FDIC

Federal Deposit Insurance Corporation
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Financial Institution Letter
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HOME EQUITY LINES OF CREDIT

Consumer Protection and Risk Management Considerations When Changing Credit Limits and Suggested Best Practices

Summary: The FDIC is issuing the attached supervisory guidance to remind FDIC-supervised financial institutions that if, for risk management purposes, they decide to reduce or suspend home equity lines of credit, certain legal requirements designed to protect consumers must be followed. In addition, the FDIC urges institutions to work with borrowers to minimize hardships that may result from such reductions or suspensions.

Distribution:
FDIC-Supervised Banks (Commercial and Savings)

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Chief Executive Officer
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Related Topics:
. 2005 Home Equity Lending: Credit Risk Management Guidance;
. 1999 Interagency Guidance on High LTV Residential Real Estate Lending

Attachment:
Regulatory Considerations When Reducing or Suspending Home Equity Lines of Credit, and Suggested Best Practices

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Highlights:

- In response to falling home prices and borrower financial difficulties, some financial institutions have reduced or suspended home equity lines of credit (HELOCs) and other institutions may be considering doing this.
- Such actions may be prudent and appropriate ways for institutions to manage credit risk, as articulated more fully in existing supervisory guidance. However, certain legal requirements designed to protect consumers must be followed.
- Regulation Z, implementing the Truth in Lending Act, permits lenders to reduce the credit limit or suspend further extensions of credit if the value of the dwelling securing the loan declines significantly, or if a consumer is likely to be unable to meet his or her obligations as a result of a material change in his or her financial circumstances.
- Compliance with Regulation B and the Fair Housing Act requires lenders to calculate revised property values and determine borrower financial circumstances using consistently applied fact-based methods, and implement any resulting limitations without regard to prohibited factors.
- The FDIC urges institutions to work with existing borrowers, when possible, to mitigate financial hardships arising from HELOC reductions or suspensions.

Consumer Protection and Risk Management Considerations When Reducing or Suspending Home Equity Lines of Credit and Suggested Best Practices for Working with Borrowers

During the past year, home values have declined in many markets across the United States and many borrowers are experiencing financial difficulties. These conditions have resulted in higher risk for home equity lines of credit (HELOCs) in the portfolios of some FDIC-supervised financial institutions (institutions).[1]

In response to the growing risk of loss, those institutions may appropriately reduce or suspend the HELOC credit limits of some borrowers under the circumstances allowed by Regulation Z and as set forth more fully in the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending*,[2] and the October 2006 *Addendum*.[3] The FDIC recommends that institutions review those risk management guidance documents when considering changes to the terms of any HELOCs.

The purpose of this guidance is to remind institutions that if, for risk management purposes, they decide to reduce or suspend home equity lines of credit, certain legal requirements designed to protect consumers must be followed. The FDIC also urges institutions to work with borrowers, where possible, to minimize hardships that may result from such suspensions or reductions.

Consumer Protection

Institutions must comply with several laws and regulations when HELOCs are reduced or suspended. The Truth in Lending Act, as implemented by Regulation Z, specifies the circumstances under which lenders may reduce or suspend home equity lines of credit. Lenders must also be mindful of their responsibilities under Section 5 of the Federal Trade Commission (FTC) Act, the Equal Credit Opportunity Act and the Fair Housing Act, to ensure their actions are implemented in accordance with these laws. Violations of these laws will result in enforcement actions and may have a negative effect on the Community Reinvestment Act (CRA) evaluations of institutions.

Truth in Lending (Regulation Z)[4]

Regulation Z generally prohibits lenders from changing the terms of home equity lines of credit; however, there are exceptions.[5] For example, Regulation Z expressly permits lenders to prohibit additional extensions of credit or reduce the applicable credit limit "during any period in

[1] *See* FDIC's ***Quarterly Banking Profile***, as of December 31, 2007; http://www4.fdic.gov/qbp/2007dec/qbpall.html.
[2] *Home Equity Lending: Credit Risk Management Guidance*, FIL-45-2005, May 24, 2005, http://www.fdic.gov/news/news/financial/2005/fil4505.html.
[3] *Addendum to Credit Risk Management Guidance for Home Equity Lending*, FIL-89-2006, October 5, 2006, http://www.fdic.gov/news/news/financial/2006/fil06089.html.
[4] http://www.fdic.gov/regulations/laws/rules/6500-1400.html#6500part226tilregz.
[5] 12 C.F.R. § 226.5b(f)(3); http://www.fdic.gov/regulations/laws/rules/6500-1600.html#6500226.5b.

which the value of the dwelling that secures the plan declines significantly below the dwelling's appraised value for purposes of the plan."[6] To use this exception, lenders must determine that a "significant decline" occurred.

The term "significant decline" is not defined within the regulation itself. However, the Federal Reserve Board's Official Staff Interpretations (Official Interpretations) to this provision of Regulation Z includes an example indicating that, while a "significant decline" will vary according to the circumstances, such a decline has occurred if the unencumbered equity is reduced by 50 percent.[7] According to the Official Interpretations, a lender is not required to obtain an appraisal before suspending credit privileges, but there must be a significant decline in value. Although full individual appraisals need not be obtained, institutions should have a sound factual basis for determining that a property has experienced a significant decline in value. For example, automated valuation models or local tax assessments may be used, taking into account the issues described in the Home Equity Guidance regarding the validity of those values.

In addition to permitting lenders to reduce or suspend credit limits following a significant decline in a property's value, Regulation Z also permits such actions if the "creditor reasonably believes that the consumer will be unable to fulfill the repayment obligations under the plan because of a material change in the consumer's financial circumstances."[8] The Official Interpretations state that two conditions must be met to use this situation as a basis for reducing or suspending a credit limit. First, there must be a "material change" in financial circumstances, for example, a significant decrease in a consumer's income.[9] Second, as a result of that material change, the lender must have a "reasonable belief" that the consumer will not be able to meet his or her repayment obligations. Although the Official Interpretations go on to indicate that a lender may — but need not — rely on specific evidence, such as a failure to pay other debts, to conclude that a consumer will not be able to pay his or her HELOC obligation, institutions should have a factual basis for any actions taken under this provision. Furthermore, that factual basis should be determined consistently, to avoid the risk of prohibited discrimination or unfair practice.

If a lender reduces or suspends a consumer's HELOC limit as a result of a significant decline in property value or a material change in his or her financial circumstances, the lender must provide written notice to each affected consumer.[10] The notice must be provided not later than three business days after the action is taken, and contain specific reasons for the action. In addition, the notice should explain if the creditor requires the borrower to request reinstatement of credit privileges. If the institution does not require the borrower to request reinstatement, the institution is responsible for monitoring the line to determine when the condition that permitted the reduction or suspension ceases to exist and reinstating the privileges as soon as reasonably possible.[11]

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[6] 12 C.F.R. § 226.5b(f)(3)(vi)(A).

[7] *See* Official Staff Interpretations, § 226.5b(f)(3)(vi), note 6; http://www.fdic.gov/regulations/laws/rules/6500-2200.html.

[8] 12 C.F.R. § 226.5b(f)(3)(vi)(B). The lender may also take such action, of course, if the borrower is actually in default.

[9] *See* Official Staff Interpretations, § 226.5b(f)(3)(vi), note 7.

[10] 12 C.F.R. § 226.9(c)(3).

[11] *See* Official Staff Interpretations, § 226.5b(f)(3)(vi), note 4.

In addition to permitting reductions or suspensions of HELOC limits in the circumstances outlined above, Regulation Z also permits such action if:

- the borrower is in default of a material obligation under the agreement;
- the lender cannot impose the annual percentage rate provided in the agreement as a result of government action;
- the priority of the lender's security interest is adversely affected by government action to the extent the value of the security interest is less than 120 percent of the credit line; or
- the lender is notified by its regulatory agency that continued advances constitute an unsafe or unsound practice.[12]

Institutions must also ensure that any reductions or suspensions of HELOC limits do not violate the FTC Act Section 5[13] prohibition against unfairness and deception. The FDIC and the Federal Reserve Board issued guidance in 2004 that includes best practices and general guidance on measures that state-chartered banks can take to avoid engaging in unfair or deceptive acts or practices.[14]

Equal Credit Opportunity Act (Regulation B)[15] and the Fair Housing Act[16]

No lender may discriminate on the basis of race, sex, or other specified factors, in any part of a credit transaction. Discrimination may occur in the context of HELOC reductions or suspensions if a lender inconsistently applies its policies or makes the changes in a manner that could constitute redlining. Lenders should calculate revised property values and determine borrower financial circumstances using methods that have a sound factual basis and are applied consistently. Any resulting limitations should be implemented without regard to any prohibited factors. Similarly, lenders should use consistent standards when implementing changes that affect particular geographic areas.

Best Practices for Working with Borrowers

In addition to ensuring legal compliance, the FDIC urges institutions to adopt best practices for working with borrowers who may experience financial hardship or significant inconvenience as a result of a reduction or suspension of their credit limits. This may especially be true for borrowers who are using their HELOCs to fund home improvements in progress, as cash management tools, or to finance small businesses.

Depending on a borrower's creditworthiness and overall financial circumstances, it may be possible to offer alternative types of credit or other arrangements to mitigate the negative

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[12] 12 C.F.R. § 226.5b(f)(3)(vi)(C) - (F).
[13] *See Guidance on Unfair or Deceptive Acts or Practices*, FIL-57-2002, May 30, 2002, http://www.fdic.gov/news/news/financial/2002/fil0257.html.
[14] *Id.*
[15] 12 C.F.R. Part 202; http://www.fdic.gov/regulations/laws/rules/6500-2900.html#6500part202regb.
[16] 42 U.S.C. 3601 et seq.; the Fair Housing Act is implemented by U.S. Department of Housing and Urban Development regulations at http://www.fdic.gov/regulations/laws/rules/6500-2510.html#6500titleviiifairhousing.

effects of credit line reductions or suspensions. Indeed, some of these types of flexible or innovative lending practices may be considered favorably in the institution's public CRA evaluation.

The FDIC also recommends that institutions offer borrowers the opportunity to seek a review of the institution's decision to reduce or suspend a credit line based on a significant decline in a property's value. Particularly if the institution is relying on an automated valuation system as the basis for this decision, the customer may be able to offer more detailed information that could change the outcome of the institution's decision. Similarly, a periodic re-evaluation of property value information may result in reinstating a higher credit limit or lifting a suspension.