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Edward S. Washburn

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## ALTERNATIVE MORTGAGE INSTRUMENTS IN CALIFORNIA

EDWARD S. WASHBURN\*

### INTRODUCTION

**M**UCH INTEREST has been generated recently in California and elsewhere in what have been termed alternative mortgage instruments (AMIs). Two separate sets of pressures have been responsible for this. One has been the tremendous increase in the cost of lendable funds requiring constantly higher yield on each lender's overall mortgage portfolio. This has been induced by the inexorable increase in interest rates required to be paid by mortgage lenders in order to obtain lendable funds for home ownership loans, along with unremitting escalation of operating costs. The second pressure has been the persistent escalation of the cost of the conventional home with its typical purchase money mortgage so that an increasing segment of potential new homeowners is being priced out of the market.

Before analyzing each of these phenomena, a few definitions are in order. Throughout this article the term "mortgage instrument" is used to describe the document, whether it be a mortgage, deed of trust or other writing, by which a lien is created against real property for the purpose of securing a loan to the owner of an interest in that real property. "Conventional mortgage" describes the typical mortgage instrument in wide use throughout the United States to facilitate the purchase of residential real property. It secures a loan made to the purchaser to supply a part of the purchase price of such real property. The conventional mortgage also provides for repayment of this loan over a number of years (typically twenty-five to thirty) at a fixed interest rate by a series of equal monthly payments which will pay all interest on the loan as it falls due and which will fully amortize (repay) the principal amount of the loan within the specified term. An "AMI" is a mortgage instrument whose terms vary in some material respect from a conventional mortgage. Finally, unless otherwise specifically stated, the "mortgage lender" dealt with here is a state or federally chartered savings and loan association in California, although

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\*General Counsel, Great Western Savings and Loan Association; B.A., Yale University; J.D., University of California at Berkeley.

much of the material is equally applicable both to state and national banks in California and to savings and loan associations elsewhere.<sup>1</sup>

### I. A PROBLEM: THE LENDER'S COST OF LENDABLE FUNDS

It has become an axiom of security analysts and other observers of financial institutions that the vice of the home mortgage lenders, and savings institutions in particular, is that they "borrow short and lend long." They thus place themselves in a strait jacket, unable to adjust effectively to rapidly changing conditions in the money market. The funds which savings associations use to make mortgage loans are derived in major part from the savings deposits they receive from their customers.<sup>2</sup> In addition, certificate accounts, authorized in 1969, are becoming increasingly popular. Both of these sources of funds are available for only short periods when compared to the length of the typical residential mortgage.<sup>3</sup> Regular, or passbook, accounts are essentially demand deposits. Although certificate deposits are term accounts and have a substantial penalty for early withdrawal, they too are essentially short term in nature in relationship to the typical residential mortgage.<sup>4</sup> This is the genesis of the first half of the axiom quoted: savings associations borrow short.

On the other hand, savings associations' lending activity is overwhelmingly devoted to making long term home mortgages. These are loans secured by residential real property of not more than four living units, the so-called "one to fours," whose terms are at least twenty-five years and more typically thirty years in today's market. Only a very small percentage of the loan portfolio of a representative savings association will ordinarily be devoted to construction or other short term loans.<sup>5</sup> These are the facts

<sup>1</sup> Savings institutions are overwhelmingly the largest source of funds for residential mortgage lending. At the end of 1975, for example, savings and loan associations held 51% of all residential mortgages, commercial banks 17%, mutual savings banks 10%, life insurance companies 4%, government agencies 13% and private lenders 5%. Kaufman, *Variable Rate Residential Mortgages: The Early California Experience*, FED. RES. BANK OF S.F. Q. ECON. REV., Summer 1976, at 5.

<sup>2</sup> Borrowings from the Federal Home Loan Bank and commercial banks are also sources of funds.

<sup>3</sup> In addition to the large certificate accounts and treasury bill accounts, small certificate accounts vary from a 90-day bearing 5.75% interest to a four year account bearing 7.5%. These generally require a minimum of \$100,000.

<sup>4</sup> As of November, 1978, the United States League of Savings Associations estimated the following distribution of total savings in all savings associations in the United States (dollars in billions): passbook (or demand) accounts — \$138; large certificate accounts (minimum amount, \$100,000; minimum term, 30 days) — \$16; "Treasury Bill" accounts (T-Bill accounts) (minimum amount, \$10,000; minimum term, 6 months) — \$34; small certificate accounts (minimum term, 1-to-4 years) — \$225. SAV. AND LOAN NEWS, January, 1979, at 32.

<sup>5</sup> For example, as of December 31, 1977, only 26% of the total loan portfolio of all commercial banks in California was in real estate loans, and 15% of those were short term construction and land loans. Telephone interview with the research department of the Federal Reserve Bank of San Francisco. By contrast, an analysis of Great Western Savings

of life from which the other half of the axiom, that of lending long, is derived.<sup>6</sup>

This situation leads to periods where the upward pressure on mortgage interest rates is accentuated. When short term interest rates rise rapidly, savings deposits decrease and withdrawals are experienced as savings depositors seek the higher yields being offered elsewhere.<sup>7</sup> As lendable funds come into short supply, lenders raise rates to dampen demand. Additionally, and increasingly, savings institutions also offer a variety of higher-yield term savings accounts in an effort to retain existing, and attract new, savings dollars.<sup>8</sup> This in turn increases the cost of lendable funds which must be offset by higher mortgage interest rates. At the same time, because of the long term nature of mortgage loans, the pace of "roll-over" is slow.

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and Loan Association's loan originations for the year 1978 (typical of the industry) shows only 9% were in construction and land loans (with terms of less than two years), the remaining 91% being in long term loans.

<sup>6</sup> While it is true that in fact the average "life" of such loans is approximately eight years, this is a somewhat misleading statistic since it is based on an average. In fact, loans with higher interest rates (and therefore generally newer) tend to be paid more quickly, while the lower rate, older loans tend to stay on the books even to maturity, a situation aggravated in times of rising interest rates.

<sup>7</sup> This is the "disintermediation" effect which has been the subject of a host of studies and articles. The term arises from the categorizing of savings associations as intermediaries between savers who have funds to lend and borrowers who wish to borrow funds. When short term interest rates rise and savings funds flow out of savings associations seeking those higher yields, the function of intermediation ceases for lack of lendable funds, and its converse, disintermediation, sets in. For an excellent exposition of the theoretical aspects of disintermediation, see *Kaufman, supra* note 1. See also *The Variable Interest Rate Clause and Its Use in California*, 19 U.C.L.A. L. REV. 468 (1972); Cowan & Foley, *New Trends in Residential Mortgage Finance*, (Aug. 1978) (a paper presented at the American Bar Association seminar on "Real Estate Financing Today and Tomorrow," in New York City). This paper contains a very comprehensive and complete bibliography covering all aspects of the disintermediation phenomenon and savings and loans response to it: the variable rate mortgage.

<sup>8</sup> The T-Bill account is an excellent example. The rate for these six-month term accounts (minimum \$10,000) is set each week at 1/4% over the average interest rate paid by the U.S. Treasury at the auction conducted each Monday for the sale of six-month treasury bills. (By regulation effective March 15, 1979, the 1/4% differential was eliminated for rates over 9%. 44 Fed. Reg. 15478 (1979).) Savings associations have been paying over 10% on some of these accounts, a rate far higher than that paid on other accounts. The result is a rapid increase in this type of account with a corresponding increase in the cost of funds to associations.

Since their inception in June, 1978, (43 Fed. Reg. 24271 (codified in 12 C.F.R. 526.3(8))) T-Bill accounts have represented 12.8% of the total savings in all associations in the United States. WASH. NOTES, March 9, 1979, at p.2. As of January 31, 1979, more than one-half of these accounts came from transfers of funds from lower interest paying existing accounts, rather than new money, thus aggravating the increased cost of funds. WASH. NOTES, Feb. 2, 1979, at 2. Senator Proxmire has introduced a "sense of the Senate" resolution, calling upon the rate control agencies to reduce the minimum qualifying amount on T-Bill accounts from \$10,000 to "not greater than \$1,000" on the theory the present system excludes the smaller saver from access to these high interest rate accounts. S. Res. 59, 96th Cong. 1st Sess., 125 CONG. REC. S1176-78 (1979). Should Senator Proxmire's views prevail, the trend towards transferring existing accounts to higher paying T-Bill accounts will be greatly accentuated in the near future.

This is particularly true in times of increasing mortgage interest rates, which tend to inhibit payoffs, as opposed to times of declining rates, when the pace of payoffs quickens. Associations find themselves with loans in their portfolio whose interest rates are below their current cost of money even before allowance is made for operating expenses. To offset these low interest rate loans still higher rates on new loans must be charged to raise the overall portfolio yield.

## II. GENESIS OF VARIABLE RATE MORTGAGES

It was to ameliorate this basic problem that the first category of AMIs, the variable interest rate loan, or variable rate mortgage (VRM) was adopted by several large state-chartered savings and loan associations in California in early 1975.<sup>9</sup>

The use of VRMs by state-chartered savings institutions in California has long been authorized.<sup>10</sup> At least thirty-five associations were using it in some form by 1969, but it was not until its adoption by the four major associations in 1975 that its use became prevalent. Other associations soon followed suit and most of the larger state-chartered savings and loans offer it today. There are a number of different types of VRMs.<sup>11</sup> The type most overwhelmingly in use pegs the interest rate to a predetermined independent index. This is the only type here discussed, with the exception of the "Canadian Roll-Over" mortgage briefly mentioned later in the text.<sup>12</sup>

The swing to VRMs was no doubt triggered in part by a premonition of managing officers that the demise of the "due on sale" clause<sup>13</sup> was at hand. The "due on sale" clause has been a standard provision in savings and loan associations' deeds of trust and mortgages for many years. Briefly stated, it permits the lender to accelerate the loan, thus "calling" it or declaring the entire remaining principal balance all due and payable, upon the transfer by the borrower of all or a part of his interest in the security property.<sup>14</sup> Lenders were able to use this right to call the loan as a device

<sup>9</sup> These four were Home Savings, Great Western Savings, Gibraltar Savings and Citizens Savings, ranking in size first, second, seventh and eleventh, respectively, in California. These four are the first, second, seventh and thirteenth largest savings and loans in the United States. Eleven of the largest fifteen savings associations are located in California. See SAV. AND LOAN NEWS, Feb. 1979, at 59.

<sup>10</sup> CAL. CIV. CODE § 1916.5 (West Supp. 1979).

<sup>11</sup> For an analysis of several types, see D. SMITH, ALTERNATIVE MORTGAGE INSTRUMENTS (January 1977) (Special Publication Series Topical Report published by the Federal Home Loan Bank of San Francisco).

<sup>12</sup> See text accompanying note 42, *infra*.

<sup>13</sup> The California Supreme Court prefers to call it the "due-on" clause. See, e.g., Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978).

<sup>14</sup> A typical "due on sale" clause reads: "If all or any part of the property is sold or transferred by Borrower without Lender's prior written consent, Lender may, at Lender's option, declare all sums secured by this Deed of Trust to be immediately due and payable."

to upgrade the yield on their loan portfolios and eliminate the lower yielding loans.

Title to residential real property in California changes hands with surprising frequency.<sup>15</sup> This high turnover triggers the "due on sale" clause and allows the lender to increase the interest rates of the loans in its portfolio. This is normally done by the lender conditioning the waiver of its right to accelerate the loan on the new buyer assuming the loan at an increase in the interest rate and with payment of an assumption fee.<sup>16</sup>

In *Coast Bank v. Minderhaut*,<sup>17</sup> the California Supreme Court examined the operation of the "due on sale" clause and validated it as not being violative of California's rule against restraint of alienation of real property. Several court of appeals decisions followed<sup>18</sup> and it appeared that California lenders could rely on this practice to adjust their portfolio yields. Then in 1971, the Supreme Court gave its first indication that the "due on sale" clause might be in trouble. In *LaSalla v. American Savings and Loan Association*,<sup>19</sup> the court held that a lender could not arbitrarily exercise its right to accelerate the loan when the borrower further encumbered the security property in violation of the "due on sale" clause unless it could show there was an impairment of its security position. Because the *LaSalla* case was a class action, and the court used the occasion to set forth major rules and guidelines with respect to this then-novel form of action, the impact of the decision as regards the "due on sale" clause was somewhat muffled.

However, in 1975 the Supreme Court followed with a blockbuster. In *Tucker v. Lassen Savings and Loan Association*,<sup>20</sup> the court held that a lender could not arbitrarily accelerate its loan, without a showing of actual

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<sup>15</sup> The author's experience has been that the average actual life of a 30 year mortgage in California is approximately eight years.

<sup>16</sup> In order to avoid this unpalatable result, borrowers will "deed out," *i.e.*, sell the property and transfer title, without notifying the lender. The lender has no simple and accurate way of monitoring this. Checking the filing of deeds at the recorder's office in some 50 counties is obviously impractical. Receipt of loan payments from an apparent stranger is ineffective since the vast number of payments, and mechanization of their processing, makes it impossible to compare the payor of each check with the name of borrower in each loan file. In addition, thousands of loan payments are legitimately paid each month by someone other than the borrower. Property management companies, trustees and family holding companies are examples. If the lender is monitoring the maintenance of hazard insurance on the property, the appearance of a new named insured, sent to the lender as a named loss payee by the insurance company, thus indicating the newly named person has an insurable interest in the property, is often the first evidence a lender has of the "deed out."

<sup>17</sup> 61 Cal. 2d 311, 392 P.2d 265, 38 Cal. Rptr. 505 (1964).

<sup>18</sup> *Cherry v. Home Sav. and Loan Ass'n*, 276 Cal. App. 2d 574, 81 Cal. Rptr. 135 (1969); *Hellbaum v. Lytton Sav. and Loan Ass'n*, 274 Cal. App. 2d 456, 79 Cal. Rptr. 9 (1969).

<sup>19</sup> 5 Cal. 3d 864, 489 P.2d 1113, 97 Cal. Rptr. 849 (1971).

<sup>20</sup> 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974).

impairment of security, where the borrower had transferred his beneficial interest in the security property under an installment land contract of sale, under the terms of which transfer of legal title would follow upon performance by the buyer.<sup>21</sup>

It was at this point that the continued use of the "due on sale" clause to upgrade portfolio yield seemed in real jeopardy and the alternative of a variable rate mortgage (VRM) suggested itself to many lenders. Following these earlier opinions to their logical conclusion, in 1978 the Supreme Court finally sounded the death knell to use of the "due on sale" by institutional lenders to increase yields on existing mortgages. In *Wellenkamp v. Bank of America*<sup>22</sup> the court held that it is impermissible for an institutional lender to accelerate its loan upon outright transfer of fee title to the security property, absent a showing of impairment of security or an increase in the likelihood of default on the loan.

### III. THE TYPICAL VARIABLE RATE MORTGAGE

The California legislature has promulgated certain terms and conditions under which VRMs may be made, and authorized the Savings and Loan Commissioner to issue regulations with respect to such loans.<sup>23</sup> These regulations have now been promulgated.<sup>24</sup> The regulations apply to all loans the purpose of which is to finance the purchase of residential real property containing four or fewer units or on which four or fewer residential units are to be constructed.<sup>25</sup> Under these regulations, a typical VRM loan has a stated initial interest rate that thereafter may vary throughout the life of the loan in accordance with the fluctuations of a predetermined

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<sup>21</sup> The *Tucker* decision led to a substantial increase in use of installment land sales contracts as a device to avoid "due on" sale accelerations. Several title insurance companies and many attorneys and real estate brokers developed forms which accomplished this result while retaining some of the more attractive features of the conventional deed of trust, such as private power of sale upon default and insurability of the title interests of buyer and seller.

<sup>22</sup> 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). At the time of the *Wellenkamp* decision, the court also had before it three other cases involving application of the "due on sale" clause in which it had granted a hearing after decision in the court of appeals. Following *Wellenkamp*, these cases were remanded back to the Courts of Appeal which had initially decided them for disposition governed by the principles announced in the *Wellenkamp* opinion. One such case has now been decided again. In *Medovoi v. American Savings and Loan Association*, 89 Cal. App. 3d 244 (1979), the Court of Appeals decided that the lender could exercise its "due on sale" clause (contrary to the holding in *Wellenkamp*) and justified this result in an astonishing set of opinions (one by each of the three justices) highly critical of the Supreme Court, which limited applicability of the *Wellenkamp* rule to owner occupied residences and the institutional lender.

<sup>23</sup> CAL. CIV. CODE § 1916.5 (West Supp. 1979).

<sup>24</sup> 10 CAL. ADM. CODE §§ 240.1-240.5 (1978).

<sup>25</sup> Note that the Commissioner's regulations thus apply to "home ownership" loans. While these are the great majority of VRMs being originated, the statute is not so limited and large commercial long term loans, as well as construction loans, are being issued with VRM provisions.

independent index. The index prescribed by the Commissioner for California state-chartered savings and loan associations is the cost-of-money index published semi-annually by the Federal Home Loan Bank of San Francisco.<sup>26</sup> It is a weighted average of several components making up the cost of lendable funds to the California associations who are members of the Bank.<sup>27</sup> These components consist of (1) the average interest rate paid by all member associations to savers on their savings accounts, (2) the average commercial bank prime rate and (3) the average interest charged by the Federal Home Loan Bank to associations borrowing funds from it.<sup>28</sup> In each instance, during the six month period covered, all are appropriately weighted to reflect each component's relative importance as a source of lendable funds. Changes in the semi-annual index which result in a lowering in the interest by at least ten basis points<sup>29</sup> (1/10%—each one percent equals 100 basis points) *must* be implemented by the lender.<sup>30</sup> Changes upward by at least ten basis points *may* be made; and if not made, may be carried forward and cumulated for later change.<sup>31</sup> Changes cannot be made more often than once every six months.<sup>32</sup> Any change must be made within two months of the publication of the semi-annual index triggering the change.<sup>33</sup> No change can be less than 1/10% (ten basis points) or greater than ¼ % (25 basis points).<sup>34</sup> Additional fluctuations unused due to these restrictions may be carried forward and may be the basis of a future change.<sup>35</sup> The total of all changes upward cannot result in an increase greater than 2.5% during the life of the loan.<sup>36</sup>

Where the interest rate is increased as outlined above, the borrower is given a period of ninety days after receiving notice of such increase during which he may pay off the loan in full without prepayment fee irrespective of any provision in the loan documents requiring such prepayment fee.<sup>37</sup> Finally, upon any such increase, the lender must permit the borrower to elect whether such increase is to be reflected by increasing the monthly loan payments (because of the higher interest rate) or by holding monthly payments the same and increasing the term of the loan.

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<sup>26</sup> 10 CAL. ADM. CODE § 240.1(a) (1978).

<sup>27</sup> *Id.* This includes virtually all savings associations, both state and federal in California.

<sup>28</sup> See 12 C.F.R. § 525.3 (1978).

<sup>29</sup> Ten basis points equal 1/10%. Each one percent equals 100 basis points.

<sup>30</sup> 10 CAL. ADM. CODE § 240.1(B)(7) (1978).

<sup>31</sup> *Id.* at § 240.1(B)(8).

<sup>32</sup> *Id.* at § 240.1(B)(5).

<sup>33</sup> *Id.* at § 240.1(B)(6).

<sup>34</sup> *Id.* at § 240.1(B)(1), (2).

<sup>35</sup> *Id.* at § 240.1(B)(3).

<sup>36</sup> *Id.* at § 240.1(B)(1). There is no corresponding limit on the downside.

<sup>37</sup> *Id.* at § 240.5.



The latter, in effect provides a longer amortization period and enables absorption of the interest increase in a more palatable fashion rather than increasing the monthly payment.<sup>38</sup> The total term of the loan, including any such extension, cannot exceed forty years, thus limiting the extension period of the typical single family residential loan to ten years.<sup>39</sup>

Introduction of VRMs in California was met with surprisingly little consumer resistance.<sup>40</sup> One probable reason for the ready acceptance of VRMs was the support by real estate brokers.<sup>41</sup> This support was elicited because VRMs are freely assumable by purchasers from the original borrower (and subsequent owners) without any negotiation respecting an increase in the interest rate or an assumption fee. Until the *Wellenkamp* case, the problem of how to handle the existing loan on property being sold had been a substantial inhibiting factor in the sale of residential real property. Brokers thus turned with some delight to VRMs as a solution to this problem.

Mention should be made of a variant of the standard VRM, called a "Roll-Over" (or "Canadian Roll-Over," because of its popularity in Canada). This is simply a mortgage which has a fixed maturity but has an interest rate (and hence a monthly payment) that is subject to renegotiation every five years. At this time the lender is committed to offer a rate no higher than that being charged for comparable new loans. The roll-over loan is specifically authorized by statute in California<sup>42</sup> and is subject to all of the same regulatory restrictions set forth above regarding VRMs except for the obviously inapplicable provisions specifying frequency of interest rate change and limiting such changes to  $\frac{1}{4}$  %.

#### IV. THE FEDERAL EXPERIENCE IN VRMS

The history of VRMs for federally chartered savings and loan associations has been stormy. All agree that the Federal Home Loan Bank Board (FHLBB), under its basic operating charter contained in the Home Owners' Loan Act of 1933,<sup>43</sup> which authorizes the Board, ". . . under

<sup>38</sup> *Id.* at § 240.3.

<sup>39</sup> *Id.*

<sup>40</sup> For example, as of December 31, 1978, 57% of Great Western Savings and Loan Association's \$7.1 billion loan portfolio had been converted to VRMs; this in a period of less than three years since they were first issued in March, 1975.

<sup>41</sup> The influence of real estate brokers, and to a lesser extent, escrow officers, on the ultimate structure of a real estate transaction in California, particularly home purchases, can hardly be over-estimated. The buyer-borrower invariably does not seek legal advice but relies on his broker to determine such vital matters as method of vesting of title and type of loan to obtain. Thus broker support of VRMs was and remains very influential.

<sup>42</sup> CAL. CIV. CODE § 1916.6 (West Supp. 1979).

<sup>43</sup> 12 U.S.C. §§ 1461-70 (1976).

such rules as it may prescribe, to provide for the organization, incorporation, examination, operation and regulation of associations to be known as 'Federal Savings and Loan Associations,'” has always had the power to authorize federal associations to make VRMs (as well as other AMI loans) by regulation without further specific statutory authority. However, in the face of considerable and articulate expressions of opposition from consumer oriented organizations, and particularly from certain Congressional groups led by William Proxmire in the Senate and Frank Annunzio in the House, the FHLBB bowed to the pressure, particularly not wishing to incur the wrath of the influential Senators and Representatives arrayed against it. The Board did propose regulations authorizing VRMs in 1972-44, but withdrew them in the face of mounting Congressional criticism.

In 1975, the Board again proposed amendments to its regulations which would have permitted federal associations to issue VRMs.<sup>45</sup> The provisions of these proposed amendments were not dissimilar to those under which the state chartered associations in California had been operating for several years.

Congressional reaction was prompt and sharp. The House Banking Committee voted 20-13 on April 14, 1975, to report legislation to prevent the FHLBB from proceeding with its proposed regulations respecting VRMs.<sup>46</sup> On the Senate side, during hearings held by the Senate Banking Committee, Chairman William Proxmire indicated he felt the Board's regulations “must be held up for modification.”<sup>47</sup> In view of these reactions, and in the light of considerable opposition by labor and consumer groups, the Board withdrew the proposed regulations.

It being apparent that authority to issue VRMs would not be forthcoming, federal associations in California turned to rigorous exercise of the “due on sale” clause as an alternative, but less effective, method of upgrading the yield on their loan portfolios. However, as discussed above,<sup>48</sup> the “due on sale” clause was itself in trouble. The *Tucker* decision,<sup>49</sup>

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<sup>44</sup> 37 Fed. Reg. 16201 (1972).

<sup>45</sup> 40 Fed. Reg. 6870 (1975).

<sup>46</sup> H.R. 6209, 94th Cong., 1st Sess. (1975).

<sup>47</sup> WASH. NOTES, April 18, 1975, at 1. The text of H.R. 6209 was short and to the point: That, notwithstanding Section 5(a) of the Home Owners Loan Act (of 1933) (12 U.S.C. 1964) nor any other provision of law of the United States, the Federal Home Loan Bank Board shall not authorize, by rule, regulation, or otherwise, a Federal association to offer loans secured by one to four homes or units with variable rate interest rates. The Federal Home Loan Bank Board may not do so unless and until Congress specifically, by law, authorizes such rates.

<sup>48</sup> See text accompanying notes 17-22, *supra*.

<sup>49</sup> See text accompanying notes 20-21, *supra*.

which held that installment land sales contracts did not trigger acceleration under the "due on sale" clause, caused a predictable increase in the use of the installment land contract.

The federal associations' answer to this ploy, and to the widespread belief that the "due on sale" clause was doomed even as to outright transfers by grant deed,<sup>50</sup> was to advance the argument of federal preemption and deny that any state law regarding "due on sale" clauses was applicable to federally chartered associations. Briefly stated, this argument runs as follows. All federal associations are chartered under the Home Owners' Act of 1933,<sup>51</sup> a federal law, and their operations are the subject of a detailed and comprehensive scheme of federal regulations promulgated by the FHLBB. Therefore, federal law in this field has preempted application of state law to the operations of such associations. Thus, state law is inapplicable, since under the Supremacy Clause of the U.S. Constitution, when a valid federal law conflicts with a state law, the federal law prevails.

The preemption battle concerning federally chartered savings associations is not new and did not begin with the issue of the "due on sale" clause.<sup>52</sup> The courts have had to determine which law applies in matters dealing with internal management of the association such as the right to inspect the corporate books to obtain stockholder lists for the purposes of soliciting proxies,<sup>53</sup> and usurpation of corporate opportunity by directors of an association.<sup>54</sup> Similarly, the conflict has arisen in the context of savings operations. An early federal district court case held that the State of California could not enjoin the use by a federal association of "banking terminology" in its advertisements in alleged violation of California law because the ads followed to the letter federal regulations which had preempted the field.<sup>55</sup>

In the area of lending practices, several conflicts have arisen. Here, it is somewhat more difficult to apply the doctrine of federal preemption to the exclusion of state law. Lending practices of federal associations differ from state to state because mortgages, recording laws, usury, foreclosure and such matters are specifically made subject to state law by

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<sup>50</sup> As eventually occurred. See text accompanying note 21, *supra*.

<sup>51</sup> 12 U.S.C. §§ 1461-1470 (1976).

<sup>52</sup> See Bartlett, *The Federal-State Preemption Conflict*, SAV. & LOAN LEGAL BULL. (Jan. 1979). In an excellent and comprehensive article, Bartlett traces the history of this conflict in a number of fields.

<sup>53</sup> *Murphy v. Colonial Federal Sav. and Loan Ass'n*, 388 F.2d 609 (2d Cir. 1967).

<sup>54</sup> *Rettig v. Arlington Heights Federal Sav. and Loan Ass'n*, 512 F.2d 147 (7th Cir. 1975)

<sup>55</sup> *Peoples v. Coast Federal Sav. and Loan Ass'n*, 98 F. Supp. 311 (S.D.Cal. 1951).

federal regulation. These state laws themselves differ substantially from each other. This destroys any scheme of uniform federal lending practices throughout the United States. Yet in other fields where preemption is at issue, and there is no specific federal law or regulation exactly in point in conflict with the state law, courts will resort to the argument that the federal law on the general subject preempts the entire field because of necessity to preserve uniformity and avoid a multiplicity of systems in the various states.<sup>56</sup> By specifically adopting differing state law as to the applicable law in many particular aspects of mortgage lending, the FHLBB has destroyed any possibility of a uniform federal system, rendering a preemption argument nugatory.

The doctrine of federal preemption has been successfully asserted regarding several areas of mortgage lending. A California statute declaring void any contracts which provided for fixed damages in the event of breach unless they complied with statutorily specified liquidated damages requirements was held to be inapplicable to federal associations who charged pre-payment penalties for payoffs of mortgage loans, the Ninth Circuit Court of Appeals holding that federal regulations on the subject preempted the field.<sup>57</sup>

Similarly rejected was the attempted enforcement of a Massachusetts statute requiring payment of interest on certain tax and insurance escrows by federal associations on the ground federal regulation had preempted the field.<sup>58</sup>

Still another field of mortgage lending where state law has recently been found to be preempted is "redlining" or mortgage disclosure. Two cases in this area were decided by federal district courts in 1978. In *Conference of Federal Savings and Loan Associations v. Silberman*,<sup>59</sup> twenty federal associations in California sued the California Business and Transportation Agency (the state agency having jurisdiction over savings and

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<sup>56</sup> See generally L. TRIBE, *AMERICAN CONSTITUTIONAL LAW* at 376-401 (1978).

<sup>57</sup> *Meyers v. Beverly Hills Federal Sav. and Loan Ass'n* 499 F.2d 1145 (9th Cir. 1974). In the *Meyers* case, there was a particular applicable federal regulation setting forth the terms and conditions under which prepayment fees might be charged by a federal association. In the light of such a specific expression of federal law, the Court had no difficulty in finding preemption. However, the court's opinion went further, saying that federal regulation had, in effect, occupied the entire field with respect to federal associations, to the exclusion of any state authority. "Pursuant to its valid statutory authority, the Federal Home Loan Bank Board has promulgated comprehensive regulations covering all aspects of every federal savings and loan association 'from its cradle to its corporate grave.'" *Id.* at 1146-47.

<sup>58</sup> *Greenwald v. Federal Sav. and Loan Ass'n*, 446 F. Supp. 620 (1978). See also *Kaski v. First Federal Sav. and Loan of Madison*, 72 Wisc. 2d 132, 240 N.W.2d 367 (1974), where the Wisconsin Supreme Court held that state law regarding a variable interest rate did not apply to validate a variable rate provision in a federal association's note, even though there was no specific federal regulation on the point.

<sup>59</sup> No. 78-55 (E.D. Cal. 1978).

loan matters in the state) through its Secretary (Silberman) contesting his requirement that federally chartered associations comply with state red-lining requirements. The FHLBB was made a defendant in the action and in turn cross-complained against Silberman. The court held that "the Federal Home Loan Bank Board's exercise of its plenary regulatory power, granted by Congress under the Home Owners' Loan Act of 1933 'to provide for the organization, incorporation, examination, operation and regulation of associations' preempts legislation by the State of California which attempts to subject federally chartered savings and loans to state regulation and discipline in the area of antiredlining practices."<sup>60</sup>

In a similar action, a federal district court in the State of Washington granted plaintiff, a trade association of federal savings and loans, an injunction enjoining the Secretary of State of Washington from enforcing state statutory requirements of disclosure and reporting contained in Washington's antiredlining legislation.<sup>61</sup>

The preemption argument has particular importance in California where it has been held that the "due on sale" clause of mortgage instruments may not be used to increase yields on mortgages unless the lender can show that his security interest will be impaired.<sup>62</sup> California state authorities have insisted that curtailment of the use of the "due on sale" clause applies equally to state and federally chartered associations in California. Given this position and the FHLBB reluctance, because of Congressional opposition, to issue regulations allowing VRMs, California's federally chartered savings and loans had no alternatives left to upgrade portfolio yields. The federal associations therefore turned to the preemption argument to avoid being subject to California's "due on sale" prohibition. Briefly, this argument simply states that inclusion of the clause in a mortgage instrument securing a loan made by a federal association, and the right to enforce such a clause, is strictly a matter of federal law and regulation under the broad regulatory powers granted the FHLBB. It is not subject to state statutory or decisional law, just as the many other areas of savings and loan activities have been found exempt from such state law.

One of the first cases to consider this assertion was *Schott v. Mission Federal Savings and Loan Association*.<sup>63</sup> The facts of the case squarely presented the question. Mission Federal had a loan on residential property at an interest rate well below current market rates. The borrower sold the property and the association attempted to increase the rate and charge an

<sup>60</sup> *Id.*

<sup>61</sup> *Washington Sav. League v. Chapman*, No. 78-1635 (W.D. Wash. 1978).

<sup>62</sup> See text accompanying notes 17-22 *supra*.

<sup>63</sup> No. 75-366, (C.D. Cal. 1975).

assumption fee to the buyer as a condition of waiving its right to accelerate the loan under the "due on sale" clause contained in the deed of trust. No impairment of the lender's security could be shown and the buyer was credit worthy.<sup>64</sup> The buyer refused to assume, Mission Federal commenced nonjudicial foreclosure, the buyer obtained a temporary injunction from the state superior court enjoining the foreclosure, and Mission Federal had the case removed to federal district court, asserting exemption from any state law limiting its right under the "due on sale" clause. Although *Schott* was eventually settled without going to trial at the trial court level, it has lingering importance for at least two reasons. First, it was assigned for trial to Judge Matthew Byrne, sitting in federal district court in Los Angeles.<sup>65</sup> As a result of this assignment Judge Byrne became the recipient of the many other cases involving the same issue subsequently filed in his district.<sup>66</sup> Second, as a part of his decisional process in *Schott*, aborted by the settlement, Judge Byrne solicited an advisory opinion from the FHLBB on the matter of federal preemption. He received a most comprehensive (and assertive) presentation by the Board expressing its view that the federal government has entirely occupied the field regarding the savings and loan activities of federally chartered associations to the complete exclusion of any state law in conflict with it. It remains the definitive expression of the Board's views on the matter.<sup>67</sup>

The *Schott* case was followed by a number of others involving federal preemption and the "due on sale" clause. Judge Byrne finally selected as the lead case, and has now decided, *Glendale Federal Savings and Loan Association v. Fox*.<sup>68</sup> California law requires that every subdivider obtain

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<sup>64</sup> Although the buyer was youthful and without established credit, his father, a man of substance, had agreed to guarantee the loan.

<sup>65</sup> Readers will remember Judge Byrne in connection with the Daniel Ellsberg case during the latter days of the Nixon administration.

<sup>66</sup> Several of these involve attempts by federal associations to foreclose a purchase money loan (after delinquency) which was secured by an owner occupied single family residence in violation of California's anti-deficiency law, which prohibits such actions where, as in these cases, a personal judgment against the borrower is sought.

<sup>67</sup> FHLBB Advisory Opinion, Res. No. 75-647 (1975). The extent to which the Board has gone in asserting preemption is exemplified by the following from the Board's Advisory Opinion:

We are discussing here [in asserting preemption] *only* Board regulation and control over the affairs, business, business powers and authority, internal and external expansion, supervisory matters, internal operations and affairs, relationships between the association, its management and its members, and all similar and related matters respecting federal associations. The Board does not seek to regulate wholly unrelated matters of purely local concern, such as zoning for Federal Association property, methods for recording title, etc., which are left by the Board to state and local authorities, since they do not impinge upon the regulatory areas under Board control, or interfere with the Board's overall regulation scheme.

*Id.* at 17, n.6 (emphasis added). Surely the "only" is facetious.

<sup>68</sup> 459 F. Supp. 903 (C.D. Cal. 1979).

a "public report" from the Commissioner of Real Estate prior to the sale of a lot in the subdivision. As a part of the documentation the developer must submit to the Commissioner an identification of any lender that will be providing take-out loans to finance the purchase of such lots and sample copies of the lender's notes, deeds of trust, and other loan documents proposed to be used by the lender in making such loans. Glendale Federal entered into an agreement with a developer to furnish such take-out loans and the latter submitted a sample of Glendale Federal's deed of trust to be used in connection with these loans. It contained a standard "due on sale" clause. The Commissioner notified the developer that the deed of trust did not conform with California law.<sup>69</sup> The developer notified Glendale Federal he would not be able to use the association for take-out loans in view of the Commissioner's position. Glendale Federal brought action against the Commissioner for declaratory and injunctive relief, alleging that federal law exclusively governed the validity and exercisability of the "due on sale" clause in its deed of trust.

After an exhaustive review of the authorities, Judge Byrne, in a lengthy opinion, concluded that California law was inapplicable:

The language, history, structure, and purpose of the Home Owners' Loan Act [of 1933] evidence a clear Congressional intent to delegate to the Bank Board [FHLBB] complete authority to regulate federal savings and loan associations and to preempt state regulation. Whenever the Bank Board, pursuant to that plenary authority, promulgates a regulation governing an aspect of the operation of federal savings and loan associations, that regulation governs exclusively and preempts any attempt by a state to regulate in that area.<sup>70</sup>

<sup>69</sup> Specifically, CAL. CIV. CODE § 2924.6 (West Supp. 1979) which places some limits on the right of a lender to accelerate under a "due on sale" clause (passed by the legislature in 1975, before the *Wellenkamp* decision). These limitations were not included in Glendale Federal's deed of trust.

<sup>70</sup> 459 F. Supp. at 910. Note that in choosing to decide the *Glendale Federal* case rather than any case involving a deed of trust executed prior to April 28, 1976, Judge Byrne may have rendered his task in finding preemption somewhat easier. It was on that date that the Board promulgated a specific regulation with respect to "due on sale" clauses. 12 C.F.R. §§ 545.6-11 (1978). Thus the issue before Judge Byrne was a specific federal regulation in conflict with a specific state statute, a clearer case for preemption than would be the case prior to that date, where there was no specific federal regulation, merely the general regulatory scheme, in conflict with state law. However, both the text of the regulation and the Preamble to the Bank Board resolution adopting the regulation, makes clear the Board's intention to have them apply to existing as well as prospective deeds of trust. The regulation states in part: "a federal association *continues* to have power . . ." *Id.* at (g) (emphasis added). The Preamble to the Bank Board resolution states,

It was and is the Board's intent to have . . . "due on sale" practices of federal associations governed exclusively by federal law. Therefore, . . . exercise of due on sale clauses by federal associations shall be governed and controlled solely by Section 545.6-11(g) on the ground that such avoidance of limitations is permissible under state law.

41 Fed. Reg. 18286, 18287 (1976).

The *Glendale Federal* case is now on appeal and more will be heard about it in due course from the Ninth Circuit Court of Appeals.

In the meantime, the FHLBB had not given up on its conviction that federal associations should have the power to issue VRMs, despite contrary views from consumer groups and Congressmen, and whatever the final outcome of the "due on sale" and preemption contest. To this end, the FHLBB finally, after an exhaustive and lengthy research and study into all aspects of alternative mortgage instruments, reported in a three volume work entitled *Alternative Mortgage Instruments Research Study (AMIRS)*,<sup>71</sup> promulgated regulations<sup>72</sup> authorizing the use of several AMIs by federal associations, including VRMs.<sup>73</sup> These changes apply only to loans secured by a home or a combination of home and business property.<sup>74</sup> They thus roughly parallel the California VRM regulations in dealing with residential property used for home ownership.

As a gesture of conciliation to Congressional opponents,<sup>75</sup> the FHLBB included in the regulations a "sunset" provision to the effect that authority granted by the regulations to issue VRMs will cease as of December 31, 1982, unless renewed or rescinded at an earlier date by the Board.<sup>76</sup> Furthermore, the Board required that the potential borrower be given an option to take either the VRM or a standard mortgage loan.<sup>77</sup>

By far the largest concession to VRM critics was the geographical limitation placed upon their use. The FHLBB originally limited VRM issuance by federal associations to "real estate located in its [the lending

<sup>71</sup> This massive three volume publication is an exhaustive study of the entire subject of alternative mortgage instruments and contains many articles examining the legal, economic and statistical aspects of such instruments. It may be obtained by writing to the Superintendent of Documents.

<sup>72</sup> 43 Fed. Reg. 59336 (1978).

<sup>73</sup> This was accomplished by amending certain existing sections and adding new sections to the regulations of the Board governing operations of federal savings and loan associations. Specifically, the Board amended its rules and regulations for the federal savings and loan system, 12 C.F.R. §§ 545, 555, by adding a new subparagraph (a)(8) to § 545.6-1 thereof, deleting the text of § 545.6-2 and adding a new text, and revoking § 555.4. *Id.*

<sup>74</sup> These are defined in the regulations as follows: "The term 'home' means real estate upon which there is located one or more single-family dwellings, or dwelling units, for not more than four families in the aggregate." 12 C.F.R. § 541.10-2 (1978). "The term 'combination of home and business property' means real property which is used, in part for business purposes and in part for residence purposes for not more than four families." *id.* at § 541.11.

<sup>75</sup> The introduction in the House of Representatives by House Consumer Affairs subcommittee Chairman Frank Annunzio of House Resolution 38, which would prohibit federal associations from issuing VRMs and roll-over mortgages, and though unlikely to be enacted into law, indicates the continuing existence of pockets of Congressional opposition to VRMs. H. Res. 38, 96th Cong., 1st Sess., 125 CONG. REC. H127 (1979).

<sup>76</sup> 43 Fed. Reg. 59339 (1978) (to be codified in 12 C.F.R. § 545.6-2(c)(2)(iii)).

<sup>77</sup> *Id.* at 59338 (to be codified in 12 C.F.R. § 545.6-2(a)).



association's] home state if the Board has determined that such associations require authority to invest in such loans to maintain competitive balance with other financial institutions lending in such state."<sup>78</sup> Concurrently, by separate resolution, the Board determined that the need for competitive balance presently existed only in California so that, as to VRMs, only federal associations based in California could issue them. On May 30, 1979, however, the FHLBB altered the regulations to withdraw the geographical restrictions.<sup>79</sup> As of July 1, 1979 all federal associations have the authority to issue VRMs.<sup>80</sup>

#### V. PROVISIONS AND RESTRICTIONS FOR FEDERAL VRMS

The FHLBB regulations contain a number of specific burdensome restrictions on issuing VRMs. These are now of general interest since all federal associations have been authorized to issue VRMs. In addition, many states, while not specifically authorizing the use of VRMs, have a "basket" provision extending state chartered associations authority to issue such instruments if federal associations in the state may do so.<sup>81</sup> The major restrictions contained in the Board's regulations follow.

First, the regulations provide an overall limitation on the dollar amount of loans an association may make in any one year. No more than 50% of an authorized association's home mortgage loans by dollar amount made or purchased in any calendar year may be in VRMs.<sup>82</sup>

The index used to determine possible future increases and decreases in the VRMs interest rate is the average cost of funds for all savings and loan associations whose accounts are insured by the Federal Savings and Loan Insurance Corporation. This index is published in the FHLBB *Journal* and is computed semi-annually.<sup>83</sup>

The federal scheme allows no change in the interest rate during the first year of the loan.<sup>84</sup> Thereafter, changes may not be made more than once a year.<sup>85</sup> The minimum change allowable is one-tenth of a percent (.10%, or ten basis points).<sup>86</sup> The maximum permissible change is one-

<sup>78</sup> 43 Fed. Reg. 59339 (1978) (to be codified in 12 C.F.R. § 545.6-2(c)(2)(i)(a)).

<sup>79</sup> 44 Fed. Reg. 32199 (1979).

<sup>80</sup> *Id.* at 32201 (to be codified in 12 C.F.R. § 545.6-2(c)(2)(i)).

<sup>81</sup> See generally Project, *Tie-in Statutes and Parity Regulations and Their Constitutionality*, 11 AKRON L. REV. 503 (1978).

<sup>82</sup> 43 Fed. Reg. 59339 (1978) (to be codified in 12 C.F.R. § 545.6-2(c)(2)(ii)).

<sup>83</sup> 44 Fed. Reg. 32201 (1979) (to be codified in 12 C.F.R. § 545.6-2(c)(3)). The index used in California is that issued by the Federal Home Loan Bank of San Francisco, the 11th District.

<sup>84</sup> 43 Fed. Reg. 59339 (1978) (to be codified in 12 C.F.R. § 545.6-2(c)(4)(i)).

<sup>85</sup> *Id.*

<sup>86</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(iii)).

half of a percent (.50%, or 50 basis points).<sup>87</sup> The rate may never increase more than 2.5% over the life of the loan.<sup>88</sup> Downward adjustments are mandatory but upward adjustments are permissive only.<sup>89</sup> Any changes in the index rate which are not taken at the time they occur are accumulated and, if down-side, must be applied as soon as permitted, and may be applied as permitted, up-side.<sup>90</sup> Such accumulated changes may also be used to offset subsequent changes.<sup>91</sup>

Upon notification of an increase in rate, several options are open to the borrower. First, he may elect to have the rate increase reflected by an extension of the term of his loan (up to an additional one-third of the original term), holding his monthly loan payments level.<sup>92</sup> To do this he must notify the lender of this desire. If he does not, the monthly payment will be adjusted upward to reflect the increased rate and the term of the loan remains the same.<sup>93</sup> Further, he may elect within ninety days of notification to prepay the loan in whole or in part without prepayment penalty, provided that the new increased rate is above the initial loan rate charged when the loan was first made.<sup>94</sup> Rate decreases must first be used to reduce any extended loan maturity previously elected by the borrower, but never below the original maturity.<sup>95</sup> The decrease must then be used to reduce monthly payments, but no reduction in loan term can result in an increase in monthly payments.<sup>96</sup>

The notice of change must contain the current and new rate,<sup>97</sup> the old and the new index rates,<sup>98</sup> any accumulated but unused rate changes,<sup>99</sup> the current monthly payment and remaining maturity.<sup>100</sup> Where an increase is being made there must be a description of the available options, including the new payment and maturity if the loan is extended to the

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<sup>87</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(iv)).

<sup>88</sup> *Id.*

<sup>89</sup> *Id.*

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> 44 Fed. Reg. 32201 (1979) (to be codified in 12 C.F.R. § 545.6-2(c)(4)(v)(b)).

<sup>93</sup> 43 Fed. Reg. 59339 (1978) (to be codified in 12 C.F.R. § 545.6-2(c)(4)(v)(a)).

<sup>94</sup> 44 Fed. Reg. 32201 (1979) (to be codified in 12 C.F.R. § 545-2(c)(4)(v)(c)).

<sup>95</sup> 43 Fed. Reg. 59339 (1978) (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vi)).

<sup>96</sup> *Id.*

<sup>97</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vii)(a)).

<sup>98</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vii)(b)).

<sup>99</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vii)(c)).

<sup>100</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vii)(d)).

maximum.<sup>101</sup> If a decrease is involved, a description of how it is to be applied must be given.<sup>102</sup>

The FHLBB regulations also contain some detailed and specific disclosures that must be made which are different and more explicit than those contained in the federal Truth in Lending disclosure statement. These include materials, "explaining in reasonably simple terms[:] the type of variable rate mortgage offered and a comparable standard mortgage instrument (with a fixed interest rate, level payments, and full amortization)."<sup>103</sup> Such materials must include a "side-by-side" comparison of differing interest rates and other terms,<sup>104</sup> payment schedules for both types of instruments, including a "worst case" schedule for the VRM showing every maximum increase at the time it could first occur, the highest possible payment during the loan term, and the total payment in dollars over the full term of each loan, including a notation that total payments for the VRM would be greater if the loan were extended (a mechanical result which will obtain when the loan is extended at the same monthly payment rather than amortized over a shorter period at the higher monthly payment).<sup>105</sup> Additionally, the potential borrower must be given information regarding the index used,<sup>106</sup> a description of his options in the event of an interest rate increase,<sup>107</sup> a statement, "prominently displayed" that borrowers have the option to elect a standard mortgage instrument<sup>108</sup> and finally the title, telephone number, and address of the officer at the Federal Home Loan Bank whom the borrower may contact regarding any questions concerning the disclosures.<sup>109</sup>

## VI. OTHER ALTERNATIVE MORTGAGE INSTRUMENTS

As stated previously,<sup>110</sup> AMIs' time has arrived by reason of two main forces manifesting themselves in mortgage lending. The first, the inexorable increase in the cost of lending, necessitating the increase in portfolio yield, has brought forth the VRM discussed above. The other force, the equally inexorable increase in the cost of housing, which is tending to price an increasing segment of potential homeowners out of the market,

<sup>101</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vii)(e)).

<sup>102</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(4)(vii)(f)).

<sup>103</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)).

<sup>104</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)(i)).

<sup>105</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)(ii)).

<sup>106</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)(iii)).

<sup>107</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)(iv)).

<sup>108</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)(v)).

<sup>109</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(c)(5)(vi)). One wonders how successful federal associations will be in marketing VRMs under this mass of regulatory requirements.

<sup>110</sup> See text accompanying notes 2-4, *supra*.

has brought forth a number of other AMIs. These are discussed below in general terms, each being followed by an analysis of the particular requirements under California and federal regulations.

There are some general regulatory requirements applicable to all AMIs authorized under state regulations. Any association offering any AMI must disclose in a pamphlet approved by the Commissioner and made available to prospective borrowers (i) the nature and effect of the AMI; (ii) an example describing the payment schedule of a typical loan and, as to Graduated Payment Mortgages and "Flexes," a comparable payment schedule for a fixed rate mortgage at the same interest rate and term; (iii) all costs or savings attributable to the AMI not disclosed above, along with any other relevant information regarding advantages and disadvantages of the particular AMI the association deems appropriate. A monthly report must be made, supplementing the fair lending information form now required, giving the sex, age and family income of the borrower. Finally, any association offering AMIs must also offer any borrower who qualifies for its standard mortgage loan a choice of a standard mortgage loan at current market terms.

#### A. *Graduated Payment Mortgages*

Graduated payment mortgages (GPMs) are one of the AMIs designed to overcome the shortcomings of the traditional fixed payment mortgage in the reality of today's spiraling cost of housing. It is designed to reflect the increase in family income due to upward mobility and inflation which will occur throughout the life of the loan. In underwriting a traditional fixed income mortgage, the amount of the loan is limited by a predetermined percentage of total annual family income representing the maximum that family can devote to housing costs. Traditionally, this has been set at 25%. For example, a family with total annual income of \$30,000 will be able to devote a \$7,500 annually to housing costs. Given the current interest rate for the particular loan being sought, this limits the total loan available to that family. In recent years, particularly at lower income levels, this percentage of income for housing has crept upward to a high as 35%. Since loan-to-value ratios must be considered (80% is the generally accepted maximum in residential lending) the limit of the total loan in turn limits the price which the particular family can afford to pay for financed housing. Here again, particularly at lower income levels, 90% loan-to-value ratios have become acceptable.

This scheme of lending practices fixes the monthly payments and annual cost of the loan for the full term (usually thirty years) based on family income at its inception. To the extent the loan does not reflect

the presumed increase in the family income throughout the loan term, the ability of the family to purchase the more expensive housing it will presumably soon be able to afford is sharply limited.

Mortgages with varying rather than fixed monthly payments are designed to overcome this problem. GPMs are one type. Under a GPM, monthly payments rise over a given period of time during the first years of the loan, starting out at a lower level and ending up at a somewhat higher level than would be true of a fixed rate mortgage for the same interest rate and term. GPMs are fully amortizing loans, however. They do not have a balloon payment at the end. Almost all of each monthly payment during the early years of a level payment loan constitutes interest. Since all interest due is payable before any reduction in principal, lowering these monthly payments results not only in no principal reduction of the loan but in "negative amortization," where the total monthly payment is insufficient to pay even the interest due. In effect, the borrower borrows the difference between payments made and interest due, paying off this accumulated difference in later years.

Another version of a GPM which avoids the problem of negative amortization while retaining the desired reduction of monthly payments during early years of the loan is the "flex" loan. Here the loan is structured so that there is an initial period of "interest only" monthly payments. After this period, the loan then amortizes in equal monthly payments of principal and interest over the remaining life of the loan. For example, if the full loan term were thirty years, the flex might provide for interest only payments during the first five years and thereafter fully amortize with monthly payments over the remaining term on a twenty-five year amortization schedule of equal monthly payments of principal and interest.<sup>111</sup>

### (1) Graduated Payment Mortgages in California

As discussed earlier,<sup>112</sup> California has long authorized state-chartered associations to issue VRMs. However, it was not until the 1977 that other types of AMIs were authorized. Effective January 1, 1978 the Savings and Loan Commissioner was given permission to issue regulations authorizing a variety of alternative mortgage instruments.<sup>113</sup> Under this legislation, state-chartered associations may issue alternative mortgage

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<sup>111</sup> Assume a \$60,000 loan at 10% interest for a 30 year term. Under a conventional mortgage the level payments throughout the life of the loan would be \$527 per month. Under a Flex with five years of interest only, monthly payments during the first five years would be \$500, and for the remaining 25 years \$545.

<sup>112</sup> See note 10 and accompanying text, *supra*.

<sup>113</sup> CAL. FINANCIAL CODE § 7153.9 (West Supp. 1979).

instruments on an experimental basis.<sup>114</sup> Such loans are not to exceed 10% of the assets of the issuing institution.<sup>115</sup> This legislation authorizes:

instruments . . . , including, but not limited to, forms of graduated payment mortgages, reverse annuity mortgages, flexible payment and flexible rate mortgages, and combinations of such mortgages, with the further provision that such alternative mortgage instruments shall be limited in number, simple and comprehensible, and provide adequate opportunities and protections to those persons and classes of persons who have previously not been able to participate in homeownership.<sup>116</sup>

Effective February 10, 1978, the Savings and Loan Commissioner promulgated extensive regulations implementing the mandate of Section 7153.9.<sup>117</sup> These regulations authorize state-chartered associations to issue several types of AMIs and dictate in some detail the specific provisions which each must contain. The Commissioner has authorized issuance of two versions of GPMs (called "Graduated Payment Loan" in the regulations).<sup>118</sup> In both versions, payments at the commencement of the loan are below what would be required in a fixed rate mortgage to amortize the loan throughout its term. Plan One permits monthly mortgage payments initially to increase each year by not more than 7.5% (on a compound basis) for a period of not more than five years.<sup>119</sup> Plan Two permits monthly mortgage payments initially to increase each year by not more than 3% (on a compound basis) for a period of not more than

<sup>114</sup> The code section has a "sunset" provision under which it is automatically repealed on January 1, 1983. *Id.*

<sup>115</sup> *Id.*

<sup>116</sup> *Id.* The preamble to the bill which added Section 7153.9 to the Financial Code, states the legislative purpose:

The Legislature finds and declares that there exists in the State of California a housing crisis that increasingly threatens to prevent a wide range of low- or middle-income persons from enjoying the benefits of home ownership, thereby adversely affecting the stability of the family and the democratic principle of widespread home ownership for all economic classes.

The Legislature further finds that one of the causes of the housing crisis is alleged to be the form of mortgage instrument presently in use by lenders providing for a fixed-rate and a fixed-term for a long-term maturity, which does not take into consideration the various needs and the financial capabilities of different classes of borrowers. The Legislature further finds that the initiation and development by experimentation of new and different types of mortgage payment instruments is necessary upon an experimental basis to determine which of such forms of mortgage instruments will aid in alleviating the housing crisis and in reducing the problems of borrowers of low- or middle- income in acquiring homes and in adjusting their payment schedules in conformity with their financial conditions.

A.B. 2370 (Cal. 1972).

<sup>117</sup> 10 CAL. ADM. CODE §§ 178-178.6 (1978).

<sup>118</sup> *Id.* at § 178.4(c).

<sup>119</sup> *Id.* at § 178.4(c)(2)(a).

ten years.<sup>120</sup> Either type of loan may not exceed a total of \$75,000 for a term of not more than thirty years.<sup>121</sup> They must be secured by owner occupied residential property of not more than four dwelling units.<sup>122</sup> The loan-to-value ratio must not exceed 95%,<sup>123</sup> with the excess over 90% insured by private mortgage insurance, written with an approved insurer.<sup>124</sup>

## (2) Federally Authorized Graduated Payment Mortgages

When the FHLBB authorized federally chartered associations to issue VRMs, they also authorized two other AMIs: GPMs<sup>125</sup> and Reverse Annuity Mortgages (RAMs).<sup>126</sup>

The GPM regulations allow annual increases in mortgage payments only once a year, beginning not less than one year after the date of the first regular loan payment.<sup>127</sup> Annual increases are limited to 7.5% for a period of five or fewer years, 6.5% for six years, 5.5% for seven years, 4.5% for eight years, 3.5% for nine years and 3% for ten years.<sup>128</sup> Provided the borrower is eligible, he may elect at any time to convert to a standard fixed rate mortgage at the then applicable rate and maturity without penalties or fees.<sup>129</sup> Loan-to-value ratios are limited to 95%.<sup>130</sup> Disclosure must be made to each prospective borrower, explaining the GPM and comparing it (in the so-called "side-by-side" comparison), to a fixed rate, level payment mortgage.<sup>131</sup> This must include a comparison of interest rates, payment schedules, total of payments, a description of the conversion option and a "prominently displayed" statement that borrowers have an option to elect a standard mortgage instrument.<sup>132</sup>

## B. Flexible Payments Loans

Flexible payment loans (FLIPs) are another version of a variable payment loan which result in lower payments during the early years of the loan

<sup>120</sup> *Id.* at § 178.4(c)(2)(b).

<sup>121</sup> *Id.* at § 178.4(c)(1).

<sup>122</sup> *Id.* at § 178.4(a).

<sup>123</sup> *Id.* at § 178.4(c)(1).

<sup>124</sup> *Id.* at § 178.4(c)(4).

<sup>125</sup> 43 Fed. Reg. 59336, 59338-39 (1978) (to be codified in 12 C.F.R. § 545.6-2(b)).

<sup>126</sup> *Id.* at 593340 (to be codified in 12 C.F.R. § 545.6-2(d)). RAMs will be discussed in the text accompanying notes, 138-166, *infra*.

<sup>127</sup> 43 Fed. Reg. 59336, 59338 (1978) (to be codified in 12 C.F.R. § 545.6-2(b)(2)).

<sup>128</sup> *Id.* This schedule of permissible annual increases tracks similar increases authorized under FHA's Section 245 GPM loan program. 24 C.F.R. § 203.45(c) (1979). The lower and upper limits (7.5% per year for five years and 3% per year for 10 years) parallel those authorized under California regulations. 10 CAL. ADM. CODE § 178.4(c)(2) (1978).

<sup>129</sup> 43 Fed. Reg. 59336, 59338 (1978) (to be codified in 12 C.F.R. § 545.6-2(b)(3)).

<sup>130</sup> *Id.* at 59339 (to be codified in 12 C.F.R. § 545.6-2(b)(5)).

<sup>131</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(b)(6)).

<sup>132</sup> *Id.*

yet allow for full amortization over the life of the loan without a balloon payment at the end. Unlike a GPM, FLIPs provide for the lender to receive full monthly payments throughout the term of the loan (as in a fixed payment loan). The difference between the fixed loan payment by the borrower and the full fixed loan payment required by the lender is accomplished by the unique handling of the down payment. Under FLIP, the lender may advance up to 100% of the sales price or appraised value, if lower. Instead of using all of the down payment to create equity in the property, a major portion is deposited in a savings account with the lender. That amount is pledged as additional security for the loan. Out of these funds (plus the interest which they earn while on deposit) come the supplemental monthly payments necessary to make up the difference between what the borrower pays during the early years of the loan and the full level payments received by the lender. This predetermined amount deducted from the savings account each month, decreases as the monthly payment of the borrower increases. When the savings account is exhausted, the borrower then must make monthly payments sufficient to fully amortize the then existing loan balance within the term of the loan. In a FLIP loan, the loan-to-value ratio (the "loan" in this calculation being the gross amount loaned less the balance in the pledged savings account) will increase during the initial period because the balance in the savings account will decrease more rapidly than the loan will amortize. However, contrary to a GPM, all monthly payments under a FLIP loan will be full amortization payments of the total loan.

### (1) Flexible Payment Loans in California

The Savings and Loan Commissioner has issued regulations authorizing FLIPs in California.<sup>133</sup> The total loan amount cannot exceed \$75,000, nor be for a term of more than thirty years.<sup>134</sup> The unpaid balance of the loan (disregarding the amount of the pledged savings account) cannot exceed 95% in loan-to-value ratio,<sup>135</sup> and the excess above 90%, must be insured by private mortgage insurance.<sup>136</sup> The sum of all payments required during the initial period, not more than five years must at least equal the total interest, excluding principal, due during that period.<sup>137</sup> Monthly payments during the initial period may not increase more than 10% per year, and at the end of the initial period, all remaining monthly payments must be sufficient to amortize the remaining loan balance without

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<sup>133</sup> 10 CAL. ADM. CODE § 178.4(b) (1978).

<sup>134</sup> *Id.* at § 178.4(b)(1).

<sup>135</sup> *Id.* at § 178.4(b)(1)(b), (c).

<sup>136</sup> *Id.* at § 178.4(b)(5).

<sup>137</sup> *Id.* at § 178.4(b)(2).



a balloon payment.<sup>138</sup> The loan-to-value ratio (the “loan” in this calculation being the gross amount loaned less the balance in pledged account) will increase during the initial period because the balance in the savings account will decrease more rapidly than the loan will amortize.<sup>139</sup>

### C. *Reverse Annuity Mortgages*

Reverse annuity mortgages (RAMs) deal with another increasingly severe problem of home ownership; that of the elderly or retired homeowner living on a fixed income in a world of constantly increasing living expenses. It presupposes that such homeowners have a very substantial equity in the home they own, with either free and clear title or very small mortgages. It also assumes that the homeowner does not wish to cash in his equity by selling, for a variety of obvious reasons *eg.*, tax consequences, finding other housing, unwillingness to move. Unlike GPMs, Flexes and FLIPs, a RAM is less structured in its approach and can take a variety of forms.

Under a typical RAM, the proceeds from the loan are paid to the borrower in equal periodic, usually monthly, payments over the term of the loan until the loan proceeds have been fully disbursed. Interest owed on the amounts disbursed is accumulated and charged against the loan as it accrues. This accrued interest plus the actual funds disbursed on which the interest is charged together equal the loan balance. When this amount reaches the total amount authorized the loan has matured and is due and payable. Typically, the unpaid balance of the loan, exclusive of interest, is unamortized and is repayable in full upon the buyer's death or death of the survivor, if there are joint borrowers, or upon prior sale of the property.

Where the loan is a simple “Rising Debt RAM” as illustrated above, a problem is presented when the borrower survives throughout the term of the loan and does not sell the property. At the end of the term, the loan is now due and payable. One possibility is that the lender might reappraise the property, and assuming appreciation, make a new RAM loan or otherwise refinance with a conventional loan, paying off the old loan with a portion of the proceeds. However, the borrower may not want another RAM loan or may not be in a position to make the monthly payments required by a new conventional loan. This problem can be solved by a modified version of the simple RAM known as a “Rising Debt Deferred Life Annuity” loan. Here, a part of the loan proceeds initially would be used to purchase a deferred life annuity from a life

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<sup>138</sup> *Id.* at § 178.4(b)(4).

<sup>139</sup> *Id.*

insurance company, with payment of the annuity deferred until monthly payments under the RAM loan had been concluded. Although the loan has matured, monthly payments through the annuity would continue until the borrower's death without the necessity of any further borrowing. Repayment of the loan would be deferred until the borrower's death or prior sale of the property. Payment of interest on the matured loan would be provided for, directly from the life insurance company, as a part of the monthly annuity payment.

There are many obvious advantages to a RAM loan, not the least of which is the ability of the elderly homeowner to cash in his equity without selling his home. The Federal Home Loan Bank Board estimates that homeowners aged sixty-five and over have an estimated net equity of \$90 billion in their homes.<sup>140</sup> However, there are also significant problems for both borrower and lender. Income tax treatment of the borrower's loan is one. The fixed monthly payments would presumably be tax free. However, since interest is being accumulated by the lender during the life of the RAM loan and the borrower is making no interest payments, deduction of the interest on the mortgage will not be available on a continuing annual basis but will be available only in a single year when the loan is paid off. This is clearly an undesirable result from the borrower's standpoint. A further problem is the treatment of the fixed monthly payments for eligibility under government assistance programs. Presumably, social security payments would not be jeopardized, since disqualification is based on *earned* income. However, supplemental income for the aged, blind and disabled, medical assistance programs and other welfare assistance might be lost because of receipt of payments from the lender.

Likewise, income tax problems might present themselves to lenders. A cash basis lender would presumably be able to defer reporting receipt of any income during the life of the loan. However, an accrual basis lender would have to report income earned each year as interest on the loan is cumulated, while continuing fixed monthly payments to the borrower. This would create a negative cashflow. Treatment of loan fees and other miscellaneous receipts might also be troublesome. For these reasons, lenders have approached RAMs with some caution, and no such programs are in place in California to the knowledge of this author.<sup>141</sup>

### (1) Reverse Annuity Mortgages in California

California's regulations on RAMs provide that the unpaid balance

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<sup>140</sup> FEDERAL HOME LOAN BANK BOARD, *ALTERNATIVE MORTGAGE INSTRUMENT RESEARCH STUDY* Chapt. 18, p.2 (1978) (hereinafter AMIRS).

<sup>141</sup> For possible methods of issuing RAMs, see *id.*, *Reverse Annuity Mortgages: How S & L's Can Write Them*, at Chapt. XVIII.

of the loan, exclusive of interest, be repayable in full upon the borrower's death or the survivor's death, if joint borrowers, or prior sale of the security property.<sup>142</sup> The unpaid balance may not exceed 95% of the value of the property.<sup>143</sup> If purchase of an annuity from a life insurance company is involved, the association must be expressly authorized by the borrower to act.<sup>144</sup> Such annuities may be either for life or a specified term and may call for immediate or deferred payments.<sup>145</sup> If deferred, the association may make loan advances during the deferral period not exceeding 95% of the initial property value.<sup>146</sup> If purchased from an insurance company, the annuity must authorize the company to make interest payments on the loan directly to the association.<sup>147</sup> Full disclosure must be made to the borrower of the gross and net annuity he will receive, the amount of the debt collectable upon his death or prior sale of the property, and a complete monthly debt schedule where the debt rises over a period of time.<sup>148</sup>

## (2) Federally Authorized Reverse Annuity Mortgages

In the FHLBB resolution adopting the regulations authorizing issuance of RAMs by federally chartered savings and loans the Board made the following statement:

RAMs although named "reverse annuity" mortgages, do not require purchase of an insurance annuity, but rather refer generally to any type of instrument involving payments to homeowners based on accumulated equity. Since these plans may vary greatly and present a number of unique questions, the Bank Board's [original] proposal did not provide rules for their formulation, but rather would have required submission on a case-by-case basis. However, . . . the Bank Board has set forth in its final regulation minimum RAM requirements . . . . In the light of this further direction, the "approval" requirement of the proposal has been changed to a review procedure with a 60-day period provided for Bank Board objection; if none is taken, the association may proceed to offer RAMs pursuant to its submitted plan.<sup>149</sup>

In addition to satisfying the review procedure, the lender must meet several requirements. The lender must give the borrower seven days after the loan commitment to back out: a "cooling-off" period.<sup>150</sup> The association

<sup>142</sup> 10 CAL. ADM. CODE § 178.4(d)(1) (1978).

<sup>143</sup> *Id.*

<sup>144</sup> *Id.* at § 178.4(d)(2).

<sup>145</sup> *Id.* at § 178.4(d)(3).

<sup>146</sup> *Id.*

<sup>147</sup> *Id.* at § 178.4(d)(4).

<sup>148</sup> *Id.* at § 178.4(d)(5).

<sup>149</sup> 43 Fed. Reg. 59336, 59337-38 (1978).

<sup>150</sup> *Id.* at 59340 (to be codified in 12 C.F.R. § 545.6-2(d)(3)(i)).

must obtain a written statement from the borrower acknowledging disclosure of all contractual contingencies which could force the sale of the home.<sup>151</sup> If the loan has a fixed term, the lender must make available refinancing at market rates current at the time payment is due.<sup>152</sup> Additionally, prepayment must be permitted at any time without penalty.<sup>153</sup> If an annuity is to be purchased, the insurance company must be one authorized to engage in such business and be supervised by the state in which it is incorporated.<sup>154</sup> Finally, the loan must have a fixed interest rate; variable rate mortgages are not permitted.<sup>155</sup>

In addition to these specific requirements for the loan, there are also detailed disclosure requirements.<sup>156</sup> These include a description of the mortgage being offered in reasonably simple terms, setting forth a schedule and explanation of payments and whether taxes and insurance are to be deducted.<sup>157</sup> A schedule of outstanding debt over the term of the loan and the repayment if a fixed term loan, or event, (such as sale of the home or death of the borrower), causing the loan to become due should also be indicated.<sup>158</sup> In addition, the lender must disclose the method and schedule of repayment<sup>159</sup> and all contractual contingencies, including lack of home maintenance and other default provisions which may result in forced sale of the home.<sup>160</sup> Notice is to be given of the interest rate, the annual percentage rate and total interest payable on the loan,<sup>161</sup> as well as the effective interest rate and interest earned or expected to be earned on purchased annuities based on standard mortality tables.<sup>162</sup> The name and address of any insurance company proposed to be used,<sup>163</sup> the initial loan fees and charges,<sup>164</sup> and a description of prepayment and refinancing

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<sup>151</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(3)(ii)).

<sup>152</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(3)(iii)).

<sup>153</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(3)(iv)).

<sup>154</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(3)(v)).

<sup>155</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(3)(vi)).

<sup>156</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)).

<sup>157</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(i)).

<sup>158</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(ii), (iii)).

<sup>159</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(iv)).

<sup>160</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(v)).

<sup>161</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(vi)).

<sup>162</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(vii)).

<sup>163</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(viii)).

<sup>164</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(ix)).

features<sup>165</sup> must be provided to the borrower. Finally, a statement that such mortgages have tax and estate planning consequences and may affect levels of, or eligibility for, certain government grants, benefits or pensions and that applicants are advised to explore these matters with appropriate authorities should be disclosed.<sup>166</sup>

#### D. *Deferred Interest Mortgage*

The deferred interest mortgage (DIM) is a variant of the GPM in which the lender defers a portion of the interest payments during the early years of the mortgage. These interest payments are then added to the loan balance and paid later. The result is the same as a standard GPM. However, a number of obvious disadvantages to both the lender and the borrower accompany the DIM. For the borrower, the income tax deduction for payment of the interest is lost. The accrual basis lender incurs income tax liability without the receipt of cash in the form of interest payments.

#### E. *Contingent Appreciation Mortgage*

The contingent appreciation mortgage (CAM) provides for monthly payments that are fixed throughout the life of the loan but are somewhat lower than those of a comparable standard mortgage. The lender shares in a portion of any appreciation of the property realized upon resale.

#### F. *Price Level Adjusted Mortgage*

The price level adjusted mortgage (PLAM) provides for a fixed interest rate that does not reflect any anticipated inflation throughout the life of the loan. It is therefore considerably lower than standard. However, the principal of the loan varies with a predetermined price level index. The object is to maintain a "real value" outstanding debt, with the nominal interest rate remaining constant.

PLAM's have been extensively used in Brazil. In Brazil, the loan principal is not a stated currency amount, but rather is calculated in units of purchasing power. These units are tied to a reference index which, in turn, is tied to a price index.<sup>167</sup>

PLAMs have been successful in Brazil. However, without the use of

<sup>165</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(x)).

<sup>166</sup> *Id.* (to be codified in 12 C.F.R. § 545.6-2(d)(4)(xi)).

<sup>167</sup> Sometimes the principal amount is referenced to a wage index instead.

indexing throughout the entire Brazilian economy, this might not have been the case. In the United State, a host of legal problems can be envisioned. Usury is one, if the increases in loan amount are treated as additional interest. Continuing priority of liens is another if the increases in loan amounts are treated as optional advances. In any event, widespread adoption seems unlikely.<sup>168</sup>

### CONCLUSION

What does the future hold for AMIs? First, it seems probable that of the AMIs here discussed, DIMs, CAMs and PLAMs will not receive acceptance because of their great drawbacks. The same can be said of RAMs. They will not meet with widespread use due to the legal, tax and other problems they carry with them.<sup>169</sup>

On the other hand, the success of VRMs in California seems to presage their increasing use by state-chartered associations and banks elsewhere. They are already in wide use in New England, Ohio and Wisconsin. There are, however, some inhibiting factors. Several states have statutes specifically prohibiting them.<sup>170</sup> Where the lenders do not enjoy the usury exemption that California associations have, usury poses a problem probably best solved by legislation. Federal authorization of VRMs will not give rise to the argument that preemption of state usury laws has occurred since by federal statute state usury laws are to apply to federal associations.<sup>171</sup> It would appear politically impossible for Congress to force a nationwide uniform usury law on individual states, a power which they presumably have through preemption.

Aside from the permissible maximum rate applicable, there are other usury problems. One is whether the particular statute in question prohibits the "charging" or the "receipt" of excessive interest. This is of particular importance in the context of purchasers of loans in the secondary market

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<sup>168</sup> Cowan & Foley, *supra* note 7

<sup>169</sup> One can speculate that life insurance companies may well be the ones who develop answers to these problems; they have both the expertise and the legislative muscle. The potential market for annuities would seem to make the effort worthwhile.

<sup>170</sup> See AMIRS, *Legal Implications of the Alternative Mortgage Instruments*, *supra* note 140 at Chapt. XX; Conference on Alternative Mortgage Instruments (February 28, 1979) (Sponsored by TICOR Mortgage Insurance Company) at exhibit VII (hereinafter Conference on AMIs).

<sup>171</sup> 12 U.S.C. § 85 (1976).

who presumably "receive" but were not involved in the "charging" of the interest which the loan bears.

A second problem is the manner in which the jurisdiction in question determines usurious rates. There are three generally recognized tests which permit exemption from what may have become, by reason of interest escalation under a VRM, an otherwise usurious rate. The first is the common law, or time of inception, test. This test provides that if the interest rate at the inception of the loan is non-usurious, absent bad faith, the loan is non-usurious throughout its life, regardless of subsequent events.<sup>172</sup> The second is the contingency test, which provides that if the contingency which later escalates an originally non-usurious rate to a prohibited rate is unsure and cannot be predicted by the lender at the time the loan is made, the loan remains non-usurious.<sup>173</sup> The third is the good faith test: if the lender acted in good faith and without intent to avoid the usury statute, the loan will not be usurious.<sup>174</sup>

A further problem unrelated to usury is the negotiability of the VRM note in the secondary market. Negotiability is very important since it gives the status of a holder in due course to the purchaser. State legislation seems the most efficacious solution to this problem.<sup>175</sup>

As to GPMs, and in particular FLIPs, their widespread acceptance seems likely. This has been demonstrated by the FHA's experience in this area. In 1976, HUD issued regulations under which it would be willing to insure GPMs.<sup>176</sup> These regulations provide for five different schedules under which initially lower monthly payments can be escalated.<sup>177</sup> Also provided is the time frame applicable to these schedules (five years and ten years).<sup>178</sup> These loans are insured just as standard conventional loans

<sup>172</sup> Conference on AMIs, *supra* note 65 at exhibit VII, 9-11.

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> The negotiability problem arises in the context of the Uniform Commercial Code requirements that an instrument contain a promise to pay a "sum certain . . . at a definite time" or that extensions at the option of the maker be to "a further definite time." U.C.C. § 3-104, 3-109. Since the rate of interest may vary throughout the life of the loan, no "sum certain" can be ascertained from the face of the instrument at its inception. Furthermore, where extensions of term (and payment schedule) are permitted upon increases in interest rate, it cannot be said that extensions at the option of the borrower are "to a further definite time." It would therefore appear that VRMs fail the test of negotiability on both counts.

<sup>176</sup> 24 C.F.R. § 203.45 (1978).

<sup>177</sup> *Id.* at § 203.45(c).

<sup>178</sup> *Id.*

would be.<sup>179</sup> Loan-to-value ratios under the regulations are allowed up to 97% to take care of early negative amortization.<sup>180</sup> The maximum loan balance permissible is \$60,000.<sup>181</sup> The Housing and Community Development Act of 1977 made this experimental program permanent and also provided a limited federal preemption of state usury laws by providing that the interest deferred during the early monthly payments shall be treated as a capitalization of interest rather than as deferred interest.<sup>182</sup>

Despite the problems posed by AMI's it is apparent with the recent federal legislation that they are here to stay. Only time will tell how successful they can be.

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<sup>179</sup> 24 C.F.R. § 203 subpart B (single family residence), § 234 subpart c (condominiums) (1978).

<sup>180</sup> *Id.* at § 203.45(b)(2).

<sup>181</sup> *Id.* at § 203.45(b)(1).

<sup>182</sup> Some state laws permit this deferred interest to be treated as capitalization of interest, but some do not, considering it instead deferred interest on which interest would then be charged impermissibly under some statutes. Others state that all sums charged over the life of the loan on the original principal must be included in calculating interest for usury purposes, however denominated. AMIRS, *supra* note 140 at Chapter V, contains a detailed analysis of the provisions and operation of the FHA Section 245 program.

GPMs also may have priority problems in states where additional advances by law are or may be treated as optional, thus losing priority over any intervening liens. Negative amortization results in adding to the principal amount outstanding, thus clearly constituting advances.



