CHAPTER 12. ADJUSTABLE RATE MORTGAGES - ANNUAL ADJUSTMENTS

12-1 GENERAL. The Housing and Urban-Rural Recovery Act of 1983 added Section 251 to the National Housing Act authorizing HUD to insure adjustable rate mortgages (ARMS) on single family properties. The ARM program is limited to owner-occupants. (24 CFR 203.49)

The initial interest rate and margin are negotiated by the mortgagee and the mortgagor. The margin must be constant for the entire term. The changes in interest rate provided for in adjustable rate mortgages have a significant impact on the mortgagor's ability and willingness to continue making payments. It is extremely important that they be accurate and that documentation on calculations be retained for the mortgage term. All ARM adjustments affect interest rates only; no negative amortization may occur. (See Handbook 4000.2 REV-2 and Mortgagee Letter 91-8, dated February 11, 1991, for details regarding origination of ARMs.)

12-2 ANNUAL INTEREST RATE ADJUSTMENT. The first adjustment must occur no sooner than 12 months and no later than 18 months from the due date of the mortgagor's initial monthly payment. This 6-month window period is designed to facilitate the pooling of mortgages for sale in the secondary market. The first adjustment date is specified in the note and or security instrument.

Subsequent interest rate adjustments will take place annually on each anniversary date of the first adjustment. The date of the adjustment rate change is called the "Change Date" by HUD and the Interest Adjustment Date by the Government National Mortgage Association (GNMA).

The adjustment is based on the weekly average yield on U.S. Treasury Securities, adjusted to a constant maturity of one year (the Index). Weekly average yields are published in the Federal Reserve Bulletin and are made available in Statistical Release H.15 (519). (See Appendix 58 for a sample H.15.) This is a national index which can be obtained from the Federal Reserve Board by requesting to be placed on the mailing list for receipt of the weekly H.15 publication. The address is:

Publications Services
Mail Stop 138
Board of Governors
Federal Reserve System
Washington, DC 20551

The index is also published regularly in many newspapers, such as The Wall Street Journal, USA Today, etc.

Interest rate adjustments on Adjustable Rate Mortgages insured by HUD are limited to one percent per year (the "annual cap") in either direction from the interest rate in effect for the period immediately proceeding the adjustments and five percent (the "lifetime cap") in either direction from the initial contract interest rate over the life of the mortgage.

NOTE: See 24 CFR 206.21, 12 CFR 226 ("Regulation Z") Subpart B, HUD Handbook 4235.1, Home Equity Conversion Mortgages, and Mortgagee Letter 90-17, for interest rate adjustments and disclosure requirements on adjustable rate home equity conversion mortgages (HECMs).

A. Computing The Adjustment.

1. Determining The Current Index. This is the most recently available published interest rate for "U.S. Government Securities, Treasury Constant Maturities, 1-Year" effective on the date which is exactly 30 calendar days before the change date. The following are the proper indices to use when the 30th exact day falls on:

a. a Monday which is a business day. Use the index rate contained in the H.15 release issued that Monday, if the 30th exact day prior to the Change Date and the issue date of a H.15 release both occur on the same day (i.e., both dates happen to be a Monday).

b. a Monday which happens to be a Federal holiday. Use the index in the H.15 release issued the prior week if the 30th exact day before the Change Date happens to fall on a Monday which is a Federal holiday.

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c. a day of the week other than a Monday. Use the index in the H.15 release issued on the Monday of that week (or issued on Tuesday if that Monday happened to be a Federal holiday).

NOTE: A sample copy of a Federal Reserve Statistical Release, H.15, is attached as Appendix 58, marked to identify the Index for a mortgage having a change date of April 1, 1989. This index is effective the day it is issued and remains in effect until the next H.15 is issued the next week.

2.Determining The Calculated Interest Rate. This is the current Index plus the Margin (i.e., the number of percentage points identified as "Margin" in Paragraph 3(b) of the Adjustable Rate Rider or the Adjustable Rate Allonge Amending Note), rounded to the nearest one-eighth of a percent (0.125 percent). Rounding is required unless the Allonge and the Rider to the mortgage have been amended to delete the provision for rounding, which is permitted. However, rounding is required for mortgages placed in GNMA pools.

3.Comparing The Calculated Interest Rate And The Existing Interest Rate. Compare the calculated interest rate and the existing interest rate (the rate currently in effect under the mortgage, not considering any interest rate buydown that might apply).

a.If the calculated interest rate is equal to the existing interest rate, the adjusted interest rate will not change.

b.If the calculated interest rate is equal to or less than one percent (i.e., 100 basis points) higher or lower than the existing interest rate, the calculated interest rate will become the new adjusted interest rate.

c.If the calculated interest rate is more than one percent higher or lower than the existing interest rate, the new adjusted interest rate will be limited to one percent higher or lower than the existing interest rate.

4.Comparing The Adjusted Interest Rate And The Initial Interest Rate. Compare the adjusted interest rate with the initial interest rate. The adjustment may not result in an adjusted rate more than five percent higher or lower than the initial rate at settlement.

B.Effective Date. The adjusted interest rate becomes effective on the Change Date (i.e., the date specified in Paragraph 2 of both the Rider and the Allonge) and becomes the existing interest rate on that date. It will remain in effect until the next Change Date. Since interest is payable on the first day of the month following the month in which it accrues, the mortgagor will begin to pay the new monthly payment one month after the Change Date, provided the mortgagor is given proper notice as required in Paragraph 12-3.

12-3MONTHLY PAYMENT ADJUSTMENT. Once the interest rate change has been established, the total monthly payment must be determined. There could be a change in the monthly payment without an interest rate change if there is a change in the required escrow.

NOTE:This does not apply to adjustable rate HECMs on which regular monthly payments do not adjust.

The new monthly payment is determined by making several computations.

A.Determining The Unpaid Principal Balance. This is the scheduled unpaid principal balance as of the Change Date, subtracting prepayments to principal, but without considering delinquent payments. If payments are delinquent, the computation should be based on the assumption that the payments have been made.

B.Reamortizing This Balance. Determine what monthly payment to principal and interest would be required to fully amortize this balance over the remaining term of the mortgage at the new adjusted interest rate.

C.Adding Escrow Requirements. To the monthly payment required to amortize the unpaid balance over the remaining term at the new interest rate, add escrow requirements.

12-4ANNUAL ADJUSTMENT (OR DISCLOSURE) NOTICE TO THE MORTGAGOR (24 CFR 203.49g, and 12 CFR 226.20(c); see 12 CFR 226 Subpart B for adjustable rate HECMs).

A.Time Frame For Sending Required Notices. A notice of the change in interest rate and monthly installment must be mailed to reach the mortgagor at least 25 days before the due date of the first payment at the new interest rate after the change. However, if the mortgage provides for 30 days notice, that provision must be followed.

The notice is required each year even if there is no interest rate change. Our rule concerning the timing of the annual notice of adjustment is consistent with the Truth-in-Lending Regulations ("Regulation Z") of the Federal Reserve Board at 12 CFR 226.20(c).

B.Type of Mailing Recommended. It is suggested that the Notice be sent to the mortgagor by Certified Mail, Return Receipt Requested. However, a Notice addressed to all property owners identified in the mortgagee's records, sent by First Class mail, is sufficient unless the mortgagors' whereabouts are known to be elsewhere.

C. Required Content Of Notice (24 CFR 203.49(g) and 234.79(g) or 12 CFR 226.20(c)). The Adjustment Notice (a suggested format is shown in Appendix 59) must include the following:

1. the date of the Adjustment Notice;

2. the Change Date and due date of the first installment after the change;

3. the current interest rate;

4. the new Existing Interest Rate (which is the Adjusted Interest Rate) effective on the change date;

5. the current Index and the date it was published;

6. the method of calculating the adjustments to the monthly payments;

7. the amount of the adjusted monthly payments;

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8. other relevant information, such as an explanation of why a new Existing Interest Rate is less than the Calculated Interest Rate when the 5 percent cap is reached; and

9. any other information that may be required by law.

NOTE: Mortgagees must keep some evidence that timely notice was given, and a record of the adjustment computations, for the balance of the mortgage term. HUD does not assume any responsibility for the legal adequacy of these records in the event of a dispute, and mortgagees should be guided by the advice of counsel in matters concerning the type and duration of record retention.

12-5 FAILURE TO PROVIDE TIMELY AND ACCURATE NOTICE.

A. Recomputing Required. If the mortgagee fails to provide timely notice of a change or changes each year, immediately upon discovering this omission, the mortgagee must do the computations described in Paragraphs 12-1 and 12-2 for each year involved, since the calculations for each year affect subsequent years.

The 1 percent and 5 percent limitations apply for each year and must be taken into consideration in reconstructing the account to determine the new Existing Interest Rate.

NOTE: A mortgagee's failure to provide Notice in advance of each Change Date will result in the penalties described in Paragraphs 12-4B and C below and in the note and/or security instrument.

B. Increased Payments. When the payments increase as the result of the computations, the mortgagee may not collect payments at the higher amount until the first payment date which occurs at least 25 days after the mortgagee has given the Adjustment Notice to the mortgagor (or 30 days if the mortgage so provides). If one or more payments come due during this 25-day (or 30-day) period, the mortgagee forfeits its right to collect the increased amount and the mortgagor is relieved of the obligation of paying the increase.

If a mortgagor tenders a payment in the old amount during the 25-day (or 30-day) Notice period when the increased payment amount would have been due had the Notice been provided on a timely basis, the old amount should be credited to the account as though it were in the higher amount.

C. Reduced Payments. When the payments are reduced as the result of the computations, but timely notice is not provided and the mortgagor makes a payment in the old amount before the delayed 25-day (or 30-day) Notice period has expired, the mortgagee must refund the excess payments, with interest on the excess at the Index rate from the date of the payment to the date of refund, unless the account is delinquent.

If the account is delinquent, any excess must be applied toward the delinquency. If there remains any excess once the account has been brought current, the mortgagor is to be given the option of a cash refund or of applying it to the unpaid principal balance of the mortgage.

D. Inaccurate Notice. When the mortgagee miscalculates the interest rate and/or monthly payments, and the error is reflected in the Notice, the errors must be corrected.

NOTE: HUD takes no position, however, as to whether an erroneous Notice would constitute a failure to provide notice under the terms of the mortgage. This is a legal matter subject to local law and court interpretation.

12-6 ASSUMPTIONS. When an Adjustable Rate Mortgage is assumed, the mortgagee must provide the assumptor (as soon as the assumptor's identity is known) with a copy of the original Disclosure Statement and a letter explaining the ARM conditions. The assumptor should be asked to acknowledge receipt of this information. When credit processing of the assumptor is required, the assumptor must be given a new Original Disclosure Statement, reflecting conditions at the time of the assumption. Credit processing is based on the existing interest rate at the time of processing.