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Home Equity Loans: To Be or Not To Be?

By Judon Fambrough

On November 4, 1997, Texas voters will decide whether to alter the course of Texas history. Since the inception of the Texas Constitution, homeowners have been protected from general creditors by the state's unique homestead law. This protection, however, restricted the use of home equity as security for a loan. Now, Texas voters have a chance to remove some of the restrictions on home equity lending.

To help voters make an informed decision, here is a synopsis of the proposed constitutional amendment. The actual amendment is lengthy and complex. For those on the Internet, the complete text of HJR 31 may be accessed at the state legislature website (<http://www.capitol.state.tx.us>).

The three-part proposal addresses: home improvement loans, home equity loans and reverse annuity mortgages.

Home improvement loans. Although home improvement loans have been constitutionally authorized for years, the amendment introduces three procedural changes: a cooling-off period, limitations on where closings may occur and a right of rescission. At least 12 days must elapse between the owner's applying for the loan and signing the contract for the work and material. The contracts for the work and material must be signed in the lender's, attorney's or title company's office. Finally, after signing, homeowners have a three-day right to rescind the contract without penalty or charge.

The 12-day cooling-off period and the right to rescind do not apply when:

- the needed work (repairs) materially affect the health or safety of the owner or the persons residing in the homestead and
- the owners and spouses acknowledge this fact in writing.

Home equity loans. The authorization, limitations and requirements for home equity loans (better known as Section 50[a][6] loans) make up the bulk of the amendment. Several procedural rules parallel those proposed for home improvement loans.

For example, with one exception, a 12-day cooling-off period must occur between the loan application and the closing. The closing may occur only in the office of a lender, an attorney or a title company. A three-day right of rescission follows closing without penalty or charge.

The exception just noted relates to the beginning of the 12-day period. It begins with the loan application or on the date the lender provides a written list of the borrower's rights for home equity loans, whichever is later. If the discussion for the loan was conducted primarily in a language other than English, the lender must provide, before closing, an additional copy of the notice translated into the language used in the discussions.

Not all the equity in the home may be used. The proposal limits the loan amount to 80 percent of the fair market value (on the date of closing) less the recorded indebtedness against the dwelling. To avoid misunderstanding, the owner and lender must acknowledge the value of the house on the date the loan is extended.

Not all lenders may make home equity loans. The proposal limits the qualified lenders to:

- a bank, savings and loan association, savings bank or credit union doing business under Texas or U.S. laws;
- a federally chartered institute or a person approved by the U.S. government to make federally insured loans;

- a person licensed to make regulated loans provided by state statutes;
- a person who sold and financed all or part of the homestead purchase to the current owner; or
- a person related to the owner within the second degree of affinity or consanguinity.

Note: A qualified lender who engaged in redlining is ineligible.

The proposal specifies the type and condition of the loans. For example, the loan can not be open ended (revolving account). It must be nonrecourse (without personal liability) unless the borrower obtained the loan by fraud. It must be entered voluntarily. The lender can not require that the proceeds be used to repay another debt on the homestead, except one held by the lender.

The proposed terms of the loan would permit the lender to contract and receive any fixed or variable rate of interest authorized by statutes. Loan repayment must be in substantially equal monthly payments, but the borrower must be allowed to prepay without penalty. The document must state that the extension of credit is a type allowed by this constitutional amendment (Section 50[a][6]).

The loan may not be accelerated because the market value of the property decreases or because the owner defaults on other indebtedness that is not a prior valid lien on the homestead. The owner can not assign wages as security.

If the borrower defaults, the lender may foreclose judicially, not nonjudicially.

The Texas Supreme Court will promulgate rules to expedite this type of foreclosure. To keep the lender from circumventing the rules, the owner can not sign a confession of judgment or a power of attorney to be used by the lender or third party in the event of default.

Some limits apply to the land used. In rural areas, a homestead designated for agricultural use for ad valorem taxes is ineligible unless the owner uses the property primarily for milk production. The lender can not require additional realty or personalty as security. Only one home equity loan can be held against the dwelling at a given time. Once a loan is retired, another home equity loan can not be extended until one year after the closing date of the prior one.

The lender can not leave blank spaces in the loan documents. To ensure compliance, the proposal requires copies of all documents signed by the owner relating to the loan to be provided to the debtor.

The proposal includes limitations on the amount of fees that can be charged. In addition to any interest, all charges necessary to originate, evaluate, maintain, record, insure or service the loan can not, in the aggregate, exceed 3 percent of the original principal.

Once the owner repays the loan, within a reasonable time, the lender must cancel and return the promissory note and give the owner a recordable release. Alternatively, if the loan is refinanced, the lender must provide the owner a copy of an endorsement and assignment of the loan to the new lender.

The penalties for breaching the rules are severe. A lender or holder of the note forfeits all principal and interest for failing to comply with the lender's or holder's obligations under the amendment within a reasonable time after being notified by the owner.

The amendment approves refinancing of the first lien in the homestead to include an additional lien (and loan amount) against the borrower's home

equity. It is unclear, however, whether the transaction requires two security instruments: one to refinance the existing lien, the other for the home equity loan.

The amendment is clear on one point. The same formalities, limitations and restrictions apply to the position of the loan secured by the home equity 50[a][b] as to any other loan.

Reverse mortgages. Reverse mortgages (sometimes referred to as Reverse Annuity Mortgages or RAMs) allow a homeowner to create an income stream for a certain period by using the home equity without selling or moving from the dwelling. According to the amendment, a reverse mortgage is a lien, voluntarily placed on the homestead by an owner or spouse 55 years old or older. The lender extends a lump sum or periodic advances based on the borrower's home equity.

Repayment of the principal or interest may be accelerated before maturity when the:

- homestead is sold or otherwise transferred or
- borrowers cease occupying the home for more than 180 consecutive days and the lender is unaware of their whereabouts.

As with home equity loans, certain limitations apply but not nearly as many. As stated, the loan must be without recourse for personal liability. The loan may be based on a fixed or adjustable interest rate. However, interest may accrue and be compounded during the loan term.

The lender may not reduce the amount or number of advances because of a change in interest rates. If more than one advance is required, each must be at regular intervals established by the loan agreement.

The owner must attest in writing that counseling has been received regarding the advisability and availability of this type of loan. Perhaps the reason stems from broad powers given lenders. The

proposal allows reverse mortgages to be made regardless of Texas laws that:

- limit the purpose and use of future advances or mortgage proceeds,
- limit future advances to a term of years,
- limit the terms of open-end account advances,
- prohibit future advances from taking priority over intervening advances,
- prohibit balloon payments,
- prohibit compound interest on interest on interest,
- require the maximum loan amount to be stated in the loan document or
- require a percentage of the proceeds to be advanced before the assignment of the reverse mortgage.

Advances made under a reverse mortgage and the interest on the advances take priority over subsequent liens filed in the deed markets against the homestead.

Because only older homeowners qualify for reverse mortgages, the proposal clarifies the effect of the advances on eligibility for state-assistance programs. The advances are considered proceeds from a loan, not income, and thus do not affect borrowers' eligibility for these programs. Undisbursed funds are considered equity in the home, not proceeds from a loan.

As with the other loans, the price for noncompliance is high. Lenders who fail to make required advances and fail to cure the default as described in the loan documents forfeit all principal and interest.

For specific questions regarding the legal effects of this amendment, consult an attorney. ☐

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