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The New Mortgages: A Functioning Legal Analysis

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I. INTRODUCTION

The residential mortgage market in the early 1980's is in the midst of a dramatic change in lending philosophies, regulations, and methods. This change is the result of inflation and the high interest rates of the late 1970's and early 1980's. To accommodate this new financial scenario, lenders are attempting to create new mortgage agreements that are more responsive to the changing economic environment. As lenders begin to use these new instruments, a new borrowing philosophy must emerge. In many instances the borrower will have to assume the risk of inflation and changing interest rates. To properly evaluate these new mortgages, the borrower will have to become more educated about the mortgage market, financial planning, and future economic activity.

The mortgage area will also require the increasing attention of attorneys during the next decade. The traditional mortgage was a standardized document for which neither borrowers nor lenders needed much legal advice; legislation protected consumers from "fine print" and excessive interest charges. Now that borrowers may have to deal with non-standard lenders and documents, attorneys inevitably will be called upon more frequently to analyze the implications of mortgage agreements.

This comment evaluates the new mortgage instruments that have evolved from the mortgage crisis of recent years.1 These instruments are generally referred to as "alternative mortgage instruments" (AMI's) and encompass variations on the elements comprising the traditional mortgage instruments. After a brief history of the problems leading to the development of the new mort-

1. Since federal savings and loans (S&L's) provide almost 50% of all one-to-four family mortgages, the primary focus will be on those thrift institutions. See Federal Role in Conventional Home Financing: Hearing Before the Subcomm. on Housing and Urban Affairs of the Comm. on Banking, Housing and Urban Affairs 97th Cong., 1st Sess. 48 (1981) (statement of John H. Dalton, Chairman of the Federal Home Loan Bank Board) [hereinafter cited as Dalton]. Federally chartered banks will also be discussed. Each state has its own specific regulations controlling state-chartered institutions and private lenders; reference to these will be in footnotes only.
gage instruments, several of the more common AMI's will be described and evaluated. The legal issues pertaining to the whole array of mortgage instruments will then be analyzed. Finally, some suggestions will be made about the future of the mortgage lending market.

II. History

The "traditional" residential mortgage instrument originated during the Depression of the 1930's. Before then, a substantial number of household mortgages were short-term, balloon payment mortgages. During the Depression many households found themselves unable to refinance their balloon payments and thus were forced into default on their mortgages. To remedy this potential for default, the standard mortgage, known as the Fixed Rate Mortgage (FRM), was adopted to provide for a longer term, fully amortized mortgage instrument. Two acts by Congress in 1932 and 1933 created the Federal Home Loan Bank Board (Board) and gave the Board the authority to operate and regulate federal savings and loan associations (S&L's). By offering these FRM's, federal S&L's have become the major supplier of residential mortgages over the past fifty years. As a result, the mortgage portfolios

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3. Balloon payments arise when a mortgage principal is amortized over a longer period than the term of the mortgage agreement. Thus, the borrower will repay at the longer amortization rate until the last payment of the term when the entire remaining balance of the mortgage must be repaid in one "balloon" payment. See infra notes 89-91 and accompanying text.


5. The Federal Home Loan Bank Board (Board) was created by the Federal Home Loan Bank Act of 1932, ch. 522, 47 Stat. 725 (codified as amended at 12 U.S.C. §§ 1421-49 (1976)). The following year, as an emergency measure, Congress passed the Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 128 (codified as amended at 12 U.S.C. §§ 1461-68 (1976)), with the following purpose:

To provide emergency relief with respect to home mortgage indebtedness, to refinance home mortgages, to extend relief to the owners of homes occupied by them and who are unable to amortize their debt elsewhere, to amend the Federal Home Loan Bank Act, to increase the market for obligations of the United States and for other purposes.

48 Stat. 128 (1933).


7. Other mortgage sources also exist. In addition to federal S&L's, federal banks, insurance companies, pension plans, and state-authorized organizations also provide a share of the mortgage money in the United States. See Strum, The Roles of Life Insurance Comp-
of federal S&L's currently consist almost entirely of these long-term, fixed rate mortgages.\(^8\)

The first significant rise in the level of inflation in the 1950's and early 1960's caused lenders to increase their fixed interest rates to reflect anticipated inflationary pressures.\(^9\) In the 1970's and 1980's, with inflation reaching double-digit levels, lenders (and specifically S&L's) have found themselves with a "portfolio lag"\(^10\) of long-term commitment to mortgage loans at low fixed rates without the ability to reinvest that capital in the current high-interest market. To compensate for this lag, lenders must thus charge higher-than-market interest rates on new FRM's: \(^11\) "In effect, the new home buyer who borrows under a FRM is subsidizing the older mortgagor who benefits from preinflation costs."\(^12\)

In addition to this portfolio lag, mortgage lending institutions have had serious trouble attracting capital into the mortgage market. Typically, these lending institutions have obtained mortgage capital by offering short-term liquid deposits such as on-demand, interest-bearing savings accounts. The lenders thereby assumed the risk of interest rate fluctuations by using the interest payments made on the long-term mortgage to provide a riskless, or guaranteed, rate of return to the depositors on a fairly liquid savings instrument.\(^13\) As long as the interest received from the mortgages was enough to provide an attractive rate of return on the deposits, capital would flow into the mortgage market. During the 1970's and early 1980's, however, the low mortgage interest payments from old FRM's have not been sufficient to pay the current high market interest rates required to attract new capital into

\(^8\) As of December 1980, only 7.2% of the mortgage portfolios of federally chartered S&L's consisted of alternative mortgage instruments. Thus, apparently 93% of their portfolios consisted of FRM's. Dalton, supra note 1, at 71. Since other lenders also provided primarily FRM's, their portfolios should have a similar ratio to that of the S&L's.

\(^9\) Although designed to produce an acceptable yield over the term of the loan, even when the yield is adjusted for inflation, the return is far below what was expected. Strum, \textit{Long-Term Fixed Rate Mortgages}, in \textit{Financing Real Estate During the Inflationary 80s} 23 (B. Strum ed. 1981).


\(^11\) \textit{Id.} at 31.


\(^13\) Hyer & Kearl, supra note 4, at 212-13.
This process of disintermediation, which periodically ravages thrift institutions, may result in insolvency and credit (mortgage) rationing, reducing mortgage availability and interrupting the orderly accumulation of housing capital. Moreover, those who maintain deposits with these institutions, either because they are small savers or lack adequate knowledge about alternatives, find their savings eroded by below market (and often below inflation) interest rates.\(^4\)

Two additional problems facing the lending institutions stem from restrictive government regulation of the banking community and government competition for capital funds. Regulation Q\(^5\) imposes deposit interest rate ceilings on savings institutions, thus preventing interest rate competition with unregulated investments. In the early 1980's, Congress began its attempt to deregulate the banking industry by 1986,\(^6\) manifesting this intent by allowing lending institutions to compete for needed capital. Optimism generated by government deregulation is offset in part, however, by increasing competition for existing capital from the government itself. In order to fund the public debt, the United States Treasury Department offers short-term riskless Treasury Bills at market interest rates. Although these Treasury Bills are issued in large denominations, small savers can now participate through certificates of deposit or pooled investment plans.\(^7\) Thus, many who formerly

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\(^4\) Significantly, much of the major competition for the investment capital for mortgages may come from debt-oriented corporations which must modernize their plants and equipment and invest in new technologies. An example of this capital-intensive modernization is our efforts to increase the nation's energy independence. Dalton, supra note 1, at 50.


\(^7\) See The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 202(b), 1980 U.S. Code Cong. & Ad. News (94 Stat.) 142 (codified at 12 U.S.C. § 3501 (1980)). In addition, the Economic Recovery Tax Act of 1981 allowed federal S&L's and national banks the capability of issuing "Savings Certificates" that provide a tax-free interest return. Theoretically, the tax-free return should be competitive with the taxed market return from other instruments, at least above a certain tax bracket, thus attracting that mortgage capital to the S&L's. More important is the requirement that a percentage of the funds received from the certificates is required to be used by the institutions for residential property financing. See The Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 301(a) (Aug. 23, 1981) (to be printed at 95 Stat. 172, 267-68) (published at 6 U.S. Code. Cong. & Ad. News 1, 98 (1981)).

\(^7\) Many of the money market plans require only a low initial investment (e.g. $2000).
kept their savings in S&L’s, thereby providing needed capital, have abandoned the S&L’s for the more lucrative Treasury Bills.

To remedy inadequate capital accumulation in the mortgage lending market, the secondary mortgage market was created.\(^{19}\) Generally, mortgages are delivered to the secondary mortgage markets after being pooled by the original lender. The pooled mortgages are then used to back a guaranteed security instrument which can be sold to investors in lieu of mortgages. Mortgage capital is thus attracted to the lending institutions from investment-oriented organizations such as pension funds and insurance companies.\(^{20}\)

The result of this competition for funds has left regulated lenders such as S&L’s in a poor position to attract new capital into the mortgage markets. In the residential mortgage market, this shortage of funds has left many potential homeowners without a source of financing, thereby damaging the construction industry.\(^{21}\)

To exacerbate the problem, the demand for housing will dramatically increase during the current decade:

The coming of age of the “baby boom” generation will generate a need for about 22 million new dwelling units during the 1980’s, compared to 17.5 million units during the past decade. Some 43 million Americans will be reaching the age of thirty during the 1980’s compared with 32 million during the 1970’s. In addition, an accelerating divorce rate, greater longevity, and increased house-
hold formation by singles and those living in nontraditional arrangements have added to the demand for housing.23

The problems of rising housing demand, disintermediation, and competition for capital highlight the significant need for alternatives to conventional FRM's. These problems have led to extensive experimentation in alternative mortgage instruments by both traditional and nontraditional lenders. New, more flexible mortgage instruments that continuously adjust to reflect current market rates are needed to solve many of the problems facing the mortgage lending industry. The Board twice attempted to authorize such a Variable Rate Mortgage (VRM) in the early and mid-1970's, but congressional pressure forced the new instruments to be withdrawn.24 By the mid-1970's, however, many states had authorized the use of mortgage instruments that provided for variable interest rates or adjustable payments.25 Finally, in 1976, the Board began an in-depth systematic review and analysis of several types of new mortgage instruments. The Alternative Mortgage Instrument Research Study26 initially focused on two problem areas: first, the inflexibility of the FRM for "lenders who cannot adjust their earnings to accommodate the rising cost of funds"27 and second, "the need for new mortgage forms to meet the wide diversity of financial requirements facing those borrowers at different points in their financial life cycles."28

As a result of the study, the Board in 1979 authorized federally chartered S&L's to use several different mortgage instruments that were tailored to meet the various needs of the parties involved.29 In

22. Id. at 50.
24. See Thomas, Alternative Residential Mortgages for Tomorrow, 26 PRAC. LAW. 55, 56 (Sept. 1980); Hyer & Kearl, supra note 4, at 221 n.30.
25. The findings and contributions to the study are published in a three volume set: ALTERNATIVE MORTGAGE INSTRUMENT RESEARCH STUDY (D. Kaplan ed. 1977).
26. Dalton, supra note 1, at 52.
27. Id.
28. The Variable Rate Mortgage (VRM) "was developed to help shift the distribution of interest-rate risk in order to better match the yield on associations' assets and liabilities." Id. The Graduated Payment Mortgage (GPM) was designed to help upwardly mobile, first-time homebuyers purchase a house with financing that matched payments to their rising income. The Reverse Annuity Mortgage (RAM) helps older homeowners receive annuity payments based on the built-up equity in their house. Id. All of the mortgage instruments will be discussed more fully in part III.
1980, the Board authorized the use of the Renegotiable Rate Mortgage that provided for a renewable loan of three to five years duration, yet amortized and secured by a long-term mortgage. Other instruments were proposed and considered in 1980 that offered variations on the basic variable rate mortgage concept. In April 1981, many of these proposals were consolidated into the most significant regulation of the Board to date: the Adjustable Mortgage Loan (AML). The AML is a comprehensive instrument that embodies features of the Variable Rate Mortgage and Renegotiable Rate Mortgage instruments as well as improvements to them.

The Office of the Comptroller of the Currency (Comptroller) has issued a similar regulation allowing national banks to offer Adjustable Rate Mortgages (ARM's). As with the Board's AML regulation, the Comptroller's regulation recognized the need for flexibility in mortgage instruments: "Rather than specifying a single mortgage instrument, the Office proposed that all national banks be authorized to design adjustable-rate mortgage loans that meet their needs and those of their customers."

In October 1981, the Board provided an ironic twist to this mortgage saga by amending its balloon payments loan regulation to "permit federally-chartered thrift institutions to make non-amortized and partially-amortized home loans in amounts not exceeding ninety-five percent of the value of the property securing the loan." From the amortization problems of the Depression that originally led to the creation of the Federal Home Loan Bank Board, the Board is again sanctioning the same balloon mortgage instrument that caused those initial problems. The situation has come full circle: once again the borrower will assume the risk of

30. The Graduated Payment Adjustable Mortgage (GPAM) was proposed in 1980, 45 Fed. Reg. 66,798 (to be codified at 12 C.F.R. § 545.6-4c) (proposed Oct. 8, 1980); in 1981, the Board authorized its use, 46 Fed. Reg. 37,625 (1981) (to be codified at 12 C.F.R. § 545.6-4b). This instrument was designed to combine the best features of the variable rate and graduated payment mortgages. However, the Shared Appreciation Mortgage (SAM) was proposed in September 1980. As of December 1981, no further action had been taken on the proposal (other than to extend the comment period), and no effort has been made to withdraw the proposal. See 45 Fed. Reg. 66,801 (1980).
34. Id.
36. See supra notes 2-4 and accompanying text.
economic fluctuations and financial disaster so that the mortgage industry can succeed. It is imperative that borrowers, lenders, attorneys, financial planners, and politicians understand the ramifications of this risk.

### III. The New Mortgage Instruments

A traditional FRM generally consists of three components: the principal, the interest rate, and the amortization period. These three components are elements of a formula that, when applied, automatically calculates a fixed payment amount which is designed to repay fully the principal and interest charges over the amortization period. Since the payments involved were the result of a fairly rigidly applied formula of three variables, any desire to modify the payment required the modification of one or more of the variables. This modification was typically performed during the negotiations for the mortgage, but once resolved and a fixed payment determined, the payment became binding on the borrower and lender for the life of the loan. Any alteration in the payment amount (through a modification of one of the three elements) required the dissolution of the old mortgage agreement and the creation of a new one, a process commonly called the refinancing of the loan.

In order to provide the flexibility that is required by the current mortgage market, the new mortgage instruments allow the varia-

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37. See Hyer & Kearl, supra note 4, at 217 for a different breakdown of the elements of a mortgage.

38. For the purpose of this discussion, “principal” will refer to the amount of money originally loaned to the borrower and decreased through an amortized payment schedule. A separate term, “loan balance,” will be used to describe the amount upon which interest is charged. Under the new mortgages, the “loan balance” may consist of unpaid principal and unpaid interest. Although it is arguable that “principal” should be defined as the “loan balance,” the definition used here corresponds to tax considerations. See infra note 187 and accompanying text.

39. The interest rate as applied to the loan balance will determine the amount the borrower is charged for the use of the lender’s money.

40. The amortization period is the amount of time over which the payments are calculated so that the entire principal and interest is repaid.

41. With P representing the principal amount, i the interest, and A the amortization period, the payment equation is:

\[
\text{payment} = \frac{i}{1 - (1 + i)^{-A}} \times P
\]

42. Changes in the amortization period typically are not an effective means to modify payments since the resulting change is typically small. See Hyer & Kearl, supra note 4, at 216 n.15; Strum, *Economics of Variable Rate Mortgages*, in *FINANCING REAL ESTATE DURING THE INFLATIONARY 80s* 25-26 (B. Strum ed. 1981).
bility of any of the three elements without refinancing. These variations are either calculated into the payments formula (such as a change in the amortization period), or are tied to an external factor that varies independently from any control by one of the parties.\textsuperscript{43} An additional variation involves the creation of a loan term that is shorter than the amortization period. This is similar to the refinancing requirements of a FRM, since the balance of the mortgage must either be repaid in full at the end of the loan term or must be refinanced using a new market rate of interest. However, a fourth possible modification is to the method of payment. The methods of payment variation include all forms of delaying or manipulating payments of either interest or principal so that the periodic payments fit the financial plans of both the borrower and lender.\textsuperscript{44}

Thus, changes can be effected through the principal, interest rate, amortization period, or method of payments. Since this opens up such a varied range of possible mortgage instruments, several broad areas of law and regulation must also be addressed. For the institutional lenders (such as those regulated by the Board and the Comptroller), a conflict arises between retaining some control over these new instruments to protect the parties involved, or allowing unregulated instruments so as not to inhibit the beneficial flow of funds through the mortgage market.

It is significant to note that these "new" instruments are actually new only to the residential real estate market. Commercial mortgages have continually provided instruments that allow variations on each of the elements.\textsuperscript{45} In the future, residential borrowers will be assuming the same interest rate risk that the commercial borrowers have always had as part of their doing business. To protect the borrowers in this transfer of risk, the regulating agencies have proceeded slowly and cautiously through progressively more complex mortgage instruments. This slow procession has also been necessitated by the foundation of laws and regulations that have been built up around the FRM since the Depression.

To simplify the following analysis of the new mortgage instru-

\textsuperscript{43} For example, a variable or renegotiable rate mortgage involves a variable interest rate that is tied to an inflation-oriented index.

\textsuperscript{44} Generally, any mortgage device that is tied to a price level index may be regarded as adjustable for inflation. Any instrument containing modifications to payments may be regarded as a convenience device. See generally Cowan & Foley, \textit{New Trends in Residential Mortgage Finance}, 13 \textit{REAL PROP. PROB. \& TR.} J. 1075 (1978); Barnett, \textit{Alternative Mortgage Instruments: How to Maintain Secured Lender Status}, 96 \textit{BANKING L.J.} 6 (1979).

\textsuperscript{45} See Iezman, \textit{supra} note 12, at 4.
ments, each mortgage will be described by identifying the implementation of the four elements of the mortgage and how they are varied. Many of the following mortgages may also be offered by state-chartered or private mortgage institutions in a somewhat different form. The following discussion will present only a general format of the various types of loans, with the Board's and the Comptroller's regulations used as examples when appropriate. These regulations can be used as complete models for the drafting and subsequent analysis of any new mortgage instrument. In addition, the generic regulations recently adopted by the Board and Comptroller will be presented. Once the instruments have been defined, the general legal issues, as well as the issues pertaining to variations of any mortgage element, will be discussed.

A. The Board's and the Comptroller's Regulations

Perhaps the most significant mortgage instrument regulations of the early 1980's have been the broad regulations promulgated by the Board and the Comptroller. In March 1981, the Comptroller issued its Adjustable Rate Mortgage (ARM) regulation that established a “framework within which all national banks may make and purchase residential mortgage loans which carry an interest rate subject to periodic adjustment.” The twofold purpose behind the regulation was “to help ensure the availability of mortgage funds by facilitating the development of new instruments responsive to changing interest rates and bank deposit structures” and to provide “for the protection of borrowers by requiring disclosures designed to facilitate their understanding and by moderating the frequency and magnitude of potential rate increases.” One month

46. For examples of similar California mortgage instruments, see Iezman, supra note 12, at 6-25. See also Scheuerman, supra note 20, at 737-38 for examples of specific implementation of the Board's adjustable mortgage plan.

47. Since these new mortgages are likely to be the most frequently used in the future, as well as being the most recent, a more detailed discussion is provided. See generally Parks, Adjustable-Rate Mortgages—New Regulations for National Banks and Federal Savings and Loan Associations, 70 Ill. B.J. 126 (1981).


50. Id.
later, the Board promulgated a similar regulation that authorized federal S&L's and mutual savings banks to “make, purchase, participate or otherwise deal in adjustable mortgage loan instruments, which permit adjustment of the interest rate.”51 The Alternative Mortgage Loan (AML) regulation further defines the possible methods of rate adjustment as those “implemented through changes in the payment amount, the outstanding principal loan balance, and the term of the loan, provided that the term never exceeds 40 years.”52 Both regulations are designed to provide lending institutions with the maximum flexibility in designing instruments that provide a variable current market return to the lenders, while at the same time protecting the borrowers from unforeseen changes that may effectively destroy their financial plans.

Generally, the Comptroller’s ARM rule and the Board’s AML rule provide for the following method of mortgage innovation. To allow the lenders the capability to charge and receive a return over the life of the loan that reflects current market rates, the interest charged must be allowed to fluctuate according to variations in the market rate. This variable rate will be determined periodically by comparison to a pre-specified index.53 Once the new rate is determined and notice given, the payment amount will be adjusted to reflect the new interest rate.54 The improvement upon the previous Variable Rate Mortgage and Renegotiable Rate Mortgage instruments of the Board is in the method of payment of the higher interest rate.55 The rules allow the increased interest charge to be added to the loan balance, instead of being immediately repaid as part of the periodic repayment.56 Another method of modifying the increased interest charge is through the adjustment of the loan term.57

52. Id.
53. The Comptroller’s ARM rule specifies the use of three possible indexes. See 46 Fed. Reg. 18,943 (1981) (to be codified at 12 C.F.R. § 29.4). The Board’s AML rule provides for similar indexes, yet allows an additional index to be used that is based on the Board’s regional cost of funds. 46 Fed. Reg. 24,152 (1981) (to be codified at 12 C.F.R. § 545.6-4a(c)(2)).
54. A 30-day notice is required to give the borrower the opportunity to search for alternate financing if desired. 46 Fed. Reg. 24,152 (1981) (to be codified at 12 C.F.R. § 545.6-4a(e)).
55. See infra note 59.
56. This process is called “negative amortization” and occurs when the loan balance increases instead of decreases over the life of the loan. Note that this amount can increase as the result of the addition of unpaid interest, or through a readjustment of the actual loan balance. See infra note 146 and accompanying text.
57. However, under the Board’s ARM rule, the total loan term cannot extend more than
In most respects, the two regulations are similar in their attitude towards interest variability, except that the Comptroller's ARM rule provides for specific limitations on the frequency of the interest rate changes and the maximum and minimum amounts of a periodic increase; the Board's AML rule establishes no specific limit for these changes. An additional difference between the two rules exists in the area of disclosure to the borrower. The Comptroller's ARM rule requires extensive disclosure to the borrower of general information about the ARM, key terms, an explanation of the rate change limitations, and the identification and past performance of the index that is to be used. Additionally, the disclosure must include a worst-case scenario of potential interest rate increases and how future payments would be affected. This disclosure is crucial to the ARM instrument:

Because the regulation relies primarily on disclosure rather than restriction of ARM terms to provide for borrower protection, the Office will view failure to provide timely and substantively complete and correct disclosures as a serious violation of the regulation [sic]. The full range of the Office's available supervisory authority will be used to assure compliance with the disclosure requirements.

40 years. 46 Fed. Reg. 24,152 (1981) (to be codified at 12 C.F.R. § 545.6-4a(b)).
58. 46 Fed. Reg. 18,943 (1981) (to be codified at 12 C.F.R. § 29.5(a)-(c)). Although there are periodic rate change regulations, there are no prohibitions on the total rate increase over the life of the loan. See id.
59. A major criticism of the Board's previous VRM and RRM regulations was that the rate change limitations imposed by them were too restrictive and resulted in the lenders not being able to receive a market return on their investment. See Scheuerman, supra note 20, at 650. However, the Board recognizes the need for limitations, and feels these will be imposed by the marketplace:

The Board is firmly of the opinion that AML's will contain a variety of payment caps and rate-change limitations even though not required by regulation. Lenders, who have an interest in ensuring that borrowers meet scheduled payments, are aware that such constraints make economic sense in a time of volatile interest rates. Thus, from the lender's point of view, some form of payment or rate-change limitation may be the surest way of simplifying underwriting of the loan. More importantly, borrower resistance to a totally unlimited mortgage instrument could render such an instrument unmarketable. Finally, third parties such as mortgage insurers and secondary market purchasers will likely exert pressure that will result in market limitations on AML's. The Board believes that competition and other factors in the mortgage market will encourage lenders to compete on terms and conditions that will best serve all parties involved, and that the mortgage market is competitive enough to produce the appropriate constraints.

60. 46 Fed. Reg. 18,944-45 (1981) (to be codified at 12 C.F.R. § 29.8(a)(1)-(3)).
61. Id. at 18,944 (to be codified at 12 C.F.R. § 29.8(a)(9)).
provisions of the final rule.\textsuperscript{63}

The Board’s AML disclosure rule, by contrast, is not as strict, providing only an outline of the requirements of disclosure as opposed to the model disclosure form of the Comptroller’s rule.\textsuperscript{63} There is no requirement to provide either a performance history of the chosen index or a worst-case scenario. The only specific requirement is to “[s]et out an example of the operation of the type of AML to be offered to the borrower, including, where appropriate, the use of a table.”\textsuperscript{64} To remedy this incomplete disclosure, the Board has included in the general description section of the disclosure form a statement that instructs the borrower that there are no federal regulations that place any limitations on rate adjustments:

This does not mean that the particular loan agreement you sign must, by law, permit unlimited interest-rate changes. It merely means that, if you desire to have certain rate-adjustment limitations placed in your loan agreement, that is a matter you should negotiate with the lender. You may also want to make inquiries concerning the loan terms offered by other lenders on AMLs to compare the terms and conditions.\textsuperscript{65}

\textbf{B. Other Mortgage Instruments}

The broad mortgage loan regulations promulgated by the Board and the Comptroller will most likely provide the basis for guidelines in most of the residential mortgage loans in the near future. Many of the popularly named mortgages may now be replaced by the generic titles of the Board’s AML or the Comptroller’s ARM instruments. However, the following listing identifies several of the most common new mortgages and defines them by their individual operation on each of the four elements of a mortgage instrument.\textsuperscript{66}

\textit{Fixed Rate Mortgage (FRM).} The FRM has a fixed interest rate and a declining principal that is amortized typically over a thirty-

\begin{itemize}
\item[62.] Id. at 18,940.
\item[63.] See 46 Fed. Reg. 24,152-53 (1981) (to be codified at 12 C.F.R. § 545.6-4a(f)).
\item[64.] Id. at 24,153. This provision has been slightly modified by a subsequent amendment, 46 Fed. Reg. 37,627 (1981) (revising 12 C.F.R. § 545.6-4a(f)).
\item[65.] 46 Fed. Reg. 24,153 (1981) (to be codified at 12 C.F.R. §§ 545.6-4a(f)). See also supra note 59.
\item[66.] See also Sweat, supra note 4, at 13-41. Although similar mortgage instruments may be given different names by the various lenders, the Board’s nomenclature has generally been followed.
\end{itemize}
year period. The term of the mortgage is the same as the amortization period. Since the elements are fixed, a constant payment schedule can be calculated.\textsuperscript{67}

\textbf{Variable Rate Mortgage (VRM).} The VRM has an interest rate that is tied to an index that generally reflects the current market rate, resulting in fluctuating payment amounts that consist of the variable interest and the declining, fully amortized mortgage principal. In 1979, the Board issued a regulation allowing federally chartered S&L's to offer VRM's.\textsuperscript{68} The regulation contained limitations on the size and frequency of any variations of the interest rate,\textsuperscript{69} as well as requirements for extensive disclosure to the borrowers of the variable features of the mortgage and a side-by-side presentation of fixed and variable rate mortgages. Significantly, the Board's VRM has been superseded by the Adjustable Mortgage Loan regulation, thus allowing a VRM-type mortgage without all of the disclosure previously required.\textsuperscript{70}

\textbf{Renegotiable Rate Mortgage (RRM).} The RRM has also been called the "rollover" mortgage.\textsuperscript{71} The RRM is essentially the same as the VRM with a variable interest rate and a principal that is amortized over a long-term period. However, the RRM is an automatically renewable series of short-term loans. Upon renewal, generally the only alteration that can be made is in the interest rate.\textsuperscript{72} Although the Board authorized the use of RRM's in 1980,\textsuperscript{73} subsequent amendments to the Board's RRM regulation rendered the instrument virtually identical to the Variable Rate Mortgage.\textsuperscript{74} As with the Variable Rate Mortgage, the Board specifically replaced the RRM with its AML regulation.\textsuperscript{75}

\textbf{Graduated Payment Mortgage (GPM).} The GPM is a long-term,
fixed interest rate mortgage with payments set at an initial level that is insufficient to amortize completely the principal over the loan term. These payments increase, or graduate, over time to a point at which the payment level is sufficient to amortize fully the remaining loan balance over the unexpired loan term. The GPM has been authorized by the Federal Home Loan Bank Board and the Federal Housing Administration, among others. Generally, the lenders are required to maintain an initial loan-to-value ratio sufficient to protect against a negative amortization build-up of the loan balance that is greater than the value of the mortgaged property. Restrictions on yearly payment increases, negative amortization periods, and disclosure may also be imposed.

Graduated Payment Adjustable Mortgage (GPAM). The GPAM has an adjustable interest rate that is tied to a pre-specified index and a payment schedule that negatively amortizes the loan balance. This loan effectively combines the "adjustable-rate feature of the RRM as well as the limitations on annual payment increases contained in the graduated payment mortgage (GPM) regulation." The Board's GPAM regulation was promulgated after the Board's AML regulation. Although the AML regulation could have incorporated a GPAM arrangement within its restrictions, "it was felt that all of the implications of such an amalgamation had not yet been fully explored." Therefore, the Board determined that the AML regulation should include payment, principal, or term adjustments only if the adjustments result from interest rate changes. Similarly, the GPAM instrument includes payment ad-

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76. This increase in payments is made through "negative amortization," an increase, instead of decrease, in the loan balance. See infra note 146 and accompanying text.
77. "The graduated payment mortgage (GPM) enables new home buyers to borrow funds with monthly payments which begin low and increase over time with increases in the borrowers' monthly income." Iezman, supra note 12, at 8 (footnote omitted); see also Dalton, supra note 1, at 53.
78. 12 C.F.R. § 545.6-4(b) (1981).
80. See, e.g., 12 C.F.R. § 545.6-4(b)(5) (1981). Note that this limitation has since been eased by the Board. 46 Fed. Reg. 37,626 (1981) (to be codified at 12 C.F.R. § 545.6-4a(b)(3)).
81. See, e.g., 12 C.F.R. § 545.6-4(b). The Board deleted some of the payment restrictions and disclosure requirements from its GPM regulation to allow more flexibility for the mortgage instruments. See 46 Fed. Reg. 37,627 (1981) (to be codified at 12 C.F.R. § 545.6-4(b)(4)).
82. 46 Fed. Reg. 37,625 (1981) (citation omitted). For an example of the payment schedule of a GPAM, see Iezman, supra note 12, at 11.
84. Id. One major difference between the AML and GPAM regulations is the limitation imposed on permissible negative amortization growth. See Scheuerman, supra note 20, at
justments that result from interest rate changes, but also allows planned payment adjustments that are independent of any interest rate changes. The Comptroller and other lenders have referred to this instrument as the Payment-Capped Mortgage (PCM). In the PCM, payments are capped over a certain period, yet the interest rate is allowed to adjust over a shorter period according to an index, resulting in fluctuating negative amortization increases.

Reverse Annuity Mortgages (RAM). The RAM is designed to provide homeowners the financial means to draw upon the accumulated equity in a home as a source of income. The basic operation allows for the purchase of an annuity with the equity. This annuity would then provide for payments to the borrower, normally over the lifetime of the borrower. The RAM was originally designed for elderly homeowners who desired retirement income or an income supplement. Although there are several different formats of the RAM, it is atypical of the new residential mortgages that provide variations on interest, principal, and payment.

Pledged Account Mortgage (PAM). The PAM is a long-term, generally fixed-interest loan that provides graduated payments for the borrower similar to the GPM, but also allows the lender to receive a fixed income stream. The deficiency is satisfied through the use of a supplementary annuity stream that accrues from a pledged interest-bearing savings account established at the time of down payment. This pledged account thus replaces the necessity for negative amortization of a graduated payment instrument.

Balloon Payment Mortgage (BPM). The BPM is a short-term, partially or non-amortized, fixed-interest mortgage. There is no guarantee of refinancing at the end of the loan term. The BPM was the primary mortgage instrument used before the Depression. Because of the potential for payment on demand at the end

653.

86. Dalton, supra note 1, at 53.
88. See generally Iezman, supra note 12, at 17; Dalton, supra note 1, at 55; 12 C.F.R. § 545.6-2(a)(5) (1981).
89. The Board has permitted the authorization of BPM's for federally chartered thrift institutions. 46 Fed. Reg. 51,893 (1981) (amending 12 C.F.R. § 545.6-4(c)). The Comptroller has included BPM's as part of its ARM regulation. 46 Fed. Reg. 18,944 (1981) (to be codified at 12 C.F.R. § 29.8(c)). See also Scheuerman, supra note 20, at 652.
90. See supra note 3, and accompanying text.
of the loan term and the risk involved, prominent disclosure is usually required.  

**Shared Appreciation Mortgage (SAM).** The SAM offers a lower-than-market fixed interest rate and a fixed payment schedule in exchange for a percentage of the future appreciated value of the property upon resale or reappraisal.  

The SAM is similar to a BPM in that the term of the loan is shorter than the amortization period, and as such requires a full payment or refinancing of the loan principal and accrued interest at the end of the term. The amount received from the appreciation is regarded as contingent interest for two reasons: First, since the appreciated value may provide a return well in excess of a state's usury ceiling, the fact that the interest received is contingent upon an event not within the lender's control provides the lender with protection from any usury implications; second, the specification that the appreciation proceeds are interest, and thus payment for the use of money, protects the loan arrangement from being viewed as an equity investment in the underlying property.

Superficially, the SAM would appear to be an attractive instrument to both borrowers, who pay lower interest rates than in other alternative mortgages, and lenders, who potentially could receive a greater-than-market rate of return if the property appreciates significantly. Several unique problems arise with a SAM, however, that mitigate its popularity. These include uncertain returns, ap-
preciation appraisal,\textsuperscript{98} and payment of the contingent interest.\textsuperscript{99} Because of these problems, a SAM may be more popular with investment-oriented lenders than with institutional lenders burdened with regulations that may inhibit the use of such instruments.

\textit{Price Level Adjusted Mortgage (PLAM).} A PLAM is a long-term mortgage with a fixed interest rate but a principal level that is tied to an inflation index.\textsuperscript{100} Since the principal is indexed for inflation, the interest rate charged can theoretically be far below the market rates, because an inflation premium need not be included in the interest rate.\textsuperscript{101} The PLAM theoretically provides a constant ratio between monthly payments and income, reflecting payments in real dollars and not nominal dollars.\textsuperscript{102} Although this instrument has been used in several high-inflation countries,\textsuperscript{103} it

\begin{itemize}
  \item An Economic and Policy Analysis, 1 \textit{Housing Fin. Rev.} 73 (Jan. 1982). In general, the lender must trade a current reduced cash flow for a future lump sum return that is dependent upon factors beyond the lender's control. If the property does not appreciate due to economic conditions or borrower negligence, the lender may be stuck with a below-market return. \textit{See generally McKenzie, supra note 92, at 12-13; Iezman, supra note 12, at 22-23; Gallagher, Computing the Lender's Yield on an Equity Participation Mortgage, 41 \textit{Mort. Banker} 33 (Feb. 1981); Iezman, The Shared Appreciation Mortgage and the Shared Equity Program: A Comprehensive Examination of Equity Participation, 16 \textit{Real Prop. Prob. \& Tr. J.} 510 (1981).}
  
  Many institutions may not allow such an investment in their portfolios because of the variable return; for this reason the SAM may be more popular with non-institutional lenders. \textit{See Iezman, supra note 12, at 21. The SAM also may not be popular in the secondary market because of the unsure return and the difficulty in pooling SAM’s. See Freiberg, supra, at 73.}
  
  98. The Board proposed that the property appraisal should parallel Internal Revenue Service methods in the case of a resale, or be performed by an appraiser, particularly if at the end of the loan term. 45 Fed. Reg. 66,802-03 (1980). Nevertheless, several significant problems arise with the Internal Revenue Service methods and with the independent appraiser, such as borrower improvements, future financing, etc. \textit{See Levine, supra note 96, at 491-92; Iezman, supra note 12, at 22; Gallagher, The Effect of Financing Terms on Residential Property Values, 14 \textit{Fed. Home Loan Bank Board J.} 20 (June 1981); Levin & Roberts, supra note 10, at 49.}
  
  99. Since the SAM is amortized over a period longer than the loan term, the contingent interest amount may be due in one lump sum if no automatic refinancing is offered. Thus, there is a risk that the borrower may have to pay a significant amount of interest based on the unrealized appreciation of the property. \textit{See McKenzie, supra note 92, at 13; Iezman, supra note 12, at 22. For a comparison of the SAM to a similar, yet improved mortgage instrument, see Kling, Son of SAM: A Proposal for a Deferred-Payment Mortgage, 1 \textit{Housing Fin. Rev.} 93 (Jan. 1982).}
  
  100. \textit{See generally Cassidy, Price Level Adjusted Mortgages Versus Other Mortgage Instruments, 14 \textit{Fed. Home Loan Bank Board J.} 3 (Jan. 1981); Cowan & Foley, supra note 44, at 1075; Iezman, supra note 12, at 25.}
  
  101. \textit{See Iezman, supra note 12, at 26.}
  
  102. Nominal dollars are those that are not adjusted for inflation.
  
  103 \textit{See Iezman, supra note 12, at 25.}
\end{itemize}
has not been popular in the United States because of the usury and indexed principal implications.\textsuperscript{104}

IV. THE LEGAL ISSUES

The following discussion provides a general overview of the various legal issues that impede or affect mortgage instrument innovation. Each of the issues affect one or more of the four elements of a mortgage and the method in which the element has been modified to achieve innovation. Many of the legal issues are based on state statutory and regulatory legislation; only a general approach to these issues will be given as they relate to the mortgage instruments described in part III. Some of the federal issues will be discussed in more detail. Because of the novelty of many of these mortgages, however, dispositive judicial decisions are not available to provide categorical interpretations.\textsuperscript{105} Many of these issues also involve the question of federal preemption of state legislation; these issues similarly have not yet reached dispositive judicial decision.\textsuperscript{106}

A. Usury

The concept of usury is ancient.\textsuperscript{107} Until recently in the United States, the responsibility for regulating usury had belonged to the states.\textsuperscript{108} In 1980, however, Congress passed the Depository Institutions Deregulation and Monetary Control Act\textsuperscript{109} for the purpose of deregulating, or preempting, any state laws restricting interest rate variability.\textsuperscript{110} The new federal system bases any interest ceilings primarily on flexible market rates; therefore, lenders in all states

\textsuperscript{104} See infra notes 107 and 150 and accompanying text.

\textsuperscript{105} The reader should reference any applicable state statutes or regulations for a more precise definition and identification of the issues in a specific state. See generally Winning, Alternative Mortgage Instruments and Legal Issues Involved Therein, in MORTGAGES AND ALTERNATE MORTGAGE INSTRUMENTS 503-15 (R. Sweat ed. 1981); Hyer & Kearl, supra note 4, at 211.

\textsuperscript{106} For a discussion of the ability of the federal government to preempt state law, see Sweat, supra note 4, at 37-38; Comment, supra note 2, at 269-73.

\textsuperscript{107} Usury is basically the charging of excessive interest for a loan.


\textsuperscript{110} Id.
have an equal opportunity to attract mortgage capital and get a market return on their investment.111 This preemption, though, is subject to an opt-out provision by states that choose not to be held under the federal standard.112 The preemption provisions outlined in section 501 of the act apply to mortgage loans made by financial institutions113 as well as to the sale or exchange of any real property by almost any individual, provided the property is owned and occupied as his principal residence.114

A second source of federal preemptive powers over usury is claimed by the Federal Home Loan Bank Board:

[T]he Board codifies its view that the regulation is promulgated pursuant to the Board's plenary and exclusive authority to regulate all aspects of the operations of Federally-chartered savings and loan associations and mutual savings banks. As such, the Board's exercise of this authority is preemptive of any state law purporting to restrict the ability or right of any Federal association or Federal savings bank to use adjustable mortgage loan instruments.115

This power has been upheld by at least one federal court in deciding that a state's regulation of interest rate increases does not apply to a federal S&L since the Board's regulatory scheme was so comprehensive as to preempt the field.116

In spite of the federal adoption of a floating interest ceiling, several potential problems remain with the new mortgage instruments.117 In general, usury will not be found if the mortgage agreement is entered into in good faith with no intent to avoid the usury laws.118 If a mortgage requires or results in negative amortization of the principal, however, the resulting "interest on interest" might cause the amount charged to be usurious. With the current provision by the Board to preempt any state law that prohibits negative

111. Id. § 521 (amending the Federal Deposit Insurance Act, 12 U.S.C. §§ 1811-32 (1976)). The Act sets the interest rate ceiling at not more than 1% in excess of the discount rate on 90-day commercial paper.
112. Id. § 501(b)(2).
113. Id. § 501(a)(2)(A).
114. Id. § 501(a)(1)(C).
117. See generally Werner, Usury and the Variable Rate Mortgage, 5 REAL ESTATE L.J. 155 (1976).
amortization,119 it is doubtful that such compounded interest would be regarded as usurious. But if any state opts out from the federal deregulation policy, or if national banks are held to state standards,120 the traditional usury principles may still be valid.121

There are several methods or defenses that can be used to get around a usury allegation, provided it can be shown that the agreement was entered into in good faith and with no intent to avoid the usury statute. Initially, all lenders can protect themselves by including provisions in the interest rate variation clause which make the adjustment only at the option of the lender; the lender subsequently would not increase the interest rate if the resulting charge would be usurious.122 Alternatively, an interest ceiling can be included so that the interest charged is never greater than the usurious rate. The problem with these methods is that they "undermine the usefulness of these mortgages in states with low usury ceilings and may complicate pricing these mortgages on the secondary market."123

A second method is that of income averaging or spreading. By prorating the loan costs over the life of the loan, a temporarily usurious rate would be averaged so that the overall interest rate charged would remain under the interest rate ceiling.124 A problem with the spreading notion is that courts may regard the rate adjustments as constituting separate periods of the loan, and thus "non-spreadable," especially when interest is added to the loan balance. Another problem arises when trying to determine the usurious rate ceiling when the ceiling itself is fluctuating over the life of the loan, as with the federal standard. Consequently, spreading may not be a viable alternative for avoiding the usury statutes.125

A third method is called the borrower control theory.126 Any increase in the interest rate entitles the borrower to the option of prepaying the loan instead of accepting the higher rate. Such a contingency is within the control of the borrower, and may not qualify as a usurious rate charged by the lender.127

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119. See infra note 147.
120. Note, supra note 108, at 533.
121. It is important to note that usury laws varied from state to state prior to federal preemption. See Hyer & Kearl, supra note 4, at 222-23.
122. Id. at 223.
123. Id.
124. Id. at 224.
125. Id. at 224-25.
126. Id. at 225; see Werner, supra note 117, at 160-61.
127. See Hyer & Kearl, supra note 4, at 225.
A related method of avoidance is called the contingent interest theory. This theory specifies that a lender can charge an interest rate above the usury ceiling provided that the usurious interest is contingent upon the occurrence of a specified condition. Even so, the risk that the high interest will not be paid must be substantial and must be one that is not ordinarily undertaken by the lender. Before the federal preemption of usury ceilings, several courts held that the risk of depreciation of the dollar is not especially hazardous and is normally incident to every loan. Accordingly, the contingent rule would not apply when the interest rate variation was tied to the consumer price index. On the contrary, another court held that a lender may provide for a variable interest rate that may exceed the usurious rate, provided that the parties contracted in good faith and without intent to avoid the usury laws. It would appear that if the index chosen by the lender and borrower generally follows the variations of the federally established, fluctuating interest rate ceiling, usury would not be found.

With the intended shift of the inflation risk to the borrower in the new variable rate mortgages, it is doubtful that an interest rate that exceeds usury limits because of compounded interest will be disallowed by the courts. This is especially true in light of Congress’ intent to deregulate usury laws.

B. Lien Priority

Generally, a mortgage is a contract that secures the underlying debt through the imposition of a lien on the real property involved in the transaction. A mortgage that is recorded will provide the constructive notice necessary to protect the priority of the lien against third parties. Yet the priority is protected only to the extent that the debt is disclosed by the mortgage document.

128. Id. at 226.
131. A clearer application of the contingent interest theory arises in a SAM. The contingent interest in a SAM is calculated by a percentage of the total appreciation of property over a period of time. Although it is arguable that property appreciation generally follows inflation, and is therefore an index similar to those used under the adjustable interest mortgages, many extrinsic factors beyond the lender's control can affect property appreciation. See supra note 98.
133. Guttmann, supra note 132, at 554.
there is a change in any aspect of the mortgage agreement, the priority of the lien may be affected.\textsuperscript{134} Although the lien on the original principal and interest would be unaffected by intervening liens, any adjustment to principal, interest, or term might give an intervening lien priority over the new adjustment.\textsuperscript{135} Any mortgage instrument that essentially consists of a series of short-term notes\textsuperscript{136} instead of a single long-term note could be regarded as a refinancing or renegotiation of the agreement. In such a case, "[a]ny liens intervening between the date of recording the original mortgage and the recording of the renegotiated loan would have priority over the renegotiated provisions later appearing of record."\textsuperscript{137} A possible solution to this would be to require the borrower, as a condition of refinancing, to satisfy or subordinate any intervening liens.

Generally, the extension of the term of the mortgage would not destroy the priority of the lien.\textsuperscript{138} Yet the adjustment of the interest rate might affect priority. If there is sufficient notice to a third party that the interest rate charged is variable, that should be sufficient to protect lien priority.\textsuperscript{139} An additional safeguard would be to include in the mortgage document the specification of the index used so as to give even more precise notice.\textsuperscript{140}

Similarly, if the mortgage instrument includes an adjustment to the loan balance,\textsuperscript{141} the situation becomes analogous to a future advance.\textsuperscript{142} The status of lien priority for future advances depends on whether the future advance is obligatory on the lender, or only optional. If obligatory, the advance will retain priority; an optional advance, however, will generally only have priority if the lender does not have knowledge of any intervening liens.\textsuperscript{143} Therefore, to

\textsuperscript{134} Id. at 555.
\textsuperscript{135} Id.
\textsuperscript{136} The original RRM was essentially a series of short-term arrangements. See supra note 74 and accompanying text.
\textsuperscript{137} Guttmann, supra note 132, at 555 (footnote omitted).
\textsuperscript{138} Id.
\textsuperscript{139} Hyer & Kearl, supra note 4, at 234.
\textsuperscript{140} Id. Note that this assumes the index used is an objective one (e.g., one specified by the Board). See Guttmann, supra note 132, at 556.
\textsuperscript{141} An adjustment to the loan balance can be made either through negative amortization, as in a GPM, GPAM, or PCM, or through the principal being directly tied to an index, as in a PLAM.
\textsuperscript{142} A future advance is money that is advanced by the lender to the borrower after the mortgage is executed, yet is also secured by the original mortgage. Hyer & Kearl, supra note 4, at 233. See generally G. Osborne, Handbook on the Law of Mortgages §§ 117-18 (2d ed. 1970).
\textsuperscript{143} Hyer & Kearl, supra note 4, at 233. The law pertaining to optional advances varies
protect fully lien priority in an area that treats adjustments to principal and interest as analogous to future advances, such instruments should be made obligatory and should be so specified in the mortgage agreement.

C. Negative Amortization

Negative amortization may also be referred to as compounding interest, indexed principal, or interest capitalization. The process consists of an adjustment to the balance of the loan either as accrued interest or as a direct adjustment to the principal through an index or revaluation. Thus, any mortgage that results in a periodic increase of the loan balance, as compared to the required payment reductions, may have legal problems with the negative amortization.

The Board and the Comptroller have both issued preemptive rulings that would allow federally chartered S&L's, mutual banks, and national banks to issue mortgage instruments that negatively amortize the mortgage balance. There are therefore no restrictions on the capability of a federal institution to issue a mortgage that negatively amortizes over a period of the loan. However, there is a difference between some of the limitations of the Comptroller and the Board on negative amortization.

Many states, either by statute or case law, prohibit the compounding of interest. Many of the new mortgages that incorporate the “interest on interest” into their instrument may therefore not

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144. See Guttmann, supra note 132, at 555.
145. Hyer & Kearl, supra note 4, at 234.
146. For this article, loan balance is defined as the amount of the mortgage upon which the interest charge is calculated. Thus, the definition incorporates any accrued interest that is added onto the principal balance; additionally, if the loan balance itself is indexed, the loan balance may also be adjusted by the revaluation.
147. The Comptroller's ARM regulation recognizes that under 12 U.S.C. § 85 states can "prohibit a national bank from charging a compound rate below the usury limit if the simple rate of interest thus charged would exceed the state limit." 46 Fed. Reg. 18,939 (1981). Yet the regulation also recognizes that "the federal usury preemption of Section 501 of the Depository Institutions Deregulation and Monetary Control Act of 1980 provide[s] national banks with a method, in many cases, of avoiding state usury limits and restrictions on compounding as they relate to these state limits." Id.
be allowed in those states. Some courts may even consider that indexed principal (as in a PLAM) is a form of compounded interest and thus not allowed. Additionally, some statutes or regulations may require the maintenance of a loan-to-value ratio that is below a certain level.

D. Disclosure

An important aspect of the new mortgages is the disclosure that is required for the borrower. As the interest rate risk shifts from the lender to the borrower, the borrower is confronted with choices beyond the simple interest rate and payment schedule. It becomes increasingly important that the borrower be made aware of all the factors and available options. There are two federal sources that compel the disclosure of credit terms to a borrower. The Truth In Lending Act (TILA) is designed to provide information to the borrower so that he is educated in the use of credit and can then shop around for the best credit terms. Additionally, Regulation Z requires all creditors to provide disclosure of meaningful information.

149. See Hyer & Kearl, supra note 4, at 227.

150. See Aztec Properties, Inc. v. Union Planters Nat'l Bank, 530 S.W.2d 756 (Tenn. 1975), cert. denied 425 U.S. 975 (1976) (loan principal indexed to the CPI illegal). The Aztec court held that "[i]t would be contrary to the national policy, as expressed by the Congress and as interpreted in several cases by the United States Supreme Court, to permit a lender to require of a borrower a different quantity or number of dollars from that loaned, insofar as the principal amount is concerned." Id. at 760. But the court based its argument on the "Gold Clause" Joint Congressional Resolution of 1933, which was revoked in October 1977 by the Helms Amendment. See McCulloch, The Ban on Indexed Bonds, 1933-77, 70 AM. ECON. REV. 1018, 1020 (Dec. 1980).

151. See, e.g., 46 Fed. Reg. 24,152 (1981) (to be codified at 12 C.F.R. §§ 545.6-4a(b)(3)). Generally, these limitations are designed to protect lenders from the problem of an increasing loan balance that may exceed the value of the underlying property.

152. See supra note 35 and accompanying text.


154. Id. § 1601(a).


156. 46 Fed. Reg. 20,892 (1981) (to be codified at 12 C.F.R. § 226.1(b)). Significantly, the latest revision of Regulation Z recognized that:

[T]he act has imposed highly complex and technical requirements on creditors, produced disclosures that sometimes obscured the important information to con-
Generally, normal disclosure requirements must be followed for any mortgage loan. For variable rate mortgages, however, additional disclosure must be made, consisting of:

1. The circumstances under which the rate may increase;
2. Any limitations on the increase;
3. The effect of an increase;
4. An example of the payment terms that would result from an increase.

It is important to note that the other disclosure requirements for the amount financed, payment schedule, total of payments, and total sale price do not contain provisions for a variable interest or principal adjustment disclosure. The consumer must therefore realize on his own the effect of the variations on his future financial plans. Although provision is made for an example of the variation, there is no requirement for disclosure of the actual or potential variations that may occur. The creditor is only required to make "good faith estimates." It is only after a change in the payment schedule caused by a rate increase that subsequent disclosure is required. This incomplete disclosure will seriously affect the ability of the borrower to make an informed choice as to the quality of the index or the potential for future payment increases.

As previously noted, the Board and the Comptroller have imposed more restrictive disclosure requirements in their adjustable mortgage regulations. The Comptroller's regulation contains an

sumers, and generated costly and burdensome litigation over technical interpretations of the regulation.

. . . . The [revised] regulation's focus on simplified disclosure of material terms should benefit consumers by providing a more useful basis for credit decisions, and creditors by reducing the difficulty of compliance.

159. Id.
160. Id. The regulation does provide for disclosure of the largest and smallest payments in a series of variable payments, but it must be assumed that these are capable of being predicted (such as in a GPM). See id. For sample disclosure forms, see 46 Fed. Reg. 20,932-33 (1981).
162. Id.
163. Id.
164. Id.
165. Scheuerman, supra note 20, at 653.
166. See supra note 66 and accompanying text.
additional requirement of disclosure of a "worst case" example of a variable rate increase.\textsuperscript{167} Although this will give the borrower additional useful information, it may also place the national banks in an unfavorable competitive lending position by requiring them to provide adverse information that is not required of other lenders.

E. Negotiability.

The negotiability of a mortgage directly affects its attractiveness on the secondary market.\textsuperscript{168} A "holder in due course"\textsuperscript{169} of a negotiable instrument becomes immune to many of the potential defenses a borrower could use against enforcement of the obligation by the original lender.\textsuperscript{170} On the contrary, the variable rate mortgages, designed to be responsive to a changing financial environment, do not promise to pay a "sum certain,"\textsuperscript{171} and probably do not qualify as negotiable instruments.

Two methods can be used to achieve negotiability for a variable rate mortgage.\textsuperscript{172} Under one method, a purchaser can attempt to obtain a waiver or estoppel certificate from the borrower, thus providing the purchaser with the same immunity benefits as a holder of a negotiable instrument. A second method, which draws on the current procedure used by many participants in the secondary market,\textsuperscript{173} involves pooling mortgages and selling certificates that are backed by the pool. The certificates may then become the negotiable instruments, provided they meet the UCC requirements.\textsuperscript{174}

Any instrument that does not have a variable mortgage provision\textsuperscript{175} should qualify as a negotiable instrument and consequently be more attractive in the secondary market. Yet the possibility that the mortgage may not provide an adequate market return in an inflationary or rising interest economy may impede the attrac-

\textsuperscript{167} 46 Fed. Reg. 18,944-45 (to be codified at 12 C.F.R. § 29.8).
\textsuperscript{168} Hyer & Kearl, supra note 4, at 231.
\textsuperscript{169} U.C.C. § 3-305 (1978).
\textsuperscript{170} U.C.C. § 3-305(2) (1978). See also Hyer & Kearl, supra note 4, at 231 n.83.
\textsuperscript{171} U.C.C. § 3-104(1)(b) (1978).
\textsuperscript{172} One commentator suggests making the variable rate provision of the mortgage a separate covenant, thus keeping the note itself negotiable. However, this gives rise to serious enforceability problems. See Hyer & Kearl, supra note 4, at 231-32.
\textsuperscript{173} See supra note 17 and accompanying text.
\textsuperscript{174} U.C.C. § 3-106 (1978).
\textsuperscript{175} E.g., graduated payment, balloon payment, pledged account, or fixed rate mortgages.
tiveness of the mortgage for market reasons.\textsuperscript{176}

\textbf{F. Tax Effects}

Although many potential tax problems arise with the use of variable rate mortgages, nothing in the federal tax code should affect the legality of any of the instruments. One of the key concerns behind tax considerations of new mortgages is the extent of the tax benefit accruing from them. The borrower must consider the tax implications of a mortgage instrument just as he would the interest rate or payment schedule when comparing different mortgages.

The primary consideration for tax purposes must be what in the mortgage agreement constitutes interest.\textsuperscript{177} For most of the variable rate mortgages this is not a problem since the mortgage consists of a stated (albeit flexible) interest rate to be applied to a fixed loan balance.\textsuperscript{178} However, a finer question arises when interest is added onto the mortgage balance,\textsuperscript{179} or when the principal is tied to an index that causes it to vary.\textsuperscript{180} In either case, the added amount represents earned but unpaid interest and it may not be clear when, or how, this amount should be declared.

Determination of the time that interest is declared depends upon the method of accounting used by the borrower or lender.\textsuperscript{181} In a residential mortgage, the borrower typically will use cash basis accounting,\textsuperscript{182} and the lender will use accrual basis.\textsuperscript{183} The borrower is not permitted to deduct interest accrued but not yet paid,\textsuperscript{184} while the lender includes the interest as gross income in

\begin{itemize}
\item \textsuperscript{176} However, the opposite may be true in a declining interest economy.
\item \textsuperscript{177} Interest on a loan is generally a deductible expense for the borrower and interest income for the lender. See I.R.C. §§ 163(a), 61(a)(4) (1980). The traditional test for interest is "the amount which one has contracted to pay for the use of borrowed money." Old Colony R.R. v. Commissioner, 284 U.S. 552, 560 (1932). See generally Rev. Rul. 69-188, 1969-1 C.B. 54 (discussing points paid by a borrower).
\item \textsuperscript{178} Examples of this type are the VRM's and RRM's and any other mortgage with a variable rate that does not involve an adjustable loan balance.
\item \textsuperscript{179} E.g., payment capped, graduated payment, or graduated payment adjustable mortgages.
\item \textsuperscript{180} E.g., price level adjusted mortgages. It is unclear whether an increase in principal would qualify as interest. For this reason, it might be advantageous to specify in the mortgage that such an increase is considered as interest to the parties involved.
\item \textsuperscript{181} See I.R.C. § 446 (1980). For a complete outline of the requirements, see Rev. Rul. 77-135, 1977-1 C.B. 133-35. This ruling was made in response to a request for the proper method of reporting interest income and deductions under a GPM.
\item \textsuperscript{182} I.R.C. § 446(a) & (c)(1) (1980).
\item \textsuperscript{183} I.R.C. § 446(c)(2) (1980).
\item \textsuperscript{184} See Rev. Rul. 77-135, 1977-1 C.B. 134.
\end{itemize}
the year in which he obtains a legal right to receive the interest.\footnote{185} Thus if the borrower is allowed to deduct interest when it is paid,\footnote{186} as under a GPM, this could result in a one year delay between the time the interest is accrued and the time it is deductible:

[T]he interest under a GPM plan . . . is deductible by the mortgagor in the year paid. The addition of the unpaid interest to the note does not constitute a payment or receipt of interest. For the early years of the mortgage term, when the amount of monthly payment does not fully cover the interest owed, the entire amount represents interest, and is . . . deductible by the mortgagor when paid. . . . For subsequent years of the mortgage term, when the amount of the payments has increased to the extent that it now exceeds the current interest charge owed, the excess . . . will be treated as discharging first that part of the unpaid balance of the loan that represents accumulated interest carried over from prior years and will be . . . deducted by the mortgagor as interest at that time.\footnote{187}

Another tax problem arises when determining the gain or loss on the sale of the residence. For the simple variable interest rate mortgage, the interest is distinct from the principal and thus the basis of the property is determined as with a FRM.\footnote{188}

G. Due-on-Sale and Prepayment Penalty Clauses

Two controversial clauses found in many mortgages are the

\footnote{185} "[P]erformance occurs when the lender allows the borrower to use the lender's money." \textit{Id. See also} I.R.C. § 451(a) (1980); Reg. 1.451-1(a) (1980); Rev. Rul. 74-607, 1974-2 C.B. 149-50.
\footnote{186} \textit{Hart v. Commissioner}, 54 F.2d 848 (1st Cir. 1932). \textit{See also} Rev. Rul. 70-647, 1970-2 C.B. 38.
\footnote{187} Rev. Rul. 77-135, 1977-1 C.B. 134. An example of interest due and interest paid is also provided. Note that the ruling considers accrued interest as part of the unpaid balance of the loan. There remains, however, a distinction between the accrued interest portion of the unpaid balance and the original principal amount for the determination of what constitutes interest. This is advantageous to the borrower from a tax standpoint since the method provides the maximum allowable interest deduction, instead of designating part of the payment as a non-deductible principal repayment. This situation is one of the few instances in which there is a significant distinction between the accrued interest in the loan balance and the original principal. Possibly the Internal Revenue Service might consider that the added balance from an indexed principal mortgage would be considered interest on the mortgage for the purpose of determining deductibility.
\footnote{188} I.R.C. § 1012 (1980) establishes that the basis of property (for determination of a gain or loss) is the cost of the property. I.R.C. § 1016 (1980) provides for several adjustments to this basis.
"due-on-sale" clause and the prepayment penalty clause. These clauses are included to protect the lender from borrower activities that would deprive the lender of the anticipated return on the loan. Currently, the permissibility of these clauses is in a state of flux, both as to their validity and as to the source of regulation. Several states have disallowed the enforcement of the due-on-sale clause; similar restrictions have been made on prepayment clauses. Pursuant to their preemptive authority, however, the Comptroller and Board have made specific provisions and interpretations in their ARM and AML regulations concerning the two clauses. The Controller has specified that:

National banks offering or purchasing adjustable-rate mortgage loans are not required to allow those loans to be assumed by new purchasers of the mortgaged property, or to allow new purchasers to take title to such property subject to the lien of an adjustable-rate mortgage loan made pursuant to this Part, regardless of any limitations on the validity or enforceability of due-on-sale clauses found in state law, which limitations are expressly preempted.

The Board has not specifically preempted state law limitations on due-on-sale clauses. Yet their desire to make thrift institutions receive a market return would imply that due-on-sale clauses would be encouraged, and thus opposing state laws would be preempted.

Assuming the purpose of the ARM is to provide a flexible return to the lender that corresponds to a fluctuating market rate, thereby shifting the interest rate risk to the borrower, it is curious that such an instrument would require a due-on-sale clause provi-
sion. If the interest rate charged accurately reflects the market return rate, there would seem to be no need for the additional control of the lender over subsequent purchasers. However, the Comptroller maintains that such control is necessary:

The Office believes that a due-on-sale provision is desirable to provide the lender with the ability to protect itself from additional market risks. In addition, because the Office has decided to limit interest rate changes and does not wish to discourage lenders from establishing more restrictive interest rate limitations, the Office has decided to adopt an expanded provision for banks choosing to permit assumption. The final regulation allows national banks to reset at assumption any loan terms, including the interest rate. The intent of the final provision is to permit banks to choose the extent to which they want to expose themselves to additional market risk when assumption is granted.\(^\text{196}\)

Both the Board’s and Comptroller’s regulations specifically prohibit any prepayment penalties in the ARM’s or AML’s.\(^\text{196}\) This prohibition recognizes one of the major potential hazards of unregulated variability of rate changes in a mortgage:

The Board believes that, since the AML regulation gives lenders broad flexibility in shaping rate-sensitive mortgage loan instruments, borrowers should be given maximum flexibility in locating alternative sources of financing should a particular interest rate or monthly payment adjustment prove excessively burdensome.\(^\text{197}\)

The due-on-sale clause and the prepayment clause may be essential to several types of mortgages, and if the clauses are held to be unenforceable in a state, may prohibit or discourage the use of these mortgages in that state. The nature of the SAM requires that the lender retain some control over the appreciated value of the property upon a resale that would encumber the equity.\(^\text{198}\) Similarly, with the investment characteristics of a SAM,\(^\text{199}\) a prepayment penalty should be allowed for the early years of a SAM in order to provide an adequate return on the mortgage invest-

\(^{196}\) 46 Fed. Reg. 18,944 (1981) (to be codified at 12 C.F.R. § 29.6). The Comptroller allows a prepayment penalty only until 30 days before the first scheduled rate adjustment date. See also 46 Fed. Reg. 24,152 (1981) (to be codified at 12 C.F.R. § 545.6-4a(b)(4)).  
\(^{198}\) Levin & Roberts, supra note 10, at 46.  
\(^{199}\) See supra note 97 and accompanying text.
ment. To facilitate refinancing by the borrower, however, the Board’s SAM proposal did not permit such a penalty.

V. THE EFFECT OF THE NEW MORTGAGES

The new mortgages are a product of change, and by themselves will require future changes. An entire industrial, philosophical, and statutory structure has developed around the fixed rate mortgage. Now that the underlying economic premise of those mortgages has been shaken, a new structure must be created to support the new mortgage instruments.

The financial industry already has begun the change to address the new economic realities. The Depository Institutions Deregulation and Monetary Control Act of 1980 has proposed the elimination of all deposit rate interest ceilings by 1986. This move will place all currently regulated financial institutions on an equal competitive footing with unregulated institutions for attracting investment capital. Additionally, the new Board’s and the Comptroller’s mortgage regulations provide the federally chartered institutions with the capability to receive a market return on their mortgage investments, and similarly provide more investment alternatives in the secondary mortgage market. The health of these financial institutions then will depend not on their capability to respond to economic changes, but on their ability to operate within the financial marketplace.

Several philosophical changes are required for the acceptance of the new mortgage instruments. Primarily, the transfer of the interest rate risk from the lender to the borrower is a necessary adjustment that must be accepted if the borrower desires the availability of long-term mortgage capital at a competitive rate in a fluctuating and unpredictable economic environment. To be able to adjust to this transfer of risk, the borrower must become educated about all of the relevant factors entering into any long-term financing de-

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200. This is especially true when the interest rate charged is significantly lower than the market rate. If the loan is prepaid before the property has a chance to appreciate (or if the housing market is temporarily depressed), the return on the loan would be inadequate, thus discouraging the use of this type of mortgage instrument.
204. See supra note 17 and accompanying text.
205. If lenders are left with this risk, a large inflation premium will be built into the interest rate charged. This has been suggested as one of the contributing factors to the high interest rates of the early 1980’s. See Levin & Roberts, supra note 10, at 50.
cision with concomitant, significant short-term effects. Now that the borrower must compare a variety of mortgage instruments to determine the best overall arrangement for his financing needs, he must be aware not only of his own situation but must also be able to understand and evaluate each of the provisions of a mortgage. Finally, the varied mortgage instrument selection will require the increased participation of financial planners and attorneys in both the drafting of the instrument and in its evaluation; most likely is the requirement that real estate attorneys become financial planners as well.

The role of the attorney/financial planner is essentially the same whether representing the lender or the borrower in a transaction, since the new instruments contain elements of flexibility that allow the mortgage to be tailored to the needs of the borrower. Although some disclosure is required, the attorney will have to explain many features and their effects to the borrower, such as the true effect of the interest rate increases, negative amortization, and any limitations or requirements imposed on the borrower. Another important task of the attorney is the evaluation of the index that is to be used and its potential effect on the borrower.

The final, and possibly most important, structural change that must be made to fully implement these new mortgages is a revision of the statutory and legal impediments that have grown up around FRM's. Since the determination of a fair interest rate will be tied to some fluctuating market rate, states can no longer allow fixed interest ceilings as their usury limitations, but must either tie them


These factors include tax considerations, financial forecasting, and family planning. The value of the mortgage itself may become an important element in various family decisions such as relocation, resale, adding on to existing homes, and even family planning. See, e.g., Gallagher, supra note 98, at 20-21.

207. See Scheuerman, supra note 20, at 738-40. Realistically, it is unlikely that a borrower will educate himself adequately in these matters, since he will make mortgage decisions infrequently.

208. See supra note 153 and accompanying text.

209. See Scheuerman, supra note 20, at 739. For example the tax effect, as well as future income flows, must be analyzed.

210. Id. at 739-40.
to a similar fluctuating rate or abolish them completely. Generally, states should modify their laws in the same manner as the federal government so as to provide a freer flow and availability of mortgage funds. By allowing experimentation, states can provide mortgage instruments that may address the specific needs of the region. Finally, more extensive disclosure may be required so as to protect the borrower and provide the maximum information that is necessary to aid in the understanding and evaluation of the new instruments.

VI. CONCLUSION

Beginning with the uncertain financial environment of the Depression, regulations and institutions were put into force to protect the innocent borrower from the trauma of refinancing residential mortgages in a reluctant lending market. The subsequent forty-year period of relative economic stability gave little incentive for deviation from the standard, long-term residential mortgage instrument that was accepted by both borrowers and lenders. The unpredictable economic environment of the 1970's and early 1980's, however, thrust traditional lenders into an inadequate position to adapt to the changing scenario, resulting in both an insufficient supply of mortgage capital and a desire to avoid participation in long-term agreements. The high cost and limited availability of mortgages for homeowners has affected both the home construction industry and family perceptions of housing needs.

Slowly, the traditional lenders have tried to find a remedy to their lending problems through the use of new mortgages that transfer the risk of economic uncertainty to the borrower, essentially retreating to their pre-Depression responsibilities. The foundation of organizations and regulations that have been built around the long-term, standard mortgage instrument has been an area of major reconstruction for the acceptance of the new mortgage instruments. Much work remains at both the state and federal level for the creation of a financial environment that supports the new mortgage instruments.

Nevertheless the most significant change in the new lending arena is the necessity of borrower education and understanding of the new mortgage instruments. No longer may the borrower afford to be a naive participant in the residential mortgage business. Borrowers must now shop around for the mortgage instrument that best fits their financial plans, and, along with their attorney and financial planner, negotiate the best mortgage terms that can be found in their area.