End of the Line: Behavior of Credit-constrained HELOC Borrowers

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Rapid growth in HELOC balances between 2002 and 2006

Under a typical HELOC, borrowers make only interest payments on outstanding debt during the draw period, and the loan converts to closed-end amortizing loans at the end of the draw period.

Source: FR Y-9C, all BHCs.
Effect of payment change on default

- Nearly 60 percent of outstanding HELOCs will reach the end of their draw (EOD) periods in the next several years
  - required payments will increase for many borrowers, and
  - renewed demand for credit if borrowers wish to maintain same household leverage.

- Often borrowers repay or refinance just prior to end of draw
  - but may have insufficient income or assets to repay
  - or may not be able to refinance

- **How will payment increase affect default rates?**
  - Will the effect be different for different types of borrowers?
Our approach

Step 1: Calculate cum. default rates (CDRs)

Step 2: Subtract predicted CDRs (estimated with competing hazard model)

Step 3: EOD effect is difference between adjusted CDR curves
Overall effect

- Higher default and payoff rates for loans reaching EOD
Does borrower credit quality matter?

- “Low Quality” HELOCs ($FICO < 725$ and $CLTV > 80$) default at higher rate than “High Quality” HELOCs ($FICO > 725$ and $CLTV < 80$)
What is the role of the size of the payment change?

► "Low Quality" HELOCs more sensitive to size of payment increase
Thank you

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