corporate affiliate of the person taking the action bearing upon the consumer's creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living (unless the information provided by the affiliate relates solely to transactions and experiences between the affiliate and the consumer or is information in a consumer report).[23]

Based on the process a creditor uses to make a determination to suspend or reduce a credit limit, the creditor may be required to provide an FCRA adverse action notice. For example, if the creditor obtains a credit bureau report and makes its decision in whole or in part on information in the credit bureau report, an FCRA adverse action notice is required.

Fair Lending

Creditors must also consider the fair lending requirements contained in the ECOA and the Fair Housing Act (*"FHA"*) when creating and implementing a program to manage the risk of HELOCs, from the selection of which HELOC accounts it will review to the factors applied in the decision to suspend or decrease credit limits. Both disparate treatment and disparate impact can occur in creating and implementing such a program. Disparate treatment could occur, for example, when a creditor chooses to apply a discretionary policy to review property values for properties located in minority areas while declining to apply the policy in non-minority areas.[24] Disparate impact can occur when a creditor applies an apparently neutral policy to all borrowers but the policy disproportionately burdens protected groups.[25]

To mitigate discrimination risk, creditors should apply their policies equally to all borrowers. Discretion should be limited and monitored to ensure there is no disparate treatment or impact in when and how the HELOC policies are used.

Creditors should consider using the same tools for all borrowers when making HELOC suspension or reduction determinations (*e.g.,* AVMs or full appraisals and same bureau scores) so that the type of information used is from the same source in all cases.

Conclusion

Financial institutions must manage their HELOC risk in accordance with applicable regulatory guidance, bearing in mind that significant limitations apply. Creditors must be careful to design and implement a risk management program that satisfies these requirements, and the program must be monitored on an ongoing basis to ensure continued compliance. In addition to regulatory compliance concerns, financial institutions must be cognizant of the potential for litigation related to HELOC suspensions or reductions. Borrower claims based on the creditor's risk management program may include violations of TILA, fair lending, breach of contract, breach of implied covenants, and unfair and deceptive acts and practices claims. Multiple class action suits have targeted actions by financial institutions to suspend or reduce HELOCs, some resulting in significant settlements.[26] As a result, a conservative approach is recommended in implementing a HELOC risk management program.

For More Information

If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

Marc P. Franson
Chicago
312.845.2988
franson@chapman.com

Scott R. Fryzel
Chicago
312.845.3784
fryzel@chapman.com

Heather L. Hansche
Chicago
312.845.3714
hansche@chapman.com

Lindsay S. Henry
Chicago
312.845.3869
lhenry@chapman.com

1 Comment 40(f)(3)(vi)-2.

2 12 CFR § 1026.40(f)(3)(vi)(A).

3 Comment 40(f)(3)(vi)-6.

4 *Id.*

5 75 FR 77450 (December 10, 2010).

6 *See, e.g., In Re Citibank HELOC Reduction Litig*., No. 09-350 (N.D. Cal. Aug. 31, 2012); *In re: JPMorgan Chase Bank Home Equity Line of Credit Litigation*, 794 F. Supp. 2d 859 (N.D. Ill. 2011); *Hickman v. Wells Fargo Bank N.A.*, 683 F. Supp. 2d 779 (N.D. Ill. 2010).

7 12 CFR § 1026.40(f)(3)(vi)(B).

8 *Id.*

9 Comment 40(f)(3)(vi)-7.

10 *Id.*

11 *Id.*

12 Comment 40(f)(3)(vi)-8.

13 Comment 40(f)(3)(i)-2.

14 12 CFR § 1026.9(c)(iii).

15 Comment 40(f)(3)(vi)-2.

16 Comment 40(f)(3)(vi)-4.

17 Comment 40(f)(3)(vi)-3.

18 *Id.*

19 12 CFR § 1002.2(c)(1)(ii).

20 12 CFR § 1002.2(c)(2)(i).

21 12 CFR § 1002.2(c)(3).

22 FCRA Section 603(k)(1).

23 FCRA Sections 615(a), 615(b)(1), and 615(b)(2).

24 Comment 1002.4(a)-1.

25 Comment 1002.6(a)-2 and Fair Housing Act's Discriminatory Effects Standard, 78 FR 11460 (Feb. 15, 2013).

26 *See, e.g., Vess v. Bank of America, N.A. et al.*, 2013 U.S. Dist. LEXIS 157427; *Hamilton v. Wells Fargo Bank, N.A.*, 2012 U.S. Dist. LEXIS 67193; *In re Citibank HELOC Reduction Litig.*, 2010 U.S. Dist. LEXIS 95938.

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Attorneys at Law · Focused on Finance®

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