Financial Consumer Agency of Canada
Agence de la consommation en matière financière du Canada

Home Equity Lines of Credit: Market Trends and Consumer Issues

Public Research Report

Canada

June 2017

Cat. No.: FC5-52/2017E-PDF
ISBN: 978-0-660-08671-2

Ce document est aussi disponible en français sous le titre ***Les marges de crédit hypothécaires : tendances du marché et questions touchant les consommateurs.***

Table of contents

1. Purpose

The Financial Consumer Agency of Canada (FCAC) recently conducted research on home equity lines of credit (HELOCs) to better understand the consumer issues, potential macroeconomic risks, market trends and lenders' business practices. FCAC has a legislative mandate to conduct research on market trends and issues with the potential to impact financial consumers. This report focuses on the market conduct of federally regulated lenders and on the risks posed to consumers by HELOCs. It summarizes the Agency's research findings, and explains how FCAC plans to respond to the risks identified.

2. Background

HELOCs are revolving, and typically non-amortized, credit products secured by a lien on the borrower's residential property.[1] The HELOC product first appeared in the late 1970s, but it was during the mid-1990s that lenders began tailoring HELOCs to appeal to a broader cross-section of consumers. Today, most HELOCs are sold as a component of readvanceable mortgages. Readvanceable mortgages combine HELOCs with amortized mortgages, and in some cases other credit products and banking services (e.g., personal loans, business loans, chequing accounts, overdraft protection and credit cards) under a global credit limit secured by a collateral charge against the borrower's property.

Figure 1: Examples of readvanceable mortgage products

Bank of Montreal	Homeowner ReadiLine
Bank of Nova Scotia	Scotia Total Equity Plan (STEP)
Canadian Imperial Bank of Commerce	CIBC Home Power Plan
Manulife Bank	Manulife One Mortgage
National Bank of Canada	All-in-One Account
Royal Bank of Canada	RBC Homeline Plan
Toronto-Dominion Bank	TD Home Equity FlexLine

1 The large majority of HELOCs in Canada have indefinite terms. For a more detailed discussion, see DBRS. (November 2014). *Rating Canadian residential mortgages, home equity lines of credit and reverse mortgages*. [Methodology Report]. Toronto. [Retrieved online] http://www.dbrs.com/research/274129/rating-canadian-residential-mortgages-home-equity-lines-of-credit-and-reverse-mortgages.pdf

Rapid expansion: 2000–2010

The HELOC market expanded rapidly during the 2000s. HELOC balances grew from approximately $35 billion in 2000 to approximately $186 billion by 2010, for an average annual growth rate of 20 percent. During this period, HELOCs emerged as the largest and most important form of non-mortgage consumer debt, growing from just over 10 percent of non-mortgage consumer debt in 2000 to nearly 40 percent of non-mortgage consumer debt in 2010. In comparison, credit cards have consistently represented around 15 percent of non-mortgage consumer debt.[2]

This rapid expansion was driven primarily by low interest rates and rising house prices. The long period of sustained increases in the price of residential real estate, which began in the early 2000s, made it easier for consumers to use their home equity as collateral for secured lines of credit. Product innovation, significant investments in marketing and favourable lending terms also helped fuel the growth of the HELOC market. Consumers borrowed against their home equity to consolidate debt, finance home renovations, fund vacations and purchase big-ticket items such as cars, rental properties, cottages and financial assets (e.g., securities), using leveraged investment strategies (see Figure 2).[3]

Figure 2: HELOC uses 1999-2010

Consumption and home renovation	40%
Financial and non-financial investments	34%
Debt consolidation	26%

Source: Canadian Financial Monitor and the Bank of Canada

The growing popularity of HELOCs during the 2000s was an important driver behind the expansion of household debt. Previously, debt and household income had increased at a similar rate and the ratio between them was relatively stable. In 2000, Canadian households owed about $1.07 for every dollar of disposable income. By 2010, the ratio of debt to disposable income had risen to $1.60. Figure 3 (below) shows that the HELOC boom coincided with the substantial expansion of household debt. Some substitution did take place, with consumers using HELOCs rather than other, higher-cost credit products (e.g., credit cards, installment loans).[4] Overall, however, growing HELOC balances contributed to a larger expansion of consumer credit than would have otherwise taken place.[5]

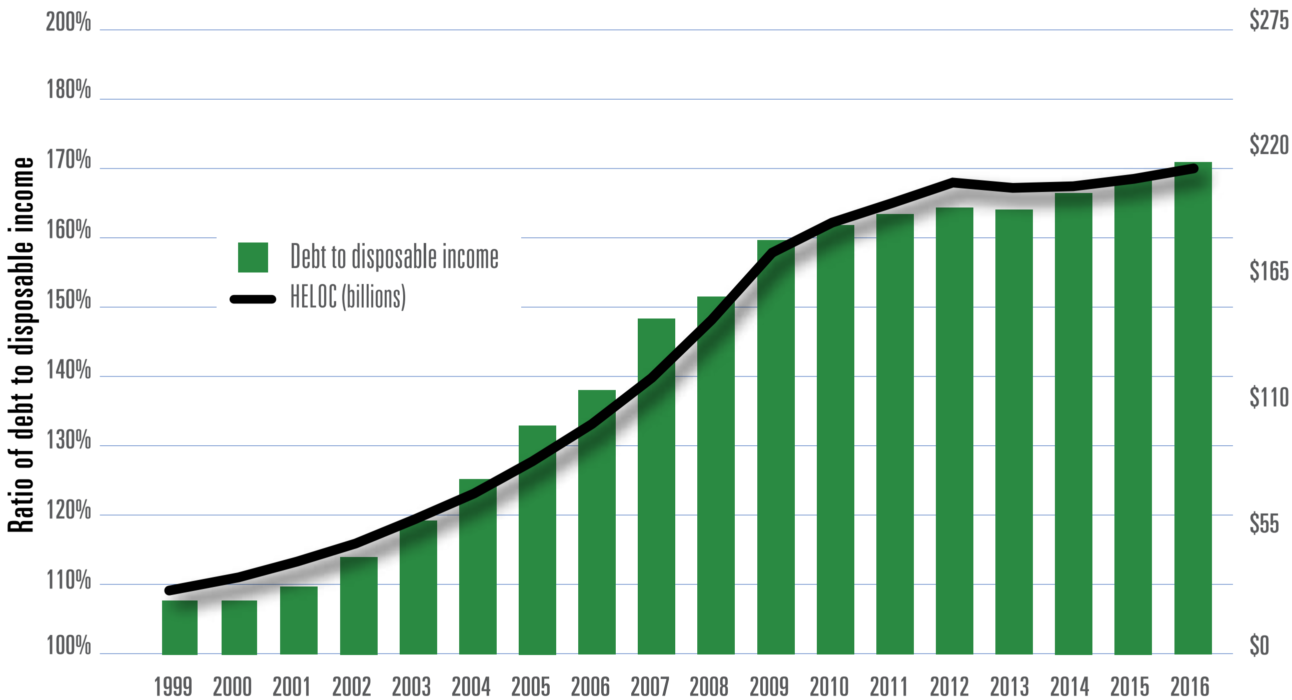
2 For more information about the share of consumer credit represented by HELOCs, see Bank of Canada. (December 2014). *Financial System Review* and Statistics Canada. (Sept. 15, 2016). "The Daily: National balance sheet and financial flow accounts, second quarter 2016." [Retrieved online] http://www.statcan.gc.ca/daily-quotidien/160915/dq160915a-eng.htm

3 Bailliu, Jeannine, Katsiaryna Kartashova and Césaire Meh. (2012). "Household borrowing and spending in Canada." *Bank of Canada Review*.

4 Dey, Shubhasis. (2005). "Lines of credit and consumption smoothing: The choice between credit cards and home equity lines of credit." *Bank of Canada* [Working Paper 2005-18].

5 Crawford, Allan and Umar Faruqui. (February 23, 2012). "What explains trends in household debt in Canada?" *Bank of Canada Review*.

Figure 3: HELOCs and household debt



Source: FCAC calculations, data from Statistics Canada Table 378-0123, Bank of Canada and the Canadian Bankers Association

Moderate growth: 2011–today

The growth of the HELOC market stabilized in the years following the recession. The average annual growth slowed to 5 percent between 2011 and 2013 and it has averaged 2 percent over the last several years. Outstanding HELOC balances reached $211 billion in 2016.[6] There are approximately 3 million HELOC accounts in Canada, with an average outstanding balance of $70,000. The moderate growth observed over the past several years can be attributed to the gradual weakening of demand, competition from low-interest traditional mortgages, and the introduction of new regulations and guidelines.

The measures taken by the federal government to protect Canadian taxpayers from the risks related to the HELOC market appear to have contributed to the market stabilization.[7] In 2011, HELOCs became ineligible for government-backed "portfolio insurance," an insurance product purchased by lenders which allows them to securitize pooled mortgages through the *National Housing Act* Mortgage-Backed Securities (NHA MBS) program. The removal of this funding mechanism may have moderated the growth of the HELOC market.

6 These figures are based on data reported to the Bank of Canada by federally regulated lenders and market trend information provided to FCAC by the Canadian Bankers Association during the industry review.

7 For a more detailed description of the new guidelines, see Department of Finance. (2011). "Backgrounder: Supporting the long-term stability of Canada's housing market." [Retrieved online] http://www.fin.gc.ca/n11/data/11-003_1-eng.asp

Furthermore, in 2012, the Office of the Superintendent of Financial Institutions (OSFI) issued its Residential Mortgage Underwriting Practices and Procedures Guideline (B-20 Guideline), which introduced stricter underwriting rules and capped the loan-to-value (LTV) ratio for HELOCs sold by federally regulated lenders at 65 percent.[8] By restricting homeowners' ability to leverage their residential property through HELOCs, the Guideline may have helped moderate market growth.

Product evolution: the emergence of readvanceable mortgages

Today, the large majority of HELOCs are sold as a component of a readvanceable mortgage. Readvanceable mortgages combine HELOCs with amortized mortgages, and in some cases other credit products and banking services. This represents an important shift in both the way HELOCs are sold and how Canadian consumers are financing their home purchases.

Banks have made significant investments in marketing and promoting readvanceable mortgages. Sales representatives are expected to introduce and sell the product to their customers. As a result, HELOCs are now marketed to a wider cross-section of consumers. In practice, readvanceable mortgages now serve as the default option for consumers purchasing a home with a down payment of at least 20 percent.

During the industry review, banks explained that creditworthy consumers are generally steered towards readvanceable mortgages rather than traditional, amortized mortgages. FCAC found that 80 percent of the approximately 3 million HELOC accounts were held under readvanceable mortgages in 2016.[9] Since 2011, the number of Canadian households who have a HELOC as stand-alone product, without also having a term mortgage on their home, has declined by 40 percent. In contrast, number of mortgaged households that have a HELOC and a term mortgage secured against their home has increased by nearly 40 percent.[10]

8 Borrowers can acquire an additional 15 percent of leverage provided it is amortized in a definite term mortgage. See Office of the Superintendent of Financial Institutions. (November 2014). *B-20 Guideline: Residential Mortgage Underwriting Practices and Policies*.

9 In 2016, there were approximately 3 million HELOC accounts held at federally regulated financial institutions (FRFIs) by consumers in Canada. Based on data collected during the industry review, FCAC estimates that 2.41 million (80%) were held under a readvanceable mortgage, while approximately 597,600 (20%) were held as a stand-alone HELOC.

10 See Mortgage Professionals Canada. (2016) *Annual State of the Residential Mortgage Market in Canada* and Canadian Association of Accredited Mortgage Professionals (2011) *Annual State of the Residential Mortgage Market in Canada*.

3. Product characteristics

From a consumer's perspective, HELOCs have four defining characteristics: flexibility, open terms, affordability and complexity.

3.1. Flexibility

The draw features of HELOCs are similar to those for credit cards and unsecured lines of credit. Consumers can use as much or as little as they need, as long as they stay within their credit limit and keep their account in good standing. Repayment terms are flexible. Most borrowers are permitted to make interest-only payments on their outstanding balance. They may also reduce their principal with lump-sum payments made at their discretion, without incurring pre-payment penalties. For these reasons, HELOCs are defined as a form of non-mortgage consumer debt.

The flexible draw and repayment features of HELOCs lead many consumers to see these products as a convenient way to finance large projects that may involve delays or unanticipated cost overruns, such as rental properties, vacation homes or home renovations. Consumers can draw on their HELOC as needed, without having to reapply for additional credit and repay as much or as little as they can afford, as long as the accrued interest is covered.

3.2. Open terms

The large majority of HELOCs are non-amortized and fully open credit products. They are "demand loans" that can be recalled by lenders at any time, but they do not have a maturity date. Provided they keep the account in good standing and stay within their credit limit, consumers can draw on and repay their HELOC over an indefinite period.

The open structure of HELOC products makes them attractive substitutes for emergency funds. For that reason, some lenders market HELOCs as a way to manage temporary income shortfalls or unanticipated expenses. Some consumers may be drawn to HELOCs if their salary is commission based or they are paid at irregular intervals. Others may see HELOCs as suitable for managing financial risks.

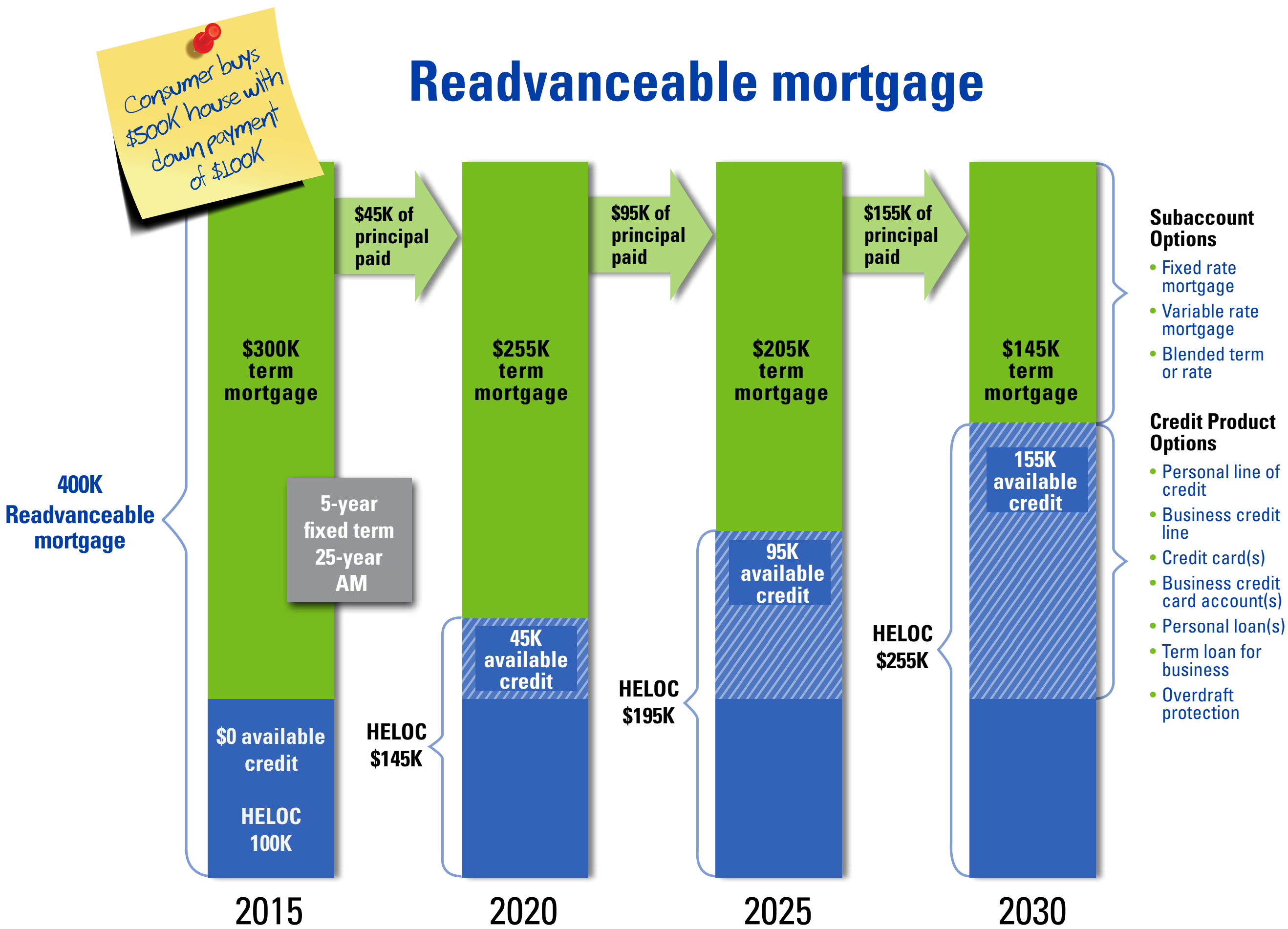
3.3. Affordability

Since they are secured by a borrower's residential property, HELOCs are considered low-risk products, and lenders often, if not always, offer them at attractive interest rates. Consumers can generally acquire a HELOC for the lender's prime rate plus a premium of between 0.5 and 2 percent. In August 2016, Canada's largest banks were offering HELOCs for 3.20 percent, on average. Because of the relatively low interest rate, lenders promote HELOCs as a way for consumers to increase their monthly cash flow by consolidating high-interest debt, such as credit cards.

3.4. Complexity

Today, most HELOCs are sold as part of a readvanceable mortgage, which can be customized to suit the needs of individual consumers and mitigate certain risks. The range of options and features available makes readvanceable mortgages relatively complex products, compared with more traditional mortgages. For example, most readvanceable mortgages also have a rebalancing feature, which automatically increases the available revolving credit as the principal on the amortized mortgage is paid down. In addition, portions of a readvanceable mortgage can be moved into amortized mortgage sub-accounts, with different term lengths and variable, fixed or blended interest rates. However, splitting a readvanceable mortgage across different sub-accounts can make switching lenders more complicated and expensive (e.g., discharge fees and prepayment penalties).

Figure 4: How readvanceable mortgages work[11]



11 Figure 4 illustrates the evolution of a readvanceable mortgage over time. Not all of the product options listed are available from every lender. In this example, the consumer has made interest-only payments on the HELOC portion of their readvanceable mortgage; interest-only payments are the default option at the large majority of federally regulated lenders.

4. Consumer issues

4.1. Over-borrowing

HELOCs offer relatively low interest rates and convenient access to large amounts of revolving credit, which may encourage some consumers to use their home equity to fund a lifestyle they cannot afford. The automatic increases to available credit, interest-only payments, and the non-amortized structure of HELOC products may tempt less-disciplined consumers to use their home as collateral against borrowing for everyday spending.

While the overwhelming majority of consumers keep their HELOC in good standing, many are doing so by making the minimum payment (i.e., interest-only payments) or making only occasional efforts to reduce the principal. Research indicates that roughly 4 in 10 consumers do not make a regular payment against their outstanding HELOC principal, and 1 in 4 only cover the interest or make the minimum payment.[12]

HELOC borrowers can find themselves in a "home equity extraction debt spiral," particularly during periods of financial distress. Some lenders market HELOCs as a source of emergency funds that can be used to cover unanticipated expenses or a loss of income. When consumers borrow against their home equity to make ends meet, they run the risk of having to extract more equity down the road just to cover the minimum payments on their HELOC. This pattern of behaviour may lead consumers to add to their debt burden during periods of financial distress rather than reigning in discretionary spending.

4.2. Debt persistence

The "evergreen" nature of HELOCs may foster debt persistence. HELOCs are designed, and often marketed, as financial products that allow consumers to borrow large sums of money against their home equity, with little or no obligation to repay it in a timely manner. In most readvanceable mortgages, the amount of revolving credit available to consumers through their HELOC increases automatically as they pay down the principal of their amortized mortgage account, and this revolving credit remains available indefinitely.

Furthermore, the rapid increase in house prices in certain markets may have convinced some consumers that HELOC repayment strategies are unnecessary, since the equity growth that will result from future price increases will be available to repay the principal when they sell their home.[13] Most of the lenders reviewed did not closely track how long it took borrowers to fully reimburse their HELOC, but those that did indicated that the large majority of HELOCs were not fully repaid until the consumer sold their home.

At a time when consumers are carrying record amounts of debt, the persistence of HELOC debt may put further stress on the financial well-being of Canadian households. High levels of consumer debt can make it more difficult for families to handle unforeseen life events such as a loss of income or unanticipated expenses. The longer consumers carry debt burdens, the higher the probability that they will struggle in the event of a negative macroeconomic event (e.g., oil price shock, economic recession or interest rate hike).

---

12 According to a recent survey conducted by the Chartered Professional Accountants of Canada, 41 percent of HELOC borrowers did not make regular payments that covered both interest and principal, while 27 percent are only making the minimum payment. This finding is consistent with FCAC's research. For more information, see Chartered Professional Accountants of Canada. (2015). *Household finances in Canada: Time for a reality check*.

13 See DBRS. (2014). *Rating Canadian Residential Mortgages, Home Equity Lines of Credit and Reverse Mortgages*.

4.3. Wealth erosion

The liquidity and easy access to home equity created by HELOCs can negatively affect the ability of some middle-class families to save money and gradually accumulate wealth. Paying down the mortgage on the family home is an important part of the average household's retirement strategy. Traditional mortgages operate as forced savings vehicles. Making regular principal and interest payments on amortized mortgages allows families to gradually accumulate more equity in their home over the course of their working lives. Mortgage repayment is a particularly important savings vehicle for the average middle-class family in Canada, because their wealth is concentrated in housing assets and their financial holdings at retirement tend to be limited.[14]

Certain forms of financial innovation can harm some consumers, weakening their financial position by creating too much liquidity. HELOCs are sold as financial products that allow homeowners to "unlock equity" and "put equity to work." However, many consumers value the benefits of immediate consumption significantly more than the benefits of accruing housing wealth slowly, over a long period of time. The benefits of accumulated housing wealth are remote and will only be realized in retirement by what behavioural economists call a "future self." HELOCs allow consumers to forgo saving in favour of extracting home equity to fund, for example, a new automobile purchase, home renovation or vacation.[15]

Consumers who choose readvanceable mortgages would benefit from financial discipline and relatively high levels of financial literacy if they are to avoid using their home equity to live beyond their means, and succeed in setting aside adequate savings. Fully amortized mortgages make it easier for households with imperfect self-control to save, accumulate wealth and prepare for retirement. Research on the issue of home equity borrowing and savings rates would be beneficial, since there is the potential for HELOCs to help some consumers diversify their wealth with leveraged investment strategies or to increase their savings by reducing their reliance on credit instruments with higher interest rates (e.g., credit cards).

4.4. Uninformed decision-making

Based on the industry review, complaints and issues reported to FCAC, and market surveys, some consumers appear to lack the resources they need to make informed decisions about whether or not to finance their home purchases with readvanceable mortgages.[16] Economists have found that "Mortgage costs appear in a number of forms, not all of which are straightforward to measure. Households take out mortgages relatively infrequently, and often negotiate them at the same time that they are undergoing a major life transition by moving homes. Under these circumstances, households may well fail to make optimal decisions."[17]

The complexity of readvanceable mortgages, and lack of awareness of the differences between readvanceable and traditional mortgages, may impede consumers' ability to make informed decisions. Consumers appear to lack information on a number of levels. First, some consumers are unaware of the

---

14 Macdonald, David. (June 2015). "The wealth advantage: The growing wealth gap between Canada's affluent and the middle class," *Canadian Centre for Policy Alternatives*.

15 Liabson, David. (1997). "Golden eggs and hyperbolic discounting," *The Quarterly Journal of Economics*, 443-77.

16 For example, in a 2011 Leger Marketing survey, 57 percent of HELOC borrowers did not realize the product was secured by a charge against their home. See CNW. (November 2011). "Canadians lack knowledge about home equity lines of credit" [Retrieved online] http://www.newswire.ca/news-releases/canadians-lack-knowledge-about-home-equity-lines-of-credit-but-only-one-in-ten-seek-expert-legal-advice-poll-reveals-509073081.html

17 See John Y. Campbell, Howell E. Jackson, Brigitte C. Madrian and Peter Tufano. (2011). "Consumer Financial Protection," *Journal of Economic Perspectives*, 25(1), 91-114. [Available online] https://dash.harvard.edu/handle/1/9887620

various fees that may be associated with readvanceable mortgages (e.g., legal, appraisal, title search, inactivity, prepayment and discharge). Complaints received through the FCAC Consumer Service Centre demonstrate that consumers were not aware of certain fees, could not make sense of the fees charged or believed that they had been overcharged.

Second, consumers do not always understand the implications of linking their credit products under the umbrella of a readvanceable mortgage. Readvanceable mortgages are almost always secured against the borrower's home by a collateral charge, which can be more expensive to discharge than a conventional charge. In addition, consumers cannot easily switch the amortized mortgage portion of a readvanceable mortgage to another lender offering a better rate. To switch lenders, consumers need to resolve all of the credit accounts tied to the amortized mortgage account under the umbrella of the readvanceable mortgage. Furthermore, when consumers divide the amortized portion of their readvanceable mortgage into a number of sub-accounts with different term lengths, they may find it more difficult and expensive to move their readvanceable mortgage to another lender.

There are no specific regulations stipulating how lenders must disclose the terms and conditions of HELOCs or readvanceable mortgages. Section 10 and Schedule 3 of the *Cost of Borrowing Regulations* provide the disclosure requirements for lines of credit, including HELOCs. Consumers selecting a readvanceable mortgage will receive separate disclosure documentation for each product they have chosen. However, lenders are not required to present consumers with any specific information explaining the consequences of linking a range of credit products under a readvanceable mortgage. A few lenders provide consumers with supplemental material (e.g., user manuals) to help them understand how readvanceable mortgages work, but the quality of the materials is inconsistent and the information tends to be limited to technical advice (e.g., how to calculate minimum payments).

5. Macroeconomic risks

5.1. Increased vulnerability to an economic shock

The expansion of the HELOC market has been a key driver behind the sizeable increase in household debt in Canada since the 2000s.[18] Record levels of debt have increased the Canadian economy's vulnerability to a lengthier and more severe downturn than would be expected if household balance sheets were stronger. Highly indebted households tend to reduce their spending disproportionately more than less indebted households in response to an economic shock (e.g., oil price collapse). When more severely indebted households cut back, it reduces demand for a range of consumer goods (e.g., automobiles, furniture), which can increase the impact of the shock by curtailing investments and increasing unemployment.[19]

5.2. Payment shock

Payment shock refers to the difficulty some consumers may experience in meeting their monthly debt obligations when interest rates rise above current historic lows. Consumers carrying large amounts of credit at variable interest rates are particularly susceptible to rising interest rates. These consumers may be significantly more vulnerable if a large share of their disposable income is applied to servicing their debt, since they may lack adequate flexibility in their monthly budget to cope with higher borrowing costs. Consumers without adequate emergency funds are also more vulnerable to payment shock, and recent surveys have found that almost half of working Canadians are living paycheque to paycheque without enough set aside to carry them through in the event of an emergency or loss of income.[20] When interest rates rise, these consumers may be unable to meet their debt obligations, and could choose to cut back drastically on their consumption of goods and services, which would negatively impact financial institutions and the real economy.

The relatively large amount of HELOC debt now held by Canadian consumers could increase the number who experience payment shock in response to rising interest rates. HELOCs make up a significant portion of non-mortgage consumer debt, and the vast majority have a floating or variable interest rate. In addition, most consumers are permitted to make interest-only payments, which could further increase sensitivity to interest rate fluctuations. It is important to note that the prevalence of the 5-year term in Canada means the cost of servicing mortgage debt is also closely tied to prevailing interest rates, since most consumers have to renew their mortgage every five years.

During the industry review, FCAC consulted with TransUnion Canada, in relation to its recent research on Canadian borrowers' exposure to payment shock. TransUnion found that roughly 720,000 Canadian consumers would experience difficulty meeting their credit obligations if interest rates rose by only 25 basis points. Nearly one million consumers could experience payment shock if interest rates were to rise by a

18 Cheung, Calista. (July 21, 2014). "Deconstructing Canada's housing markets: Finance, affordability and urban sprawl," in Organization for Economic Co-operation and Development. (2014), *OECD Economic Surveys: Canada 2014* and Crawford, Allan and Umar Faruqui. (February 23, 2012). "What explains trends in household debt in Canada?" Bank of Canada Review.

19 Schembri, Lawrence. (February 24, 2016). "Connecting the dots: Household debt and the risk to financial stability." Remarks by the Deputy Governor of the *Bank of Canada*. Guelph, Ontario.

20 See, for example, the recent survey by the Canadian Payroll Association covered in Jonathan Chevreau. (September 7, 2016). "Nearly half of Canadians are living paycheque to paycheque," *The Financial Post*.

full percentage point, or 100 basis points. On the other hand, TransUnion found that the impact would be relatively minor for most consumers, particularly higher income consumers, many of whom could meet the challenge of rising interest rates by reducing discretionary expenses. Should this occur, however, weakening consumption could negatively affect the income of other consumers.[21]

Finally, the underwriting standards introduced by OSFI's B-20 Guideline may serve to mitigate the risks posed by the potential for interest rate increases. When assessing a consumer's capacity to service a HELOC, readvanceable, variable rate, or uninsured mortgage, federally regulated lenders are expected to use the Bank of Canada's benchmark qualifying rate if it is higher than the contractual rate offered to the consumer. For many borrowers, this amounts to assessing their total debt service ratio and gross debt service ratio with a higher rate than the interest rates which are currently available in the market.

5.3. Housing market correction

HELOC borrowers are exposed to a housing market correction to the extent that the product is a demand loan secured against residential property. In the event of a correction, HELOC borrowers could find themselves "underwater" with a house that is worth less than the loan obligations secured against it. Consumers with negative equity are at an elevated risk of default. Falling house prices may constrain HELOC borrowers' access to credit, forcing them to curtail their spending, which could in turn negatively affect the economy. Furthermore, during a severe and prolonged market correction, lenders may revise HELOC limits downward or call in the loans.

The long period of sustained growth in the price of housing since the early 2000s may have created some overvaluation in Canadian housing markets.[22] Rising levels of household debt have both supported and been fueled by increases in house prices.[23] There is considerable uncertainty over the degree to which residential property is overvalued; estimates vary from 10 to 30 percent.[24] It appears the market may be more overpriced in the Greater Toronto and Greater Vancouver areas. An overvalued housing market is more vulnerable to a correction, in part because of the potential for an erosion in housing demand.

In 2012, OSFI's B-20 Guideline lowered the maximum loan-to-value (LTV) ratio for HELOCs offered by federally regulated lenders from 80 to 65 percent of the residential real estate used as security. This limits the amount of potentially more persistent debt that consumers can borrow against their home. Consumers can increase their leverage by another 15 percent, but they must use an amortized mortgage product to increase their LTV ratio to 80 percent. The expansion of the HELOC market was greater before the maximum LTV ratio was lowered, suggesting this measure has contributed to the moderation of the market. In addition, lenders are aware that certain housing markets may be riskier than others, and they can respond with LTV ratio restrictions that are lower than those introduced by OSFI's B-20 Guideline.

21 There are approximately 26 million credit consumers in Canada. Consumers were considered at risk for payment shock if their monthly credit obligations would rise more than $50 in response to interest rate increases. For more detail, see TransUnion Canada. (September 2016). *A Deeper Understanding of Payment Shock Dynamics*.

22 Bailliu, Jeannine, Katsiaryna Kartashova and Césaire Meh. (2012). "Household borrowing and spending in Canada," *Bank of Canada Review*.

23 Bank of Canada. (December 2015). *Financial System Review*.

24 See Bank of Canada. (December 2014). *Financial System Review* and Xu, Shaofeng. (2015). "On the welfare cost of rare housing disasters," *Bank of Canada* [Working Paper 2015-26].

5.4. The role of HELOCs in the U.S. financial crisis

The recent experience of the United States may provide insight into how HELOCs can potentially worsen the impact of an economic downturn. In their influential book *House of Debt*, economists Atif Mian and Amir Sufi argue that borrowing heavily against home equity (e.g., HELOCs, mortgage refinancing and home equity loans) played a significant, and often underappreciated, role in the U.S. financial crisis (2007–2008) and the great recession (2009–2010).[25]

In short, home equity borrowing significantly increases the probability of mortgage holders defaulting because it increases the homeowner's leverage and loan-to-value (LTV) ratio. It also consumes equity that might otherwise be used to maintain mortgages during periods of financial distress. Finally, home equity borrowing increases consumers' sensitivity and exposure to a housing price correction. Mian and Sufi found that existing homeowners who had borrowed aggressively against the rising value of their home were responsible for 40 percent of the large number of mortgage defaults between 2006 and 2008.[26]

It is worth noting here that the United States is one of the only high-income countries with no LTV ratio restrictions or debt service coverage limitations on home equity borrowing. Following the passage of the *Garn-St. Germain Depository Institutions Act* of 1982, mortgage lenders are not permitted to place restrictions on borrowers' rights to acquire junior liens on their residential property.[27] Consequently, U.S. consumers are permitted to borrow aggressively against their home equity. On the other hand, the HELOC market is significantly larger relative to GDP in Canada (11 percent) than it is in the United States (3 percent). In addition, the overwhelming majority of HELOCs originated in the United States have definite terms, which could mitigate the risk of debt persistence, credit deterioration and adverse selection.[28]

25 Mian, Atif and Amir Sufi. (2014). *House of Debt*. University of Chicago Press.

26 Mian, Atif and Amir Sufi. (2011). "House prices, home equity-based borrowing and the U.S. household leverage crisis," *American Economic Review*, 101, pp. 2132–2156.

27 Levitin, Adam J. and Susan M. Wachter. (2015). "Second-liens and the leverage option," *University of Pennsylvania Law School: Institute for Law and Economics*, Research Paper No. 15-13. Retrieved from the Social Sciences Research Network.

28 Definite term HELOCs are originated with a predetermined maturity date. The maturity date is preceded by two periods: the draw and repayment periods. During the draw period, consumers can borrow as much or as little from their HELOC account as they wish, up to their credit limit, as long as they keep their account in good standing. Draw periods tend to last 10 to 20 years. During this time, borrowers typically can keep their HELOC account in good standing by making interest-only payments. At the end of the draw period, borrowers with definite term HELOCs make arrangements to enter the repayment period. The outstanding balance is amortized over a term (e.g., 10 years), borrowers are no longer permitted to draw from their HELOC and, instead, consumers are obligated to make regular monthly payments, which combine interest and principal until the balance is repaid.

6. Improving consumer protection and education

6.1. Education

When used responsibly, HELOCs may help consumers improve their financial well-being. Consumers can increase the value of their home with renovations, improve their earning potential with education and training, or increase their monthly cash flow by consolidating higher-interest debt. At the same time, HELOCs and readvanceable mortgages are inherently risky and complex products. FCAC has found that a significant number of consumers do not appear to appreciate the risks or understand how these products work. To address this gap, the Agency will raise awareness of the risks related to HELOCs and will educate consumers on the manner in which HELOCs may be used to enhance financial wellness and well-being.

FCAC will develop plain language web content that sets out key factors for consumers to consider when deciding if a readvanceable mortgage, or a stand-alone HELOC, would be appropriate for their financial needs. The content will also provide information about fees (e.g., legal, administrative), penalties (e.g., prepayment), risks (e.g., rising interest rates) and typical product features, terms and conditions (e.g., lender's right to demand payment or revise the credit limit).

Second, the Agency will highlight to consumers the importance of establishing a realistic repayment plan before borrowing against their home equity through a HELOC. Having a repayment plan will help mitigate the risk of debt persistence and wealth erosion. FCAC will also encourage consumers to avoid using their HELOC to meet daily and routine expenses or to live beyond their means. When consumers use their HELOC to borrow more than they can afford, they can find themselves in a debt spiral, forced to extract additional home equity to stay current on their mortgage and on the home equity they have already extracted.

Third, FCAC will provide consumers with strategies, such as transferring the portion of a HELOC used to consolidate high-interest debt into an amortized sub-account, to help them mitigate the risk of worsening their financial position over time. Additionally, consumers who are using their HELOC as part of a leveraged investment strategy will be cautioned to assess their risk tolerance, choose their investments wisely and stick to a well thought-out investment strategy.

6.2. Disclosure

FCAC's review found that some consumers lack an adequate understanding of the terms, conditions, fees and risks associated with HELOCs, particularly when they are sold under the umbrella of readvanceable mortgages, which are more complex than traditional mortgages. The information box requirements for lines of credit and other relevant products are prescriptive in nature, and the current disclosure regime does not specifically address HELOCs or readvanceable mortgages. This has made it difficult to improve specific aspects of HELOC disclosure, such as information about fees or key terms.

FCAC will develop guidance with respect to the disclosure of key information for HELOCs and readvanceable mortgages to help consumers make more informed decisions and choose the product that best suits their needs and financial goals. Improved disclosure will help consumers make comparisons between different types of HELOCs, and between readvanceable and traditional mortgages, which will increase competition and encourage product innovation. Finally, the enhanced disclosure will raise consumer awareness about the implications of tying credit products, and other banking services, together under a readvanceable mortgage.

7. Summary

In the past two decades, HELOCs have emerged as the largest and most important form of non-mortgage consumer debt. When used responsibly, HELOCs increase consumers' access to relatively low-cost credit, which can assist them in achieving their short- and long-term financial goals.

However, the product's characteristics may increase consumers' vulnerability to over-borrowing, debt persistence and wealth erosion. The Agency's industry review found that high-risk features are prevalent. For example, interest-only payments over indefinite periods of time can lead to unintended consequences. When consumers finance their home purchase with a readvanceable mortgage, the amount of revolving credit available often increases automatically as the amortized mortgage portion is repaid.

Today, the large majority of HELOCs are originated under readvanceable mortgages, which are now marketed to a wide cross-section of consumers. It is important to educate consumers and improve the information provided to them, since readvanceable mortgages are more complex products than stand-alone HELOCs or traditional mortgages.

In conclusion, FCAC will take action to provide consumers with the resources they need to make informed choices. The Agency will produce consumer education material to increase awareness of the fees, penalties, terms (e.g., credit limit revisions), and risks (e.g., debt persistence, rising interest rates) associated with HELOCs and readvanceable mortgages. New disclosure expectations will be communicated to the industry in the interest of ensuring that consumers are in a position to make informed choices.