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ADJUSTABLE RATE MORTGAGES: A PROPOSED STATUTORY REFORM

I. INTRODUCTION

There is no way our savings institutions can remain viable . . . without the widespread use of ARMs.¹

As a solution to rising interest rates, ARMs could prove to be the cure that is worse than the disease.²

Imagine that the year is 1978. Home mortgage interest rates are below ten percent and there are only faint signs of dramatic interest rate increases on the horizon. The traditional thirty-year fixed-rate mortgage is enjoying unprecedented popularity. Our protagonist, Mr. Van Winkle, purchases one such traditional mortgage from his neighborhood savings and loan. Satisfied with the economic stability and financial calm of the day, Van Winkle decides to take an eight-year nap, a sleep slightly longer than the average life of a home mortgage.³

The year is now 1986. Van Winkle awakens and visits his old savings and loan institution to see about financing a new home. After meeting with a loan officer, however, Van Winkle is confounded. He sees a home financing world which he scarcely recognizes. Although interest rates are similar to their 1978 levels, there is a mind-boggling array of mortgage instruments from which to choose. The familiar fixed-rate mortgage is now commonly referred to as an "FRM,"⁴ and it is joined by new instruments known as ARMs,⁵

¹ Adjustable Rate Mortgages [ARMs], Hearings Before the Subcommittees on Housing and Community Development of the Committee on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. 50 (1984) (statement of Edwin Gray, Chairperson, Federal Home Loan Bank Board) [hereinafter cited as Subcommittee Hearings].
⁴ The fixed rate mortgage was introduced in the 1930s as an alternative to the short-term “balloon” mortgages that were linked to numerous mortgage defaults during the Great Depression. Comment, The Due-on-Sale Clause and Alternative Mortgage Instruments, 1981 DET. C.L. REV. 1105, 1106. The FRM is characterized by a relatively lengthy term (usually 20-30 years), a fixed interest rate for the life of the loan, and monthly payments that are also fixed. See, e.g., Walleser, Balancing The Interest: The Changing Complexion of Home Mort-
Van Winkle's head is spinning; purchasing a home mortgage in 1986 is like trying to make sense out of alphabet soup. To further complicate matters, Van Winkle learns that there is also a host of other new considerations in today's mortgage instruments, elements known as teaser rates, payment caps, interest rate caps, life-of-
gage Financing in America, 31 Drake L. Rev. 1, 3 (1981-82). An FRM which requires the borrower to make payments on a bi-weekly basis has become increasingly popular in the mid-1980s. The bi-weekly payments lead to a shorter amortization period and a dramatically reduced total payment amount than the same mortgage paid in monthly installments. See The Yuppies Mortgage: Instrument of the 1980s, Mortgage Banking, August 1985, at 87, 88.

5. Adjustable Rate Mortgages. These mortgages are characterized by a fluctuating interest rate linked to an index that will rise and fall with market conditions. See, e.g., Quinn, Escalating the ARMs Race, Newsweek, March 12, 1984, at 64. In this comment, unless otherwise noted, the term "ARMS" will encompass all types of adjustable rate mortgages.

6. Adjustable Rate Mortgage Loans. These are adjustable rate mortgages without any limit placed on periodic or aggregate adjustment of interest rates. Sweat, AMLS, GPAMLs, ARMs: Updated Look at the Differences, Mortgage Banking, July 1982, at 16, 17.

7. Graduated Payment Mortgages. Payments increase at a predetermined rate each year during the first few years of the mortgage (usually five), and are then adjusted to a fixed amount for the remaining period. Iezman, Alternative Mortgage Instruments: Their Effect on Residential Financing, 10 Real Estate L.J. 3, 10-12 (1981). The graduated payment feature of the GPM can also be combined with the adjustable feature of the ARM to produce a Graduated Payment Adjustable Rate Mortgage, or "GPARM." Id.

8. Growing Equity Mortgages (also known as Accelerated Payment Rate Mortgages, or "APRMS"). Mortgage payments are adjusted upward each year according to a specified percentage of the annual increases in a borrower's adjusted disposable income. The increased payments are used to reduce the principal so that the loan is usually paid off in 10-15 years, instead of 30 years. See Roth, Growing Equity Mortgage: Equitable Compromise?, Mortgage Banking, Jan. 1982, at 10, 11-12.

9. Price Level Adjusted Mortgages. Monthly payments, rather than remaining constant in terms of current dollars, are constant in terms of their purchasing power as measured by a price index such as the Consumer Price Index. Thus, for example, a $500 monthly payment would increase to $550 during a period of 10% inflation. See, e.g., McCulloch, Affordability and Inflation Protection, Mortgage Banking, Sept. 1982, at 6.

10. Shared Appreciation Mortgages. The interest rate on the note is typically written at approximately two-thirds of the current market rate, thus lowering the borrower's monthly payments, and permitting more borrowers to qualify for financing. In exchange, the borrower agrees contractually to return to the lender between 40-50% of the property's appreciation when the loan matures. The note maturation date is often 10 years after the loan is originated, although monthly payments are amortized over a thirty-year period. Reichelt, SAMs: Recognizing Economic Reality, Mortgage Banking, July 1981, at 31, 35; Angell & Wardrep, SAM: Evaluating the Shared Appreciation Mortgage, Mortgage Banking, Apr. 1981, at 31-33.

11. Reverse Annuity Mortgages. The lender makes a fixed number of periodic payments to the borrower, who agrees to repay this amount, plus interest, upon either the maturity date of the mortgage, or the borrower's death, whichever is earlier. Typically written for retired homeowners, the RAM provides homeowners with the use of both their home and the equity therein. Sjogren & Feins, Home Equity Conversion Through Reverse Annuity Mortgages: An Income Supplement for the Elderly, Fed. Home Loan Bank Board J., Jan. 1983, at 15, 18.

12. Teaser rates are the below-market interest rates which are often used to help induce
Van Winkle leaves his lender's office. He is bewildered and confused by the staggering selection of financing options. He wonders if he should just go back to sleep, or maybe even rent. Like thousands of other homebuyers in the 1980s, Van Winkle is ill-prepared for the complexity of today's home financing world.

As Van Winkle and numerous others have discovered, the purpose underlying the ARM is to enable institutional lenders\(^1\) to market a loan instrument which ensures that the lender's mortgage yield correlates with the lender's current cost of funds.\(^2\) To potential homebuyers, the ARM offers two distinct advantages over the fixed-rate mortgage. First, the ARM provides home ownership opportunities to a greater number of people than does the traditional fixed-rate mortgage because the generally lower ARM rates qualify some people who could not qualify for fixed-rate financing.\(^23\) Second, the flex-

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13. Payment caps limit the amount of a borrower's monthly mortgage payment. See infra notes 115-19 and accompanying text.
14. Interest rate caps limit the fluctuation of the loan interest rate, usually on an annual basis. See infra notes 120-21 and accompanying text.
15. Life-of-loan caps limit the fluctuation of the loan interest rate over the life of the loan. See infra notes 122-23 and accompanying text.
16. Negative amortization is the amount of money added to the outstanding loan balance when the borrower's monthly mortgage payments are insufficient to reduce the outstanding debt. See infra note 124 and accompanying text.
17. Negative amortization caps limit the amount of negative amortization which can be added to the outstanding loan balance before the lender “recasts” the loan, i.e., adjusts the monthly payments upward so that the loan becomes fully amortizing. See infra notes 129-30 and accompanying text.
18. Variable equity is the result of negative amortization cutting into the borrower's equity in the property used to secure the loan. See infra note 128 and accompanying text.
19. The interest rate on an ARM is adjusted based on an index beyond the lender's control. See infra note 74 and accompanying text.
20. Mortgage payment shock is the result of increases in a borrower's monthly payments which, if significant, may eliminate the borrower's ability to continue making mortgage payments. See infra notes 98-106 and accompanying text.
21. In this comment, the term “lender” means any individual or business entity that makes a loan secured by real property. This definition incorporates, essentially, the definition used by the Federal Home Loan Bank Board in its regulations which interpret the Garn-St. Germain Depository Institutions Act of 1982. See 12 C.F.R. § 591.2(g) (1984).
23. An ARM can carry a lower initial rate than its fixed-rate counterpart because its adjustable mechanism reduces the lender's need to include an inflation or interest rate risk premium in the loan. J. MEYERS, BUYING AND SELLING A HOME IN TODAY'S MARKET 29
ible nature of the ARM allows borrowers to tailor their mortgage payments to their own particular financial situation, a feature which is unknown to the fixed-rate mortgage.\textsuperscript{24}

It is generally agreed that the ARM helped to restore vigor to the housing industry,\textsuperscript{25} despite the presence of interest rates in the early 1980s which were significantly higher than those of ten years ago.\textsuperscript{26} By the end of 1983, federally-insured savings and loan institutions had more than $100 billion of ARMs in their portfolios, and the 1984 levels were estimated at twice that amount.\textsuperscript{27} Estimates of the ARM percentage of home mortgages purchased nationwide in 1983-84 range from sixty\textsuperscript{28} to eighty percent.\textsuperscript{29} In California, thrift institutions alone originated over $8 billion in ARMs in 1983 to finance new or existing home purchases for 160,000 households.\textsuperscript{30}

Despite such impressive statistics, the ARM has generated a storm of controversy. It has been called “an abomination,”\textsuperscript{31} “the neutron bomb of the industry (wrecking havoc but leaving buildings intact),”\textsuperscript{32} “sheer extortion,”\textsuperscript{33} and a “loan shark’s trap for the unwary.”\textsuperscript{34} And whereas one speaker for the lending industry has la-

\begin{itemize}
\item \textsuperscript{24} The drawback to mortgage instrument flexibility is that it creates an overwhelming variety of mortgages from which to choose. This, in turn, makes it difficult for homebuyers to shop for the best mortgage deal. See infra notes 77-93 and accompanying text.
\item \textsuperscript{25} See, e.g., \textit{California Association of Realtors, Position Paper: Lender Advertising and Disclosure Practices With Adjustable Rate Mortgages} 3 (April 23, 1984) [hereinafter cited as \textit{CAR, ARM Practices}].
\item \textsuperscript{26} \textit{Federal Home Loan Bank of San Francisco, Interest Rate Indices For Adjustable Mortgage Loans} 1 (June 1984).
\item \textsuperscript{27} \textit{CAR, ARM Practices}, supra note 25, at 3 (estimate by the U.S. League of Savings Institutions).
\item \textsuperscript{28} \textit{Id.} (estimate by the Federal Home Loan Bank Board).
\item \textsuperscript{29} \textit{Lenders Defend ARMs, Note Interest Ceilings}, The Los Angeles Times, Aug. 29, 1984, at 6.
\item \textsuperscript{30} \textit{CAR, ARM Practices}, supra note 25, at 3. A total of 160,000 ARMs works out to an average of one ARM originated every three and one-half minutes throughout every day and night in 1983. California is a particularly active market for ARMs because the housing affordability problem is greater than in the rest of the country. \textit{Id.}
\item \textsuperscript{31} \textit{House Leader Wants to Abolish Variable Rate Loans}, San Francisco Examiner, May 9, 1984, at 7 (statement of House of Representatives Majority Leader James Wright).
\item \textsuperscript{32} San Francisco Examiner, April 6, 1984, at 12 (statement of Kent Colton, Exec. V.P., National Association of Home Builders).
\item \textsuperscript{34} \textit{Id.} at 634, 224 S.E.2d 589.
\end{itemize}
beled the fixed-rate mortgage as "financial arsenic," a consumer advocate has retaliated with the statement that an adjustable rate mortgage "is arsenic for the homebuyer."

This comment examines the unfair practices associated with ARMs, and the concomitant need for statutory reform. In the following section, the comment describes the economic, judicial, and legislative forces which led to the introduction of ARMs. Section III divides the problems associated with ARMs into five areas, providing examples of the most serious hidden dangers associated with ARMs. Section IV proposes congressional reform to address the five problem areas discussed in Section III. Finally, Section V presents the author's conclusion that immediate congressional action is necessary to stem the tide of ARM loan defaults and foreclosures.

II. HISTORICAL BACKGROUND

In truth, the deregulation of liabilities—which the Congress decreed in 1980 would become the law of the land, and which the Congress reinforced in 1982 with the passage of the historic Garn-St. Germain Act—made the use of the adjustable rate instrument inevitable.

Although ARMs have only been in use since 1981, one needs to travel farther back in time to understand how and why they were developed.

Between 1929 and 1966, mortgage interest rates remained at relatively low levels, between two and six percent. As interest rates then began to inch upward, lenders became concerned that the cost of securing funds to make new loans was outpacing the return generated by their existing loan portfolios. As a result, several California lenders in the mid-1960s attempted to enforce something called an "escalator clause" in their loans. The lenders' efforts, however, were short-lived due to adverse borrower reaction.

35. Subcommittee Hearings, supra note 1, at 50 (statement of Edwin Gray).
36. Id. at 344-45 (statement of James Paulson, President, San Jose Real Estate Board, and Director, National Association of Realtors).
37. Id. at 42 (statement of Edwin Gray).
38. Id. at 1-2 (statement of Rep. Gonzalez).
41. Borrowers picketed the lenders' offices to protest an attempted 1% interest rate increase in their mortgages. The event was reported in the national press, and the lenders agreed...
In the late 1960s, the disparity between the lenders' existing loan portfolios and the cost of new money increased. In response, California lenders adopted twin strategies which they and other lenders around the country would follow for more than a decade. One strategy involved the use of the due-on-sale clause to ensure that money was loaned at existing rates. The parallel strategy involved lobbying state legislatures (and later, Congress) for legislation which would provide for a variable rate clause in home mortgages. Ultimately to cancel the rate boost and to abolish the escalator clause. Id.


43. A due-on-sale (or "acceleration") clause permits the holder of a note or beneficiary of a trust to accelerate the debt if the maker of the note or trustor sells, transfers, conveys, or disposes of the property without the written consent of the holder. S. Faber, Real Estate Liens, Encumbrances, and Secured Transactions 67-68 (2d ed.) (1979). Historically, the principal purpose of the clause was to protect the lender's security interest by ensuring the creditworthiness of the new buyer. The lender's right to accelerate provides the lender with the opportunity to evaluate the credit of the buyer and accelerate if the buyer is not a good risk. Holiday Acres No. 3 v. Midwest S. & L. Ass'n, 308 N.W.2d 471 (Minn. 1981). With the rise of interest rates in the 1960s, the due-on-sale clause became a vehicle, particularly in residential financing, to ensure the lender's position in the money market. Id. at 481. The clause provided the lender with leverage to negotiate a higher rate of interest, or in the alternative, to demand the entire balance due. Id; see also Wellenkamp v. Bank of America, 21 Cal. 3d 943, 953 n.11, 582 P.2d 970, 976 n.11, 148 Cal. Rptr. 379, 385 n.11 (1978). In the 1970s, few areas of mortgage lending generated as much debate and acrimony as the controversy surrounding the lenders' use of the due-on-sale clause. Sanders, A Legal Perspective of "Due-on-Sale" Loans, Mortgage Banking, Oct. 1979, at 29-30. Lenders which enforced the clause found buyers throughout the country increasingly willing to file court actions seeking to enjoin the lenders' action. Of the 30 state courts and legislatures which addressed the issue by 1982, about one-half declared the lenders' actions to be illegal, while the other half reached the opposite conclusion. See Martin v. Peoples Mutual S. & L. Ass'n, 319 N.W.2d 220, 230-31 (Iowa 1982). The due-on-sale issue was finally resolved in the lenders' favor by the U.S. Supreme Court with respect to federally chartered lenders, and by Congress with respect to all other lenders. See infra note 64 and accompanying text. For an exhaustive list of scholarly commentary pertaining to the due-on-sale clause, see Cobert, The Due-on-Sale Perspective in California From Early 1982 to Late 1983: From the "Dawn" of the Current Era to the "Sunset Date" and Beyond, 23 Santa Clara L. Rev. 353, 363 n.39 (1983).

44. Variable rate clauses in home mortgages and due-on-sale enforcement produce the identical result: a closer match between the lenders' loan portfolio returns and the cost of obtaining new funds. See Olean v. Treglia, 190 Conn. 756, 765, 463 A.2d 242, 249 (1983) (the adjustable rate mortgage is an alternative device to the due-on-sale clause for controlling the risk of interest rate fluctuations); Freeman, Alternative Mortgage Instruments and Potential Mortgage Enforcement Problems, 14 Urb. Law. 760, 762 (1982) (the due-on-sale clause has been sustained on the basis of economic necessity; alternative mortgage instruments diminish or eliminate altogether the economic necessity argument); Comment, Variable Rate Mortgages: The Transition Phase, 61 Marq. L. Rev. 140, 144 n.15 (1977) (due-on-sale clauses can be eliminated from variable interest mortgages because they will be unnecessary to protect the lenders' interest in a current rate of return); Volkmer; The Application of the Restraints on Alienation Doctrine to Real Property Security Interests, 58 Iowa L. Rev. 747, 799 (1973) (a due-on-sale clause, when used to raise interest rates, "might be thought of as functioning as a variable interest rate device, albeit in disguise").
mately, both strategies were successful; this comment will focus on the results of the variable rate legislation.

The legislation which was enacted in California in 1970 incorporated the variable interest rate clause sought by the lenders, and also included consumer safeguards which regulated the frequency and size of the interest rate adjustment. At first, only a few lenders used the variable interest rate (VIR) mortgages, at least in part because of a perceived "borrower/consumer skepticism." This skepticism subsided in 1975, when the California legislature provided additional consumer safeguards to the VIRs. Encouraged by surveys which showed that consumers would tolerate tightly-regulated variable rate mortgage instruments, California lenders began

46. The variable rate clause differed from the unpopular escalator clause in two important respects: the variable rate clause provided for downward as well as upward movement of interest rates, and tied the interest rate movement to an external economic indicator, rather than to the lender's discretion. Comment, The Variable Rate Clause and its Use in California Real Estate Transactions, 19 UCLA L. REV. 468, 475 (1972).
47. In pertinent part, CAL. CIV. CODE § 1916.5(a) (West Supp. 1985) reads:
(2) The rate of interest shall change not more often than once during any semi-annual period, and at least six months shall elapse between any two such changes.
(3) The change in interest rate shall not exceed one-fourth of one percent in any semiannual period.
(4) The rate of interest shall not change during the first semi-annual period.

Id.

California's legislation was the first to authorize the use of interest-sensitive mortgages and also the first to ensure that specific safeguards were present in mortgages containing a variable rate provision. Comment, Adjustable Interest Rates in Home Mortgages: A Reconsideration, 1975 Wis. L. REV. 742, 748 n.25.
49. CAL. CIV. CODE § 1916.5(a)(3) (West Supp. 1985), as amended in 1975, placed a 2.5% limit (or "life-of-loan cap") on the VIRs. One commentator has speculated that lenders turned to the VIRs in the mid-1970s not due to the enhanced consumer safeguards in the statute, but because of the California Supreme Court's decision in Tucker v. Lassen S. & L. Ass'n, 12 Cal. 3d 629, 526 P.2d 1169, 116 Cal. Rptr. 633 (1974). Tucker held that a lender could not exercise the due-on-sale clause when the borrower sold by an installment land contract unless the lender could establish that the transfer would impair the mortgage security or increase the chances of default. Id. After Tucker, lenders "presumably acknowled[ed] that variations in interest rates through the due-on-sale clause were not likely to remain permissible." J. HETLAND, SECURED REAL PROPERTY TRANSACTIONS 34 (1977). Indeed, in 1978, the California Supreme Court invalidated the enforcement of the due-on-sale clause to increase interest rates or to demand the loan principal due unless the lender could demonstrate that the transfer impaired the property securing the loan. Wellenkamp v. Bank of America, 21 Cal. 3d 943, 582 P.2d 970, 148 Cal. Rptr. 379 (1978). Wellenkamp was limited to state-chartered lenders. Id. Significantly, the Wellenkamp court suggested that the lender's interest in maintaining the return on its portfolio could be protected by using the VIR instead of the due-on-sale clause. Id. at 952 n.10, 582 P.2d at 975 n.10, 148 Cal. Rptr. at 384 n.10.
marketing VIRs in earnest.50

During the 1970s, at the federal level, lenders throughout around the country lobbied Congress51 for the authority to sell a completely adjustable loan instrument, the adjustable-rate mortgage (ARM).52 For most of the decade, the policy of Congress was that ARMs were not necessary and perhaps were anti-consumer.53 By 1978, however, interest rates approached ten percent 54 and lenders with large portfolios of fixed-rate mortgages were suffering huge losses.55 The lenders argued that ARMs, as well as the due-on-sale clause, were vital to the lending industry's survival.56 Congressional opposition to these arguments melted away as interest rates soared by the end of the decade.57

With the passage of the Depository Institutions Deregulation Act of 1980,58 Congress made clear its intention that savers at depository institutions should receive market rates of interest for their funds.59 This action created an environment which mandated the introduction of a flexible mortgage instrument, closely tied to the fluctuating cost of money paid by the lender.60 Indeed, in 1982, Con-

50. See generally Albaum and Kaufman, Survey Analyzes Consumer Attitudes Toward Variable Rate Mortgages, MORTGAGE BANKING, Nov. 1977, at 47.
52. Subcommittee Hearings, supra note 1, at 227 (statement of William Eskridge, Asst. Prof. of Law, University of Virginia).
53. Id. at 113 (statement of Edwin Gray).
54. Id. at 1-2 (statement of Rep. Gonzalez).
55. Id. at 227 (statement of William Eskridge).
57. Subcommittee Hearings, supra note 1, at 174 (statement of Professor Jack Gutten-tag, Wharton School of Business, University of Pennsylvania).
59. Id. This permitted lenders to meet the challenge of attracting and retaining savers in the face of strong competition from the money market funds. The Act helped to stem the "disintermediation," or massive savings outflow, which was devastating to the lending industry in 1979-81. M. DENNIS MORTGAGE LENDING: FUNDAMENTALS & PRACTICES 18 (1983).
60. Subcommittee Hearings, supra note 1, at 42 (statement of Edwin Gray).
gress passed another massive piece of legislation, the Garn-St. Germain Depository Institutions Act. The Garn Act was designed to revitalize the housing industry and to ensure "the availability of home mortgage loans." The Garn Act seeks to reach these goals, in part, by granting all non-federally chartered lenders the authority to issue ARMs, as well as by preempting state laws which restricted due-on-sale enforcement. The Garn Act is the congressional response to pleas from the nation's lenders. During prolonged hearings to consider the bill, Congress heard numerous lenders emphasize that the ability to adjust their loans upward in response to changing economic conditions was essential to their survival. Convinced by the powerful financial lobbies that the bill was necessary, Congress passed the Garn Act on the closing night of the ninety-seventh Congress, over the protests of many congressmen who had not even had

ble mortgage instrument was needed because the lenders' loan portfolios were comprised primarily of low interest, fixed-rate mortgages, but the lenders were now paying out high market rates to their savers.

64. 12 U.S.C. § 1701j-3 (1982). The Garn Act overturned two decades of California judicial and legislative law restricting due-on-sale enforcement as well as similar restrictions in fourteen other states. Additionally, the statute removes the disparity that had been created earlier in 1982 by the U.S. Supreme Court's decision in Fidelity First Fed. S. & L. Ass'n v. de la Cuesta, 458 U.S. 141 (1982). de la Cuesta permitted federally chartered lenders to enforce the due-on-sale clause, but left state laws intact regarding enforcement of the clause by state lenders. In the immediate aftermath of de la Cuesta, there was an exodus of state lenders over to the federal system in order to obtain the economic benefits of the decision. See Lockyer, de la Cuesta: Federal Determination of Contract and Property Rights? 14 Pac. L.J. 15 (1982). Since the Garn Act preempted state due-on-sale laws as they applied to all lenders, the need to transfer to the federal system was obviated.
65. See The Depository Institutions Amendments of 1982: Hearings on S. 2879, H.R. 4603, and H.R. 6267 Before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the House Committee on Banking, Finance, and Urban Affairs, 97th Cong., 2d Sess. 453 (1982) (statement of Roy Green, Chairman of U.S. League of Savings Associations). With the exception of spokesmen from the AFL-CIO and the National Association of Realtors, all the testimony was given on behalf of lending institutions. Id.
66. The bill satisfies, for the moment, the powerful interests that control the major financial lobbies in town . . . . The results are likely to be good for the already powerful institutions, but not good for people who seek home mortgages, hope for assistance at a locally owned bank, or would like to see the survival of a diverse financial industry that is not dominated by a few remote and omnipotent—perhaps omnivorous—megabanks.

the opportunity to read the text of the bill.  

Thus, many factors led to the development of ARMs: the rising and volatile nature of interest rates over the past two decades; the lenders' interest in having their loan portfolios cover the cost of obtaining new funds for lending; the controversial use of the due-on-sale clause to keep loan portfolios current; the judicial and state legislative restrictions on the lenders' enforcement of the due-on-sale clause; the lenders' requests for more flexible loan instruments; and the general deregulatory stance of Congress in the 1980s. Forged under such varied and tumultuous conditions, it is not surprising that ARMs emerged as a paradox of attractiveness and imperfection.

III. ARMS: THE NEW AMERICAN NIGHTMARE

"The track record shows that where the sky is the limit, the sky will become the limit."  

The premise underlying the introduction and widespread use of ARMs is that a borrower usually can absorb interest rate volatility because the borrower's own income is likely to rise. Yet the variability of ARM mortgage payments increases the uncertainty as to...
whether a borrower will find future payments affordable.\textsuperscript{71} Unlike the regulated, variable-rate mortgages used by California lenders in the 1970s,\textsuperscript{72} ARMs have the potential to fully transfer the interest rate risk from the lender to the borrower.\textsuperscript{73} This is accomplished by tying interest rate adjustments to fluctuations in one of several indices which reflect the cost of new money to the lender.\textsuperscript{74} Thus, an ARM, even with numerous safeguards built in,\textsuperscript{75} may provide a borrower with virtually no protection against economic forces that may make the borrower’s home unaffordable.\textsuperscript{76}

The problems associated with ARMs fall under five major headings: excessive diversity, teaser rates, payment caps, negative amortization, and disclosure.

\textsuperscript{71} Subcommittee Hearings, supra note 1, at 60 (statement of Edwin Gray).
\textsuperscript{72} See supra notes 45-50 and accompanying text.
\textsuperscript{73} CAR, ARM PRACTICES, supra note 25, at 3.
\textsuperscript{74} An ARM may be tied to any regional or national cost of funds index which is beyond the lender’s control. 12 C.F.R. § 545.6-2a (1984). A lender can also tie ARM payment adjustments to increases in the amount of the borrower’s disposable income (growing equity mortgage) or to increases in the value of the property securing the mortgage (shared appreciation mortgage). See supra notes 8, 10 and accompanying text. The formulas used to calculate how a particular adjustment will affect the loan rate are often difficult for a borrower to comprehend. CAR, ARM PRACTICES, supra note 25, at 1. Additionally, some ARMs may have a “floor” which prevents the interest rate from falling below the initial interest loan rate. See Quinn, ARMs May Defy Law of Gravity, San Francisco Chronicle, Dec. 1, 1984, at 51. Thus, ARMs which do not permit monthly payments to decrease below the initial payments are similar to the “escalator” clauses used briefly by California lenders in the 1960s, with the only significant difference being that the ARM payment adjustments are tied to indices beyond the lender’s control. See supra notes 40-41 and accompanying text. In its explanatory pamphlet, the Federal Home Loan Bank of San Francisco states: “Please note that the movement of an index may not coincide exactly with changes in your payments. The use of indices varies among lending institutions and among loan contracts.” FEDERAL HOME LOAN BANK OF SAN FRANCISCO, AN EXPLANATION OF COST OF FUNDS INDEXES USED IN ADJUSTABLE RATE MORTGAGES, Aug. 1984, at 1.

\textsuperscript{75} ARMs are frequently marketed with “caps” on annual payment increases and on the amount of negative amortization which will be permitted to accrue by the lender. To the uninformed borrower, such limits may be welcomed as stabilizing factors on the amount of future payments. These “consumer protections,” however, retain a nasty surprise for the borrower when the loan is recast. See infra notes 115-31 and accompanying text.

\textsuperscript{76} Powell v. Phenix Fed. S. & L. Ass’n, 434 So.2d 247, 253 (Ala. 1983). Similarly, the fixed-rate mortgage now provides less protection against interest rate increases than it once did. Increasingly, lenders are inserting “call” provisions into fixed-rate mortgages. These provisions enable the lender to call the loan due at the end of 5-10 years if market rates have risen above the contract rate. The clause could compel borrowers to sell their properties or refinance their mortgages at the higher interest rates. Scherschel, Confused by All Those Different Mortgages?, U.S. NEWS & WORLD REP., Nov. 29, 1982, at 85. Call provisions are the manifestation of Gray’s theory that fixed-rate mortgages do not necessarily represent a future danger to lenders “if interest rate risk exposure can be transferred elsewhere.” Gray, Bank Board/Thrift Perspectives, FED. HOME LOAN BANK BOARD J., May/June, 1983, at 4, 5 (italics in original).
A. Excessive Diversity

There exists a vast array of ARMs in the marketplace. Experts have estimated the number of ARM types to be as low as fifteen to twenty within a local community, to perhaps as many as 400,000 in the national marketplace. There seems to be some agreement that in practice, there are at least 300 ARM types from which a borrower may choose. The number is not static, and is “limited only to the ingenuity of the marketplace.”

The argument frequently made to support the proliferation of different types of ARM instruments is that a borrower can now tailor mortgage payments to meet the borrower’s own particular needs. Surveys indicate that most borrowers prefer having numerous options from which to choose.

The problem is that the diversity of ARMs engenders “confusion, information overload, and an inability to do effective shopping and make sensible decisions.” Shopping costs are raised, and the

77. Subcommittee Hearings, supra note 1, at 55 (statement of Edwin Gray).
79. Id. See also Butler, Funding Techniques for ARMs, MORTGAGE BANKING, April 1985, at 68, 72 (300 types of ARMs); Miller, How Experts View Mortgage Outlook, San Francisco Examiner, Oct. 14, 1984, (Homes), at 2 (300 types of ARMs; estimate by Mark Riedy, Exec. V.P., Mortgage Bankers Association of America); Address by Professor Jack Guttentag, Wharton School of Business, University of Pennsylvania, to the Annual Conference, Federal Home Loan Bank of San Francisco, December 11, 1984 (790 types of ARMs) [hereinafter cited as Guttentag speech].
80. Subcommittee Hearings, supra note 1, at 11 (statement of Edwin Gray). The staggering number of mortgage choices facing a potential borrower has provided a strong impetus to the computerization of the mortgage lending industry. For a modest fee, realtors can now obtain access to a computerized service which locates loans that are tailored to a specific borrower’s financial abilities and needs. Sigmund Anderson, president of one such national mortgage network, describes this new service as one way that a potential borrower can deal with the financing challenge presented by “over 4000” fixed and adjustable rate loan packages available in California alone. Miller, Computer Jitters Rock Mortgage Industry, San Francisco Examiner, Nov. 4, 1984, (Homes), at 1. Anderson adds that lenders change interest rates and loan programs “on an average of [one] every eight days.” Id.
81. Subcommittee Hearings, supra note 1, at 55 (statement of Edwin Gray).
82. In a survey conducted by the Federal National Mortgage Association, 78% of the public expressed a preference for having a variety of mortgage options available. Murray, Consumer Opinion on Mortgages and Housing, MORTGAGE BANKING, Nov. 1982, at 10, 12.
83. Subcommittee Hearings, supra note 1, at 119 (statement of Jack Guttentag). See also Pope and Cortes, Mortgage Instruments: Choices and Trends, MORTGAGE BANKING, Oct. 1983, at 13, 14 (“[C]onsumer acceptance of ARMs has been severely impeded by the multiplicity of plans and . . . information overload.”).
84. This includes the time spent visiting the lenders’ offices as well as the application fees required in order to obtain all of the facts about a particular loan. Guttentag speech, supra note 79. Given the diversity and complexity of today’s mortgage instruments, numerous commentators recommend that homebuyers also purchase legal advice before signing any mortgage contract. See, e.g., R. IRWIN, THE NEW MORTGAGE GAME viii (1982); Scherschel, Con-
multitude of ARM variables makes it extremely difficult for a potential borrower to draw meaningful comparisons among different ARMs and between ARMs and fixed-rate mortgages. Loan officers have also demonstrated that they can occasionally become confused by the long-range ramifications of a particular loan instrument.

Much debate exists over whether or not excessive diversity of ARMs is a problem which will be self-correcting. One view holds that market forces will ensure the survival of popular ARMs while at the same time drive less desirable loan instruments from the marketplace. This theory is bolstered by the argument that the market's self-correcting mechanisms, when left alone, preserve the opportunity for innovation and refinement in ARM product design. This view may indeed be sound when one considers consumer products in general. In the context of ARMs, however, this Darwinian "survival of the fittest loan instrument" does not work because the

fused by All Those Different Mortgages?, U.S. NEWS & WORLD REP., Nov. 29, 1982, at 85, 86.

85. Subcommittee Hearings, supra note 1, at 119 (statement of Jack Guttentag). To illustrate how vexing ARM shopping has become, Professor Guttentag provided the following example:

Mortgage A looks better than mortgage B because it has a lower initial rate. Except that the margin over the index is higher on A which makes B look better. Except that A and B are tied to different indices, and currently A's index is lower which makes A look better. Except that the rate on A is adjusted every year while the rate on B is only adjusted every 3 years which makes B look better. Except that A has a cap on payment adjustments which makes it look better. Except that B has a lifetime interest rate cap which makes it look better, and so on.

Id.

See also Thode, Competitive Comparisons, MORTGAGE BANKING, July 1985, at 60 ("[B]ecause of the array of additional variables in an ARM . . . comparisons between ARMs and fixed-rate mortgages are extremely complicated."). The stress which is created for homebuyers who are faced with a series of high risk alternatives that are difficult to compare has led many homebuyers to simply avoid comparison shopping. Subcommittee Hearings, supra note 1, at 232-35 (statement of William Eskridge).

86. Emmerman, One Viewpoint on ARMs, MORTGAGE BANKING, Oct. 1984, at 169, 170. The task of educating loan officers about the particular features of ARMs as those instruments are developed has proven to be a formidable challenge for the lending industry. Cortes & Schuette, Keeping in Step with ARMs, MORTGAGE BANKING, Dec. 1984, at 8, 11; ARMs Have Lenders in a Bind, San Francisco Examiner, Dec. 2, 1984, (Homes), at 3. Additionally, the increased number of ARM variables can cause lenders to err in calculating mortgage adjustments. For example, an audit conducted in 1984-85 by the Massachusetts Banking Commission found errors in handling ARM adjustments at all 12 banks and thrifts it surveyed. Doublecheck The Banks, The Sacramento Bee, reprinted in The Los Angeles Daily Journal, December 31, 1985, at 4, col. 1.

87. Subcommittee Hearings, supra note 1, at 111 (statement of Edwin Gray).

88. Id. at 109.
average borrower lacks the sophistication\textsuperscript{89} to intelligently discern between the multitude of ARMs. This lack of sophistication is greatly exacerbated by inadequate disclosure practices,\textsuperscript{90} thus creating fertile ground for the continuing existence of the least desirable ARMs. Moreover, because lenders act competitively,\textsuperscript{91} there is incentive to continually create new types of ARMs. In fact, that is exactly what is happening\textsuperscript{92} as ARMs enter their sixth year in the marketplace.\textsuperscript{93}

B. \textit{Teaser Rates}

One of the most controversial aspects of an adjustable rate mortgage is the “teaser” rate.\textsuperscript{94} The purpose of this special rate is to attract and to qualify potential borrowers who could not otherwise qualify for financing in the current market.\textsuperscript{95} Generally praised by lenders as an effective loan marketing tool,\textsuperscript{96} the teaser rate has also

\textsuperscript{89} Subcommittee Hearings, supra note 1, at 220 (statement of William Eskridge, questioning whether deregulation is appropriate, "given the vulnerability and ignorance of the consumer in the home loan transaction"), at 315 (statement of Harry Snyder, West Coast Director, Consumers Union, noting that "most borrowers do not sufficiently understand ARMs to comprehend all the extra risks they are accepting"), at 338 (statement of Jack Paulson, noting that many people who have purchased ARMs "are not aware of what is going to happen down the line").

\textsuperscript{90} Subcommittee Hearings, supra note 1, at 120 (statement of Jack Guttentag). "Existing disclosure . . . is not adequate. In fact, it is wretched." Id. See also infra notes 132-50 and accompanying text.

\textsuperscript{91} Subcommittee Hearings, supra note 1, at 116 (statement of Jack Guttentag).

\textsuperscript{92} Id. at 117, 119.


\textsuperscript{94} The teaser rate is sometimes referred to as a "discount" rate, or "buydown," because the lender reduces the initial mortgage contract rate. Thomas, Freddie Mac Guidelines, Mortgage Banking, Oct. 1984, at 85, 88. The initial rate usually extends for a six-month or one year period. Quinn, Escalating the ARMs Race, Newsweek, Mar. 12, 1984, at 64. Occasionally, a third party such as a builder, will offer to pay part of the initial mortgage payments; this is called a "third-party buydown," or "builder buydown." Subcommittee Hearings, supra note 1, at 117 (statement of Jack Guttentag).

\textsuperscript{95} CAR, ARM PRACTICES, supra note 25, at 3. Teaser rates not only encourage borrower demand for housing by making it easier to qualify for a loan, but they also permit a borrower to qualify for a more expensive home than might be possible under a fixed-rate scheme. Moser & Whiteley, Short Fuse on ARMs, Mortgage Banking, Aug. 1984, at 22, 24.

\textsuperscript{96} Subcommittee Hearings, supra note 1, at 641-42 (statement of James Montgomery on behalf of the U.S. League of Savings Institutions). Lenders are also encouraged to offer low initial rates by builders of new homes, sellers of old homes, and the anxious buyers. Miller,
frequently been maligned by commentators as being the ARM "time bomb," because it can easily lead the unsuspecting borrower into payment shock.

Table 1 below illustrates how an ARM with a teaser rate can cause payment shock. Assume, for example, that a buyer locates and agrees to purchase a home for $110,000. The buyer makes a twenty percent down payment, and must obtain financing for the balance of $88,000. The market interest rate is 13.5% The buyer tries to obtain a fixed-rate mortgage at that rate, but is unable to do so because the buyer lacks the requisite annual income of $48,000.

<table>
<thead>
<tr>
<th>Interest rate</th>
<th>Income required (principal + interest)</th>
<th>California households that qualify</th>
<th>Households not qualifying</th>
<th>Percent households qualifying</th>
</tr>
</thead>
<tbody>
<tr>
<td>10%</td>
<td>$39,000</td>
<td>1,500,000</td>
<td>7,525,000</td>
<td>17.8</td>
</tr>
<tr>
<td>11</td>
<td>42,300</td>
<td>1,350,000</td>
<td>7,675,000</td>
<td>15.6</td>
</tr>
<tr>
<td>12</td>
<td>45,000</td>
<td>1,150,000</td>
<td>7,875,000</td>
<td>13.3</td>
</tr>
<tr>
<td>12.5</td>
<td>46,000</td>
<td>1,050,000</td>
<td>7,975,000</td>
<td>12.1</td>
</tr>
<tr>
<td>13</td>
<td>47,800</td>
<td>987,000</td>
<td>8,038,000</td>
<td>11.4</td>
</tr>
<tr>
<td>14</td>
<td>50,000</td>
<td>868,000</td>
<td>8,157,000</td>
<td>9.6</td>
</tr>
<tr>
<td>15</td>
<td>53,300</td>
<td>749,000</td>
<td>8,276,000</td>
<td>8.3</td>
</tr>
<tr>
<td>16</td>
<td>56,100</td>
<td>630,000</td>
<td>8,395,000</td>
<td>7</td>
</tr>
<tr>
<td>17</td>
<td>59,000</td>
<td>538,000</td>
<td>8,487,000</td>
<td>6.2</td>
</tr>
</tbody>
</table>

The lender then describes an adjustable rate mortgage, offering to qualify the buyer for the ARM at the first year teaser rate of eleven percent. The buyer purchases the ARM, moves into the

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97. See, e.g., Moser & Whiteley, Short Fuse on ARMs, Mortgage Banking, Aug. 1984, at 22, 23; Miller, Why a Fixed-Rate Loan is a Good Deal Now, San Francisco Examiner, Oct. 21, 1984, (Homes), at 1; CAR, ARM PRACTICES, supra note 25, at 7.

98. Payment shock is defined as the result of increases in a borrower's monthly payments which, depending upon the amount and frequency of payment increases, as well as the borrower's income, may eliminate the borrower's ability to continue mortgage payments. Moser & Whiteley, Short Fuse on ARMs, Mortgage Banking, Aug. 1984, at 22, 23.

99. Table 1, reprinted with permission from San Francisco Examiner, Mar. 23, 1984, (Homes), at 1.

100. The borrower in this situation would not be alone; only one out of ten California households qualify for an $88,000 fixed-rate mortgage at 13.5%. See Table 1, supra note 99 and accompanying text.

101. A teaser rate 2.5% below the market rate is common. Subcommittee Hearings, supra note 1, at 477 (statement of David Maxwell, Chairman, Federal National Mortgage Association). Teaser rates as much as five to seven points below the market rate have been reported. Quinn, Escalating the ARMs Race, Newsweek, Mar. 12, 1984, at 64. The trend in
home, and makes each of the first year's monthly payments of $838 (See Table 1). During that first year, the buyer feels secure because the index to which the ARM is tied\textsuperscript{102} has not moved upward. Just before the buyer's thirteenth monthly payment, however, the buyer receives a notice from the lender stating that the interest on the mortgage has been bumped to sixteen percent\textsuperscript{103} and therefore monthly payments will now be $1183, a forty-one percent increase.\textsuperscript{104} At this point the buyer has the choice of permitting the loan to go into default, or restructuring his lifestyle in order to keep the house.\textsuperscript{105} This is payment shock.

As seen in this example, ARMs with initial interest rate discounts increase the probability of payment shock. This is because upon termination of the initial rate, such loans mandate an increase in monthly payments, regardless of whether there is any change in

\textsuperscript{102} See \textit{Subcommittee Hearings, supra} note 1, at 434 (statement of David Maxwell).

\textsuperscript{103} The 16\% figure is based on the 13.5\% index rate, plus a 2.5\% margin (or "spread") added each month to cover the lender's profit and servicing costs. The margin also helps to protect the lenders against index interest rate increases which might exceed the permissible levels of the loan. The margin may be calculated in a variety of ways such as a percentage of the loan balance, or as the difference between the teaser rate and the index rate on the date when the loan was signed. Telephone interview with Ms. Colleen Buckles, Home Loan Specialist, Bank of America, Santa Clara branch (Jan. 24, 1985). Generally, the margin is set between two and three percentage points above the index to which the loan is tied. Miller, \textit{Why a Fixed-Rate Loan is a Good Deal Now}, San Francisco Examiner, Oct. 21, 1984, (Homes), at 1; Austin, \textit{Buyer's Guide Explains ARMs}, The Philadelphia Inquirer, July 22, 1984, (Real Estate), at 1. Since the index is not prominently displayed in most ARM documents, borrowers may not be aware that different lenders using the same index often use different margins to calculate the borrower's monthly payments. \textit{CAR, ARM Practices, supra} note 25, at 1, 4.

\textsuperscript{104} This would constitute a monthly increase of $345. Had interest rates gone up 1\% during the first year, the borrower's 13th monthly payment would have jumped $387 to $1,225, or 49.76\% over his 12th monthly payment. By contrast, one industry spokesperson speculated that a 20\% increase in the borrower's monthly payments "might well cause foreclosure." Address by James Montgomery, Federal Home Loan Bank of San Francisco, Annual Conference (Dec. 11, 1984) [hereinafter cited as Montgomery speech].

\textsuperscript{105} Whether or not it is ethical for a lender to deny a borrower fixed rate financing (involving monthly payments of $1008) only to then qualify that same borrower for a more expensive ARM (involving monthly payments of $1183) has been the source of much debate. See, \textit{e.g.}, \textit{Subcommittee Hearings, supra} note 1, at 339 (statement of Jack Paulson, noting that the lenders' refusal to qualify borrowers for fixed-rate financing while marketing ARMs which are ultimately more expensive is "forcing" ARMs on the average consumer). \textit{Contra id.} at 44, 54 (statement of Edwin Gray, noting that all borrowers who purchased ARMs "had a choice" of obtaining fixed-rate or adjustable rate financing). The issue is exacerbated by the fact that ARMs with low initial rates are inherently risky because the loans are aimed at qualifying that segment of the homebuying public which has difficulty qualifying at market rates. Thomas, \textit{Freddie Mac Guidelines, Mortgage Banking}, Oct. 1 1984, at 85, 88.
ADJUSTABLE RATE MORTGAGES

the index to which the payment adjustments are tied. In California, most ARMs are sold with these initial teaser rates. The rates are, according to one theory, the primary reason why the market share for ARMs significantly increased in 1983. The arrival of such rates, however, had long been foreseen.

Although the teaser rate qualifies more people for homeownership, it exacts a dear price in return: significantly higher monthly payments when the teaser rate expires, as well as a dramatically higher rate of loan delinquencies. In 1984 the number of home

106. Thomas, Freddie Mac Guidelines, Mortgage Banking, Oct. 1, 1984, at 85, 88. One commentator summarized this phenomenon of sharply rising ARM payments even while market rates remain steady, by stating that "Isaac Newton would be shocked." Quinn, ARMs May Defy Law of Gravity, San Francisco Chronicle, Dec. 1, 1984, at 51. Another commentator described ARMs with low initial payments as "meretricious instruments" adding:

The adjective, "meretricious," was originally coined to describe London street-walkers, and it has two connotations, both of which are applicable to the mortgages described here. One connotation is "falsely attractive" meaning that they look good in the dim light but cannot withstand close scrutiny. The second connotation is "deceptive" in the sense that the customer is exposed to a possible unpleasant surprise down the road.

107. CAR, ARM PRACTICES, supra note 25, at 1, 4.

108. Id. at 5 (the recent acceptance of ARMs by consumers is not due to the increased sophistication and willingness of the public to accept ARMs, but rather to "the aggressive advertisement . . . of the 'teaser' rate"). Accord Kaplan, Pitfalls in ARM Lending, Mortgage Banking, July 1984, 94, 95 (consumer acceptance has been "artificially inspired" by initial qualifying rates that can lead to payment shock). Between July, 1983, and September, 1983 ARMs as a share of total savings and loan originations jumped from 28% to 50%, reaching nearly 66% by the end of 1983. Address by Edwin Gray, National Council of Savings Institutions Annual Meeting, Baltimore, MD, May 14, 1984 [hereinafter cited as Gray, Annual Meeting]. This is roughly the same period during which teaser rates on ARMs were advertised at "2 to 4 or more percentage points" less than fixed-rate mortgages. CAR, ARM PRACTICES, supra note 25, at 3.

109. Comment, The Variable Interest Rate Clause and Its Use in California Real Estate Transactions," 19 UCLA L. REV. 468, 479-80 (1972). The author notes that due to the existence of borrower hostility to any device which may increase one's loan obligation, "[l]enders will probably accede to granting a lower initial interest rate" in order to enhance the adjustable loan's marketability. Id.

110. See supra Table 1.

111. See supra notes 101-06 and accompanying text.

112. Figures for ARM default rates vary. MGIC Corporation, the nation's largest private mortgage insurer, studied 30,000 ARMs, and found that the default rate was 24% higher than with fixed-rate loans. CAR, ARM PRACTICES, supra note 25, at 9. Congressman Gonzalez, relying on a 1982 survey of 21,100 mortgages conducted by Investors Mortgage Insurance Company, stated that the ARM default rate was 39% higher than for fixed-rate loans. Subcommittee Hearings, supra note 1, at 97. A more recent survey conducted by Investors Mortgage placed the risk of default on ARMs at 45% greater than for fixed-rate loans. CAR, ARM PRACTICES, supra note 25, at 8. For ARMs which have gone through one payment increase, there is a "50% greater incidence of default" than with fixed-rate mortgages held during the
loan delinquencies, as well as foreclosures, was higher than at any time since the Great Depression. The outlook for the future is that they will continue to increase.

C. Caps

There are three types of caps: annual payment caps, periodic interest rate caps, and life-of-loan caps. Each is designed to pro-

same period. Warning System is Urged for Adjustable Loans, San Francisco Examiner, Dec. 9, 1984, (Homes), at 2 (quoting James Aylward, President, Investors Mortgage Insurance Co.). In response to such statistics, the position of the lending industry appears to be that the ARM default figures are not reliable. Subcommittee Hearings, supra note 1, at 601 (statement of Felix Beck, President, Mortgage Bankers Association of America, noting that "we do not have sufficient data to make a proper analysis"), at 643 (statement of James Montgomery on behalf of the U.S. League of Savings Institutions, noting that "most ARM originations are too recent for there to be any reliable data at all"), at 697 (statement of William Dwire, on behalf of the American Bankers Association, noting that "as yet there is no empirical data on the delinquency of ARMs as compared to fixed-rate mortgages").

Subcommittee Hearings, supra note 1, at 23 (statement of Rep. Wright). The high number of home foreclosures has also contributed to an escalation 1930's-style violent protests against the forced sale of homes. Morganthau, et al., Again the Fear of Foreclosure, Newsweek, Jan. 17, 1983, at 12. Not surprisingly, the foreclosure phenomenon has also led to an increased number of seminars offered to advise debt-ridden individuals of their legal and financial options. Califoreclosure, TIME, June 14, 1982, at 65. Finally, the increase of foreclosures has not escaped the notice of America's popular culture. In 1985, immediately following the London/Philadelphia Live Aid concert, which raised an estimated $65,000,000 for African famine relief, rock musician Bob Dylan said, "Maybe they can take 1 or 2 million and use it to pay the mortgages on some of the farms." ROLLING STONE 1985 YEARBOOK, December 19, 1985—January 2, 1986, at 63-64. Dylan's idea was the genesis of "Farm Aid: A Concert for America," which raised $10,000,000 to assist American farmers facing enormous mortgage debts. Id. at 64. In 1984, two major motion pictures, Places in the Heart (Tri-Star Productions), and Country (Disney Films), explored the ramifications of imminent foreclosure. In 1982, rock musician Bruce Springsteen recorded, "Johnny 99," a song which described the frustrations of a man whose home was being foreclosed upon, and who had "debts no honest man could pay." Nebraska (Columbia Records).

Gray, Annual Meeting, supra note 108, at 17. Payment shock and the specter of foreclosure create obvious problems for the borrower, including: the trauma of losing one's home, the loss of equity therein, the need to relocate, the enduring damage to one's credit rating, and the ill-feeling within a family that might be engendered by the upheaval. Telephone interview with Mark A. Hiller (Jan. 24, 1985). Significant problems are also posed for the lender. For example, there is currently some concern in the lending industry over "portfolio default," the phenomenon that could occur if interest rates rise and payment shock strikes a lender's entire ARM portfolio because the ARMs are tied to the same index and adjustment rate. Moser & Whiteley, Short Fuse on ARMs, Mortgage Banking, Aug. 1984, at 22, 23. Additionally, as ARM foreclosures increase, so will a number of other pesky problems for a lender: adverse publicity, business disruption, hostile consumer contact, as well as the threat of litigation. Id. at 27. In 1986, farmers will be especially hard hit. See Coming: 'Massive' Farm Foreclosures, San Francisco Examiner, January 1, 1986, at A-8, col. 1.

An ARM may be structured to include a life-of-loan cap in conjunction with either of the other caps. Or, the loan can be structured to include only one of the types of caps, or none of them. For a discussion of these last two loan types, see Miller, The New No-Limit
vide the borrower with some reassurance that the mortgage payments won’t go through the roof. But each carries with it a little surprise.

The annual payment cap limits the fluctuations in a borrower’s mortgage payments, so that payments will not change more than once per year for as long as the cap is in effect.\textsuperscript{116} The cap does not, however, place a lid on the interest rate increases for which a borrower will be responsible.\textsuperscript{117} Rather, when interest rates are steady, the loan payments remain stable.\textsuperscript{118} But if interest rates rise to a level beyond the capped monthly payments, then the difference is added to the loan principal.\textsuperscript{119}

The periodic interest rate cap limits the fluctuations in the note rate at each rate adjustment.\textsuperscript{120} This cap limits the borrower’s payment increase or decrease accordingly. However, in years where the market interest rate increases beyond the interest rate cap, the difference is carried over to the next adjustment period.\textsuperscript{121}

A life-of-loan cap provides a ceiling which the note rate cannot exceed over the life-of-the loan.\textsuperscript{122} Generally, this type of cap offers the borrower the surest degree of protection against steep payment increases. The life-of-loan cap, however, rarely uses the initial teaser rate as a benchmark, but rather uses the note rate after the teaser has expired.\textsuperscript{123}
D. Negative Amortization

Negative amortization is an increase in the principal balance of a mortgage caused by an insufficiency of the monthly payments to cover accrued interest on the note.\textsuperscript{124} Before ARMs were introduced in 1981, negative amortization was virtually non-existent,\textsuperscript{125} although the concept, itself, is not new.\textsuperscript{126}

As is the case with caps and teasers, negative amortization is controversial. It is defended on the ground that it effectively keeps monthly mortgage payments low during the first few years when a homeowner is least likely to be able to absorb sharp payment increases, while still protecting the lender against sudden upward swings in interest rates.\textsuperscript{127}

Negative amortization, on the other hand, potentially presents both short and long-term problems for the borrower. In the short-term, if property values are appreciating slowly but interest rates are rising, then negative amortization can reduce a borrower’s equity in his property.\textsuperscript{128} In the long-term, a borrower may hit the 125% neg-

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\textsuperscript{124} Moser & Whiteley, Short Fuse on ARMs, MORTGAGE BANKING, Aug. 1984, at 22, 42.

\textsuperscript{125} The conventional fixed-rate mortgage, as well as the variable interest rate mortgage of the 1970s did not permit negative amortization. This is because both mortgages were structured to ensure that the monthly payments would completely retire the debt.

\textsuperscript{126} In the early part of the twentieth century, it was not uncommon for a sharecropper working the land to owe more money at the end of the year than at the beginning. H. KESTER, REVOLT AMONG SHARECROPPERS 48-49 (1969); Subcommittee Hearings, supra note 1, at 24 (statement of Rep. Wright).

\textsuperscript{127} Negative amortization “is the most important consumer benefit in the ARM,” according to James Montgomery, quoted in Miller, Adjustable Mortgages Put on the Spot, San Francisco Examiner, Dec. 9, 1984, (Homes), at 2. See also Sharplin, Negative Amortization: Mistaking Grandmother for the Wolf, MORTGAGE BANKING, Jan. 1983, at 45, in which the author argues that negative amortization “offers the only way” for lenders to maintain a high level of lending activity during an inflationary period. “Far from being the ‘big bad wolf’ many people see it as, negative amortization is Grandmother rushing to our rescue.” Id. at 49. The practice of permitting negative amortization is generally more popular with the larger institutions. Pope & Cortes, In Search of the Standardized Mortgage, MORTGAGE BANKING, Jan. 1983, at 15, 16. Pope and Cortes found that 48% of the S&L’s with assets over $1 billion permitted negative amortization in their ARMs, whereas only 8.3% of the S&L’s with assets of less than $100 million allowed negative amortization. Pope and Cortes speculate that the lenders with relatively small assets “may not have the capacity to service loans with negative amortization [since new] computer programs must be written and implemented to accommodate rising loan balances.” Id. at 16.

\textsuperscript{128} Thomas, Freddie Mac Guidelines, MORTGAGE BANKING, Oct. 1984, at 85, 86; Friedman, Protecting Lenders Against ARM Risks and Uncertainties, MORTGAGE BANKING, Oct. 1981, at 82. Gray also acknowledges the possibility of negative amortization when prop-
Recasting the loan involves restructuring the borrower’s monthly payments upward to ensure loan pay-off by the end of the loan term. Significant confusion surrounds the ramifications of loan recasting and the 125% limit. The result is hauntingly familiar, however, because mortgage recasting is reminiscent of lending practices used until 1929.

E. Disclosure Problems

Like other creditors who regularly extend consumer credit, lenders offering ARMs must comply with the Truth-in-Lending
The purpose of the Act is to ensure that a meaningful disclosure of credit terms is made. This permits the consumer to compare the various credit terms available, and to avoid the uninformed use of credit. The Act is implemented by regulations promulgated by the Federal Reserve Board.

Disclosure is particularly important in the context of ARMs. Given the tremendous combination of rates, caps, maturities, and other elements in today's ARMs, a potential borrower depends on meaningful disclosure in selecting a mortgage. Yet the Truth-in-Lending Act only requires a lender offering an ARM to disclose the finance charge, amount financed, and the number, amount, and due dates of payments scheduled to repay the indebtedness. In the context of ARMs, the Act is therefore deficient because it fails to adequately regulate in the following three areas: timing of disclosure, adequacy of disclosure, and uniformity of disclosure.

At present, the disclosures mandated by the Truth-in-Lending Act arrive too late to help the prospective borrower. They are provided after the prospective borrower submits a loan application and is already partially committed because he has paid loan application fees. Thus, the requisite disclosures fail to provide much assistance when shopping for a loan.

134. Id.
137. 15 U.S.C. § 1638. The inadequacy of the required disclosures for variable rate mortgages has been recognized at least since 1977. See, e.g., Comment, Variable Rate Mortgages: The Transition Phase, 61 MARQ. L. REV. 140, 147 (1977). When disclosures are inadequate, there is a tendency for consumers to turn to intermediaries, such as real estate brokers, for information. Yet because the main interest of intermediaries is usually to make a sale and earn a commission, the information they provide is often biased. Subcommittee Hearings, supra note 1, at 222 (statement of William Eskridge). Additionally, the intermediary may be faced with a conflict of interest because [generally] the more expensive the sale, the larger the commission. Id. at 264. The likelihood of this conflict existing has increased since the Garn Act was passed in 1982. This is because the Garn Act repealed the provision of the Truth-In-Lending Act which included "arrangers of credit" within the scope of the Act. 15 U.S.C. § 1602(i) (1982).
138. Subcommittee Hearings, supra note 1, at 120 (statement of Jack Guttentag).
139. Id.
140. Id. Mortgage loan application fees vary; in some areas, borrowers must initially pay a $250 loan application fee before they receive the ARM disclosure information. Id. at 718 (statement of William Simpson, President, Mortgage Insurance Companies of America).
141. Subcommittee Hearings, supra note 1, at 120 (statement of Jack Guttentag).
The disclosure statements, themselves, are deficient in that they sometimes contain actual mistakes or relevant omissions. One aspect of ARMs which tends to be glossed over in disclosure statements is negative amortization. Assumability is another such neglected area. Index adjustments and the lender's margin above the index are other aspects of ARMs which are particularly ripe for obfuscation. The failure of lenders to provide adequate disclosures has contributed to consumer confusion, a fact acknowledged by lending industry spokespersons.

Finally, disclosure statements are not uniform. This increases the difficulty for potential borrowers to compare one loan package with another. The single piece of information which is common to ARM disclosure statements is the Annual Percentage Rate.

142. Id. Additionally, reports of outright misrepresentation are not uncommon. CAR, ARM PRACTICES, supra note 25, at 14.

143. Subcommittee Hearings, supra note 1, at 120 (statement of Jack Guttentag). Of the "40 or 50" disclosure statements which Guttentag examined, none explained the implications of a negative amortization cap, nor provided an illustration of what happens if the cap is reached. Id. The California Association of Realtors notes the same deficiency in loan disclosures (CAR, ARM PRACTICES, supra note 25, at 2), as does Consumers Union, the non-profit publisher of CONSUMER REPORTS magazine. See Subcommittee Hearings, supra note 1, at 321 (statement of Harry Snyder, West Coast Director of Consumers Union).

144. In the wake of Fidelity Fed. S. & L. Ass'n v. de la Cuesta, 458 U.S. 141 (1982) and the Garn Act, lenders are no longer required to permit the buyers of a home to assume the old mortgage at the old contract rate. See supra note 64 and accompanying text. Instead, the lender can demand significant adjustments in the mortgage. These adjustments, including changes in the loan caps and new borrower qualification standards (CAR, ARM PRACTICES, supra note 25, at 7), are not required to be disclosed by the Truth-in-Lending Act. See supra note 137 and accompanying text.

145. See supra note 74 and accompanying text.

146. CAR, ARM PRACTICES, supra note 25, at 1. Details of the consumer confusion engendered by the lenders' disclosure practices are beginning to surface in several class action suits which are based on the lenders' alleged fraud and misrepresentation. See, e.g., Leroy Keely, et al. v. Great Western Savings, Santa Clara Cty. Super. Ct. No. P47105 (Complaint filed on behalf of over 200 potential class members, October 2, 1985); Feroze P. Bhandara, et al. v. Fremont Bank, et al., Alameda Cty. Super. Ct. No. TR586944-6 (Third Amended Complaint filed on behalf of over 200 potential class members, June 18, 1985); Franklin Mayne, et al. v. Bank of America Nat'l Trust and Sav. Ass'n, San Francisco Super. Ct. No. 823583 (Third Amended Complaint filed on behalf of over 18,000 potential class members, March 12, 1985).

147. Subcommittee Hearings, supra note 1, at 43 (statement of Edwin Gray). ("Unfortunately, not all [lenders] have achieved the levels of disclosure . . . we would like to see."); William Barger, savings and loan executive, quoted in Furlong, Adjustable-Rate Loan Marketing Triggers Concerns, The Los Angeles Times, March 25, 1984, at Part V, at 1 ("It's a problem of the marketplace . . . . We would be happy to be straightforward, but we couldn't get any loans that way.").

148. Subcommittee Hearings, supra note 1, at 120. (statement of Jack Guttentag).

149. Id.
The problems of excessive diversity, teaser rates, caps, negative amortization, and poor disclosure practices are the result of congressional acquiescence to the concept of a deregulated, adjustable loan instrument. It is unlikely that these problems will be resolved by anything short of congressional intervention. As was the case once before in this century, congressional legislation "is necessary to protect homeowners from foreclosure and to relieve them [from] the burden of excessive interest and principal payments."

IV. PROPOSED STATUTORY REFORM

Anyone who believes in deregulation should not kid himself or herself into believing that deregulation is a fait accompli from now until the end of time.

Given the problems described in the preceding section, it is not surprising that members of Congress began to express concern over the matter. In 1984, two separate and quite distinct efforts were made to address the ARM issue: one in the Senate, which

150. Id. The APR, however, is not a particularly useful piece of information because it is calculated based on the assumption that the initial interest rate on the ARM will not change during the life of the loan. Id. See also BANK OF AMERICA, CONSUMER INFORMATION REPORT NO. 31, SHOPPING FOR ADJUSTABLE RATE CREDIT 2 (Oct. 1984).

151. See infra notes 160-61 and accompanying text.

152. Letter from President Franklin Roosevelt to Congress, H.R. Doc. No. 19, 73rd Cong., 1st Sess. 1 (April 13, 1933). Roosevelt's letter led to the introduction and passage of the Home Owners Loan Act, which created a system of federal savings and loan associations, "to promote the thrift of the people in a cooperative manner, to finance their homes and the homes of their neighbors." S. REP. No. 91, 73rd Cong., 1st Sess. 2 (1933).


154. In the closing days of the 98th Congress, there was an attempt to pass comprehensive banking legislation. S. 2851, sponsored by Sen. J. Garn (R-Utah), proposed to close loopholes which allowed banks to evade federal laws prohibiting the operation of interstate branches and the marketing of non-banking services. Additionally, S. 2851 continued the plan for deregulation of the banking industry by sanctioning state-formed pacts to keep the larger New York and California banks from opening branches in their regions in order to compete with local banks. The House version of the bill, H.R. 5916, was much narrower, however, focusing simply on the loophole closing aspects. Calmes, Critics Block Senate Action on Banking Deregulation Bill, 1984 CONG. Q. 2183. Shortly before the Senate approved its version (see Calmes, St. Germain Jettisons Bank Deregulation Bills, 1984 CONG. Q. 2342), Sen. H. Metzenbaum (D-Ohio) added an amendment which would have placed a 5% life-of-loan cap on all ARMs for residential mortgage transactions less than $500,000. S. 2851, 98th Cong., 2d Sess., 130 CONG. REC. S10979 (Sept. 12, 1984). In describing his amendment, Sen. Metzenbaum singled out those lenders who do not provide a life-of-loan cap on their ARMs, calling the practice "unfair." Id.
failed,\textsuperscript{155} and one in the House of Representatives,\textsuperscript{156} which successfully generated a discussion of the ARM issue, but which produced only a flaccid, non-legislative response.\textsuperscript{157} In sum, neither house of Congress passed anything approaching the type of regulatory reform which is needed to resolve the problems associated with ARMs.

Congress must address the ARM issue squarely. Congress must first recognize that it bears the ultimate responsibility for the problems which ARMs have engendered. This is because Congress sanctioned the development of ARMs in the first place.\textsuperscript{158} That Congress may have abrogated its public responsibility by approving in 1982 the massive deregulation of home financing virtually sight-un-

\begin{enumerate}
\item[155.] S. 2851, because of its broad deregulatory features, differed so significantly from H.R. 5916 that Rep. St. Germain, Chairman of the House Banking Committee, refused to let the House version emerge from the Banking Committee. This effectively precluded the reconciliation of the House and Senate Bills; thus, the Senate version with its last minute ARM amendment died. Calmes, \textit{St. Germain Jettisons Bank Deregulation Bills}, 1984 \textit{Cong. Q.} 2342. Rep. St. Germain said that he blocked the bill because, "it is obvious the Senate will not consider it [the House version] unless we buy off on new and greatly expanded powers for banks and other financial institutions . . . . This is not the stuff of quickie midnight conferences in the closing hours of the session." \textit{Id.} St. Germain's statement appears to be a veiled reference to what happened in 1982 when the House version of the Garn-St. Germain banking deregulation bill was substituted in conference at the eleventh hour with the far broader Senate version. \textit{See} Calmes, \textit{Professor Runs the Show at House Banking}, 1984 \textit{Cong. Q.} at 2203. \textit{See also supra} note 67.
\item[156.] The House action in response to the ARMs problem took the form of three days of hearings before the Subcommittee on Housing and Urban Development of the Committee on Banking, Finance and Urban Affairs. The hearings were held during the summer of 1984, and were not related to either S. 2851 or Sen. Metzenbaum's amendment to S. 2851. The purpose of the hearings was to gather information on the use of ARMs in the marketplace, and to determine if legislation was needed to regulate ARMs. \textit{Subcommittee Hearings, supra} note 1, at 1 (introductory statement of Rep. Gonzalez). After hearing several experts in the field of mortgage banking present written and oral testimony forming a transcript in excess of 900 pages, the Subcommittee decided against proposing legislative action. \textit{See infra} note 157.
\item[157.] The House Subcommittee decided to take three steps. First, the subcommittee formed a task force comprised of various lenders in the respective lending associations for the purpose of authoring a "Public Information Brochure on Adjustable Rate Mortgages." The brochure is intended to improve consumer education. \textit{Subcommittee Hearings, supra} note 1, at 453-55 (Letter from Reps. Fernand St. Germain, Henry Gonzalez, Chalmers Wylie, and Stewart McKinney to Edwin Gray, Chairman, Federal Home Loan Bank Board (August 1, 1984)). Second, Subcommittee Reps. Gonzalez and McKinney requested that § 226.18(f) of Regulation Z (consumer disclosure requirements for variable rate transactions) be modified to include a "worst case scenario" that would show the consumer the maximum potential monthly mortgage payment for a particular ARM. \textit{Subcommittee Hearings, supra} note 1, at 457-58 (letter from Reps. Henry Gonzalez and Stewart McKinney to Paul Volker, Chairman, Federal Reserve Board, (August 1, 1984)). Third, the Subcommittee resolved to continue to "monitor the situation." Telephone interview with Ms. Bonnie Caldwell, staff member to the Subcommittee on Housing and Community Development (January 2, 1985).
\item[158.] \textit{See supra} notes 61-67 and accompanying text.
\end{enumerate}
seen only heightens the congressional duty to consider fresh methods to eradicate the misery which deregulation has wrought. Neither the courts nor state legislatures are likely to supply the required regulation.

The goals of congressional intervention should be to: 1) lessen consumer confusion; 2) eradicate deceptive loan instruments; and 3) push the pendulum of interest rate risk away from homeowners and toward a more equitable location between homeowners and lenders. Congress must endeavor to resolve the ARM problem, not just study it, and not just leave the problem to industry self-regulation. The

159. See supra note 67.

160. Cases involving ARMs are generally limited to issues raised in a specific transaction, such as ambiguous terms in the loan instrument, or particular disclosure irregularities. Thus, the courts have yet to address the larger question of whether the regulations governing ARMs provide adequate protection to the consumer. Even if a litigant were to challenge those regulations directly, there would be the formidable hurdle presented by the courts' traditional reluctance to act in a legislative capacity. If that hurdle could be overcome, then it would still take several years to resolve the issue. The due-on-sale controversy, for example, was litigated in California for well over a decade before the U.S. Supreme Court resolved the dispute in Fidelity Federal Savings & Loan Ass'n v. de la Cuesta, 458 U.S. 141 (1982).

161. State legislatures are not likely to regulate ARMs in a manner inconsistent with Title VIII of the Garn Act (codified at 12 U.S.C. §§ 3801-05). This is because Congress, in passing the Garn Act, appears to have preempted the field. U.S. CONST. art VI, cl. 2. To determine whether a federal enactment preempts inconsistent state regulations, the inquiry begins with congressional intent. Jones v. Rath Packing Co., 430 U.S. 519, 525 (1977). Congressional intent to preempt may be found in an express statutory command or by implicit legislative design. Id. Both explicitly and implicitly, the language of the Garn Act appears to preempt inconsistent state legislation regarding ARMs. See 12 U.S.C. § 3801(b) ("It is the purpose of this title to . . . authorize[e] all housing creditors to make, purchase, and enforce alternative mortgage transactions so long as the transactions are in conformity with the regulations issued by the Federal agencies."); 12 U.S.C. § 3803(2) ("The term 'housing creditor' means depository institution . . . or any person who regularly makes loans. . . .").

162. The industry self-regulation argument is suspect for three reasons. First, lenders "have a vested interest in making the most profitable loan possible." Michael Jessee, Exec. V.P., Federal Home Loan Bank of San Francisco, quoted in Miller, Warning on 'Deep Discount' Mortgages, San Francisco Examiner, April 15, 1984, (Homes), at 1. Second, lenders act in an intensely competitive environment, one which is not conducive to self-discipline. Corrigan, U.S. Bank Deregulation: The Longer-term Consequences, THE BANKER, Aug. 1984, at 21, 24. Third, lenders are without a mechanism, except regulation, by which they can act collectively. Subcommittee Hearings, supra note 1, at 116 (statement of Jack Guttentag). Thus far, self-regulation has permitted widespread consumer confusion, loan delinquencies, and foreclosures. Industry experts expect this situation to become worse. Gray, Annual Meeting, supra note 108, at 17. As one commentator observed, "Self-regulation is not happening . . . and it won't happen." Subcommittee Hearings, supra note 1, at 116 (statement of Jack Guttentag). A mortgage loan officer observed that the self-regulation argument is akin to "placing a bowl containing many candies in front of unsupervised children with instructions that each could have one piece. How long would it last? The not-so-good child grabbing handfuls would cause others to do likewise . . . ." Letter from A. Mitchell Godwin, Conway National Bank, to the Consumer Affairs Division of the Board of Govenors of the Federal Reserve System (August 2, 1984).
following proposed legislation meets these goals.

**TITLE IX—ALTERNATIVE MORTGAGE TRANSACTION REGULATIONS**

**SHORT TITLE**

Sec. 901. This title may be cited as the "Alternative Mortgage Transactions regulation Act of 1986."

**FINDINGS AND PURPOSE**

Sec. 902(a) The Congress hereby finds that—

(1) the unchecked proliferation of types of alternative mortgage instruments has created an over-abundance of home financing possibilities, has engendered widespread consumer confusion, and has seriously impaired consumer efforts to make sensible decisions regarding home financing;\(^{164}\)

(2) the use of short-term, discounted mortgage interest rates to qualify consumers for alternative financing has increased the number of loan defaults and home foreclosures to intolerably high levels;\(^{165}\)

(3) the use of "caps" to limit fluctuations in alternative mortgage payments has not, in practice, been consistent with consumers' reasonable expectations;\(^{166}\)

(4) the use of "negative amortization" in alternative mortgage transactions has significantly reduced consumers' equity;\(^{167}\) and

(5) current disclosure practices are abysmal, greatly adding to the difficulty which consumers have in comparing various alternative mortgage instruments.\(^{168}\)

Sec. 902(b) The purpose of this title is to redistribute the interest rate risk between housing creditors and consumers in an equitable manner, to eradicate deceptive loan practices associated with alternative mortgages, and to improve and to standardize disclosure requirements for alternative mortgage transactions.


\(^{164}\) See supra notes 77-93 and accompanying text.

\(^{165}\) See supra notes 94-114 and accompanying text.

\(^{166}\) See supra notes 115-23 and accompanying text.

\(^{167}\) See supra notes 124-31 and accompanying text.

\(^{168}\) See supra notes 132-50 and accompanying text.
Sec. 903. As used in this title—

(1) the term "alternative mortgage transaction" means a loan or credit sale secured by an interest in residential real property, a dwelling, all stock allocated to a dwelling unit in a residential cooperative housing corporation, or a residential manufactured home (as that term is defined in section 603(6) of the National Manufactured Home Construction and Safety Standards Act of 1974)—

(A) in which the interest rate or finance charge may be adjusted or renegotiated;

(B) involving a fixed-rate, but which implicitly permits rate adjustments by having a debt mature at the end of an interval shorter than the term of the amortization schedule; or

(C) involving any similar type of rate, method of determining return, term, repayment, or other variation not common to traditional fixed-rate, fixed-term transactions, including without limitation, transactions that involve the sharing of equity or appreciation, described and defined by applicable regulation;¹⁶⁹

(2) the term "housing creditor" means—

(A) a depository institution, as defined in section 501(a)(2) of the Depository Institutions Deregulation and Monetary Control Act of 1980;

(B) a lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act;

(C) any person who regularly makes loans, credit sales, or advances secured by interests in properties referred to in paragraph (1); or

(D) any transferee of any of them.

A person is not a "housing creditor" with respect to a specific alternative mortgage transaction, if except for this title, in order to enter into that transaction, the person would be required to comply with licensing requirements imposed under State law, unless such person is licensed under applicable State law and such person remains or becomes subject to the applicable regulatory requirements and enforcement mechanisms provided by State law.¹⁷⁰

(3) the term "discounted mortgage interest rate" means an in-

¹⁶⁹. The definition of an alternative mortgage transaction is identical to that used in Title VIII of the Garn Act. 12 U.S.C. § 3802(1).

¹⁷⁰. The definition of a housing creditor is identical to that used in Title VIII of the Garn Act. 12 U.S.C. § 3801(2).
terest rate used to qualify consumers who could not qualify at the current market rates; 171

(4) the term "current market rate" means the most recent interest rate published for any of the following interest rate indices used by the housing creditor as a basis for adjusting mortgage interest rates—

(A) National Average Contract Interest Rate;
(B) Federal Home Loan Bank District Semiannual Average Cost of Funds;
(C) Average Cost of Funds, All Federal Home Loan Bank Districts;
(D) Federal Home Loan Bank District Monthly Weighted Average Cost of Funds;
(E) U.S. Treasury Bills Auction Average, 3 Months;
(F) U.S. Treasury Bills Auction Average, 6 Months;
(G) U.S. Treasury Notes and Bonds, Constant Maturity, 1 Year;
(H) U.S. Treasury Notes and Bonds, Constant Maturity, 3 Year; and
(I) U.S. Treasury Notes and Bonds, Constant Maturity, 5 Year; 172

(5) the term "cap" means any mechanism used by the housing creditor to limit periodic payment adjustments in mortgage transactions and any mechanism used to limit the maximum payment adjustments possible during the life of loan; 173

(6) the term "negative amortization" means the amount of money added by the housing creditor to the outstanding loan balance when periodic mortgage payments are insufficient to fully amortize the loan. 174

REGULATIONS

Sec. 904(a). In order to ensure the equitable distribution of interest rate risk between housing creditors and consumers— 176

171. See supra notes 94-96 and accompanying text.
172. The indices listed in § 903(4) of the proposed legislation are recognized by the Federal Home Loan Bank Board as "nine possible interest indices used for adjusting mortgage loan interest rates up or down." Federal Home Loan Bank of San Francisco, Interest Rate Indices for Adjustable Mortgage Loans 1 (June, 1984).
173. See supra notes 115-23 and accompanying text.
174. See supra notes 124-25 and accompanying text.
175. The need for an equitable sharing of interest rate risk in ARMs is recognized by lenders, realtors, and consumer advocates. See Subcommittee Hearings, supra note 1, at 635 (statement of James Montgomery on behalf of the United States League of Savings Institu-
(1) periodic payment adjustments in alternative mortgage transactions shall not exceed a one percent adjustment in the interest rate in any annual period, regardless of greater fluctuations during that annual period in the index used by the housing creditor to determine periodic payments;\textsuperscript{176}

(2) periodic payment adjustments in alternative mortgage transactions shall, under no circumstances during the entire loan amortization period, exceed the midpoint between the lowest and highest published rates of any single index listed in Sec. 903(4) of this title, provided that each of the lowest and highest published rates are taken from a period not more than seven years preceding the loan origination,\textsuperscript{177} regardless of greater fluctuations during the loan amortization period in the index used by the housing creditor to determine periodic payments;

(3) the annual limit in subsection (1) of this section and life-of-loan limit in subsection (2) of this section shall be fixed according to the contract rate at the loan origination;\textsuperscript{178} and

(4) negative amortization shall not be permitted.\textsuperscript{179}

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{176} The 1\% annual interest rate cap is already in use for ARMs underwritten by the Department of Housing and Urban Development (HUD). Subcommittee Hearings, supra note 1, at 423 (statement of Marice Barksdale, Federal Housing Commissioner, HUD, noting that the “most effective” protection in HUD ARMs is a 1\% annual interest cap).
\item\textsuperscript{177} The requirement that lenders calculate the life-of-loan cap based on the midpoint of interest rate fluctuations during the seven years preceding loan origination is intended to permit borrowers to share in the benefit of information traditionally relied on by lenders. The life of the average mortgage is seven years. See supra note 3 and accompanying text. Lenders consider this seven-year average and the expected interest rate fluctuations in pricing their mortgages. Indeed, their reliance on this seven-year average was utilized to justify their enforcement of the due-on-sale clause. R. IRWIN, THE NEW MORTGAGE GAME 25 (1982). If lenders price their 30-year mortgages with the notion that the mortgages will actually be retired or rewritten in seven years, it seems only fair that borrowers as a class should obtain something in return for helping the lenders wipe these old loans off the books. Section 904(a)(2) recognizes this need by requiring lenders to limit life-of-loan interest fluctuations to whatever amount is equal to one-half the fluctuations during the seven years prior to loan origination.
\item\textsuperscript{178} Section 904(a)(3) will greatly reduce instances of payment shock and loan default. See infra notes 185-86 and accompanying text.
\item\textsuperscript{179} An across-the-board prohibition of negative amortization is supported by at least 60 national and local civil rights, labor, neighborhood, church, and consumer organizations. These organizations include the National Urban League, National Urban Coalition, National Committee Against Discrimination in Housing, National Association of Neighborhoods, Na-
\end{itemize}
\end{footnotesize}
Sec. 904(b). In order to better ensure that meaningful disclosure is made by housing creditors, the Comptroller of the Currency, the National Credit Union Administration, and the Federal Home Loan Bank Board shall revise their respective regulations to facilitate the development of a single, universal disclosure statement to be used by all housing creditors, which shall include—

(1) type of loan description (e.g., ARM, GPARM, SAM, etc.,) with a narrative explanation describing to the borrower the manner in which the loan operates;

(2) dates of loan origination, monthly payments, and amortization period;

(3) loan principal and interest rate, including annual caps up to one percent and a life-of-loan cap as specified in Sec. 904(a)(2);

(4) prominent listing of index to which payment adjustments are tied;

(5) chart showing semi-annual performance of the index specified in Sec. 904(b)(4) in comparison with the other eight indices specified in Sec. 903(4) for a period not less than seven years preceding the loan origination date;

(6) monthly payments for each year of the loan expressed in dollars using both a straight-line extrapolation of current interest rates and a worst-case scenario showing the maximum monthly payments possible under this loan;

(7) the maximum amount of total money this loan could cost as compared with a fixed-rate mortgage at the same interest rate used at loan origination;

(8) what conditions, if any, the housing creditor will place on the assumability of this loan;

(9) housing creditor’s margin added to each monthly payment, expressed in dollars, and expressed as a percentage of the borrower’s monthly payments.

180. Numerous trade associations and lending industry experts support the standardization of ARM disclosure requirements. They include: the National Association of Realtors, Subcommittee Hearings, supra note 1, at 654, 668, 672 (statement of Kent Colton, Executive V.P., National Association of Home Builders); Mortgage Insurance Companies of America, id. at 722 (statement of William Simpson, President, Mortgage Insurance Companies of America); Consumers Union, id. at 311-12, 316 (statement of Harry Snyder, West Coast Director, Consumers Union); Professor Jack Guttentag, id. at I20-2l; Professor William Eskridge, id. at 224, 250; Rep. Stewart McKinney id. at 334-35.
Sec. 904(c). In order that consumers are able to effectively utilize the universal disclosures requirements mandated in Sec. 904(b), the universal disclosures set forth in Sec. 904(b) shall be available at no charge from the housing creditor. 181

Sec. 904(d) The universal disclosure requirements mandated in Sec. 904(b) shall be written in clear, plain English. 182

APPLICABILITY

Sec. 905(a). The provisions of section 904 shall apply to all mortgage transactions originated 60 days after the date of enactment of this title.

EFFECTIVE DATE

Sec. 906(a). This title shall be effective sixty days after the enactment.

As explained below, this proposed legislation addresses each of the five problem areas examined in Section III of this comment.

A. Excessive Diversity

The excessive diversity of ARMs has given rise to two theories on how best to attack the diversity problem. One theory is the “menu approach,” 183 and the other is the “relevant disclosure approach.” 184 Sections 904(a) and 904(b) are an attempt to translate the beneficial aspects of both theories into practice. A specified menu of ARMs is not mandated, so as not to compromise market creativity, innovation, and refinement. On the other hand, specific guidelines regarding caps, negative amortization, and disclosures are provided. These guidelines will reduce the number of ARM instruments by: 1) prohibiting the sale of those ARMs which fail to meet the guidelines

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181. The idea that lenders should provide standardized disclosure information as a public service is advocated by Professor Jack Guttentag, Subcommittee Hearings, supra note 1, at 120, and by the Mortgage Bankers Association of America, id. at 590 (statement of Felix Beck, President, Mortgage Bankers Association of America).

182. See infra note 198 and accompanying text.

183. The menu approach involves defining a carefully constructed but limited list of types of mortgages which, in combination, meet all of the essential needs of borrowers and lenders. Subcommittee Hearings, supra note 1, at 119 (statement of Jack Guttentag). The various types of ARMs on the list would permit a range of interest rate risk-sharing between borrowers and lenders. The problem with this approach is that the menu could become nonresponsive to the market. Id.

184. The relevant disclosure approach is based on the premise that borrowers can handle the diversity of ARM instruments provided that the disclosure practices are adequate. Id.
specified; and 2) ensuring that only the most popular ARMs remain in the marketplace because the enhanced disclosure requirements will permit market forces to drive out the less popular instruments. By checking the proliferation of ARM instruments, sections 904(a) and 904(b) will facilitate efforts by potential homebuyers to thoroughly examine available home financing options. Additionally, a trend toward standardization of ARM products will make it easier for lenders to promote, originate, and service the loans; the administrative ease associated with such standardization will also have a positive impact on overhead costs.

B. Teaser Rates

Section 904(a)(3) addresses the use of teaser rates to qualify borrowers who cannot qualify for fixed-rate financing. Under section 904(a)(3), two problems will be resolved. First, lenders will be reluctant to continue the current practice of offering exceptionally low initial rates because section 904(a)(3) fixes both the annual and life-of-loan caps according to the initial contract rate. The result will be fewer instances of payment shock and loan defaults because borrowers will no longer be qualified at ridiculously low rates, only to be hit with sharp payment adjustments after one year. Second, section 904(a)(3) will eliminate the deceptive lending practice of letting teaser rates expire, adjusting the interest rate upward, and then using that adjusted rate as a basis for calculating the annual and life-of-loan caps. This practice will be eradicated because section 904(a)(3) specifies that the benchmark used for calculating loan caps will be the interest rate used at loan origination.

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185. The enhanced disclosure requirements are the missing link to support Gray's argument (see supra notes 87-88 and accompanying text) that good ARM instruments will act to drive out bad ARM instruments. Guttentag speech, supra note 79.


187. See supra notes 94-114 and accompanying text. Of course, fewer people may qualify for financing if the low teaser rates disappear. It merits questioning, however, whether or not qualifying people who stand a high risk of defaulting on their mortgage debt is a desirable public policy. Rep. James Wright has observed, "You don't do a person a favor if you lure him into a debt that he can't pay. You don't do him any favor at all." Subcommittee Hearings, supra note 1, at 33.

188. See supra note 123 and accompanying text.
C. *Caps*

Sections 904(a)(1)-(4) address the problem of those caps that fail to safeguard the borrower against significant increases in monthly mortgage payments. The proposed one percent annual interest rate cap would, for example, limit the first mortgage payment increase on an $88,000 loan originated at fourteen percent to $70 per month (See Table 1). This would provide borrowers with a great deal of stability which is currently missing from ARMs, while redistributing the interest rate risk between borrowers and lenders. The one percent cap, although it appears modest, is twice the annual limit imposed on California lenders in the 1970s. As shown in Table 2, the one percent cap would also cover a substantial amount of the annual fluctuations which occurred in the seven years between 1978 and 1984 in any of the nine indices specified in Sec. 903(4).

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<th>Table 2</th>
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<tr>
<td>National Average Contract Interest Rate</td>
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<tr>
<td>June, 1979</td>
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<td>June, 1980</td>
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<td>December, 1982</td>
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<td>December, 1984</td>
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189. The amount of monthly payments is a consideration of vital importance to the borrower since it is the factor most directly related to the possibility of default. Goebel v. First Fed. S. & L. Ass'n of Racine, 83 Wis. 2d 668, 266 N.W.2d 352, 356 (1978) (lender's failure to provide explicitly for increase in monthly payments demonstrated that no such increase was contemplated by the parties).

190. See supra note 47.

191. In the Eleventh District Semiannual Cost of Funds Index, Eleventh District Monthly Weighted Average Cost of Funds Index, and the Average Cost of Funds for all Federal Home Loan Bank Districts Index, semi-annual fluctuations in the interest rate were, with four exceptions each, approximately 1% or lower. Thus, the 1% annual limit would, for these three indices, mean that the borrower and the lender were sharing the interest rate risk fairly evenly even during periods of high interest rate volatility. For the remaining indices, except the U.S. Treasury Bill Auction Average for 3 Months and 6 Months, there were six to
The life-of-loan cap specified in Sec. 904(a)(2) is similarly intended to redistribute the interest rate risk equally between borrowers and lenders. The cap achieves this by being based on the midpoint in interest rate fluctuations during the seven years preceding loan origination. Fluctuations above that midpoint must be borne by the lenders, while fluctuations below that midpoint can be borne by the borrowers. Lenders would be free to choose from any of the nine indices specified in Sec. 903(4) to fix the midpoint. In the 1978-84 period, for example, the index which showed the greatest difference between the lowest and highest rates was the U.S. Treasury Bills Auction Average for 3 Months (See Table 2). Between 1978 and 1984, this index showed movement of 8.95% between its lowest and highest rates. The midpoint would therefore be 4.475%, and this would be the life-of-loan cap.

A two-fold benefit exists to the life-of-loan cap specified in Sec. 904(a)(2). First, neither the borrower nor lender is constrained by whatever fixed percentage appeared reasonable at the date of loan origination. Rather, a midpoint is selected from the preceding seven years; thus, during prolonged periods of interest rate volatility, the cap will tend to be higher, providing greater protection to the lender. Because an interest rate midpoint will be used, rather than an average, sudden upward swings will also be reflected in a higher cap, further protecting the lender. During prolonged periods of interest rate stability, the borrower will benefit because the cap will be lower. The result would be a rate-sensitive asset which, unlike many of today's ARM instruments, still considers the ability of the borrower to meet monthly payments.

Second, the proposed life-of-loan cap would protect borrowers against sudden and dramatic jolts in the monthly payment burden. This protection, unlike today's caps, would be consistent with the

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eight semiannual periods since 1978 when the interest rate increases exceeded 1%. During those periods, a 1% annual limit would have resulted in the lenders shouldering a greater part of the interest rate risk than would the borrowers. The two U.S. Treasury Bill indices, the most volatile of all nine, experienced semi-annual interest rate increases which exceeded 1% eight times for the 6 Month index and nine times for the 3-Month index. Table 2 statistical information quoted in Federal Home Loan Bank of San Francisco, Interest Indices for Adjustable Mortgage Loans 1 (Dec. 1984).

192. In June, 1978, the index rate was 6.71%. By December, 1980, it had climbed to 15.66%. The difference between the two extremes is 8.95%.

193. 8.95% x \( \frac{1}{2} \) = 4.475%. The other eight indices in Sec. 903(4) fluctuated approximately between 6 and 8%, therefore, the midpoint on these would be approximately 3-4%. See Table 2. Currently, many of the life-of-loan caps available are between 4-6%. Subcommittee Hearings, supra note 1, at 483 (statement of David Maxwell, citing a survey conducted in June, 1984, by the Federal National Mortgage Association.)
borrower's reasonable expectations of what the caps are supposed to accomplish. Additionally, the caps promise to greatly increase the marketability of ARMs.\textsuperscript{194}

D. Negative Amortization

Section 904(a)(4) prohibits negative amortization. The prohibition is grounded in public policy; very few borrowers are enamored with the Sisyphean concept of making monthly mortgage payments for a few years, only to find that at the end of that period, they are right back where they started, owing the same or more money than the original loan principal.\textsuperscript{195} The prohibition would not have a harsh effect on lenders since the new caps will virtually eliminate the very low initial payments which were the primary causes of negative amortization.\textsuperscript{196} Elimination of negative amortization would also eliminate the need for "negative amortization caps" and loan "re-casting," two of the more confusing and potentially dangerous tools currently used by lenders.\textsuperscript{197}

E. Disclosure Problems

The universal disclosure statement proposed in Sec. 904(b) should alleviate today's inadequate disclosure practices. The statement provides the consumer with a wealth of useful information in clear language\textsuperscript{198} at the initial "shopping stage" when it is most needed. Disclosure would be at no initial cost and obtainable in much the same way that a bank account holder discovers the interest rates on various savings accounts. Given the infusion of computerization into the lending industry,\textsuperscript{199} the requisite information would be

\textsuperscript{194.} One FNMA survey showed that an interest rate cap increased the percentage of people who found an ARM attractive from 26% to 72%. CARE, ARM PRACTICES, supra note 25, at 6. An American Mortgage Insurance Company survey, however, indicated that more than one-half of the savings and loan institutions offering ARMs do not cap the potential change in interest rates. S. Rep., Pt. 2, at 3.

\textsuperscript{195.} Subcommittee Hearings, supra note 1, at 580 (statement of David Maxwell, noting that negative amortization "is not particularly popular with consumers"). A National Association of Realtors survey conducted in June, 1984, showed that 84% of ARM purchasers preferred ARMs that do not allow any negative amortization. Subcommittee Hearings, supra note 1, at 620, 628 (statement of John Wood).

\textsuperscript{196.} See supra note 127 and accompanying text.

\textsuperscript{197.} See supra notes 129-31 and accompanying text.

\textsuperscript{198.} Clear language, free of technical and complicated terms, is essential if full disclosure is to be meaningful. An excellent example of the simple language which should be used in disclosure statements can be found in CAL. CIV. CODE \textsection 1916.7 (West Supp. 1985) (general description of adjustable-rate loans).

\textsuperscript{199.} Address by Richard Pratt, Federal Home Loan Bank of San Francisco Annual
easily accessible. The added expense of providing this service to consumers can readily be calculated and then factored into the lender’s margin with other loan servicing costs. In this way, the borrower pays for the enhanced disclosure, yet the payment is spread over the life of the loan, rather than being an initial cost.

Because borrowers will no longer have to pay several hundred dollars before they obtain the necessary disclosures, they will be encouraged to shop vigorously for the best financing deal. This, in turn, will compel lenders to be more aggressive in their pricing of ARMs, a phenomenon which is certain to enhance the attractiveness of ARMs to consumers.

Conceivably, even soundly designed ARMs could produce payment shock for borrowers whose wages or land values cannot keep pace with higher interest rates. Yet full disclosure should enable borrowers to better understand their obligations and avoid the possibility of foreclosure, even during periods of high interest rates. Additionally, full disclosure will ensure that lenders carry out their fiduciary duty to act in the utmost good faith toward the borrowers.

Better disclosure will benefit lenders as well. Some of the unpleasant by-products of poor disclosure practices—adverse publicity, business disruption, hostile customer contact, and litigation—will be reduced if disclosure is enhanced and standardized. Adequate initial disclosure should therefore be viewed not only as a necessary consumer safeguard, but also a key factor in reducing the lenders’ potential legal exposure. In short, a good general system of disclosure will go a long way toward reducing the dimensions of the disclosure problem.

V. Conclusion

In the same way we ban unsafe cars and unsafe drugs, we
should prohibit unsafe mortgages.206

Until 1981, lending institutions carried virtually all of the interest rate risk in home financing. After that date, however, the burden was shifted to borrowers. The shift was facilitated by the adjustable rate mortgage. Although home ownership opportunities have increased with the use of the ARM, so have loan defaults and foreclosures, as well as a host of deceptive lending practices. These problems can be traced directly to congressional deregulation. To alleviate the problems and to ensure that lenders and borrowers share the burden of carrying the interest rate risk, Congress must intervene. Limited reregulation is necessary.

The statutory reform proposed in this comment seeks to establish the equitable allocation of interest rate risk which is missing from today's deregulated lending environment. The proposed reform also seeks to eradicate the numerous deceptive loan practices, unfair loan instruments, and inadequate disclosure statements which deregulation has permitted. In place of the current inequities, the proposed legislation endeavors to strike a responsible compromise between the lender's interest in profitability and the borrower's interest in housing affordability.

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