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Home Equity Amendments: Servicing Perspective

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Texas Home Equity Amendments: Servicing Perspective

Home Equity Loans in Texas

As far back as 1845, the authors of the Texas Constitution specifically created a homestead exemption to protect Texans land from forced sale by creditors.¹ Professor Joe McKnight stated that the idea of homestead protection actually originated on the Texas frontier prior to statehood.² Eventually, most other states followed Texas' lead in creating some form of homestead protection, although often times in different forms and with lesser protections, in value or otherwise.³ Eventually, federal law caught up by permitting debtors in bankruptcy to exempt their homestead property from general creditors.⁴

The homestead exemption generally limits the ability of general creditors to execute a judgment on a debtor's homestead property. However, not even the original homestead protection of 1845 limited the ability of the parties to contractually agree to use homestead property to secure debts. That changed in Texas in 1876. The Texas Constitution of 1876 only permitted debts for purchase money, improvements, and taxes on homestead property. From 1876 until 1997, these remained the only valid liens on homestead property.

While every other state in the United States allowed home equity liens on homestead property, Texas remained firm in its prohibition of anything other than debts for purchase money, home improvement, and taxes being secured by an individual's domicile. Once again federal law put Texans in an adverse position from the other states. A homeowner was allowed interest paid on a home equity lien, up to a specified maximum, to be deducted from their federal income taxes.⁵ The potential benefits of home equity loans became obvious to both borrowers and

¹ Tex. Const. of 1845, art. IVV, Sec. 22.

² Joseph W. McKnight, *Protection of the Family Home from Seizure by Creditors: The Sources and Evolution of a Legal Principal*, 86 SW. L.Q. 369 (1983).

³ *Id.* at *supra* note 2, at 396.

⁴ *Id.* at 398.

⁵ I.R.C. Sec. 163(h)(3) (1994).

lenders. For borrowers, they know had the option to take the equity out of their home with a loan with typically better interest rates and favorable tax treatment than a typical credit card. For lenders, having security for a loan in the form of a primary residence would greatly reduce the risk of losses associated with nonpayment of the loan. However, home equity lending also had the potentially disastrous disadvantage for the borrower in the potential forced sale of their residential homestead that would have otherwise been protected from creditors.

Finally, in 1997, the Texas Legislature proposed a constitutional amendment to be presented to Texas voters to authorize home equity liens, but they included several provisions to attempt to ensure that Texans, and especially their homesteads, were protected from unscrupulous lenders. These consumer protections included, but were not limited to: 1) requirement that a lender could foreclose a home equity loan only by court order; 2) the home equity loan, and all other loans secured by the property, could not exceed eighty percent of the fair market value of the homestead; 3) the home equity loan must be nonrecourse; 4) the home equity loan may not be secured by any other collateral; 5) a limitation on the amount of fees that can be charged as a percentage of the loan amount; 6) the home equity loan must not have a prepayment penalty; 7) a twelve day notice requirements prior to closing the loan; 8) requirements that the loan be closed only in certain locations; 9) the borrowers have three days to rescind the loan after closing; and 10) the loan must be signed by each owner and their spouse of the property to be secured.⁶

The nonrecourse nature of a Texas home equity loan was designed to ensure that the risk of the failure to comply with the Texas Constitution would lie squarely with the lender. If the loan did not comply, then the lender would have nothing more than an unsecured loan for which the borrower could not be held personally liable if they failed to pay.

Development of Home Equity Servicing

Most mortgage companies separate out its loan origination group from its loan servicing group, which makes sense because the differing groups are typically regulated under a different set of federal and state regulations. However, a prudent lender will make sure that its servicing

⁶ Texas Constitution Article XVI, Section 50.

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