BUREAU OF BANKING
Department of Professional and Financial Regulation
State of Maine
May 7, 1990

# BULLETIN #49 FNMA "TWO STEP" MORTGAGE PROGRAM

To the Chief Executive Officer Addressed:

Over the past several weeks, both the Bureau of Banking and the Bureau of Consumer Credit Protection have received numerous calls and correspondence from lenders who are interested in participating in the new FNMA "Two Step" Mortgage Program. This program, which is accepted for sale on the secondary market, provides for an adjustable rate mortgage loan which is linked to the weekly average yield on United States Treasury securities adjusted to a constant maturity of ten (10) years.

The "Two Step" Mortgage provides for a seven-year initial period; the only rate change, which occurs at the beginning of the eighth year, cannot exceed six (6) percentage points. The initial rate of a "Two Step" Mortgage is discounted. Bureau of Banking Regulation #19 requires that, when the initial interest rate is discounted, any subsequent increases in the interest rate may not exceed 2% for any one year. For the "Two Step" Mortgage, the change in interest rate is predicated upon the change in the index at a specific point in time -- seven years from the date of origination. The index could remain relatively stable for several years into the contract, and then experience a dramatic increase just before the change date occurs. Bureau of Banking Regulation #19, Section 5F would appear to preclude a financial institution from applying the full change in the index to the formula for computing the interest rate of the loan.

The phrase, "2% for any one year", which appears in Regulation #19, Section 5F, does not necessarily preclude a rise of six (6) percentage points after a seven-year initial plateau. This new FNMA product would clearly be affected by a rule which applied the 2% ceiling to "any one time" or "any 12-month period." However, the current phraseology is more liberal, and no matter how low the initial rate, the average rise for any one year cannot exceed 2%.

The Bureau recognizes that Regulation #19 was promulgated at a time when an adjustable rate mortgage generally provided for at least an annual review of the interest rate. In September, 1983, the Bureau issued Regulation #21 authorizing Partially Amortized Loans (Balloon Mortgages). The Bureau recognizes similarities between the "Two Step" Mortgage and a Balloon Mortgage; both provide for a lower initial rate which is set for a period of time. The ultimate cost to the consumer, however, may be quite different. With a

Balloon Mortgage, a consumer incurs substantial closing costs at the time the balloon payment is due. Refinancing, which is the option of the lender, would be at prevailing market rates. With a "Two Step" Mortgage, there is an identifiable index, the rate increase is capped at 6%, and no additional closing costs are incurred.

Based on the foregoing, the Bureau can be convinced that to strictly interpret the provisions of Regulation #19, Section 5F would effectively prohibit state-chartered financial institutions from offering an innovative loan product that is saleable on the secondary market. It would also inhibit a Maine consumer's ability to access potentially lower cost financing for home ownership. This is contrary to the stated purpose of Regulation #19. Therefore, it is the Bureau's position that the "Two Step" Mortgage program promoted by FNMA in its Announcement No. 90-09, dated March 6, 1990, may be offered by state-chartered financial institutions. This is consistent with the interpretative ruling being issued concurrently by the Bureau of Consumer Credit Protection with respect to other licensed lenders.

It is recognized, however, that this type of program carries with it a certain level of risk for consumers and lenders alike because of the potential for a sharp increase in the interest rate. Therefore, the Bureau will begin initiating rule-making proceedings immediately to amend Regulation #19 to assure that proper disclosures are provided. Should any state-chartered financial institution wish to proceed immediately in offering this type of loan, it is recommended that they look to the special disclosures provided in Regulation #21 as an example of the type of notices that the Bureau would feel is appropriate.

/s/ Colette Mooney
Deputy Superintendent