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Development and Practical Application of the Adjustable Rate Mortgage Loan: The Federal Home Loan Mortgage Corporation's Adjustable Rate Mortgage Loan Purchase Program and Mortgage Loan Instruments, The

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THE DEVELOPMENT AND PRACTICAL APPLICATION OF THE ADJUSTABLE RATE MORTGAGE LOAN: THE FEDERAL HOME LOAN MORTGAGE CORPORATION'S ADJUSTABLE RATE MORTGAGE LOAN PURCHASE PROGRAM AND MORTGAGE LOAN INSTRUMENTS

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I. INTRODUCTION

In the early 1930s, with the enactment of the Home Owners' Loan Act[1] and the National Housing Act,[2] the long-term, fixed interest rate loan became the primary mortgage financing mechanism in the United States. This mechanism was effective when interest rates were relatively stable and the cost of funds to lenders was low. Over the past fifteen years, however, volatile but generally rising interest rates have made lenders increasingly reluctant to lend on a long-term basis at fixed interest rates.

State legislatures and state and federal regulators have concluded that if mortgage lenders are to continue to loan money, they need broader authority than that traditionally possessed to design mortgage instruments that are more responsive to current economic conditions. A number of creative mortgage financing alternatives have been developed over the past few years. The goal of most of these alternatives has been to alleviate lenders' problems that result from a mismatch of assets and liabilities and borrowers' problems that result from high interest rates coupled with high home prices.

The alternative that has received possibly the most attention in recent years from lenders, regulators, and secondary market investors[3] is the adjustable rate mortgage loan.[4] The interest rate on an adjustable rate mortgage changes to reflect changes in market interest rates over the life of the loan. This Article will explore the adjustable rate loan concept, discussing the need for the rate adjustment mechanism and the statutory and regulatory changes that have enabled the origination of loans incorporating this concept. The Article then will explore some practical applications of the con-

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1. 12 U.S.C. §§1461-1468 (1976 & Supp. IV 1980).

2. *Id.* §§1701-1750g(h).

3. Secondary market investors include the Federal Home Loan Mortgage Corporation (the "FHLMC"), the Federal National Mortgage Association (the "FNMA"), and a number of private corporations that purchase mortgage loans or interests in mortgage loans from primary market originators. The secondary mortgage market is discussed in greater detail in Part IV. *infra.*

4. Loans on which the interest rate may be adjusted may be structured in a variety of ways and have been given a variety of names, *e.g.,* Adjustable Rate Loan (ARM), Adjustable Mortgage Loan (AML), Variable Rate Mortgage Loan (VRM), and Renegotiable Rate Mortgage Loan (RRM). In this Article, "adjustable rate loan" or "adjustable rate mortgage loan" will be used as the generic term to describe loans on which the rate of interest may be adjusted over the loan's life.

cept, focusing on the adjustable rate mortgage ("ARM") loan documentation of the Federal Home Loan Mortgage Corporation (the "FHLMC") and its secondary market program.

II. Economic Background

The introduction to the Alternative Mortgage Instrument Research Study,[5] conducted by the Federal Home Loan Bank Board (the "FHLBB") in 1977, noted that the mortgage and housing markets were performing inadequately, largely because of the structure of the traditional mortgage instrument. That instrument was designed to operate in a relatively stable economic environment, but the American economy since the mid-1960s had been characterized by periods of high and volatile interest rates.[6] The structure of the traditional mortgage instrument, coupled with the structure of the thrift industry, caused lenders' earnings not to keep pace with their rising costs of funds. Lenders, therefore, have been unable to support the mortgage market during periods of "tight money," when lendable funds are scarce and, consequently, expensive.[7]

The fundamental problems of the thrift industry, which is the largest supplier of home mortgage loans,[8] have resulted from the practice of lending on a long-term basis with funds borrowed on a short-term basis, or "borrowing short and lending long." This practice has been particularly troublesome during times of high interest rates.[9] While thrift institutions

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5. Kaplan, Marcis & Cassidy, *An Overview and Summary*, in 1 ALTERNATIVE MORTGAGE INSTRUMENT RESEARCH STUDY 4 (1977).

6. *Id.* at 2.

7. *Id.* at 3. The "credit crunches" of 1966, 1969-1970, and 1974-1975 were cited as such periods. Subsequent to the AMIRS project, the problems became even more evident during the credit crunch beginning in 1980.

8. In 1976, savings and loan associations made 54.9% of all loans made for the purchase of one-to-four family homes and 62.9% of all conventional loans made for that purpose. While these percentages had declined by 1980 to 46.4% and 55.6%, respectively, savings and loan associations nevertheless continue to make more home mortgage loans than any other type of institution. *See* U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, SURVEY OF MORTGAGE LENDING ACTIVITY, 1970-1979 (Apr. 1980); *id.*, 2d Quarter, 1981 (Aug. 1981).

9. In 1978, a time of readily available credit, the average cost of funds to federally insured thrift institutions was 6.67%. FED. HOME LOAN BANK BOARD J., Oct. 1981, Table S.4.8. The interest return on the mortgages held by these same institutions in that year was 8.47%, *id.*, Table S.4.10, representing a positive spread of 180 basis points. This positive spread was reduced to 136 basis points in 1979. *Id.*, Oct. 1980, Tables S.4.8 & S.4.10. In the first half of 1980, the spread was reduced to 41 basis points and then to 33 basis points in the second half of 1980. *Id.*, Jan. 1982, Tables S.4.8 & S.4.10. In the first half of 1981, the spread had become negative: the interest return on mortgages held by FSLIC-insured institutions was 9.72%, while the average cost of funds to these institutions had climbed to 10.31%. *Id.* Thus, during 1981, the average federally insured thrift institution was paying more in borrowing costs than it made on its mortgage portfolio.

traditionally have lent money to home buyers on a thirty year basis at a fixed rate, they have obtained their funds primarily through passbook accounts, certificates of deposit, and other short-term deposits. As interest rates have risen, depositors have withdrawn funds from these low-yielding accounts and invested in other, higher yielding instruments. To compensate for this shortage of deposits, lenders must borrow at high rates, while their income on the mortgages in portfolio remains fixed. Thrift institutions in recent years have been granted increased flexibility concerning the types of savings instruments and the rates they can offer savers, and rate ceilings are scheduled to be phased out altogether over a six-year period ending in 1986.[10] Thus, in the future, there should be no legal impediment to savings and loan associations' paying competitive, albeit expensive, rates to attract funds.[11]

To counter current low portfolio mortgage interest rates, lenders have increased the rates on new mortgage loans.[12] Lenders are charging current borrowers rates that not only reflect lenders' current costs of funds, but that also compensate them for the low rates still being paid by earlier borrowers. Thus, current borrowers are subsidizing borrowers who obtained their loans when rates were lower and stable.[13]

The concept of the adjustable rate loan was developed to alleviate problems of this economic environment. The goals of the adjustable rate mortgage loan are to enable lenders to match the yields on their portfolios to their costs of funds during times of rising interest rates and to allow borrowers to take advantage of decreases in market rates without the costs associated

10. The rates of interest that thrift institutions could pay to depositors were previously set by the Federal Home Loan Bank Board (the "FHLBB"), in consultation with the Board of the Governors of the Federal Reserve System and the Board of Directors of the Federal Depositor Insurance Corporation (the "FDIC"), pursuant to "Regulation Q." *See* 12 C.F.R. § 526.3 (1981). Pursuant to the Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 203, 94 Stat. 142 (1980) (as amended by the Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1674 (1980)), this power was transferred to the Depository Institutions Deregulation Committee, and rate ceilings were scheduled to be phased out by 1986.

11. For a more complete analysis, see Worthen, *Variable Rate Mortgages: Texas Savings & Loan Associations Authorized to Offer Flexible Financing Alternatives,* 12 ST. MARY'S L.J. 1144 (1981).

12. The process of raising the yield on the portfolio by raising rates on newly originated loans is slow. Between the first half of 1978 and the first half of 1981, the spread between new rates and average portfolio rates increased from 84 basis points to 442 basis points, an increase of 358 basis points. Pickering, *Association Earnings—First Half 1981,* FED. HOME LOAN BANK BOARD J., Oct. 1981, at 23, 27, Table 2. During that same time, the average portfolio yield increased from 8.39% to 9.72%, an increase of only 133 basis points. *Id.*, Table S.4.10.

13. Current interest rates also reflect lenders' expectations of future interest rate movements because typical fixed rate lenders will be locked into particular rates potentially for long time periods.

with refinancing.[14] Further, the adjustable rate mortgage loan provides the borrower with an interest rate that reflects only those market conditions specific to him, rather than an interest rate that compensates for low rates paid by previous borrowers.

III. LEGAL BACKGROUND

Articles on adjustable rate mortgage loans in the mid-to-late 1970s noted two principal impediments to lenders' ability to offer such loans.[15] First, numerous legal prohibitions or restrictions applied specifically to interest rate adjustments. The Federal Home Loan Bank Board had prohibited federal associations from originating home mortgage loans on which the rate could change over the life of the loan. A number of states had adopted statutes or regulations that either prohibited rate adjustments or imposed such restrictive conditions on the right to adjust the rate that rate adjustments were in effect precluded. Second, a number of states had adopted usury ceilings that made infeasible the origination of loans on which the rate could be increased. Statutory and regulatory changes over the past several years have eliminated most of these problems, removing the barriers to the origination of adjustable rate loans by most federally chartered and state-chartered lenders. Discussed below are current federal and state restrictions on the use of adjustable rate mortgages.

A. *Federal Home Loan Bank Board Regulation*

On April 23, 1981, the Federal Home Loan Bank Board adopted the

14. The standard fixed rate loan is, to a considerable extent, an adjustable rate loan from the borrower's standpoint. The Federal Home Loan Bank Board regulations applicable to federal savings and loan associations provide that the home mortgage loan borrower may prepay the loan without penalty unless the loan contract expressly provides for a prepayment penalty. 12 C.F.R. § 545.8-5(b) (1981). The prepayment penalty provided in the contract may not exceed six months' interest on the aggregate amount of all prepayments made on that loan in any 12 month period that exceed 20% of the original principal amount of the loan. *Id.* An increasing number of states have imposed even more severe constraints on the ability of state-chartered lenders to impose prepayment penalties or have prohibited such penalties. *See, e.g.*, N.J. STAT. ANN. § 46:10B-2 to -3 (West Cum. Supp. 1981-1982); N.Y. GEN. OBLIG. LAW § 5-501(3) (McKinney Cum. Supp. 1981-1982); W. VA. CODE § 47-6-5b (1980). The FNMA/FHLMC uniform one-to-four family mortgage instruments were changed in 1979 to permit borrowers to prepay loans in whole or in part at any time without penalty. Previously, the instruments prepared for use in most states had permitted a penalty only during the first five years of the loan term and only if the loan were refinanced with a lender other than the noteholder. Thus, borrowers have for some time had increased flexibility to refinance when market rates dropped, paying only closing costs.

15. *See, e.g.*, Hyer & Kearl, *Legal Impediments to Mortgage Innovation*, 6 REAL ESTATE L.J., Winter 1978, at 211; Werner, *Usury and the Variable-Rate Mortgage*, 5 REAL ESTATE L.J., Fall 1976, at 155.

Adjustable Mortgage Loan (AML) regulation, which authorizes federal associations to deal in adjustable mortgage loan instruments.[16] The regulation is substantially more flexible than earlier regulations,[17] leaving most of the significant loan terms to be worked out by the individual borrower and lender.

The AML is a single, long-term obligation on which the interest rate may be adjusted over the life of the loan in accordance with an interest rate index agreed on in advance by the borrower and lender and specified in the loan document. The index must be beyond the control of the individual lender and must be readily verifiable by the borrower; the individual lender's cost of funds or current mortgage loan origination rate may not be used. The regulation specifies several acceptable indices: the FHLBB's mortgage contract rate; the cost of funds to Federal Savings and Loan Insurance Corporation-insured institutions; three- and six-month United States Treasury bill rates; and one-, two-, three-, and five- year Treasury securities rates. In addition, any other interest rate that is beyond the control of the individual lender and readily verifiable by the borrower may be used.

Interest rate adjustments on an AML may be reflected in one of several ways. First, the monthly payment may be adjusted. Second, the outstanding principal balance on the loan may be adjusted. Third, the term of the loan may be adjusted, up to a maximum term of forty years. Finally, a combination of these methods may be used.

Under the second method, when interest rates decline, a greater percentage of the borrower's monthly payment is applied to principal, and the loan amortizes more quickly. When interest rates increase, more of the borrower's monthly payment is applied to interest, and the loan amortizes more slowly. If the interest rate increases such that the borrower's monthly payment does not cover the interest due, the interest due but not paid is added to the loan's outstanding principal balance, a process known as "negative amortization." The initial monthly payment must be sufficient to amortize the loan fully at the beginning of the loan term, and the monthly payment must be adjusted at least every five years to an amount sufficient to amortize the outstanding principal balance over the remaining term of the loan, assuming no further adjustments in the interest rate. The regulation prescribes no maximum or minimum time intervals between rate adjustments; the borrower and the lender agree in advance on the length of the adjustment period. There are no maximum or minimum limitations on the amount of interest rate adjustments, but the borrower and lender may agree to such limitations. The lender has discretion to increase the interest rate when merited by an upward movement in the index.[18] The lender must

16. 46 Fed. Reg. 24,152-53 (1981) (to be codified in 12 C.F.R. § 545.6-4a(a)(1)).

17. 12 C.F.R. §545.6-4a (1981); *id.* § 545.6-4(c) (1980).

18. The lender may waive the right to exercise this discretion by contracting

decrease the interest rate when called for in the loan documentation and merited by a downward movement in the index, but there is no requirement that the loan documentation provide for decreases.

The regulation provides certain consumer protections. The borrower may prepay the loan in whole or in part at any time without penalty. The regulation also prescribes the form of notices and disclosures.

The AML regulation specifies that it was

> promulgated pursuant to the plenary and exclusive authority of the [Federal Home Loan Bank] Board to regulate all aspects of the operations of Federal associations, as set forth in section 5(a) of the Home Owners' Loan Act of 1933, as amended. This exercise of the Board's authority is preemptive of any state law purporting to address the subject of a Federal association's ability or right to . . . deal in adjustable mortgage loans . . . .[19]

No court has decided whether the FHLBB has the authority to pre-empt state laws that limit the use of adjustable rate instruments.[20] Even if the pre-

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with a third party, such as a secondary market purchaser of the loan, to exercise its right to make all increases called for under the loan documents.

19. 46 Fed. Reg. 24,152 (1981) (to be codified in 12 C.F.R. § 545.6-4a(a)(2)).

20. A number of courts have, however, ruled on an analogous issue: the authority of the FHLBB to pre-empt state laws restricting the right of a mortgage lender to accelerate the loan on transfer or sale of the security property. 12 C.F.R. § 545.8-3(f) (1981) recognizes the right of a federal association to include, as a matter of contract between the association and the borrower, a provision in its loan instrument by which the association may declare immediately due and payable sums secured by the security instrument if all or any part of the real property securing the loan is sold or transferred by the borrower without the association's prior written consent. This section further provides that, with certain exceptions, the exercise of this option is to be governed exclusively by the terms of the loan contract.

The authority of the FHLBB to pre-empt state law restrictions on the enforcement of due-on-sale clauses has been litigated with a variety of results. The validity of pre-emption has been upheld firmly by the federal courts. *See, e.g.,* First Fed. Sav. & Loan v. Development & Management Enters., Inc., No. CIV 79-880 PHX-EHC (D. Ariz. Apr. 2, 1981); Dantus v. First Fed. Sav. & Loan Ass'n, 502 F. Supp. 658 (D. Colo. 1980); Great W. Union Fed. Sav. & Loan Ass'n v. Walters, Civil Action No. C79-906V (W.D. Wash. June 18, 1980); Williams v. First Fed. Sav. & Loan Ass'n, 500 F. Supp. 307 (E.D. Va. 1980), *aff'd on other grounds,* 651 F.2d 910 (4th Cir. 1981); Bailey v. First Fed. Sav. & Loan Ass'n, 467 F. Supp. 1139 (C.D. Ill. 1979). Some state courts have also upheld the validity of the pre-emption. *See, e.g.,* First Fed. Sav. & Loan Ass'n v. Duncan, No. 80CV-96 (Colo. Dist. Ct. Sept. 8, 1980); Hauger v. Western Fed. Sav. & Loan Ass'n, No. 79CV-4080 (Colo. Dist. Ct. June 18, 1980). Several state courts, however, have rejected federal pre-emption as a defense in suits brought by mortgagors to enjoin foreclosure proceedings that arise out of the unauthorized sale or transfer of the security property. *See, e.g.,* de la Cuesta v. Fidelity Fed. Sav. & Loan Ass'n, 121 Cal. App. 3d 328, 175 Cal. Rptr. 467 (1981), *probable jurisdiction noted,* No. 81-750 (U.S. Jan. 25, 1982); Panko v. Pan Am. Fed. Sav. & Loan Ass'n, 119 Cal. App. 3d 916, 174 Cal.

emption is not upheld, the resulting problems would not have a severe impact on federal associations because few states now restrict lenders' rights to originate adjustable rate loans.

B. *Comptroller of the Currency Regulation*

On March 27, 1981, the Comptroller of the Currency adopted the Adjustable Rate Mortgage (ARM) regulation, which authorizes the origination of adjustable rate mortgages by national banks.[21] The regulation is less flexible than the FHLBB regulation discussed above. The loan may be structured either as a single long-term obligation with an interest rate that may be adjusted at regular intervals or as a series of short-term obligations, secured by a long-term mortgage, on which the interest rate may be adjusted on each renewal. Rate adjustments must reflect movement in one of three specified indices: the FHLBB's mortgage contract rate, the monthly average yield on three-year United States Treasury securities, or the monthly average of the weekly auction rate on Treasury bills. No other indices may be used. Rates may be adjusted at regular intervals as short as six months; no maximum adjustment period is specified. Rates may be adjusted by as much as one percent for each six-month period between adjustments, but no one rate increase may exceed five percent.[22] The lender may establish minimum rate changes. Interest rate decreases merited by a change in the index are mandatory, within the interest rate adjustment limitations established in the loan documentation; the lender has discretion to increase the interest rate when otherwise proper.

Interest rate adjustments may be reflected in either one of two ways or a combination of the two ways. First, the monthly payment may be adjusted. Second, the outstanding principal balance of the loan may be adjusted. The limitations on the adjustment of the outstanding principal balance are far more restrictive than those of the FHLBB regulation. The monthly payment

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Rptr. 240 (1981), *appeal docketed,* No. 81-922 (U.S. Nov. 13, 1981); First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980); Holiday Acres No. 3 v. Midwest Fed. Sav. & Loan Ass'n, 308 N.W.2d 471 (Minn. 1981).

The state courts in *de la Cuesta*, 121 Cal. App. 3d at ____, 175 Cal. Rptr. at 475, and *Panko*, 119 Cal. App. 3d at ____, 174 Cal. Rptr. at 245, emphasized that there was no incompatibility between state law and the federal regulation. While state law restricted the enforcement of the due-on-sale clause to instances in which the lender's security was impaired, the FHLBB regulation simply *permitted* federal associations to enforce the clause more broadly. Thus, federal associations in California can comply both with federal and state requirements. The FHLBB's AML regulation is similarly permissive. It therefore appears likely that the Supreme Court's decision in the *de la Cuesta* case will be highly relevant to a determination of the validity of the federal pre-emption of state adjustable rate loan restrictions.

21. 46 Fed. Reg. 18,943-47 (1981) (to be codified in 12 C.F.R. §§ 29.1-.10).

22. This 5% maximum should establish 2½ years as the maximum length of the period between rate adjustments.

must be adjusted at least every five years to an amount sufficient to amortize the outstanding principal balance at the interest rate then in effect over the remainder of the original loan term. The amount of negative amortization may not exceed one percent of the principal balance outstanding at the beginning of the adjustment period multiplied by the number of six-month intervals in the adjustment period, subject to a maximum negative amortization amount of ten percent of the principal outstanding at the beginning of the adjustment period. The original loan term may not exceed thirty years, and no extension beyond thirty years is permitted.

The method of calculating the interest rate adjustment is different from the method prescribed in the FHLBB regulation. Under the FHLBB regulation, the calculation is performed by referring back to the initial interest rate and the base index. The Comptroller's regulation provides for the calculation to be made from one adjustment period to the next. The Comptroller's regulation also provides, however, that changes in the index that do not result in interest rate changes shall, to the extent not offset by subsequent movement in the index, be carried over and used in later calculations. The period-to-period calculation coupled with this provision for the carryover of unused changes produces results identical to the results produced by calculation under the FHLBB formula.

The Comptroller's regulation specifies that the lender is not required to permit ARM loans to be assumed[23] and that if the lender does permit assumption, the interest rate and other loan terms may be changed. In order to take advantage of this authority, however, the lender must include a due-on-sale clause in the note as well as in the security instrument.

Consumer protection features similar to those contained in the FHLBB regulation are included in the Comptroller's regulation. The Comptroller's regulation prescribes the form of borrower disclosures and notices. The borrower may prepay the ARM loan in whole or in part at any time beginning thirty days before the first scheduled interest rate adjustment. The ARM regulation specifies that national banks may make or purchase ARM loans pursuant to that regulation and that state limitations on adjustable rate mortgage lending are expressly pre-empted.[24] In pre-empting state laws, the Comptroller cited the rulemaking authority granted under Title 12, United States Code sections 93a[25] and 371(g).[26] The Comptroller believed that the authority to make adjustable rate loans was essential to national banks' safe and sound participation in the residential mortgage market and that it was,

23. Unlike the FHLBB, which has specifically authorized federal associations to include due-on-sale clauses in all types of mortgage documents, the Comptroller of the Currency has not addressed this issue elsewhere in its regulations.
24. 46 Fed. Reg. 18,943 (1981) (to be codified in 12 C.F.R. § 29.3).
25. (Supp. IV 1980).
26. (1976).

therefore, the responsibility of the Comptroller to enable them to do so by pre-empting restrictive state laws.[27]

The authority of the Comptroller of the Currency to promulgate regulations pre-empting state restrictions on interest rate adjustment, negative amortization, and due-on-sale clauses was recently upheld by the United States District Court for the District of Columbia.[28] Assuming that this decision is not overturned, national banks in all states may originate adjustable rate mortgage loans to the extent permitted by the Comptroller.

C. *State Statutes and Regulations*

A state-by-state analysis of state laws and regulations dealing with the authority of state-chartered lending institutions to originate adjustable rate loans is beyond the scope of this Article. A brief discussion of the types of restrictions that the states have imposed and the ways in which these restrictions have changed over the past few years illustrates that state legislatures and regulators, like federal regulators, have become increasingly aware of the need for broader authority to originate adjustable rate loans. The state authorities also appear to have recognized the need to grant state-chartered lenders sufficient authority to enable them to compete with federally chartered lenders. One consequence of a failure to provide such authority is an unwillingness of secondary mortgage market investors to invest in loans made by state-chartered lenders operating under restrictive statutes and regulations, resulting in a decline of mortgage money available in those states.

Restrictions on the ability of state-chartered lenders to originate adjustable rate loans typically have taken one of three forms. The first form is an explicit prohibition of the origination of home mortgage loans on which

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27. 46 Fed. Reg. 18,942 (1981).

28. *See* Conference of State Bank Supervisors v. Lord, Civil Action No. 81-1591 (D.D.C. Feb. 11, 1982). Case law indicates that the Comptroller of the Currency's authority to exercise exclusive control over its regulated institutions is less clear than is the FHLBB's authority in this respect. The Home Owners' Loan Act provides the FHLBB "is authorized, under such rules and regulations 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.' " 12 U.S.C. § 1464(a) (Supp. IV 1980). This provision has been interpreted as granting to the FHLBB authority to regulate every aspect of a federal association's existence "from its cradle to its corporate grave." California v. Coast Fed. Sav. & Loan Ass'n, 98 F. Supp. 311, 316 (S.D. Cal. 1951). The Comptroller of the Currency's mandate is far less sweeping, and case law has held the national banking system to be one of dual state and federal control. *See, e.g.,* McClellan v. Chipman, 164 U.S. 347 (1896); National Bank v. Commonwealth, 76 U.S. (9 Wall.) 353 (1869); National State Bank v. Long, 630 F.2d 981 (3d Cir. 1980). Thus, the decision of the court in *Conference of State Bank Supervisors* upholding federal preemption with respect to the Comptroller's ARM regulation indicates that similar pre-emptive powers probably will be found for the FHLBB.

the rate may change over the life of the loan. Prior to August 1980, Illinois prohibited such loans.[29] The Illinois statute was amended in 1980 to allow changes in the rate of a mortgage contract secured by residential real estate during the term of the mortgage if the changes were made in accordance with the rules of the Federal Home Loan Bank Board or other agencies of the federal government or Act of Congress.[30] It was not clear whether the Illinois legislature simply recognized the right of the FHLBB to pre-empt the application of state law to federal associations or whether the legislature intended that lenders other than federal savings and loan associations could avoid the application of the Illinois law by following the FHLBB's current regulations on adjustable rate loans. This ambiguity was eliminated in 1981 when the Illinois legislature provided that if Congress or any federal agency authorizes, with certain limitations, any class of lenders to enter mortgage loan agreements on which the rate of interest may change, Illinois lenders may enter, with the same limitations, mortgage loan agreements on which the rate of interest may change.[31]

The second type of restrictive statute imposes such onerous conditions on lenders' rights to originate adjustable rate loans that the restrictions are tantamount to a prohibition. The onerous condition typically has taken the form of a low usury ceiling. For example, Virginia provided that if the loan documentation provided for adjustment to the interest rate over the term of the loan, the interest rate on the loan could never exceed eight percent.[32] Michigan had a similar law.[33] South Carolina provided that if the original principal amount of the loan was under $100,000, the interest rate could not be increased by more than one percent over the life of the loan.[34]

The restrictions in Virginia and South Carolina have been removed by legislation. Virginia now specifically permits adjustment to the interest rate.[35] South Carolina now authorizes the State Board of Financial Institutions to issue regulations permitting state-chartered lenders authority equal to that enjoyed by federal savings and loan associations.[36] Although the Michigan statute has not been amended, application of the Michigan statute may have been severely limited by the federal pre-emption of state usury ceilings contained in Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980.[37]

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29. *See* ILL. ANN. STAT. ch. 74, § 4(2)(d) (Smith-Hurd Cum. Supp. 1981-1982).
30. *Id.*
31. 1981 Ill. Laws 3,162.
32. VA. CODE § 6.1-330.37 (1979) (current version in Cum. Supp. 1981).
33. MICH. COMP. LAWS ANN. § 438.31 (1978).
34. S.C. CODE ANN. § 34-31-90(2) (Law. Co-op. 1976). In 1979, the interest rate ceiling on first lien real estate loans was temporarily lifted, but not for loans of $100,000 or less on which the interest rate was not fixed. 1979 S.C. Acts 7.
35. VA. CODE § 6.1-330.37 (Cum. Supp. 1981).
36. 1980 S.C. Acts 1238.
37. Pub. L. No. 96-221, 94 Stat. 161 (1980).

The third and predominant type of restriction on the origination of adjustable rate loans by state-chartered lenders is found in the statutes and regulations of states in which lenders have been making adjustable rate loans for some time.[38] Such statutes and regulations permitted lenders to make adjustable rate mortgage loans, but only under the terms and conditions specified. These limitations generally have been more severe than those imposed by the FHLBB and the Comptroller of the Currency, either because the restrictions were enacted when adjustable rate lending was less accepted or because the state legislature or regulatory body attempted to provide state lenders with powers similar to federal savings and loan associations and adopted statutes or regulations based on earlier, more restrictive versions of the federal regulations.

The largest state, in terms of lending volume, in which such restrictions were imposed was California. It has been estimated that by 1969 at least thirty-five California associations were originating adjustable rate loans and that that form of instrument had become prevalent by 1975.[39] The California legislature prescribed the terms and conditions under which California associations could originate adjustable rate loans.[40] The interest rate could not be changed more frequently than semiannually, changes could not exceed one-fourth of one percent each six months, and interest rate increases were limited to two-and-one-half percent over the life of the loan.[41] A number of other states imposed similar restrictions on state-chartered lenders.[42]

Restrictive state statutes and regulations generally have been amended to enable state-chartered lenders to compete with federal savings and loan associations and national banks and to eliminate restrictions that would impede the acceptance by secondary market investors of loans originated by state-chartered lenders. California achieved these goals by enacting legislation effectively granting state-chartered lenders parity with their federally chartered counterparts.[43] Most other states with restrictive statutes or regula-

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38. Until quite recently, adjustable rate lending was heavily concentrated in certain geographical areas. As of the end of 1976, it was estimated that 80% of the activity in adjustable rate mortgage loans was concentrated in California, Ohio, Wisconsin, and New England. Rochester & Marcis, *National Survey of Current AMI Activity*, in 1 ALTERNATIVE MORTGAGE INSTRUMENT RESEARCH STUDY (1977).

39. Washburn, *Alternative Mortgage Instruments in California*, 12 AKRON L. REV. 599, 602 (1979).

40. CAL. CIV. CODE § 1916.5 (West Cum. Supp. 1982).

41. *Id.*

42. IND. CODE ANN. § 28-1-21.5-5 (Burns 1973); N.Y. BANKING LAW §§ 103(4)(b), 235(6) (McKinney 1971 & Cum. Supp. 1981-1982); PA. STAT. ANN. tit. 41, § 301 (Purdon Cum. Supp. 1981-1982); VT. STAT. ANN. tit. 8, § 1256(c) (1970); WIS. STAT. ANN. § 138.055 (West 1974); TEX ADMIN. CODE tit. 7, § 65.3(6)(A) (1981).

43. California Assembly Bill No. 650 (the "Bane Bill") was signed into law

tions have either sufficiently altered their statutes or regulations to grant state-chartered lenders competitive equality or, at least, have permitted such lenders to originate adjustable rate loans that meet the requirements of secondary market investors.[44] As a result, few state-chartered lenders are excluded from participation in the national secondary market, and the number is continually growing smaller.

Another impediment to the origination of loans on which the rate could be adjusted during the loan term was the maximum interest rate limitations, or usury ceilings, imposed by most states.[45] The problems created by these ceilings, however, have been substantially alleviated within the past two years.

The application of a usury rate ceiling to adjustable rate loans can be somewhat complicated. Although the initial interest rate on the loan might be below the maximum specified, the rate could, at some point during the loan term, exceed the ceiling in effect at the time the loan was originated. Depending on the manner in which the usury law is structured, the possibility of such an occurrence could render the loan usurious, even if the increased rate does not exceed the usury ceiling in effect at the time of the adjustment.[46] Limiting the rate to the maximum rate permissible when the loan is originated severely limits the usefulness of the adjustable rate loan. It would not fulfill one of the major goals of the adjustable rate concept: to permit the lender to increase the yield on its investment as the interest it was required to pay on its liabilities increased. There was little precedent in this area,[47] and this very uncertainty detracted from the attractiveness of adjust-

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on August 27, 1981. That bill directed the State Superintendent of Banks to adopt regulations permitting state-chartered banks to originate adjustable rate loans on terms identical to those permitted for national banks doing business in California. Regulations parallel to the Comptroller's ARM regulation have been adopted. The State Savings and Loan Commissioner was directed to adopt regulations permitting state-chartered savings and loan associations to originate adjustable rate loans on terms identical to those permitted for federal savings and loan associations. Regulations parallel to the FHLBB's AML regulation have been adopted. The Secretary of Business, Transportation, and Housing Agency was directed to determine whether other types of lenders, including mortgage bankers, should be permitted to originate loans under the regulations adopted by the Banking Superintendent, the regulations adopted by the Savings and Loan Commissioner, or both. The Secretary has promulgated regulations permitting origination of adjustable rate loans under both the banking and the savings and loan regulation.

44. 1981 Pa. Laws 91; 1981 Wis. Laws 596; TEX. ADMIN. CODE tit. 7, § 11.2(a)(3) (1979); VT. BANKING REG. 80-3.

45. *See* Hyer & Kearl, *supra* note 15, at 238; Werner, *supra* note 15, at 156.

46. *See* Harroch & Frasch, *The New California Usury Law in Light of the Monetary Control Act of 1980,* 35 BUS. LAW. 1053, 1074 (1980).

47. Werner, *supra* note 15, at 156.

able rate loans as investments,[48] particularly in view of the severity of the penalties imposed on lenders found guilty of usury.[49]

In 1979, Congress enacted temporary legislation[50] pre-empting state usury ceilings on first lien residential mortgage loans for all types of mortgage lenders. Concurrently with the expiration of the temporary legislation, Congress enacted legislation permanently pre-empting such ceilings. Title V of the Depository Institutions Deregulation and Monetary Control Act of 1980[51] pre-empts state usury ceilings on federally related,[52] first lien residential mortgage loans made on or after April 1, 1980.[53] The states may override this federal pre-emption of state law by a constitutional or statutory

48. Usury restrictions created a problem for federally chartered savings and loan associations, as well as for state-chartered lenders. The FHLBB had made no attempt to pre-empt state usury laws. Thus, state restrictions applied to federal associations. National banks could charge interest at the rate allowed by the laws of the state, territory, or district in which the bank was located, or at a rate 1% above the discount rate on 90-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district in which the bank was located, whichever was greater. If the state law provided a different maximum rate for state banks, that rate was allowable for national banks as well. If the law of the state, territory, or district prescribed no limit on rates, the national bank could charge a rate not exceeding 7%, or 1% above the discount rate on 90-day commercial paper in effect at the Federal Reserve Bank in the Federal Reserve district in which the bank was located. 12 U.S.C. § 85 (Supp. IV 1980). Thus, all national banks were subject to a usury ceiling.

49. Penalties for usury vary substantially from state to state. The most common penalty is the forfeiture of all interest on the loan. The most severe penalties appear to be imposed in Arkansas, Minnesota, New York, and Rhode Island, where the usurious contract is deemed void. *See* ARK. CONST. art 19, § 3; ARK. STAT. ANN. § 68-608 (1979); MINN. STAT. ANN. §§ 334.02-.03 (West 1981); N.Y. GEN. OBLIG. LAW § 5-511 (McKinney 1978); R.I. GEN. LAWS §§ 6-26-3 to -4 (Cum. Supp. 1981).

50. Act of Dec. 28, 1979, Pub. L. No. 96-161, 93 Stat. 1233 (1979).

51. Pub. L. No. 96-221, 94 Stat. 161 (1980).

52. The loans covered by this legislation include loans made by federally chartered savings and loan associations, banks, and credit unions; loans made by state-chartered lenders whose accounts are insured by the FSLIC, the FDIC, or the National Credit Union Administration; loans made by members of the Federal Home Loan Bank System or the Federal Reserve System; loans made by lenders approved by the Department of Housing and Urban Development ("HUD"); loans made by or assisted by the Secretary of HUD or other federal agencies in connection with a HUD program; loans eligible for purchase by FNMA, FHLMC, or GNMA; and loans made by any institution from which the loans could be purchased by the FHLMC. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1), 94 Stat. 161 (1980); 12 C.F.R. § 590.2 (1981).

53. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(b)(1), 94 Stat. 161 (1980).

provision enacted on or after April 1, 1980, and before April 1, 1983.[54] As of this writing, ten jurisdictions have enacted legislation specifically overriding the federal pre-emption.[55] Eight of these jurisdictions, however, have not imposed a usury ceiling.[56] They have simply stated that they do not wish the federal usury pre-emption to apply, in order to preserve their rights to impose an interest rate ceiling later. Thus, the operation of primary and secondary markets in adjustable rate loans continue unimpaired in those states, notwithstanding the enactment of override legislation. Kansas and Puerto Rico, on the other hand, have floating interest rate ceilings tied to FHLMC auction results.[57] In both jurisdictions, the ceiling applicable to an adjustable rate loan is the current ceiling at the time of each rate adjustment, not the ceiling in effect at the time the loan was originated. Nevertheless, the ceilings create problems for both the primary and the secondary markets. The FHLMC auction rate tends to represent the upper portion of the market. Thus, a usury ceiling tied to this rate would usually be sufficiently high to permit an ARM loan to be adjusted without exceeding the ceiling. The FHLMC auction rate is, however, to some extent an administered price, and the FHLMC might determine, in connection with a particular auction, to accept loans with rates below current market rates. Because neither the FHLMC nor the Federal National Mortgage Association (the "FNMA") adjustable rate mortgage loan purchase program permits the use of the FHLMC auction rate as an index, at some point during the life of the loan, adjustment of the rate in accordance with the index specified in the loan document could result in a rate higher than the current usury ceiling. Thus, the lender would have to set the rate at a level below that contemplated in the loan document or violate the usury law.

While this result would be unattractive to a lender, the problems would

54. *Id.* § 501(b)(2).

55. *See* COLO. REV. STAT. §§ 5-13-101 to -105 (Cum. Supp. 1981); HAWAII REV. STAT. § 478-12 (Supp. 1981); 1980 Iowa Acts 547, § 32; KAN. STAT. ANN. § 16-207a (1981); 1981 Mass. Acts 261, § 2; MINN. STAT. ANN. § 47.203 (West Cum. Supp. 1981); 1981 Nev. Stat. 1,596, § 11; P.R. Law No. 3 (Mar. 20, 1980) (implemented by P.R. Reg. No. 22-A (Nov. 23, 1981)); S.C. Act No. 6, § 3 (1981); S.D. CODIFIED LAWS ANN. § 54-3-15 (Supp. 1981).

56. The exceptions are Kansas and Puerto Rico.

57. The Kansas ceiling is fixed at an amount equal to 1½ percentage points above the average weighted yield on mortgages accepted under the FHLMC's weekly purchase program, as effective on the first day of each month. KAN. STAT. ANN. § 16-207 (1981). The Puerto Rico ceiling is fixed at an amount equal to the "gross yield" on the weekly auction held by the FHLMC. The ARM loan auction rates are used to set the ceiling with respect to ARM loans. P.R. Reg. No. 22-A, § 4 (Nov. 23, 1981). The reference in the regulation to the "gross yield" creates interpretation and enforcement problems. The FHLMC purchases loans on a net yield, not a gross yield, basis, and the spreads between gross and net yields are not consistent over time.

be far more severe for the secondary market purchaser. The efficient operation of the national secondary market is highly dependent on the ability to purchase loans with uniform characteristics. As a result, both the FHLMC and the FNMA have declined to purchase adjustable rate loans secured by properties in jurisdictions[58] with usury ceilings applicable to adjustable rate loans.[59]

IV. Development of the National Secondary Mortgage Market

Prior to 1970, there was no significant secondary market in conventional home mortgage loans. The material terms in mortgage loan documents, as well as the standards by which the lender evaluated the borrower and the security property, differed substantially not only from region to region and from state to state, but also from lender to lender. Some lenders were willing to deal in conventional mortgage loans with individual lenders whom they trusted to make financially sound loan decisions. The general lack of uniformity, however, effectively precluded the development of a nationwide secondary market. Lenders simply had no way of knowing, without slow and costly individual review of each loan, what the substantive terms of the loan documents were and what standards had been applied in the initial determination of whether the loan should have been made.[60]

The absence of a secondary market in conventional loans exacerbated credit shortages. It was difficult to reallocate capital from areas with adequate supplies of capital to meet local mortgage demands to those areas with inadequate supplies of capital. In an attempt to alleviate this problem during the "credit crunch" of 1969-1970, Congress enacted the Emergency Home Finance Act of 1970.[61] Title III of that Act, known as the Federal

58. The FNMA and the FHLMC have dealt with the choice of laws issue by providing in their mortgage instruments that the local law applicable to the mortgage loan transaction is the law of the jurisdiction in which the secured property is located. *See* FNMA/FHLMC One-to-Four Family Mortgages/Deeds of Trust, Uniform Covenant 15. Thus, the location of the property determines the application of state usury laws.

59. The FNMA has formally announced that it will not purchase ARM loans secured by Kansas or Puerto Rico properties. The FHLMC has formally announced that it will not purchase ARM loans secured by Kansas properties. The FHLMC has not completed development of ARM documents to be used in connection with ARM loan transactions in Puerto Rico and is, therefore, not purchasing ARM loans in Puerto Rico in any event.

60. A nationwide secondary market in federally insured (FHA) and federally guaranteed (VA) loans had developed prior to the 1970s. Not only had the FNMA been authorized to purchase such loans, but the federal insurance or guarantee largely removed the risk to the lender and the secondary market purchaser.

61. Pub. L. No. 91-351, 84 Stat. 450 (1970).

Home Loan Mortgage Corporation Act,[62] created the Federal Home Loan Mortgage Corporation as a part of the Federal Home Loan Bank System.[63] The FHLMC was authorized to purchase government-insured and government-guaranteed loans, as well as conventional loans. Its status as a part of the Federal Home Loan Bank System, however, ensured that it would focus on the purchase of conventional loans, the predominant type of loan originated by thrift institutions. At the same time, pursuant to Title II of the Emergency Home Finance Act,[64] the FNMA's charter was amended to permit it to purchase conventional mortgages.[65] It previously had been limited to the purchase of government-insured or government-guaranteed loans.

In order to overcome the problems created by the lack of uniformity among conventional home mortgage loans, the FHLMC, frequently in cooperation with the FNMA, has attempted to standardize home mortgage loans. The two corporations have developed uniform mortgage loan instruments for single family and multi-family residential mortgage loans. The use of these documents generally is required for conventional mortgage loans to be sold to either corporation.[66] The uniform mortgage documents have gained wide acceptance in the lending industry, even by lenders who do not intend to sell the loans in the federal secondary market, and have become essentially the industry standard. By the late 1970s, the FHLMC estimated that the FNMA/FHLMC instruments were used in approximately eighty percent of all residential mortgage loan transactions.

Elements of the mortgage loan transaction other than the terms of the

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62. 12 U.S.C. §§ 1451-1459 (1976 & Supp. IV 1980).

63. The FHLMC is directed by a board of directors composed of three members of the FHLBB, with the Chairman of the FHLBB also serving as Chairman of the Board of the FHLMC. 12 U.S.C. § 1452(a) (1976). The capital stock of the FHLMC consists of $100,000,000 in nonvoting stock held exclusively by the federal home loan banks, and the FHLMC is a member of each federal home loan bank. 12 U.S.C. § 1454 (Supp. IV 1980). As of this writing, legislation has been introduced in both houses of Congress that would permit the issuance of public stock and expand the FHLMC Board to include directors elected by the shareholders. S.1805, 97th Cong., 1st Sess. (1981). Pursuant to this proposed legislation, the FHLMC would no longer be a part of the FHLBB System.

64. Pub. L. No. 91-351, § 201, 84 Stat. 450 (1970).

65. 12 U.S.C. § 1717(b) (Supp. IV 1980).

66. There are limited circumstances under which nonuniform documents may be accepted. For example, in 1981, the FHLMC initiated a program called the Guarantor Program, under which the FHLMC purchases participation interests in older, low-yielding loans and, in exchange for the mortgages, sells Mortgage Participation Certificates representing interests in those loans. Under this program, the FHLMC will accept nonuniform documents with respect to loans purchased on a participation basis when the loans being purchased were originated more than two years prior to purchase, as long as the loans may be serviced in accordance with FHLMC requirements.

borrower's obligation also have been standardized. For example, uniform borrower's application forms, property appraisal forms, and underwriting guidelines have been developed by the two corporations. The use of these forms and guidelines is also required for all loans sold to either corporation. Thus, the standards by which the borrower and the security property are evaluated prior to the making of the loan also have been made largely uniform.

The level of standardization achieved since 1970 has facilitated the sale of standard fixed payment conventional mortgage loans in the secondary market in three respects. First, because detailed review of each mortgage loan is not necessary, the federal secondary market corporations can purchase large volumes of loans with relatively small staffs and at low transaction costs. Second, potential private secondary market purchasers now can better assess the quality of loans purchased from lenders with whom they have not previously dealt. As a result, private purchasers are more willing to deal with lenders on a nationwide basis and to treat mortgage loans essentially as fungible commodities. The third aspect of standardization involves the sale by the FHLMC of mortgage securities to both traditional and nontraditional investors in mortgage loans. Once the FHLMC had developed a product that it could purchase under its mandate to purchase "investment quality" loans,[67] it needed to raise the capital to finance additional purchases. The FHLMC, therefore, developed two types of mortgage securities by which it sells the mortgage loans it purchases. These securities represent percentage undivided interests in large pools of mortgage loans.

The first type of mortgage security is the Mortgage Participation Certificate (the "PC"), through which the investor receives from the FHLMC monthly payments of principal and interest on the underlying mortgages. The PC is considered a real estate asset that entitles thrift institution investors to favorable tax treatment.[68] This security is, therefore, a very attractive investment to savings and loan associations and other thrift institutions. Other institutional investors and some individuals also have purchased substantial numbers of PCs. The other type of FHLMC security is the Guaranteed Mortgage Certificate (the "GMC"). GMC holders receive interest payments semiannually and a pro rata share of principal payments annually. The GMC is not considered a real estate asset for tax purposes and, thus, is less attractive to thrift institutions than the PC. GMCs are sold primarily to insurance companies, pension funds, and other nontraditional investors in the mortgage lending industry.

The ability of the FHLMC to sell loans in this manner has benefited the housing finance industry in two ways. First, the FHLMC can reallocate funds from areas with capital surpluses to areas with capital deficits by selling loans to thrift institutions and other typical mortgage market investors

67. 12 U.S.C. § 1454(a)(1) (Supp. IV 1980).
68. I.R.C. §§ 593(d), 7701(a)(19)(C)(v).

and using the funds to purchase additional mortgages in areas where the demand for mortgage money is high. Second, the sale of mortgage securities to nontraditional mortgage market investors has brought additional funds into the total supply of funds available for mortgage lending.[69]

With recent shortages in mortgage money, lenders in both capital surplus and capital deficit areas have come to rely increasingly on the secondary mortgage market as a source of additional lendable funds.[70] Many lenders are now reluctant to make any loan unless they are relatively certain that they will be able to sell it. Although, in times of rising interest rates, lenders prefer to hold in portfolio adjustable rate mortgage loans rather than fixed rate loans, the adjustable rate loan concept does not eliminate the needs of primary market lenders for immediate additional capital to make additional mortgage loans. Thus, the development of the secondary market in these loans will be crucial to the success of the adjustable rate loan concept.

V. DEVELOPMENT OF THE FHLMC ARM LOAN PURCHASE PROGRAM

A. *Underlying Policy Considerations*

In order for the FHLMC to develop a viable ARM purchase program, it was not necessary that all ARM loans to be purchased be identical. It was necessary, however, that the loans to be purchased be sufficiently uniform to minimize individual loan review and to enable the FHLMC to pool together and account for the loans on a group basis. These needs are essentially the same as the needs of the fixed rate loan purchase program; there are simply more potential variables with respect to adjustable rate loans that could impair the necessary level of uniformity.

Two factors complicated the FHLMC's development of an ARM purchase program. First, the standards relating to ARM loans differed among the states and among lender types. Thus, the development of a single uniform program, particularly one that permitted significant rate fluctuation, would necessarily eliminate some lenders from the program. Second, there was no established primary market in adjustable rate loans.

The FHLMC attempted to deal with these problems in a manner that

69. Although the FNMA traditionally has held the loans it purchases in portfolio and financed its loan purchases through debt, the FNMA has recently developed a mortgage pass-through security as well.

70. Lenders in northeastern states have only recently begun to participate in the secondary market. This is due in part to relief from legal restrictions, such as usury ceilings, as well as to economic causes. Statistics from two large northeastern states illustrate the increased importance of the secondary market in that part of the country. While Massachusetts lenders sold only $1,396,000 worth of loans to the FHLMC in 1977, by 1980 that number had increased to $79,955,000. New York lenders sold $223,000 worth of loans to the FHLMC in 1977 and $23,846,000 in 1980.

provided the necessary uniformity, access to the maximum number of lenders, and guidance for the development of the primary market. The FHLMC adopted two nearly identical programs designed to comply with the FHLBB's AML regulation and the Comptroller of the Currency's ARM regulation. Thus, all federal savings and loan associations, federal mutual savings banks, and national banks, as well as most state-chartered institutions, could participate in the FHLMC ARM program. To the extent that state laws or regulations precluded state-chartered institutions from originating loans in conformance with the purchase program characteristics, the FHLMC's need for uniformity precluded participation by these institutions, at least during the pilot phase of the program.

In order to facilitate group accounting for ARM loans and to permit the pooling of loans for sale in the form of mortgage securities,[71] a number of features of the loans in the pool must be identical. First, the interest rates on all loans within a pool must be adjusted on the basis of the same index and the same value of that index. For example, if a monthly index is selected, the same month's index figure must be used as a base index value from which the adjustments for all loans in the group are calculated. Further, the interest rates on all loans in the group must be adjusted on each adjustment date on the basis of the same month's index figure. Thus, the adjustment period of all loans in the group must be of equal length, and all loans in the group must adjust on the same date.[72] The loans must be subject to the same limitations, both interim and over the life of the loan, with respect to interest rate

71. The FHLMC does not, at this writing, offer a security representing interests in ARM loans. Development in this area is progressing, however, with the hope that ARM loans already purchased, as well as those to be purchased in the future, can be sold in this manner.

72. The FHLBB AML regulation, the Comptroller's ARM regulation, and a number of state laws and regulations require that the borrower be given notice of rate or payment adjustments a specified number of days prior to the date on which the adjustment becomes effective. This type of provision, which typically provides a range of the number of days during which notice may be given, *e.g.*, both the FHLBB and the Comptroller require that notice be given at least 30 but no more than 45 days prior to adjustment, protects the borrower in two ways. First, it makes the borrower aware of the impending adjustment and gives him an opportunity to look for a loan on more favorable terms elsewhere. Second, it limits the lender's discretion. Under most regulations, the lender must use the most recently available index value at the time the notice is given. Thus, requiring that notice be given a specified number of days prior to the adjustment limits the lender's ability to choose a favorable index value. The length of the notice period per se is not crucial to the operation of the secondary market. It is crucial, however, that notice periods be sufficiently similar to result in the use of the same index figure to calculate rate adjustments occurring at the same time. For example, assuming that the index to be used in calculating the rate adjustment is the most recently available index at the time of notice, loans calling for a 30 to 45 day notice period could not be pooled with loans in which a 90 to 120 day notice period is prescribed.

movement. Any such limitation should be expressed in the loan document in terms of fixed percentage points; limitation to the "lender's current rate," for example, would not be workable.

Because it anticipated that the small volume of ARM loans purchased during the pilot phase would not permit the creation of large numbers of pools of different characteristics, the FHLMC assessed the range of feasible options to choose one set of characteristics that appeared to serve best the needs of all parties to the loan transaction.

B. *Program Characteristics Selected*

1. Index

The first decision was the selection of the appropriate index on which to base interest rate adjustments. On the basis of extensive research,[73] the FHLMC concluded that the best index for use in the ARM program was the one that best met the following four criteria. First, because the purpose of the ARM is to permit mortgage lenders to match interest rates on assets with interest rates on liabilities, the index must be sensitive to interest rates paid on and composition of mortgage originators' liabilities. Second, in order to minimize deviations that would either inhibit or induce prepayment, movements in the index must be highly correlated with movements in average mortgage contract rates. An index that rises faster than current mortgage commitment rates would encourage loan prepayment, while an index that falls faster than current mortgage commitment rates would encourage loan assumption and prolong the life of the loan beyond that reasonably contemplated when the loan was originated. Third, movement of the index must correlate with movement of secondary market rates. In times of rising interest rates, lenders cannot convert to cash lower rate loans held in portfolio without substantially discounting the loans and taking a loss for tax, regulatory, and accounting purposes. If the index on adjustable rate loans tracks secondary market rates, lenders can keep their portfolios current and easily liquify assets if necessary. Finally, the index must be acceptable to a broad range of mortgage lenders, borrowers, and potential investors. Therefore, the index should be free of regional influences and of the manipulative control of any one type of institution, it should be published frequently and currently, and the relationship between movement in the index and the mortgage rate should be readily apparent to all parties.[74]

The FHLMC tested ten indices against these criteria: (1) the six-month Treasury bill auction rate; (2) the one-year Treasury bill rate; (3) the two-year Treasury note rate; (4) the three-year Treasury note rate; (5) the five-year Treasury note rate; (6) the twenty-year Treasury bond rate; (7) the AA corporate bond rate; (8) the AA corporate utility rate; (9) the cost of funds

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73. *See* FHLMC Study Entitled "Selection of an ARM Index," Published by Mortgage Guarantee Insurance Corporation (June 1981).
74. *Id.* at 4.

to FSLIC-insured institutions; and (10) the FHLBB mortgage contract rate.[75] While several of these indices met one of the four criteria better than did any of the others, the index found to perform best in relation to all four criteria was the FHLBB mortgage contract rate index.[76] The FHLMC found first that while this index did not directly reflect the lender's cost of funds, it did so indirectly. Because lenders typically do not originate loans at a loss, their own costs of funds were reflected in the rate they currently charged borrowers. The FHLBB mortgage contract rate reflected the costs of all types of funds and the costs to all types of lenders, not merely costs to FSLIC-insured institutions. The reflection of the lender's cost of funds remained consistent over time; approximately sixty percent of the level of the FHLBB mortgage contract rate was determined by a level of the cost of funds to thrift institutions.[77] Second, the FHLBB mortgage contract rate index correlated closely with current market rates. Thus, the use of that index would not tend either to shorten or to lengthen the average loan life.[78] Third, the FHLBB mortgage contract rate correlated well with secondary market rates, enabling lenders to keep current portfolios.[79] Finally, the FHLBB mortgage contract rate was found likely to be acceptable to all parties to the mortgage transaction.[80] In addition, all federally chartered and most state-chartered lenders could use the FHLBB index, thus promoting a broad secondary market in ARM loans. A combination of these factors led the FHLMC to choose the FHLBB mortgage contract rate index for use in the pilot purchase program.[81]

2. Length of Adjustment Period

The FHLMC's next decision was to determine the time period between interest rate adjustments. Although the FHLBB regulation permits interest rate adjustments as frequently as monthly, such frequent adjustments would impose a heavy servicing burden on the lender. Under the FHLMC program, the rate change is always accompanied by a payment change. The servicer would be required not only to recalculate the amortization schedule on each loan on a monthly basis, but also to send monthly notices to each borrower. Such frequent adjustments would be unsatisfactory from the borrower's viewpoint as well because he would be unable to predict from month to month what his mortgage payment would be. Additionally, because the Comptroller's regulation imposes a minimum period of six months between rate adjustments, a program of more frequent rate adjustments could not

75. *Id.* at 6-8.
76. *Id.* at 8.
77. *Id.* at 7.
78. *Id.* at 8, Graphs P & Q.
79. *Id.*, Graphs R & S.
80. *Id.*
81. Invitation-FHLMC Adjustable Rate Mortgage Pilot Purchase Program, § 3(a) (July 1, 1981) (hereinafter "Invitation").

include national banks. On the other hand, the very purpose of the adjustable rate loan concept is to adjust the rate to meet changing market conditions. A lengthy adjustment period would deprive the parties of this flexibility.

In an attempt to balance these needs, the FHLMC seriously considered adjustment periods of six months and one year. The one year adjustment period was finally chosen.[82] Salaries generally are adjusted annually rather than semiannually, so annual adjustments were less likely to impose hardships on borrowers in times of rising interest rates. If rates decline dramatically between the annual adjustment dates, the borrower, of course, can refinance the loan.

3. Interest Rate Adjustment Limitations

The third decision dealt with possible interest rate adjustment limitations. In this area, the FHLMC decided to provide two options, establishing, in effect, two separate programs. Lenders may sell to the FHLMC either loans with no limitations on rate adjustments or loans on which rate adjustments may not exceed two percentage points per year.[83] These alternatives allow federally chartered savings and loan associations and other lenders not subject to any limitations on rate adjustments flexibility to experiment with loans on which the rates are fully adjustable, within the limitations of the index. At the same time, the FHLMC did not want to exclude national banks, which were limited by the Comptroller's regulation to rate adjustments equal to one percentage point per six month period. National banks and other types of lenders subject to equivalent restrictions may participate in the program by selling to the FHLMC loans on which rate adjustments are limited to two percentage points on any adjustment date. These "capped" loans are priced somewhat higher, to compensate the lender and the investor for the reduced potential for interest rate increases.[84] The FHLMC must pool and account for these two types of loans separately. Although the FHLBB mortgage contract rate index tends to be relatively stable and generally will not result in adjustments in excess of two percentage points per year, the possibility that the two types of loans could be adjusted differently precludes pooling.[85]

82. Invitation, *supra* note 81, § 3(c).

83. *Id.* § 3(f).

84. The rates on capped loans purchased by the FHLMC have generally been approximately 20% higher than the rates on uncapped loans purchased.

85. Historically, the index has been quite stable. Even in the late 1970s, when interest rates were beginning to rise significantly, increases in the index did not approach 2% per year. From 1977 to 1978, the average monthly index figure for purchases of previously occupied homes moved from 8.83% to 9.37%. It then increased to 10.66% in 1979 and 12.58% in 1980. Increases in excess of 2% per year did not begin to occur until 1981. From November 1980 to November 1981, for example, the index moved from 12.85% to 15.80%. Movement has slowed since that time, however, and the index figure has decreased. The January 1982 index figure was

The FHLMC determined not to purchase loans with aggregate limitations on rate adjustments, *i.e.*, loans on which the loan documents prescribe maximum or minimum interest rates to which the loans may be adjusted over their lives.[86] Because the FHLBB mortgage contract rate index reflects current interest rates on closed loans and because there are interest rates beyond which potential borrowers will not or cannot borrow, there is an inherent limitation on upward rate adjustments on loans tied to the FHLBB mortgage contract rate index. This limitation made an artificial upward limitation unnecessary. In the absence of an upward cap, a downward cap would be unfair to the borrower and would be prohibited under the Comptroller's ARM regulation.[87]

4. Adjustments to Amortization Schedule

The fourth decision made by the FHLMC was not to purchase loans on which all or part of a change in the index would be reflected by a change in the amortization schedule.[88] A change in the amortization schedule typically would occur when the loan documentation provided for payment change caps instead of or in addition to interest rate caps. Changes in amortization schedules would create problems in the FHLMC's programs. Not only could loans on which the rate of amortization might change not be pooled with loans on which the monthly payment would change while the amortization schedule remained constant, but loans on which the rate of amortization might change could not even be pooled with each other. The percentage of payment adjustment would depend on the loans' principal balances and interest rates at the time of the adjustments. Thus, after the first interest rate adjustment, the yield on the pool as a whole could not be calculated, making individual tracking and accounting necessary.

If the amortization schedule changes such that the monthly payment is not adequate to cover even the interest due, resulting in negative amortization, the problems become even more severe. Because a number of states prohibit negative amortization, a program that prescribed this method of accommodating rate adjustments could not include many state-chartered lenders. In addition, the possibility of losing first lien priority for the amount of principal in excess of the original principal balance could create problems for federally chartered as well as state-chartered lenders.[89]

15.37%, as compared with 13.24% for January 1981. FED. HOME LOAN BANK BOARD J., Mar. 1982, Table S.5.1.

86. Invitation, *supra* note 81, § 3(b).

87. The Comptroller's regulation requires that any limitation on decreases be matched by an equivalent limitation on increases. 46 Fed. Reg. 18,943-44 (1981) (to be codified in 12 C.F.R. § 29.5).

88. Invitation, *supra* note 81, § 3(f), requires that all changes in the interest rate be fully reflected by adjustments to the monthly payments.

89. *See* Ege, *Legal Analysis of AMIs*, in 3 ALTERNATIVE MORTGAGE INSTRU-

Loans providing for negative amortization are also unattractive to investors for practical reasons. The certainty of the return, *i.e.*, the ability to calculate the yield over the life of a loan or over the life of a security representing an interest in loans, influences the lender's determination of the soundness of investing in that loan or security. The return on a mortgage loan or a mortgage security can never be calculated with absolute certainty. Even on a fixed rate loan, prepayments or default can alter the rate of return. On any type of adjustable rate loan, the rate of return is necessarily uncertain, even if the loan is paid off as scheduled. When a loan provides for rate adjustment and permits negative amortization, not only is the lender unable to calculate the rate of return; it is not even able to calculate the amount of principal that ultimately will be repaid. This added element of uncertainty makes this type of loan less attractive to investors.

In addition, the possibility of loss to the lender or investor is likely to be greater on loans that provide for negative amortization. A borrower might be less inclined to continue to make payments as the principal on the loan increases and his equity in the property decreases. At the same time, the lender could become significantly under-secured if the value of the property does not increase as quickly as does the outstanding principal balance. Thus, a negative amortization program might create no problems in areas that experience steady increases in property values, but likely would not be the best solution on a nationwide basis.

Finally, negative amortization could cause detrimental tax consequences to all parties to the mortgage loan transaction. The typical home mortgagor reports on a cash basis for tax purposes and, thus, cannot deduct the interest on his loan until it is actually paid,[90] making less of the monthly payment currently deductible. Further, it is not clear whether the interest due but not paid retains its characterization as interest after it is added to the loan balance; if this "interest" is characterized as principal, the borrower could not deduct it at all. Lenders and investors reporting on an accrual basis owe tax on interest when it is earned, even if it is not actually paid until later,[91]

MENT RESEARCH STUDY at XX-5 to XX-7 (1977). Research performed by the FHLMC and the FHLBB indicated that in 1977, negative amortization created obvious or potential problems in several states. The number of such states has apparently decreased since 1977. The FHLMC had sufficient other concerns about negative amortization that the adoption of a program incorporating a negative amortization feature was deemed not feasible, at least during the pilot phase of the program. The FNMA, however, has an ARM purchase program under which negative amortization is permitted. Because of prohibitions on negative amortization or potential lien priority problems, the FNMA will not purchase loans containing a negative amortization feature if secured by properties in the following jurisdictions: Alabama, Alaska, Arkansas, the District of Columbia, Hawaii, Idaho, Indiana, Kansas, Maine, Michigan, New York, Oregon, and West Virginia.

90. Treas. Reg. § 1.461-1(a)(1) (1957).

91. *Id.* § 1.451-1(a).

which would further aggravate cash flow problems for these entities.

For all of the above reasons, the FHLMC decided not to purchase under the pilot program loans that provided for changes in the amortization schedule. All interest rate adjustments must be fully reflected by changes in the monthly payment.

5. Other Program Characteristics

In addition to the decisions discussed above, a number of other decisions were made as well. These decisions were made primarily for the convenience of the servicer and the FHLMC and to ensure that the FHLMC could purchase a sufficient number of loans of similar characteristics to permit pooling of similar loans. The program required that interest rates adjust on one of two dates during the year, March 1 or September 1, with the first adjustment period being extended by up to six months to accommodate this schedule.[92] Monthly payments were due on the first of each month to preclude the need to calculate partial months' interest at different rates.[93]

VI. Development of the FHLMC ARM Loan Documents

A. *History of the Development*

The other aspect of the development of the FHLMC ARM loan purchase program, in addition to the development of program characteristics, was the development of uniform loan documents for use in connection with all ARM loans sold to the FHLMC. The FHLMC began drafting its original adjustable rate mortgage loan document in April 1980 and soon developed a single form of ARM note designed to comply with the FHLBB regulation in force at that time. The FHLMC did not develop a separate ARM security instrument, but instead developed an ARM rider to the existing FNMA/FHLMC one-to-four family mortgages and deeds of trust. This rider incorporated some of the adjustable rate features contained in the ARM note, in order to give subsequent lenders against that same security notice that the interest rate on the loan could be adjusted during the term of the loan and that, in the event of a default, the ARM lender could have priority not only for the principal amount of the loan and interest accrued at the note rate, but possibly for interest accrued at an increased rate as well. During this stage of the development of the documents, no attempt was made to tailor them to the laws of any particular jurisdiction.

Identical drafts were sent to the FHLMC's special counsel in each state in which the FHLMC is authorized to purchase loans,[94] with a request for

92. Invitation, *supra* note 81, § 3(c).

93. *Id.* § 3(d).

94. The FHLMC is authorized to purchase loans in 54 jurisdictions: the 50 states, the District of Columbia, Puerto Rico, the Virgin Islands, and Guam. 12 U.S.C § 1451(d), (k) (1976).

drafting suggestions and a preliminary opinion regarding the enforceability of the documents in their respective jurisdictions. At the same time, the FHLMC requested public comment on the documents, sending them to a number of lenders, trade associations, title insurers, law professors, consumer groups, and others who had expressed an interest in the documents.

The documents were then redrafted to reflect general drafting and policy considerations and the diverse requirements of state laws other than those prescribing standards for adjustable rate loans. The FHLMC obtained final opinions of state counsel on the state-tailored documents, and the ARM instruments were provided to lenders for their use. The FHLMC did not, at that time, have a program for the purchase of adjustable rate loans and never purchased loans originated on these ARM instruments developed in 1980. Before the FHLMC completed development of a program for the purchase of ARM loans, the FHLBB adopted its AML regulation, which superseded its regulation in effect when the documents were developed, and the Comptroller of the Currency adopted its ARM regulation.

The FHLMC then revised its instruments to reflect the more liberal provisions of the new regulations. Because of the nature of the revisions, new state counsel opinions and public comments were not deemed necessary. Development of revised ARM documents for most jurisdictions was completed by June 1981, and the documents were released to the lending industry at that time. The use of these documents is currently required in connection with the FHLMC ARM loan purchase program. Copies of the Missouri ARM note and the uniform ARM rider are included as an Appendix to this Article.

B. *Legal Issues Addressed*

Although many of the provisions of the ARM instruments are similar to the provisions of the existing FNMA/FHLMC documents, the FHLMC faced in the development of the ARM instruments a number of issues that were unique to adjustable rate loans. Other issues were considered simply because the forms were developed as new documents. Some of the more significant of these issues are discussed below.

1. Accommodation of State Law Requirements and Alternative Loan Provisions

In light of its mission of creating and maintaining a nationwide secondary market, the FHLMC hoped that its ARM instruments would become widely used, as are its fixed rate instruments, even by lenders that do not intend to sell ARM loans to the FHLMC. To accomplish this goal, the FHLMC needed to resolve two issues. The first issue concerned the extent to which the requirements of state law could or should be accommodated consistent with the need for comformity to and consistency with the FHLMC ARM purchase program. The second issue concerned the extent to which the documents could be made flexible enough to encourage use by lenders that were unable to originate loans in compliance with FHLMC's ARM purchase program characteristics because of state law restrictions and by lenders that for some other reason simply wished to originate adjustable rate loans with different types of characteristics.

Because of the need for uniformity, the FHLMC could not accommodate diverse state law restrictions on adjustable rate loans by including in the documents restrictions on such crucial ARM features as length of adjustment period, restrictions on amount of interim or aggregate rate adjustments, or the index by which the rate is to be adjusted. Features of state law that did not affect the amount of potential future rate adjustments could be accommodated, just as such differences have been accommodated in the fixed rate FNMA/FHLMC uniform instruments. Thus, the ARM notes were tailored to take these differences into account.

The FHLMC developed a separate ARM note for use in each of the fifty-four jurisdictions in which the FHLMC is authorized to purchase loans. Special tailoring was required for only twelve of the fifty-four jurisdictions. Forty-two of the notes are identical, except for the state "tag line" at the bottom of the first page of the document.[95] All of the FHLMC's Puerto Rico documents differ significantly from the documents prepared for use in other jurisdictions because of substantive differences in Puerto Rico's legal system and because Puerto Rico documents must be prepared in Spanish as well as in English. Aside from Puerto Rico, however, the other state-tailored ARM notes varied only slightly from the uniform version.

Most differences among the ARM notes are merely technical. For example, the North Carolina note contains an additional sentence, immediately above the space provided for the borrower's signature, that reads, "Witness the signature(s) and seal(s) of the undersigned." The Georgia note refers to the fact that the note is secured by a deed to secure debt, rather than by a mortgage or a deed of trust. Even the more substantive changes were relatively minor. For example, the Kansas note omits reasonable attorneys' fees as an expense that the lender can collect from the borrower, due to a state law prohibiting the collection of such fees.[96] Similarly, the Louisiana note eliminates the right to "reasonable" attorneys' fees and includes instead a reference to a specified percentage, to be filled in at the closing. Alaska and Pennsylvania laws provide for a minimum thirty-day cure period after default.[97] Thus, while other states' notes provide for a period of at least thirty

95. The 12 notes different from the uniform version were the notes prepared for use in Alaska, California, Georgia, Kansas, Louisiana, Minnesota, Nebraska, North Carolina, Pennsylvania, Virginia, West Virginia, and Puerto Rico. At this writing, the drafting of the Puerto Rico ARM instruments is in progress, but has not been completed.

96. KAN. STAT. ANN. § 58-2312 (1976).

97. ALASKA STAT. § 34.20.070(b) (Cum. Supp. 1981); 41 PA. CONS. STAT. ANN. §§ 403-404 (Purdon Cum. Supp. 1981-1982).

days after delinquency before the borrower can be declared in default, the Alaska and Pennsylvania notes provide for immediate notice of default on delinquency, but require at least a thirty-day cure period. The note of only one state was tailored to comply with state laws relating to adjustable rate loans. California law requires that if a loan document provides for an adjustable interest rate, the note must contain a notice to the borrower in a form specified in the statute.[98] There was some concern whether federal savings and loan associations could originate loans without complying with this requirement because the FHLBB did not prescribe any form for such a notice and the California requirement was not incompatible with the FHLBB regulation. Because this requirement was only technical and did not affect the loan's interest rate adjustment feature, the "Notice to Borrower" at the top of the California ARM note is worded somewhat differently than the notice in the other ARM notes.[99]

Even fewer differences were necessary among the riders to the security instrument. The rider is not lengthy, and nearly all of the relevant differences among state laws were already reflected in the security instrument itself. Further, the formalities of execution were not included in the rider; individual lenders are expected to add to the rider any provisions required under state law to make the instrument recordable. State-tailored riders were required for only two states. California law, as discussed above, specified the form of the notice to the borrower of the rate adjustment feature. This requirement applied to the security instrument as well as the note.[100] Further, state law required that any interest rate adjustment provision be set forth in the security instrument as well as in the note.[101] In order to avoid potential conflict with state law, the rate adjustment provisions were set forth in the California ARM rider in more detail than in the other states' ARM riders. A separate rider was also developed for use in New York for essentially technical reasons. The New York FNMA/FHLMC one-to-four family mortgage was revised in 1978 to comply with the New York "plain language" law.[102] A separate ARM rider reflected these unique features of the underlying document.[103]

State tailoring of the ARM documents was limited to accommodation of laws that did not restrict interest rate adjustments. The FHLMC was

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98. CAL. CIV. CODE § 1916.5 (West Cum. Supp. 1982).

99. This decision was made prior to enactment of the Bane Bill discussed in note 43 *supra*. Because there is now another statutory scheme for the origination of adjustable rate loans in California, this requirement of California law may no longer apply.

100. CAL. CIV. CODE § 1916.5 (West Cum. Supp. 1982).

101. *Id.*

102. N.Y. GEN. OBLIG. LAW § 5-702 (McKinney Cum. Supp. 1981-1982).

103. Puerto Rico practice precludes the use of a rider to the mortgage. Thus, a separate ARM mortgage, as well an an ARM note, are being developed for use in Puerto Rico.

nevertheless able to make the documents sufficiently flexible to accommodate both lenders subject to more restrictive state laws and lenders that wanted to originate ARM loans with characteristics other than those prescribed under the FHLMC purchase program, to hold in portfolio or to sell to an investor other than the FHLMC. This flexibility was achieved by leaving a number of blank spaces in the documents, to be filled in by the lender at the time of loan closing. As a result of the use of blanks, the lender has a range of choices for virtually every feature central to the structure of an ARM loan. For example, section 2 of the note states that "[i]nterest rate changes may occur on the ____ day of the month beginning on ________, 19__ and on that day of the month every ________ month thereafter." The lender selects the day of the month on which interest rate changes will occur, the day and month of the first adjustment, and the frequency with which rates will adjust during the life of the loan. Thus, although the FHLMC program requires that changes occur on the first day of the month, that changes occur on either September 1 or March 1, and that adjustments be made at twelve-month intervals following the first adjustment, lenders may use the forms without being so limited.

Additional choices are provided in section 4 of the note, captioned "Interest Rate Changes." Subsection (A) of that section provides a choice of indices. Most indices have fairly lengthy names, increasing the possibility of error and ambiguity in the loan contract. Thus, rather than simply leaving a blank, section 4(A) provides the lender with the option of checking "box 1," which specifies that the FHLBB mortgage contract rate index will be used to adjust the interest rate on the loan. If the lender wishes to use some other index, it may check "box 2" and insert the name of the index chosen. A footnote at the bottom of that page of the note states that if neither box is checked or if both are checked, and if there is no other agreement on an index, the FHLBB mortgage contract rate index will apply. The FHLMC thus attempted to provide some protection against error for lenders originating loans in compliance with the FHLMC program charactertistics, while granting other lenders the flexibility to choose another index.

Section 4(B) of the note states that "[t]he Current Index Figure [which is used to calculate the new interest rate on each Change Date] is the most recent Index Figure available ____ days prior to each Change Date." This provision relates to the notice period required prior to an adjustment of the interest rate and the monthly payment. Both the FHLBB's AML regulation[104] and the Comptroller's ARM regulation[105] require that the index figure used to calculate the new interest rate be the most recently available index figure at the time the rate adjustment notice is given. Further, both regulations require that notice to the borrower be given thirty to forty-five days

104. 46 Fed. Reg. 24,152 (1981) (to be codified in 12 C.F.R. § 545.6-4a(c)(1)).
105. 46 Fed. Reg. 18,943 (1981) (to be codified in 12 C.F.R. § 29.4).

prior to the rate adjustment.[106] The number of days inserted, therefore, must be in the thirty to forty-five day range if the lender is a federal savings and loan association or a national bank or operates under a statute or regulation granting parity with the federally chartered institutions. The same requirement is imposed under the FHLMC ARM purchase program.[107] Other lenders subject to an incompatible requirement or who wish to adjust the rate on the basis of a different index value may fill in a different number. Section 4(B) also provides the lender with a choice of a maximum limitation on interest rate adjustments on any adjustment date. The lender may check "box 1" to place no limitation on adjustments, or the lender may check "box 2" and insert the maximum percentage amount of any adjustment. If the loan is to be sold to the FHLMC, the lender must either check the first box or check the second box and insert "2%" in the blank. If the lender is subject to a law or regulation providing for a smaller percentage of adjustment, or if the lender simply wishes to provide for a limitation other than two percent per year, the lender may still use the FHLMC ARM note, but the loan will not be salable in the FHLMC's ARM program. Section 4(B) states that if neither limitation box is checked, there will be no maximum limit on rate adjustments. Not only does this provision resolve ambiguity; it likely implements the intention of the parties. The interest rate adjustment calculations are set forth in detail in section 4(B). If the parties do not specify a limitation on those adjustments, it can be presumed that they intended the changes to be made in the prescribed manner without limitation. A presumption of limitation would not be feasible because there would be no way of determining what that limitation should be.

Although substantial flexibility was provided in the FHLMC instruments, total flexibility was not feasible. Alternatives were provided when the choice could be made by filling in a blank and when one or more of the possible choices would comply with the FHLMC's purchase program requirements. In other instances, however, a desire to keep the document relatively short and to avoid confusion precluded the provision of alternatives, and the FHLMC drafted the document based on its own program characteristics. For example, the FHLMC could not readily make the documents

106. 46 Fed. Reg. 24,152 (1981) (to be codified in 12 C.F.R. § 545.6-4a(e)); 46 Fed. Reg. 18,944 (1981) (to be codified in 12 C.F.R. § 29.8(b)).

107. Although the number of days inserted determines the index used to determine the new rate and, therefore, is crucial to uniformity, the FHLMC can accommodate the use of any number in the 30 to 45 day range. The index used is the FHLBB mortgage contract rate index, which changes on approximately the eleventh day of each month. Rate changes always occur on the first day of the month under the FHLMC program. For example, notice of a rate change to occur on September 1 would be given between the middle and end of July, and the change would be based on the index figure that became available on July 11. Thus, all numbers in the 30 to 45 day range produce the same results. This might not be the case if some other index were used or if rate adjustments were made on a day other than the first of the month.

usable for a loan on which the percentage of payment adjustment was limited and on which the rate of amortization could change. The calculation of such an adjustment would differ substantially from the calculation used when all rate adjustments are to be recognized through payment adjustments. As a result, a note that attempted to accommodate both types of loans would contain lengthy alternative provisions and require the lender to check appropriate provisions or cross out inappropriate provisions. Such a scheme would not only greatly increase the opportunity for error, but would also result in a significant increase in the length of the already long note. Similarly, the note contains no provision for aggregate limitations on rate adjustment. Such an option would further increase the length of the note, and because the FHLMC program does not permit aggregate limitations, such a provision would likely confuse lenders and would cause them to insert limitations, thereby rendering the loan unsalable in the program.

Although the documents are not infinitely flexible as drafted, lenders can make them substantially more flexible. The documents are in the public domain, and a lender could alter the provisions of the documents to incorporate whatever terms it wished. Loans could be kept in portfolio or sold to investors other than the FHLMC, provided the FHLMC tag line was eliminated and the document did not purport to be a FHLMC-approved document.

2. "Plain Language"

The decision to draft the ARM note in plain language resulted in documents substantially different in format from the FNMA/FHLMC one-to-four family notes. This decision was to some extent mandated by law, but reflected policy considerations as well.

In 1977, a statute was enacted in New York which required that consumer contracts involving $50,000 or less be written in a clear and coherent manner, using words with common and everyday meanings, and divided into sections and appropriately captioned.[108] Because the law applied to mortgage loan documents, the FNMA and the FHLMC began developing "plain language" one-to-four family notes and mortgages for use in New York.[109]

On May 31, 1978, prior to the effective date of the statute, the statute was amended to exclude "words or phrases or forms of agreement required by state or federal law, rule or regulation or by a governmental instrumentality."[110] Because the FNMA and the FHLMC are governmental instrumentalities, this amendment exempted the FNMA/FHLMC documents from the plain language requirement. By that time, however, the plain

108. N.Y. GEN. OBLIG. LAW § 5-702 (McKinney Cum. Supp. 1981-1982).

109. The limitation of the plain language requirement to consumer transactions involving $50,000 or less made changes to the multi-family documents unnecessary.

110. 1978 N.Y. Laws ch. 199.

language mortgage documents had been substantially completed, and the corporations were pleased with the results, finding the documents to be more readable. Further, the corporations felt that their public purpose to develop a national secondary mortgage market obligated them to provide usable mortgage documents in all jurisdictions to the extent possible without impairing their ability to function on a nationwide basis. Because the plain language requirement was one of form and not of substance, the FNMA and the FHLMC could comply with the New York statute without impairing the uniformity necessary to their operation. Work on the documents was, therefore, completed and the documents released to New York lenders prior to the November 1, 1978, effective date of the statute.[111]

Other states have followed New York's lead and enacted plain language legislation for some or all of the documents used for single family mortgage loan transactions. Connecticut enacted legislation in 1979 that required mortgage notes of less than $25,000 to be in plain language, although the law specifically excluded the security instrument.[112] A FNMA/FHLMC plain language Connecticut note was developed prior to the July 1, 1980, effective date of the statute. Maine and New Jersey have also enacted plain language legislation applicable to mortgage loan documents.[113]

Because of this trend toward plain language requirements, the FHLMC decided to draft the ARM note in plain language. The ARM notes are divided into more sections than are "nonplain" notes, with captions for each section and subsection. Terminology was simplified, with the common word being substituted for the more formal "legal" word to the extent feasible. For example, interest is paid at a specified "yearly" rate, rather than at a specified rate "per annum." The note is written in the first person, referring to the borrower as "I," rather than as "the borrower" or "the undersigned." Thus, the FHLMC complied with plain language requirements already in effect and at the same time retained a significant degree of uniformity among documents. Drafting all of the ARM notes in plain language also precluded the need to translate the notes as additional states adopted plain language requirements.

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111. For a detailed discussion of the development of the New York plain language documents, see Browne, *Development of the FNMA/FHLMC Plain Language Mortgage Documents—Some Useful Techniques,* 14 REAL PROP., PROB. & TR. J. 696 (1979).

112. CONN. GEN. STAT. ANN. §§ 42-151 to -152 (Cum. Supp. 1981).

113. ME. REV. STAT. ANN. tit. 10, § 1124 (1980); N.J. STAT. ANN. § 56:12-1 to -13 (West Cum. Supp. 1981-1982). Plain language legislation also has been enacted in Hawaii. HAWAII REV. STAT. § 487A-1 to -4 (Supp. 1981). This legislation applies only to transactions involving amounts under $25,000. Real estate costs in Hawaii are so high that the FNMA and the FHLMC are authorized to establish loan purchase limits for Hawaii loans up to 50% higher than the limits applicable in the continental United States. 12 U.S.C. §§ 1454(a)(2), 1717(b)(2) (Supp. IV 1980). Thus, development of plain language documents was not deemed necessary in Hawaii.

Because the FNMA/FHLMC mortgages and deeds of trust were not redrafted for use in connection with ARM loans, the security instrument is generally not in plain language. The exception is in New York, where a separate state-tailored rider was developed for use with the plain language mortgage. As additional states develop plain language mortgages and deeds of trust, revisions to the ARM riders for those states will be necessary as well.

3. Mandatory Interest Rate Adjustments

Under both the FHLBB's AML regulation[114] and the Comptroller's ARM regulation,[115] interest rate decreases merited by movements in the index must be taken, but the lender has the option to take rate increases so merited. Neither regulation, however, prevents the lender from contracting to take any increases merited by upward movements in the index. Because the FHLMC, as well as any investors in securities representing interests in ARMs, would expect to benefit from any upward movements in the index, the FHLMC decided to require in its ARM loan purchase program that all merited increases be taken.[116] The question was whether the ARM documents should reflect the lender's discretion under the regulations, notwithstanding the fact that the increases would be taken if the FHLMC purchased the loan. The FHLMC determined that the increases would be characterized as mandatory. Thus, section 4(B) of the note states that if the current index figure is larger than the base index figure, the rounded amount of the change will be added to the initial interest rate in calculating the new rate on the loan. Further, section 3(C) of the note and paragraph A of the rider, as well as the "Notice to Borrower" in the note and the "Notice" in the rider, indicate that an increase in the interest rate will result in higher payments. Finally, the calculations contained in section 4(B) of the note and paragraph A of the rider contain no reference to the lender's option not to take increases. The only situation in which the documents recognized that the full amount of increase might not be taken is when the amount of rate adjustment is limited by an interest rate adjustment cap agreed on by the borrower and the lender at the time of loan origination.

Interest rate adjustments were characterized as mandatory for two reasons. The simpler reason was one relating to consumer disclosure. The FHLMC believed it likely that lenders would take most merited increases, particularly because the FHLMC purchase program required that such increases be taken. It would, therefore, be somewhat misleading to the borrower to indicate that the lender might not take the increases, as the borrower might be led to believe that he had more negotiating power than, in fact, he had. The other reason for characterizing rate adjustments as mandatory is more complicated and relates to the preservation of first lien priority

114. 46 Fed. Reg. 24,152 (1981) (to be codified in 12 C.F.R. § 545.6-4a(c)).
115. 46 Fed. Reg. 18,943 (1981) (to be codified in 12 C.F.R. § 29.5(c)(1)-(2)).
116. Invitation, *supra* note 81, § 7(a)(ii).

for interest accrued at a rate above the initial interest rate stated in the note. Because adjustable rate loans are relatively new to the law, there is little precedent for determining the priority of such incremental interest. In the absence of any statute[117] or case law, an analogy to the law of future advances is relevant. Courts have generally decided the respective priorities of a mortgagee on a mortgage to secure future advances and a subsequent lender whose interest attached after the making of the mortgage but before the making of the future advances on the basis of whether the future advance was optional or obligatory under the terms of the loan documents.[118] Although obligatory advances have been held to be secured from the time the mortgage was recorded and, thus, to have equal priority with the original mortgage,[119] the priority of optional advances is less certain. Most courts have held that an optional advance made pursuant to a mortgage of which subsequent lienors had notice retains priority over intervening liens, unless the mortgagee had actual notice of the intervening lien at the time the future advance was made.[120] In some jurisdictions, however, the intervening lien has priority over the optional future advance if the mortgagee had constructive notice of the intervening lien at the time the future advance was made.[121] Thus, a court might find that the incremental interest due from an optional increase in the interest rate on an ARM note has priority only to the extent that the lender had no actual or constructive notice of the intervening lien at the time the rate was increased. Therefore, it appeared prudent to require in the ARM documents that merited rate increases would be mandatory. At the same time that the mandatory characterization makes the priority of the lender's lien more certain, the borrower loses no advantage he might otherwise have had. A party to an agreement may always waive a right, assuming there is no agreement with a third party to exercise the right. Thus, as long as the lender has not agreed with a third party, such as a secondary market purchaser of the loan, to take all merited rate increases, the lender may decline to increase the rate notwithstanding the mandatory language.

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117. *See, e.g.,* 1981 Or. Laws ch. 304; VA CODE § 6.1-330.37B (Cum. Supp. 1981).

118. Barnett, *Alternative Mortgage Instruments: How to Maintain Secured Lender Status,* 96 BANKING L.J. 6, 24 (1979).

119. Citizens' Sav. Bank v. Mack, 180 Cal. 246, 249-51, 180 P. 618, 619-20 (1919); Erickson v. Ireland, 134 Minn. 156, 158-59, 158 N.W. 918, 919 (1916); Elmendorf-Anthony Co. v. Dunn, 10 Wash. 2d 29, 36-40, 116 P.2d 253, 255-57 (1941).

120. Atkinson v. Foote, 44 Cal. App. 149, 159-65, 186 P. 831, 835-37 (1919); Frye v. Bank of Illinois, 11 Ill. 367, 381 (1849); Gray v. McClellan, 214 Mass. 92, 97, 100 N.E. 1093, 1095 (1913); 55 AM. JUR. 2D *Mortgages* § 354 (1971).

121. Spader v. Lawler, 17 Ohio 371, 378-80 (1848); McClure v. Roman, 52 Pa. 458, 460-61 (1866); 55 AM. JUR. 2D *Mortgages* § 354 (1971). Courts in a few jurisdictions have held that properly recorded intervening liens take priority over optional future advances, regardless of actual or constructive notice. *See* Ladue v. Detroit, 13 Mich. 380 (1865); Kuhn v. Southern Ohio Loan & Trust Co., 101 Ohio

4. Due-on-Sale Clause

Like the FNMA/FHLMC fixed rate instruments, the FHLMC ARM instruments include a due-on-sale clause, by which the loan may be accelerated by the lender on the sale or transfer of the security property. The due-on-sale clause is, however, treated differently in two respects in the ARM instruments. First, the due-on-sale clause is included in all FHLMC ARM notes. Among the fixed rate notes, only the California note contains the clause, to comply with state law.[122] Inclusion of the clause in the fixed rate note was generally deemed unnecessary because the note states that it is secured by a mortgage or a deed of trust and that the rights of acceleration of the note indebtedness are contained in the security instrument. The Comptroller's ARM regulation, however, permits national banks to include due-on-sale clauses in their ARM loan documents and to enforce such clauses, notwithstanding contrary state law.[123] In order to take advantage of this provision the regulation requires that the due-on-sale clause itself or some indication that the security instrument contains a due-on-sale clause be included in the note.

The FHLMC wished to ensure that national banks would have the authority to enforce the due-on-sale clause in all jurisdictions, to the extent that such authority could be ensured in view of the unsettled state of the law in this area. Because the clause was required in the California note, inclusion of the clause in all of the ARM notes furthered uniformity. Aside from the increased length of the documents, inclusion of the clause in the note was not disadvantageous to any of the parties to the loan transaction. Thus, the FHLMC decided to include the due-on-sale clause in all of the FHLMC ARM notes.

The second difference between treatment of the due-on-sale clause in the ARM instruments and in the fixed rate instruments is found in the security instruments. The due-on-sale clause set forth in uniform covenant 17 of the FNMA/FHLMC mortgage and deed of trust is modified by the ARM rider. Paragraph D of the rider indicates that if a transfer of the security property triggers uniform covenant 17, the lender may require one or all of the following as a condition to the waiver of its right to accelerate: an increase in the current note interest rate, an increase in or a removal of any limit on the amount of any one interest rate change, or a change in the base index figure. This variation in the security instrument is also reflected in section 10 of the note.

The first option, increasing the current note rate, is identical in effect to the provision in uniform covenant 17, which states that the lender may require the transferee of the security property to pay interest at a new rate

St. 34, 126 N.E. 820 (1920); Nicklin v. Nelson, 11 Or. 406, 5 P. 51 (1884); 55 AM. JUR. 2D *Mortgages* § 354 (1971).

122. CAL. CIV. CODE § 2924.5 (West 1974).

123. 46 Fed. Reg. 18,944 (1981) (to be codified in 12 C.F.R. § 29.7).

as a condition to the lender's waiving its right to accelerate. This option was included simply to clarify the lender's right to a rate increase in the ARM context, to state explicitly that the lender has the right to raise the interest rate on an assumption, apart from any rights to raise the rate under the loan's interest rate adjustment feature. The second and third options, changing the interest rate adjustment caps and changing the base index figure, provide lenders with the right to adjust terms of the loan in addition to the current note rate and are unique to the ARM situation.

Although all of these rights are provided in the loan documents,[124] it is not clear whether lenders will be able to exercise them. A number of states limit, by statute or case law, the lender's right to accelerate a loan on transfer of the security property to instances in which the borrower is uncreditworthy or the lender's security is otherwise impaired.[125] Thus, in these jurisdictions, the lender generally is prohibited from raising the rate on assumption. These statutes and cases would be equally applicable in the ARM context. In fact, a court might be more likely to prohibit an interest rate increase on assumption of an ARM loan because the loan documents already provide the lender with a mechanism for adjusting the rate on the loan in accordance with movements in market interest rates. Further, to the extent that changes in the interest rate adjustment caps or the base index figures are detrimental to the borrower, the lender presumably could not require the transferee to agree to these changes as a condition to the lender's waiving its right to accelerate the loan. The FHLBB has purported to pre-empt state law restrictions on the enforcement of due-on-sale clauses, but its authority to do so has been the subject of much controversy.[126]

An additional question is whether the FHLBB's due-on-sale regulation would require in certain circumstances that the base index figure be changed, particularly if such a change would be advantageous to the borrower. The FHLBB due-on-sale regulation provides that on an agreement between the transferee and the lender regarding the creditworthiness of the transferee and the rate of interest to be paid by the transferee and the lender's waiver of its right to accelerate, the lender must release the original borrower and

124. No state prohibits inclusion of the full due-on-sale clause in the loan documents; the prohibitions relate only to enforcement of the clause.

125. *See, e.g.,* First S. Fed. Sav. & Loan v. Britton, 345 So. 2d 300 (Ala. Civ. App. 1977); Patton v. First Fed. Sav. & Loan Ass'n, 118 Ariz. 473, 578 P.2d 152 (1978); Tucker v. Pulaski Fed. Sav. & Loan Ass'n, 252 Ark. 849, 481 S.W.2d 725 (1972); Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978); First Fed. Sav. & Loan Ass'n v. Lockwood, 385 So. 2d 156 (Fla. Dist. Ct. App. 1980); Nichols v. Ann Arbor Fed. Sav. & Loan Ass'n, 73 Mich. App. 163, 250 N.W.2d 804 (1977); ARIZ. REV. STAT. ANN. § 33-806.01 (1974); COLO. REV. STAT. § 38-30-165 (Cum. Supp. 1981); 1981 Ga. Laws 480; IOWA CODE § 535.8(2)(c) (1981); N.M. STAT. ANN. § 48-7-12 (1981).

126. *See* note 20 *supra*.

is deemed to have made a new loan.[127] The new loan characterization would not require that the interest rate be changed or that the rate adjustment caps, if any, be changed. The lender may set any caps it wishes and may originate the loan at any rate it wishes, subject to applicable usury restrictions. The FHLBB's AML regulation, however, requires that the base index on a loan be the index value most current at the time of loan origination or within six months prior to loan origination.[128] This provision, in conjunction with the due-on-sale regulation, might require that an assumed loan be assigned a new base index when the original borrower is released from liability. Like the entire due-on-sale issue, this issue has not yet been resolved.

5. Usury Savings Clause

Both section 9 of the ARM note and paragraph B of the ARM rider provide that if the interest or other charges on the loan would exceed applicable usury limits, the charges are to be reduced to the permitted limit, and any amounts collected in excess of the permitted limits are to be refunded to the borrower. This provision, commonly known as a "usury savings" clause, was included even though at the time the FHLMC drafted the clause, no state had a usury ceiling on first lien residential mortgages because of federal pre-emption legislation. The possibility existed that states would override the federal pre-emption and that a loan originated with FHLMC ARM documents subsequent to the imposition of the ceiling could be found to be usurious. Although this probably would not create a problem for the FHLMC because the FHLMC does not purchase ARM loans to which a usury ceiling applies, the FHLMC anticipated that the documents would be used for loans that were subject to a ceiling. Because of the severity of the penalties for usury, it appeared prudent to draft the documents to prevent usury from occurring. It is unclear how effective the usury savings clause will be. The FHLMC requested state counsel opinions with respect to the usury savings clause and received diverse answers. Some state counsel believed that if usurious interest has been contracted for or collected, subsequent reduction of the interest rate and/or refunding of the excess interest collected probably would not preclude a finding of usury. Thus, no type of usury savings clause would be effective. Other state counsel believed that the usury savings clause would likely be effective. In their view, intent was important to a finding of usury. Inclusion of the clause, indicating a lack of intent to charge usurious interest, coupled with other indications of good faith, including protecting the consumer through other provisions in the documents and acting quickly to remedy any future usury violations, would likely preclude a finding of usury. No court has ruled on the usury savings clause, and its effectiveness remains to be seen.

127. 12 C.F.R. § 545.8-3(g) (1981).

128. 46 Fed. Reg. 24,152 (1981) (to be codified in 12 C.F.R. § 545.6-4a(c)(1)).

VII. Conclusion

The concept of a long-term mortgage loan on which the interest rate may be adjusted on a periodic basis in response to movements in market rates is not new. Only recently, however, have economic conditions made obvious lenders' needs for the authority to originate adjustable rate loans of this type and have the legislative and regulatory barriers to their origination been removed. There has been, therefore, little experience on a nationwide basis with the practical application of the adjustable rate loan concept, and it is unclear what type or types of adjustable rate loans best meet the needs of all parties to the transaction while minimizing the burdens placed on the other party or parties to the transaction. Further, there has been little opportunity for the courts to rule on issues relating to adjustable rate loans, either the authority of particular types of lenders to originate loans of specified characteristics or the application of general principles of mortgage lending law in the context of an adjustable rate mortgage loan. Thus, the programs and instruments discussed in this Article represent only a beginning, and with the increasing popularity of the adjustable rate loan, presumably answers to both the economic and legal issues will begin to evolve.

VIII. Appendix

A. *Missouri ARM Note*

ADJUSTABLE RATE NOTE

NOTICE TO BORROWER: THIS NOTE CONTAINS A PROVISION ALLOWING FOR CHANGES IN THE INTEREST RATE. INCREASES IN THE INTEREST RATE WILL RESULT IN HIGHER PAYMENTS. DECREASES IN THE INTEREST RATE WILL RESULT IN LOWER PAYMENTS.

. . . ., 19 . . . . , ...
City *State*

. . . .
Property Address *City* *State* *Zip Code*

1. BORROWER'S PROMISE TO PAY

In return for a loan that I have received, I promise to pay U.S. $ . . . (this amount will be called "principal"), plus interest, to the order of the Lender. The Lender is. . . . .

. . . .

I understand that the Lender may transfer this Note. The Lender or anyone who takes this Note by transfer and who is entitled to receive payments under this Note will be called the "Note Holder".

2. INTEREST

Interest will be charged on that part of outstanding principal which has not been paid. Interest will be charged beginning on the date I receive principal and continuing until the full amount of principal I receive has been paid.

Beginning on the date of this Note, I will pay interest at a yearly rate of ....% (the "Initial Interest Rate"). This interest rate that I will pay will change in accordance with Section 4 of this Note until my loan is paid. Interest rate changes may occur on the ..... day of the month beginning on ...., 19 ..... and on that day of the month every .... months thereafter. Each date on which the rate of interest may change will be called a "Change Date".

3. PAYMENTS

(A) Time and Place of Payments

I will pay principal and interest by making payments every month. I will make my monthly payments on the ..... day of each month beginning on ...., 19. .... I will make these payments until I have paid all of the principal and interest and any other charges, described below, that I may owe under this Note. I will pay all sums that I owe under this Note no later than .... (the "final payment date").

I will make my monthly payments at ....or at a different place if required by the Note Holder.

(B) Borrower's Payments Before They Are Due

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a "prepayment". When I make a prepayment, I will tell the Note Holder in writing that I am doing so. I may make a full prepayment or a partial prepayment without paying any penalty. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. If I make a partial prepayment, there will be no delays in the due dates of my monthly payments unless the Note Holder agrees in writing to those delays. My partial prepayment will reduce the amount of my monthly payments after the first Change Date following my partial prepayment. However, any reduction due to my partial prepayment may be offset by an interest rate increase.

(C) Amount of Monthly Payments

My initial monthly payments will be in the amount of U.S. $.................... If the interest rate that I pay changes, the amount of my monthly payments will change. Increases in the interest rate will result in higher payments (unless my prepayments since the last Change Date offset the increases in my monthly payments). Decreases in the interest rate will result in lower payments. The amount of my monthly payments will always be sufficient to repay my loan in full in substantially equal payments by the final payment date. In setting the monthly payment amount on each Change Date, the Note Holder will assume that the Note interest rate will not change again prior to the final payment date.

4. INTEREST RATE CHANGES

(A) The Index

Any changes in the interest rate will be based on changes in an interest rate index which will be called the "Index". The Index is the: [*Check one box to indicate Index.*]

(1) ☐* "Contract Interest Rate, Purchase of Previously Occupied Homes, National Average for all Major Types of Lenders" published by the Federal Home Loan Bank Board.

(2) ☐* ....
....

If the Index ceases to be made available by the publisher, or by any successor to the publisher, the Note Holder will set the Note interest rate by using a comparable index.

(B) Setting the New Interest Rate

To set the new interest rate, the Note Holder will determine the change between the Base Index figure and the Current Index figure. The Base Index figure is .... The Current Index figure is the most recent Index figure available .... days prior to each Change Date. If the amount of the change is less than one-eighth of one percentage point, the change will be rounded to zero. If the amount of the change is one-eighth of one percentage point or more, the Note Holder will round the amount of the change to the nearest one-eighth of one percentage point.

If the Current Index figure is larger than the Base Index figure, the Note Holder will add the rounded amount of the change to the Initial Interest Rate. If the Current Index figure is smaller than the Base Index figure, the Note Holder will subtract the rounded amount of the change from the Initial Interest Rate. The result of this addition or subtraction will be the preliminary rate. If there is no change between the Base Index figure and the Current Index figure after rounding, the Initial Interest Rate will be the preliminary rate.

[*Check one box to indicate whether there is any maximum limit on interest rate changes; if no box is checked, there will be no maximum limit on changes.*]

(1) ☐ If this box is checked, there will be no maximum limit on changes in the interest rate up or down. The preliminary rate will be the new interest rate.

(2) ☐ If this box is checked, the interest rate will not be changed by more than ...... percentage points on any Change Date. The Note Holder will adjust the preliminary rate so that the change in the interest rate will not be more than that limit. The new interest rate will equal the figure that results from this adjustment of the preliminary rate.

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* *If more than one box is checked or if no box is checked, and Lender and Borrower do not otherwise agree in writing, the first Index named will apply.*

(C) Effective Date of Changes

Each new interest rate will become effective on the next Change Date. If my monthly payment changes as a result of a change in the interest rate, my monthly payment will change as of the first monthly payment date after the Change Date.

(D) Notice to Borrower

The Note Holder will mail me a notice by first class mail at least thirty and no more than forty-five days before each Change Date if the interest rate is to change. The notice will advise me of:

(i) the new interest rate on my loan;
(ii) the amount of my new monthly payment; and
(iii) any additional matters which the Note Holder is required to disclose.

5. BORROWER'S FAILURE TO PAY AS REQUIRED

(A) Late Charge for Overdue Payments

If the Note Holder has not received the full amount of any of my monthly payments by the end of . . . . calendar days after the date it is due, I will pay a late charge to the Note Holder. The amount of the charge will be . . . . % of my overdue payment of principal and interest. I will pay this late charge only once on any late payment.

(B) Notice from Note Holder

If I do not pay the full amount of each monthly payment on time, the Note Holder may send me a written notice telling me that if I do not pay the overdue amount by a certain date I will be in default. That date must be at least 30 days after the date on which the notice is mailed to me.

(C) Default

If I do not pay the overdue amount by the date stated in the notice described in (B) above, I will be in default. If I am in default, the Note Holder may require me to pay immediately the full amount of principal which has not been paid and all the interest that I owe on that amount.

Even if, at a time when I am in default, the Note Holder does not require me to pay immediately in full as described above, the Note Holder will still have the right to do so if I am in default at a later time.

(D) Payment of Note Holder's Costs and Expenses

If the Note Holder has required me to pay immediately in full as described above, the Note Holder will have the right to be paid back by me for all its reasonable costs and expenses to the extent not prohibited by applicable law. Those expenses may include, for example, reasonable attorneys' fees.

6. WAIVERS

Anyone who signs this Note to transfer it to someone else (known as an "endorser") waives certain rights. Those rights are (A) the right to require the Note Holder to demand payment of amounts due (known as "presentment") and (B) the right to require the Note Holder to give notice that amounts due have not been paid (known as "notice of dishonor").

7. GIVING OF NOTICES

Except for the notice provided in Section 4(D), any notice that must be given to me under this Note will be given by mailing it by certified mail. All notices will be addressed to me at the Property Address above. Notices will be mailed to me at a different address if I give the Note Holder a notice of my different address.

Any notice that must be given to the Note Holder under this Note will be given by mailing it by certified mail to the Note Holder at the address stated in Section 3(A) above. Notice will be mailed to the Note Holder at a different address if I am given a notice of that different address.

8. RESPONSIBILITY OF PERSONS UNDER THIS NOTE

If more than one person signs this Note, each of us is fully and personally obligated to pay the full amount owed and to keep all of the promises made in this Note. Any guarantor, surety, or endorser of this Note is also obligated to do these things. The Note Holder may enforce its rights under this Note against each of us individually or against all of us together. This means that any one of us may be required to pay all of the amounts owed under this Note.

Any person who takes over my rights or obligations under this Note will have all of my rights and must keep all of my promises made in this Note. Any person who takes over the rights or obligations of a guarantor, surety, or endorser of this Note is also obligated to keep all of the promises made in this Note.

9. LOAN CHARGES

It could be that this loan is subject to a law which sets maximum loan charges and that law is interpreted so that the interest or other loan charges collected or to be collected in connection with this loan would exceed permitted limits. If this is the case, then: (A) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (B) any sums already collected from me which exceeded permitted limits will be refunded to me. The Note Holder may choose to make this refund by reducing the principal I owe under this Note or by making a direct payment to me. If a refund reduces principal, the reduction will be treated as a partial prepayment.

10. THIS NOTE SECURED BY A DEED OF TRUST

In addition to the protections given to the Note Holder under this Note, a Deed of Trust, dated ...., 19..... protects the Note Holder from possible losses which might result if I do not keep the promises which I make in this Note. That Deed of Trust describes how and under what conditions I may be required to make immediate payment in full of all amounts that I owe under this Note. One of those conditions relates to any transfer of the property covered by the Deed of Trust. In that regard, the Deed of Trust provides in paragraph 17:

17. Transfer of the Property; Assumption. If all or any part of the Property or an interest therein is sold or transferred by Borrower without Lender's prior written consent, excluding (a) the creation of a lien

or encumbrance subordinate to this Deed of Trust, (b) the creation of a purchase money security interest for household appliances, (c) a transfer by devise, descent or by operation of law upon the death of a joint tenant or (d) the grant of any leasehold interest of three years or less not containing an option to purchase, Lender may, at Lender's option, declare all the sums secured by this Deed of Trust to be immediately due and payable. Lender shall have waived such option to accelerate if, prior to the sale or transfer, Lender and the person to whom the Property is to be sold or transferred reach agreement in writing that the credit of such person is satisfactory to Lender and that the interest payable on the sums secured by this Deed of Trust shall be at such rate as Lender shall request. If Lender has waived the option to accelerate provided in this paragraph 17, and if Borrower's successor in interest has executed a written assumption agreement accepted in writing by Lender, Lender shall release Borrower from all obligations under this Deed of Trust and the Note.

If Lender exercises such option to accelerate, Lender shall mail Borrower notice of acceleration in accordance with paragraph 14 hereof. Such notice shall provide a period of not less than 30 days from the date the notice is mailed within which Borrower may pay the sums declared due. If Borrower fails to pay such sums prior to the expiration of such period, Lender may, without further notice or demand on Borrower, invoke any remedies permitted by paragraph 18 hereof.

An Adjustable Rate Loan Rider supplements the Deed of Trust and provides:

If there is a transfer of the Property subject to paragraph 17 of the Security Instrument, Lender may require (1) an increase in the current Note interest rate, or (2) an increase in (or removal of) the limit on the amount of any one interest rate change (if there is a limit), or (3) a change in the Base Index figure, or all of these, as a condition of Lender's waiving the option to accelerate provided in paragraph 17.

.... (Seal)
Borrower
.... (Seal)
Borrower
.... (Seal)
Borrower
(Sign Original Only)

MISSOURI ADJUSTABLE RATE LOAN NOTE—6/81—FHLMC
UNIFORM INSTRUMENT

B. *Uniform ARM Rider*

ADJUSTABLE RATE LOAN RIDER

NOTICE: THE SECURITY INVESTMENT INSTRUMENT SECURES A NOTE WHICH CONTAINS A PROVISION ALLOWING FOR CHANGES IN THE INTEREST RATE. INCREASES IN THE INTEREST RATE WILL RESULT IN HIGHER PAYMENTS. DECREASES IN THE INTEREST RATE WILL RESULT IN LOWER PAYMENTS.

This Rider is made this . . . . . . day of . . . ., 19. . ., and is incorporated into and shall be deemed to amend and supplement the Mortgage, Deed of Trust, or Deed to Secure Debt (the "Security Instrument") of the same date given by the undersigned (the "Borrower") to secure Borrower's Note to . . . .
. . . .
(the "Lender") of the same date (the "Note") and covering the property described in the Security Instrument and located at . . . .
. . . .
Property Address

Modifications. In addition to the covenants and agreements made in the Security Instrument, Borrower and Lender further covenant and agree as follows:

A. INTEREST RATE AND MONTHLY PAYMENT CHANGES

The Note has an "Initial Interest Rate" of . . . .%. The Note interest rate may be increased or decreased on the . . . . day of the month beginning on . . . ., 19. . . . . and on that day of the month every . . . . .months thereafter.

Changes in the interest rate are governed by changes in an interest rate index called the "Index". The Index is the:
[*Check one box to indicate Index.*]

(1) ☐* "Contract Interest Rate, Purchase of Previously Occupied Homes, National Average for all Major Types of Lenders" published by the Federal Home Loan Bank Board.

(2) ☐* . . . .
. . . .

*[*Check one box to indicate whether there is any maximum limit on changes in the interest rate on each Change Date; if no box is checked there will be no maximum limit on changes.*]

(1) ☐ There is no maximum limit on changes in the interest rate at any Change Date.

(2) ☐ The interest rate cannot be changed by more than . . . . percentage points at any Change Date.

* *If more than one box is checked or if no box is checked, and Lender and Borrower do not otherwise agree in writing, the first Index named will apply.*

If the interest rate changes, the amount of Borrower's monthly payments will change as provided in the Note. Increases in the interest rate will result in higher payments. Decreases in the interest rate will result in lower payments.

B. LOAN CHARGES

It could be that the loan secured by the Security Instrument is subject to a law which sets maximum loan charges and that law is interpreted so that the interest or other loan charges collected or to be collected in connection with the loan would exceed permitted limits. If this is the case, then: (A) any such loan charge shall be reduced by the amount necessary to reduce the charge to the permitted limit; and (B) any sums already collected from Borrower which exceeded permitted limits will be refunded to Borrower. Lender may choose to make this refund by reducing the principal owed under the Note or by making a direct payment to Borrower.

C. PRIOR LIENS

If Lender determines that all or any part of the sums secured by this Security Instrument are subject to a lien which has priority over this Security Instrument, Lender may send Borrower a notice identifying that lien. Borrower shall promptly act with regard to that lien as provided in paragraph 4 of the Security Instrument or shall promptly secure an agreement in a form satisfactory to Lender subordinating that lien to this Security Instrument.

D. TRANSFER OF THE PROPERTY

If there is a transfer of the Property subject to paragraph 17 of the Security Instrument, Lender may require (1) an increase in the current Note interest rate, or (2) an increase in (or removal of) the limit on the amount of any one interest rate change (if there is a limit), or (3) a change in the Base Index figure, or all of these, as a condition of Lender's waiving the option to accelerate provided in paragraph 17.

By signing this, Borrower agrees to all of the above.

.... (Seal)
—Borrower

.... (Seal)
—Borrower

ADJUSTABLE RATE LOAN RIDER—6/81—FHLMC UNIFORM INSTRUMENT