Notice to Members

DECEMBER 2004

SUGGESTED ROUTING

Legal and Compliance
Registered Representatives
Senior Management

KEY TOPICS

Communications with the Public
Home Equity Lines of Credit
Leverage
Liquefied Home Equity
Margin
Mortgages

GUIDANCE

Liquefied Home Equity

NASD Alerts Members to Concerns When Recommending or Facilitating Investments of Liquefied Home Equity

Executive Summary

The rapid increase in home prices over the past several years, in combination with refinancing activity by homeowners, has lead to increasing investment activity by homeowners with equity from their homes. This *Notice* reminds members that recommending liquefying home equity to purchase securities may not be suitable for all investors and that members and their associated persons should perform a careful analysis to determine whether liquefying home equity is a suitable strategy for an investor. In addition, members should ensure that all communications with the public addressing a strategy of liquefying home equity are fair and balanced, and accurately depict the risks of investing with liquefied home equity. Finally, members should consider whether to employ heightened scrutiny of accounts that they know, or have reason to know, are funded with liquefied home equity.

Questions/Further Information

Questions regarding this *Notice* may be directed to Gary L. Goldsholle, Associate Vice President and Associate General Counsel, Office of General Counsel, Regulatory Policy and Oversight, at (202) 728-8104.

04-89

Background

The escalation of home values has made many homeowners wealthier as the equity in their homes has risen. Many investors have sought to access this equity in connection with mortgage refinancing or home equity lines of credit. Moreover, given the recent historically low interest rates, the cost of accessing this capital has been relatively low. In many cases, lower interest rates have allowed investors refinancing their mortgages to liquefy equity and lower their monthly payments. However, the benefit of these trends has the potential to be undone by inappropriate speculation or investments in securities.

NASD has observed increasing use of liquefied home equity for investments and recent studies corroborate these observations. According to the Federal Reserve Board, in the most recent period studied, the period 2001 through the first half of 2002 (2001-2002 period), 11 percent of the total funds liquefied in mortgage refinancings were used for stock market and other financial investments, up from less than two percent for the period 1998 through the first half of 1999 (1998-1999 period). The average amount of liquefied home equity being used for investments also has increased substantially. In the 1998-1999 period, the Federal Reserve Board found that "most homeowners who used the cash [from liquefied equity] to make stock market investments invested relatively small amounts."[1] However, in the 2001-2002 period, the average spent on stock market and other financial investments was more then $24,000, greater than nearly all other categories, including home improvement.[2]

Discussion

NASD believes that a recommendation for a homeowner to liquefy home equity for investments poses significant and unique risks for investors.[3] A home is a basic necessity and is often an individual's largest asset. Homeownership also provides stability and plays an important part in many social policies.

One of the primary concerns of investing liquefied home equity is that an investor may lose his or her home. If a homeowner takes out a mortgage to invest in securities on the assumption that the return from the investments will be sufficient to cover the mortgage payments, and the investment fails to earn the necessary rate of return, the investor may be unable to meet his or her mortgage obligations and default on the mortgage.

Another concern is that investors may misapprehend their risk tolerance for investments using liquefied home equity, particularly since liquefying home equity may often have an accompanying increase in mortgage obligations or create a new obligation in the case of a home equity line of credit. Thus, if the value of an investment decreases, as can happen with many investments, the investor may need to sell his or her investments to protect his or her home and limit further losses.

When liquefying home equity for investments in securities, homeowners, in pursuit of lower interest rates, also may select a mortgage or home equity loan with a variable interest rate. In an environment of increasing interest rates, as exists today, homeowners could see a significant increase in their debt service payments potentially forcing a sale of investments to meet these higher obligations.

In addition, investors may fail to recognize certain potential conflicts of interest, for example, a broker's interest to capture commissions or fees on investments from the proceeds of liquefied home equity. In addition, if the member or its affiliate is the lender, investors may not understand that they also will be paying compensation to the member or its affiliate for originating and/or servicing the loan. Conflicts also may exist even in the absence of an affiliate relationship if a member receives referral or other payments from a lender.

Finally, liquefying home equity may undermine the asset diversification benefit of home ownership. While home values fluctuate, they may not be correlated with equity or securities markets. Moreover, homes are an illiquid investment, given the generally high transaction and other costs associated with moving. Because of this, many homeowners do not realize gains (or losses) in the appreciation (or depreciation) in their homes. However, once liquefied for investments in securities, a homeowner can much more easily and quickly lose the equity in his or her home.[4]

In light of these concerns, NASD is reminding members of their obligations in connection with investments of liquefied home equity.

Suitability

Members are reminded that recommending liquefying home equity to purchase securities may not be suitable for all investors. Members should consider not only whether the recommended investments are suitable, but also whether the strategy of investing liquefied home equity in securities is suitable.[5] In addition to the factors typically considered as part of a suitability analysis,[6] a member and its associated persons also may wish to consider: (1) how much equity does the investor have in his or her home; (2) what is the level of equity being liquefied for investments; (3) how will the investor meet his or her increased mortgage obligations; (4) is the mortgage or home equity loan at a fixed or variable rate;[7] (5) what is the investor's risk tolerance with respect to the funds being invested; (6) what is the investor's overall debt burden; and (7) what is the sustainability of the value of the investor's home.[8]

In addition, members also are reminded that IM-2310-2 (Fair Dealing with Customers) prohibits recommending purchases beyond a customer's capability, stating that it is a violation of a member's responsibility of fair dealing to "recommend[] the purchase of securities or the continuing purchase of securities in amounts which are inconsistent with the reasonable expectation <u>that the customer has the financial ability to meet such a commitment</u>."[9]

Best Principles

As noted above, investing liquefied home equity presents unique risks and also may present certain conflicts. NASD believes members should ensure that their supervisory systems address these risks and conflicts.

Firms that recommend or facilitate investments of liquefied home equity should consider the extent to which customers are adequately informed of the risks and conflicts of such a strategy. NASD has previously developed risk disclosure statements for certain other trading strategies, such as margin[10] and day trading accounts.[11]

Although NASD is not proposing a specific, standardized risk disclosure document, NASD believes members recommending investments of liquefied home equity should pay particular attention to providing investors with adequate risk disclosure. Among the risks and conflicts of investing liquefied home equity are: (1) the potential loss of one's home; (2) the fact that unlike other potential lenders, the member has an interest in having the proceeds of the loan used for investments that may generate commissions, mark-ups or fees for the member; (3) the member or its affiliate may earn fees in connection with originating the loan; (4) the impact of liquefied home equity on the ability to refinance a home mortgage; and (5) depending on the amount of home equity liquefied and any change in home value, the homeowner may have negative equity in his or her home.

Members also should pay particular attention to their sales materials and oral presentations concerning investments of liquefied home equity. NASD reminds its members that the promotion of liquefying home equity must be fair and balanced, and must address the associated risks. For example, if a member presents a scenario in which the investment returns from liquefied equity will be sufficient to pay the costs of accessing such capital, the member should highlight the risk that such returns may not be achieved and that the customer may have to access additional sources of funding to pay the mortgage or equity line of credit or risk foreclosure.

Members also should consider the extent to which accounts investing liquefied home equity should require heightened supervision or specific account approval. Again, in other contexts where leverage is involved,[12] such as options, or specific trading strategies, such as day trading, NASD has required specific account approval procedures.[13] NASD recommends that firms consider whether similar procedures should be developed for accounts that invest liquefied home equity loaned by the member directly or arranged by the member through an affiliate or third party.

The situation where a member or its affiliate simultaneously recommends the strategy of liquefying home equity and originates the mortgage or equity line of credit presents additional conflicts, as the member or its affiliate may earn compensation from originating the loan, and if applicable, servicing or selling the loan, in addition to commissions or other fees earned by the member in connection with investments of the proceeds of the loan. Members should ensure that customers are adequately informed of the nature of the compensation that the member or its affiliate may earn from extending a mortgage or home equity loan. Conflicts also may arise where a member has a referral or other relationship with an unaffiliated lender. Members should ensure that customers are adequately informed about the nature of any such relationships.

Finally, NASD recommends that firms consider whether there should be any general standards for when a recommendation to invest liquefied home equity should be prohibited. While the circumstances surrounding an investment are fact-specific, there may be certain circumstances where recommending a strategy involving liquefied home equity is in all cases, or nearly all cases, inappropriate. For example, a firm may determine that it is inappropriate for a customer to use liquefied home equity to invest on margin, or withdraw home equity above a certain threshold (*i.e.*, reducing their home equity to below a certain level).

Endnotes

1. Peter J. Brady, Glenn B. Canner, and Dean M. Maki, "The Effects of Recent Mortgage Refinancing," Federal Reserve Bulletin, vol. 86 (July 2000), pp. 441, 446.
2. Glenn Canner, Karen Dynan, and Wayne Passmore, "Mortgage Refinancing in 2001 and Early 2002," Federal Reserve Bulletin, vol. 88 (December 2002), pp. 469, 473.
3. NASD has previously expressed concerns over liquefying home equity and 100% loan-to-value or pledged asset mortgages, including that many investors are not aware of the attendant risks. *See* Investor Alert Betting the Ranch: Risking Your Home to Buy Securities, at *www.nasd.com/betting*; and Investor Alert 100% Mortgages: The Low Down on No Money Down, at *www.nasd.com/mortgages.*
4. *See* Report for Congress, U.S Housing Prices: Is There a Bubble?, May 16, 2003, page 18.
5. *See* In *re F.J. Kaufman and Company of Virginia*, 50 S.E.C. 164 (1989).
6. *See* generally Rule 2310.
7. Inasmuch as investors with adjustable or hybrid mortgages may see their mortgage payment increase in the future, such factors must be taken into account in evaluating whether liquefying equity is a suitable strategy. Where, for example, an investor has an adjustable mortgage that, based on current or anticipated rates, is expected to increase, members should take such higher expected mortgage payments into account when considering whether liquefying equity to purchase securities is a suitable strategy.
8. A member also should evaluate whether an increase in home value is reasonably sustainable. An investor who liquidates a portion of his or her home equity and then sees the value of the home fall may find that he or she has little or even negative equity in his or her home. The loss of equity in one's home may make it difficult or more expensive to refinance a mortgage. In addition, an investor that sells a home with negative equity will be required to pay funds at closing.
9. IM-2310-2(b)(5) (emphasis added).

10. Rule 2341 prohibits a member from opening a margin account for or on behalf of a non-institutional customer unless the member has furnished the customer with a specified margin disclosure statement.

11. Rule 2361 prohibits a firm that is promoting a day-trading strategy from opening an account for or on behalf of a non-institutional customer unless the member has furnished the customer with a specified day-trading risk disclosure statement.

12. Liquefied home equity is akin to leverage as both involve investments with borrowed funds. In the case of liquefied home equity, money is typically borrowed from a bank and secured by the home; in the case of investing on margin, the money is borrowed from a broker-dealer and secured by the securities in the investor's account.

13. *See* Rule 2860(b)(16) (Options: Opening of Accounts); Rule 2360 (Approval Procedures for Day-Trading Accounts).