Texas Department of Banking
Testimony

Testimony Presented To The Committee On Financial Institutions Of The Texas House Of Representatives By Catherine A. Ghiglieri, Banking Commissioner

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NONRECOURSE LENDING

WHAT IS NONRECOURSE LENDING?

A nonrecourse loan is one in which the lender does not have the legal right to hold the borrower personally responsible for repayment. Instead, nonrecourse loans are generally repaid from the sale or cash flow of the collateral.

Nonrecourse lending is generally considered to be high risk to the lender. This is because the most basic element to any lending relationship is the pledge by an individual borrower that a loan will be repaid. Lacking such individual responsibility, history has shown that a borrower is more likely to engage in higher risk activity, and is more inclined to abandon a troubled project than a borrower who will be held personally responsible. Financial institutions are generally reluctant to engage in any lending relationship wherein the borrower's personal financial capacity is not committed to the loan.

HISTORICAL IMPACT OF NONRECOURSE LENDING IN TEXAS

Nonrecourse lending was considered to be a contributing factor to the banking crisis of the 1980's in Texas. It was generally borne of the increased competition among financial institutions during the boom years, when prudent lending standards were sacrificed as financial institutions vied to win over or retain borrowing clients. Some analysts believe that access to nonrecourse lending encouraged overbuilding and speculative development during that time. Ultimately, when the economy collapsed, the financial institutions suffered higher losses due to dependence on collateral sales to recover the debts, which hurt all Texans.

NONRECOURSE LENDING AND BANK SAFETY AND SOUNDNESS

Banking regulators monitoring the safety and soundness of the banking system would be concerned with the introduction of a large volume of nonrecourse lending, albeit secured by equity in borrowers' homes. Given the potential volume of home equity lending in Texas, this type of risk could be considered a threat to the stability of the banking system if improperly managed.

Bank examiners evaluate the quality of a loan based primarily upon an assessment of its prospects for repayment. Loans which have only a single source of repayment are generally considered speculative and of higher than normal risk. To enhance repayment prospects, financial institutions structure most loans to have both a primary and secondary source of repayment. Cash flow from the borrower is the primary source of repayment in most properly structured loans. As a precaution, collateral is commonly taken as a secondary source of repayment. However, because of the collection costs and market discounts usually imposed in the liquidation of collateral, reliance on the secondary source to pay off a loan frequently results in a loss situation for the institution.

As a general matter of safety and soundness, most financial institutions require the personal guarantee of the individuals borrowing the money. This not only ensures that any external cash flow of these individuals is accessible for repaying the loan, but it also binds the borrowers personally to the loans. Failure to have borrower accessibility in a problem situation can lead to more difficult workout situations and higher volumes of foreclosures and discounted sales.

Unless substantial other mitigating factors are evident, nonrecourse home equity loans could be susceptible to potential examiner criticism during an examination. This is due to the fact that there would be no legal means for the lender to access the standard primary source of repayment, which is the borrower's income. Instead, the loan would be totally based upon the traditional secondary source of repayment, i.e. sale of the home. Based upon historical experience, loans structured in this way would have a substantially higher level of risk than normal loans possibly warranting examiner criticism. Loans which are criticized are considered potentially problematic, and require a higher level of management attention and bank capital to prudently administer.

CONCLUSION

The possible impact on the banking system in Texas of this volume and type of lending risk is substantial. According to a 1996 study on home equity lending by the State Comptroller's Office, the total potential untapped home equity loan market in Texas was an estimated $8.6 billion in 1990. This number is undoubtedly higher today due to increased home ownership and equity accumulation in existing homes. As of September 30, 1996, total bank capital in Texas comes to $17.2 billion. Thus, to bank regulators, the prospect of banks exposing up to 50% of bank capital in potentially risky loans is unsettling. While the home equity market has many positive elements and opportunities for both lenders and borrowers, we believe that the market and banking system would be better served through a more traditionally structured loan product.