U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-
FEDERAL HOUSING COMMISSIONER

March 19, 2004

MORTGAGEE LETTER 2004-10

TO: ALL APPROVED MORTGAGEES

SUBJECT: Adjustable Rate Mortgages

On March 10, 2004, the Department of Housing and Urban Development published a final rule in the *Federal Register* amending the mortgage insurance regulations to implement additional product offerings known as "hybrid" adjustable rate mortgages (ARMs). The Federal Housing Administration (FHA) has insured ARMs since 1984; however, these were limited to 1-year ARMs. Under the terms and conditions described below, FHA is now offering mortgage insurance on 3-year, 5-year, 7-year and 10-year ARMs. These hybrid ARMs expand home buying opportunities through the creation of additional product offerings tailored to the financial conditions and desires of the borrowers.

This Mortgagee Letter provides a synopsis of the final rule, as well as specific guidance to assist lenders with implementing these new products. It supercedes Mortgagee Letter 89-24, FHA's prior instructions on 1-year ARMs, and incorporates the two paragraphs from Mortgagee Letter 98-1 which apply to ARMs. This Mortgagee Letter contains a definition section at the end.

Highlights of the Final Rule

In addition to 1-year ARMs, under this rule change, FHA may insure ARMs on single-family properties that have interest rates that are fixed for the first three years, five years, seven years or ten years of the mortgage term and adjusted annually thereafter. The 1-, 3- and 5-year ARMs allow a one percentage point annual interest rate adjustment after the initial fixed interest rate period and a five percentage point interest rate cap over the life of the loan. The 7- and 10-year ARMs allow a two percentage point annual interest rate adjustment after the initial fixed interest rate period and a six percentage point interest rate cap over the life of the loan.

The final rule also requires a pre-loan disclosure. A mortgagee must provide the mortgagor, at the time of loan application, a written explanation of the features of the adjustable rate mortgage consistent with requirements applicable to variable rate mortgages secured by a principal dwelling under the Truth-In-Lending Act (TILA), "Regulation Z," at 15 USC 1601, 12 CFR §226.18. FHA will not provide these disclosures.

Programs Eligible for Hybrid ARMs

These products may be used on owner-occupied principal residences only for loans to be insured under sections 203(b)(single-family mortgage insurance), 203(h)(disaster victims), 203(k)(rehabilitation loans) and 234(c)(mortgage insurance on condominium units). Lenders are not permitted to make ARMs to nonprofits (including those normally eligible as mortgagors) and units of government.

Frequency of Interest Rate Changes

Interest rate adjustments must occur on an annual basis, except that the first adjustment may occur no sooner than:

1-year ARMs - no sooner than 12 months nor later than 18 months
3-year ARMs – no sooner than 36 months nor later than 42 months
5-year ARMs – no sooner than 60 months nor later than 66 months
7-year ARMs – no sooner than 84 months nor later than 90 months
10-year ARMs – no sooner than 120 months nor later than 126 months

Pre-loan Disclosure

Mortgagees must make available to the mortgagor, at the time of loan application, a written explanation of the features of an ARM consistent with the disclosure requirements applicable to variable rate mortgages secured by a principal dwelling under TILA. Since mortgage lenders already prepare their own disclosures for FHA 1-year ARMs as well as conventional ARMs, FHA will rely upon lenders to comply with TILA and will not provide disclosures for these products. On the date of the loan application, the lender must explain fully and in writing to the prospective mortgagor, the nature of the proposed obligation.

A hypothetical monthly payment schedule that displays the maximum potential increases in monthly payments for the term of the ARM must be provided to the applicant. For example, a 7-year ARM payment schedule would show the maximum potential increases over the three years following the initial fixed interest rate period of 7 years.

Note: Examples will differ depending on the caps, i.e., 1/5 vs. 2/6. The hypothetical payment schedule will illustrate the maximum increases over the shortest possible time frame.

Underwriting

The ARM loan will be processed and underwritten using the initial interest rate negotiated between the lender and borrower, as stated in the Form HUD-92900-A, Addendum to Uniform Residential Loan Application. Mortgage credit processing shall be in accordance with existing

instructions except as modified below:

a. An adjustable rate mortgage disclosure statement, signed by all borrowers, must accompany the loan application and applicable FHA addenda. The disclosure statement must meet the criteria of the Federal Reserve Board's Truth-in-Lending regulations ("Regulation Z").

b. The periodic mortgage insurance premium (MIP) amount and any termination provisions will be based on the initial interest rate throughout the term of the loan and regardless of the annual interest rate adjustments to the loan.

c. The initial interest rate, the margin, the date of the first adjustment to the interest rate and the frequency of adjustments must be specified in the mortgage documents.

d. For all adjustable rate mortgages, regardless of LTV, any form of temporary interest rate buydown is prohibited. If there is a permanent buydown, the underwriting will be based on the rate in the application.

e. ARM loan maturities shall not exceed 30 years.

f. This Mortgagee Letter does not apply to Home Equity Conversion Mortgages.

g. Borrowers choosing the 1-year ARM must qualify for payments based on the contract or initial rate plus one percentage point (1%). This only applies to the 1-year ARM where the loan to value (LTV) is 95.00 percent or greater. (For this purpose, the LTV is defined as the lesser of the base loan amount divided by the appraiser's estimate of value, or the percentage shown on line 16a of the HUD-92900-PUR or line 14a of the HUD-92900-WS.)

h. Borrowers choosing the 3-, 5-, 7- or 10-year ARMs are to be qualified at the entry level (note) rate (i.e., there is no requirement to underwrite at one percentage point above the note rate as there is for 1-year ARMs).

Adjustable Rate Mortgage and Note

For the model adjustable rate mortgage and note, see Handbook 4165.1, Rev 1, Chg 3, Chapter IV and the applicable appendices.

Mortgage lenders are to modify the model adjustable rate note form contained in Handbook 4165.1, to accommodate the type of ARM being offered (i.e., the Change Date, the limits on the interest rate changes associated with the initial fixed rate period of the ARM and the lifetime caps).

Amortization Provisions

The ARM must be fully-amortizing and contain amortization provisions that allow for

periodic adjustments in the rate of interest charged.

Maximum Number of ARM Units

The aggregate number of all ARMs insured by FHA in any fiscal year may not exceed 30 percent of the aggregate number of mortgages insured by the Commissioner under Title II of the National Housing Act during the preceding fiscal year. FHA will notify lenders accordingly should it be close to reaching that maximum percentage during any fiscal year.

Interest Rate Index

Changes in the interest rate charged on an ARM must correspond to changes in the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year, or equivalent, as provided by the Department of the Treasury and found on the Federal Reserve Statistical Release H.15, Selected Interest Rates website at: www.federalreserve.gov/releases. Except as otherwise provided in this Mortgagee Letter, each change in the mortgage interest rate must correspond to the upward or downward change in this index.

To establish the adjusted interest rate, the lender must compare the initial contract interest rate to the sum of the current index figure and the mortgage margin (calculated interest rate). The adjusted interest rate will be the interest rate charged to the mortgagor, subject to the limitations of the annual and lifetime caps for the respective ARM type. The current index figure shall be the most recent index figure available 30 calendar days before the Change Date (effective date of an adjustment to the interest rate as shown in paragraph 5(A) of the model adjusted rate note form.)

Section 203.49 (c) of the regulations has long provided for a method for setting the new interest rate as an alternative to the use of the margin to set the new rate. Section 203.49 (c) states that "(T)o set the new interest rate, the mortgagee will determine the change between the initial (i.e., base) index figure and the current index figure, or will add a specified margin to the current index figure." However, Ginnie Mae will only purchase ARMs that use the margin method for arriving at the new interest rate. If a lender wishes to use the other method in the regulations for computing the new interest rate, HUD requests that the lender contact the FHA Single Family Program Development Office at 202-708-2121 for further guidance.

Method of Calculating Interest Rate Adjustments

The mortgagee and the borrower negotiate the initial interest rate and margin. The margin must be constant for the entire term of the mortgage. To calculate the annual adjustments to the initial interest rate:

A. Determine the current index. "Current Index" means the most recent Index figure available 30 days before the Change Date.

The index used, based on the weekly average yield on United States Treasury securities adjusted to a constant maturity of one year, must be the one effective on the date thirty (30)

calendar days before the Change Date. The Federal Reserve Board Statistical Release H.15

is published weekly on Monday, or, on Tuesday, if Monday is a Federal holiday. The index figure shown on that release is effective the day it is issued until such time a new H.15 index is published.

The following are examples of the proper index figure to use when the 30th calendar day falls on:

1. A Monday that is a business day. Use the index figure contained in the H.15 release issued that Monday, if the 30th calendar day prior to a Change Date and the issue date of an H.15 release both occur on the same day, i.e., they both occur on a Monday.

2. A Monday that is a Federal holiday. Use the index figure in the H.15 release issued the prior week if the 30th calendar day before the Change Date falls on a Monday that is a Federal holiday.

3. A day of the week other than Monday. Use the index figure in the H.15 release issued on the Monday of that week (or issued on Tuesday if that Monday is a Federal holiday).

    For example, assume a December 1, 2003 Change Date. Thirty (30) calendar days before December 1 is Saturday, November 1. The correct index figure to use is the one contained in the H.15 release issued on Monday of that week, which is October 27.

B. Determine the calculated interest rate. This is the current index plus the margin (the number of basis points identified as "margin" in paragraph 5(C) of the model adjustable rate note) rounded to the nearest 1/8th of one percentage point (0.125 percent). This will comply with Ginnie Mae's requirement that the mortgages placed into Ginnie Mae pools must be rounded to the nearest 1/8th of one percentage point at each Change Date.

C. Compare the calculated interest rate (index plus margin, rounded to the nearest 1/8th of one percentage point) to the existing interest rate (rate in effect for the preceding 12 months) to determine the new adjusted interest rate. If the calculated interest rate is:

1. Equal to the existing interest rate, the adjusted interest rate will be the same as the existing interest rate.

2. Less than the existing interest rate:

a. For 1-, 3-, and 5-year ARMs, if the calculated interest rate is less than one percentage point (100 basis points) higher or lower than the existing interest rate, the calculated interest rate will become the new adjusted interest rate.

b. For 7- and 10-year ARMs, if the calculated interest rate is less than two percentage points (200 basis points) higher or lower than the existing interest rate, the calculated interest rate will become the new adjusted interest rate.

3. More than the existing interest rate:

a. For 1-, 3-, and 5-year ARMs, if the new calculated interest rate is more than one percentage point (100 basis points) higher or lower than the existing interest rate, the adjusted interest rate will be limited to one percentage point higher or lower than the existing interest rate. Index changes in excess of one percentage point (100 basis points) may not be carried over for inclusion in an adjustment in a subsequent year.

b. For 7- and 10-year ARMs, if the calculated interest rate is more than two percentage points (200 basis points) higher or lower than the existing interest rate, the calculated interest rate will become the adjusted interest rate. Index changes in excess of two percentage points (200 basis points) may not be carried over for inclusion in a subsequent year.

Adjustments in the interest rate over the entire term of the mortgage may not result in a change in either direction of more than five percentage points (500 basis points) from the initial contract interest rate for 1-, 3-, and 5-year ARMs or six percentage points (600 basis points) for 7- and 10-year ARMs.

D. An adjusted interest rate becomes effective on the Change and thereafter will be deemed to be the existing interest rate. The new interest rate will remain in effect until the next Change Date. During the term of the mortgage, each adjustment will be effective on the same date of each succeeding year.

Method of Rate Changes

Interest rate changes may only be implemented through adjustments to the mortgagor's monthly payments.

Computation of the Monthly Installment

If there is a new interest rate on the mortgage as a result of the above calculations, a new monthly payment must be determined. The monthly payment attributable to principal and interest will be calculated by determining the amount that is necessary to fully amortize the unpaid principal

balance during the remaining term of the mortgage. For this purpose, the unpaid principal balance

shall mean that which would be due on the Change Date if there had been no default in any payment, but reduced by the amount of any prepayments to principal. (Accordingly, the mortgagee must credit all eligible prepayments, but must not debit any delinquency.) Escrow requirements will then be added to principal and interest to arrive at the new monthly payment.

Since interest is payable on the first day of the month following the month in which it accrued, the borrower will begin to pay the new monthly payment 30 days after the Change Date, provided the borrower is given proper notice as required under the Annual Disclosure section of this Mortgagee Letter.

All ARM adjustments affect interest percentages only; negative amortization is not permitted.

Annual Adjustment Notice

At least 25 days before any adjustment to a mortgagor’s monthly payment may occur, the mortgagee must advise the mortgagor of the new mortgage interest rate, the amount of the new monthly payment, the current index, and how the payment adjustment was calculated.

There are two basic steps which the mortgagee must take each year with respect to the interest rate adjustment:

Step 1: Make the computation to adjust the interest rate and the monthly payments. The first adjustment to the interest rate will become effective on the day specified in paragraph 5A of the ARM Note (Change Date) and thereafter each adjustment will be effective on the same date of each succeeding year during the term of the mortgage. (As previously noted, the new monthly payment is effective 30 days after the Change Date.)

Step 2: At least 25 days before any adjustment to a mortgagor’s monthly payment may occur, the mortgagee must advise the mortgagor of the new mortgage interest rate, the amount of the new monthly payment, the current index, and how the payment adjustment was calculated.

The mortgagee's obligation to compute, adjust the interest rate, if necessary, and give notice to the mortgagor on the prescribed dates, is not affected by delinquencies or foreclosures so long as the mortgage debt exists. It is the mortgagee's responsibility to see that its collection actions continually update the mortgage debt. Notice of any adjustment to the interest rate and monthly payment, increase or decrease, must be mailed to the mortgagor at least 25 days prior to the change in payment. (If an existing mortgage provides for 30 days notice, that provision must be followed.) Our rule concerning the timing of the annual notice of adjustment is consistent with Federal Home Loan Bank Board (FHLBB) regulations and policy.

The Adjustment Notice must contain (a) the date the Adjustment Notice is mailed, (b) the Change Date, (c) the existing interest rate, (d) the adjusted interest rate, (e) the current Index and publishing date, (f) the method of calculating the adjustment to the monthly payments, (g) the amount of the adjusted monthly payments, and (h) any other information which may be required by law from time to time. The Notice should contain other relevant information such as an explanation of why the adjusted interest rate is less than the calculated interest rate when the cap is reached.

The content of the Adjustment Notice must meet the criteria of 24 CFR 203.49(h).

It is recommended that the Notice be sent to the mortgagor by Certified Mail, Return Receipt Requested. However, a Notice addressed and mailed via first class mail to all property owners identified on the mortgagee's records shall be sufficient unless the mortgagors' whereabouts are known to be elsewhere. A Notice must be given each year, even if the existing interest rate does not change.

For HUD review purposes, lenders must keep evidence that timely notice has been given, and evidence of the annual adjustment computations retained for the mortgage term. A file copy of the suggested HUD annual adjustment notice will be sufficient to satisfy this requirement. However, should disputes arise as to timely notice or as to the annual adjustment computations, compliance with our suggested methods may not satisfy local legal interpretations of the mortgage provisions in determining whether the evidence was sufficient. Lenders should, therefore, be guided by the advice of counsel in matters concerning the type and duration of record retention.

The mortgagee's collection personnel should be alerted to the prospect of Notice not being received by the mortgagor, and should take appropriate remedial action when necessary. If the mortgagor's payments do not reflect the increase or decrease recited in the Notice, a follow-up call should be made to determine if the Notice was received. If it is determined that the Notice was not received, a duplicate should be mailed promptly.

Failure to Provide Timely Notice

If the mortgagee fails to provide notice for more than one year, an Adjusted Interest Rate must be determined for each omitted year because the calculations for each year affect the rate for subsequent years. The one and two percentage point limitations, and five and six percentage point caps are applicable each year and must be taken into consideration in determining the new Interest Rate. The mortgagee's failure to provide Notice in advance of each Change Date results in penalties (to be found in the Note) to the mortgagee.

Although the new interest rate may increase, the mortgagee is prevented from collecting any increase in payments until such time the Notice has met the required 25 days advance notice requirement. If timely notice is not provided, the lender forfeits its right to collect the increased amount and the borrower is relieved from the obligation to pay the increased payment amount.

In the event that the new interest rate was to decline, the failure of the mortgagee to provide proper Notice would result in overpayments until the mortgage rate was properly adjusted. In such case, the mortgagee must refund the excess with interest, at a rate equal to the sum of the Margin and the Index in effect on the Change Date, from the date of the excess payment to the date of repayment. The borrower has the option of a cash refund or application of the excess to the unpaid principal balance of the mortgage, after application of the refund to any existing delinquency.

Failure to Provide Accurate Notice

If the mortgagee miscalculates the interest rate and/or the monthly payment, and the error(s) are reflected in the Notice, HUD takes the position that the errors need to be corrected. However, HUD takes no position as to whether an erroneous Notice would constitute a failure to provide notice under the terms of the mortgage contract. This is a legal matter subject to local law and court interpretation.

Sales, Assignments and Transfers of Servicing Among Mortgagees

It is the responsibility of the transferor (seller) to provide the transferee with complete servicing records reflecting total compliance with ARM disclosure and reporting requirements. Although HUD regulations require the transferee/assignee to assume all servicing obligations, we do not intend that a negligent ARM mortgagee-transferor be permitted to avoid its disclosure obligations. In the event that a failure of Notice or other error is discovered, it shall be the responsibility of the mortgagee-transferor who was holding the loan when the failure occurred, to reimburse the mortgagee currently holding the loan, where any burden of refund to the mortgagor is required.

Assumptions

Lenders should encourage sellers to disclose the terms of an existing ARM in any sales transaction; however, when an assumption takes place both the seller and the lender should assume responsibility for notifying the purchaser (assumptor) about the terms and conditions of the ARM.

As soon as the lender becomes aware of an assumption and has the name of the purchaser, it should provide the purchaser with a copy of the original Disclosure Statement and an explanatory letter addressing the ARM obligations. Documented acknowledgement of the assumptor's receipt of this information is advisable.

For assumption transactions which require a creditworthiness review or in cases where a release from personal liability is requested and approved, the lender must prepare a new Disclosure Statement to ensure that the purchaser is aware of the ARM obligation. Processing of the HUD-92210, Request for Credit Approval of Substitute Mortgagor, and/or HUD-92210.1, Approval of Purchaser and Release of Seller or other similar forms used by the lender, must be based on the interest rate in effect at the time the complete credit review package is submitted to the DE

Underwriter.

Statistical Information

To track ARM activity, the following case number suffix codes (Section of the Act ADP Codes) will be indicated on all HUD application addendums (Form HUD-92900) and printed on computer generated mortgage insurance certificates (Form 59100). The suffix codes for DE cases are as follows:

Eligible Program	Section of the Act Suffix Code – Direct Endorsement
203(b)	729
223(e)	829
203(k) first lien	730
234(c)	731
247 - Hawaiian Homelands	780
248 - Indian Lands	788
203(k)- Condominium	815

Product Identifier

In addition to existing Automated Data Processing (ADP) codes assigned to ARMs, a hybrid ARM-type indicator has been added to FHA's Computerized Home Underwriting Management System (CHUMS). When submitting loan data to FHA via the FHA Connection or its functional equivalent, if an ARM is indicated by an ADP code, the lender must also identify the type of ARM by selecting the 1-, 3-, 5-, 7- or 10-year ARM-type indicator. This process is less likely to result in errors than adding additional ADP codes for each individual hybrid ARM offering.

Definitions

INDEX — The weekly average yield on United States Treasury securities adjusted to a constant maturity of one year (published in the Federal Reserve Bulletin H.15). See ARM Note.

CURRENT INDEX — The most recently available Index published 30 calendar days before the Change Date.

CHANGE DATE — The effective date of an adjustment to the interest rate (called the Interest Rate Adjustment Date by Ginnie Mae). The date is specified in paragraph 5(A) of the ARM Note. (This is not the date on which monthly payments

change.)

MARGIN	The agreed upon number of percentage points added to the Current Index to determine the Calculated Interest Rate. The number is specified in paragraph 5(C) of the ARM Note, and remains constant for the life of the mortgage.
INITIAL INTEREST RATE	The interest rate stated in the note that will be in effect from the date of the first monthly payment for the initial: 12 to 18 months on a 1- year ARM, 36 to 42 months on a 3- year ARM, 60 to 66 months on a 5- year ARM, 84 to 90 months on a 7- year ARM, and 120 to 126 months on a 10- year ARM (See Frequency of Interest Rate Changes above.)
CALCULATED INTEREST RATE	The Current Index plus the Margin, rounded to the nearest one-eighth of one percentage point (0.125%). The Calculated Interest Rate is used to determine the Adjusted Interest Rate.
ADJUSTED INTEREST RATE	The new interest rate effective for the twelve month period following each Change Date. (The Adjusted Interest Rate will become the Existing Interest Rate on the next Change Date.)
EXISTING INTEREST RATE	The interest rate in effect immediately prior to any adjustment on the pending Change Date.

If you have any questions about this Mortgagee Letter, please contact your local Homeownership Center in Atlanta (888-696-4687), Denver (800-543-9378), Philadelphia (800-440-8647), or Santa Ana (888-827-5605).

Sincerely,

John C. Weicher
Assistant Secretary for Housing-
Federal Housing Commissioner