How Collateral Signals Risk in the HELOC Market
Research Executive Summary

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Business Problems: Home equity lines of credit (HELOC) are an important part of your business, and you need a better understanding of your HELOC customers' risk profiles.

Solutions: This research shows how to determine if an applicant is a low- or high-risk HELOC borrower. This also enables lenders to better analyze the number of low-risk and high-risk borrowers they currently have in their portfolio to ensure portfolios stay within risk management guidelines.

Research Details: The amount of collateral that a borrower provides not only reduces a lender's risk but also provides lenders with information about the probability a loan will be repaid. In the commercial real estate market researchers have identified a direct relationship between collateral and risk. Commercial real estate loans with high loan-to-value ratios are less risky than those with low ratios because lenders force risky clients to put up more collateral.

Since the HELOC market is relatively new compared to commercial real estate, bankers and researchers are still determining how this market operates. The HELOC market may be similar to the commercial real estate market, with risky customers providing more collateral than credit-worthy borrowers. However, the HELOC market might also work the opposite way. Low-risk clients might back their loans with higher than needed amounts of collateral. Low-risk clients might do this because they need to borrow less money and also as a way to show lenders that they are a superior credit risk.

The research presents a theoretical model, empirical model, and a direct test that show how to distinguish between the competing ideas. The empirical results show that in the HELOC market, borrowers with low loan-to-value ratios tend to be low-risk customers. This is the opposite of what is seen in commercial real estate. The empirical results also suggest that since customers with lower loan-to-value ratios are less risky, lenders can provide these customers with lower interest rates and charge customers with high loan-to-value ratios higher rates.

Research Title: *Collateral and Sorting: An Empirical Investigation of the Market for HELOCS*

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