Economic Effects of Enforcing Due-on-Sale Clauses

The housing industry in the United States has been in a severe slump over the past three years. High interest rates have sharply reduced both new housing starts and sales of existing homes. Although the housing industry recently has begun to show signs of recovery, existing single-family home sales are still nearly two million below the peak of almost four million reached in 1978.

Potential sellers of houses have developed several methods of "creative financing" in an attempt to make their homes more attractive to buyers. The most popular creative financing technique has been the assumption of an existing mortgage by the home buyer. This technique enables the buyer to continue to make payments on the existing mortgage of the house that is purchased. In 1981, about one million home sales—almost half of the sales of existing homes—involved assumptions of existing mortgages.[1] Many of these assumptions took place at interest rates substantially below market interest rates.

In October 1982, the Congress passed the Garn-St Germain Depository Institutions Act, which among other things will permit enforcement of due-on-sale clauses in many mortgage contracts. These clauses allow lenders to require full payment of the remaining mortgage debt when a home is sold (box). The Congressional action was a response to actions taken by the legislatures and courts in several states which limited due-on-sale enforcement.

This article examines the impact of the Congressional action and concludes that stricter enforcement of due-on-sale clauses could lower mortgage rates and stimulate housing activity. In addition, the earnings of thrift institutions that issued low-rate mortgages may be improved substantially by the repayment of these loans. However, there are some losers, namely, homeowners who formerly could offer attractive financing via assumptions of old mortgages issued at low interest rates. The net result most likely will be a benefit to home buyers as a group, lending institutions, and the construction industry and a loss to homeowners who are no longer released from the due-on-sale clauses in their mortgages.

The value of an assumable mortgage

At times of high interest rates, assuming a low-interest mortgage is similar to obtaining a new loan at an interest rate below the market rate. A loan carrying an interest rate lower than the market rate on new loans is a valuable commodity to someone who needs a loan. That is, a home buyer would be willing to pay a premium to obtain such a loan. In 1981, three quarters of the mortgages assumed had an interest rate more than 2 percentage points below the going market rate.

The author wishes to acknowledge the assistance of David Kroop and Daniel Rossner of the Legal Department in preparing the box.

[1] National Association of Realtors, *Attitudes of Real Estate Industry* (November 1981), page 9. This figure includes homes purchased "subject to" an existing mortgage. This technique is similar to a mortgage assumption except that liability in event of default lies with the original owner rather than with the new home buyer.

The value of the assumable mortgage to a home buyer is the difference between the present discounted cost of payment streams on the old assumable mortgage and a new market-rate mortgage for the same amount. The table shows some sample calculations of the value of a below-market-rate mortgage. For example, the present discounted cost of a $100,000, 8 percent mortgage with a ten-year maturity is $78,140 if the current interest rate is 14 percent, whereas a mortgage of 14 percent has a present discounted cost of $100,000. This means that a home buyer would be willing to pay up to $21,860 to assume a $100,000 mortgage with an 8 percent interest rate. Ignoring tax considerations for the moment, a buyer should be indifferent between (1) paying $121,860 for a house and assuming a $100,000 ten-year mortgage at 8 percent and (2) paying $100,000 for the same house and obtaining a $100,000 ten-year mortgage at 14 percent.

Present Discounted Value of a Below-Market-Rate Mortgage

In dollars

	Original Mortgage Rate and Years Remaining to Maturity								
Market rate	8 percent original rate			10 percent original rate			12 percent original rate		
(percent)	10 years	15 years	20 years	10 years	15 years	20 years	10 years	15 years	20 years
14	78,140	71,760	67,260	85,110	80,690	77,600	92,400	90,120	88,550
16	72,430	65,070	60,120	78,890	73,170	69,360	85,650	81,720	79,140
18	67,330	59,340	54,200	73,340	66,730	62,530	79,620	74,530	71,350

Entries show the estimated present discounted value of a payment stream for a $100,000 mortgage with an original 8, 10, or 12 percent contract rate when the market rate is 14, 16, or 18 percent.

Source: *Thorndike Encyclopedia of Banking and Financial Tables,* Revised Edition (Boston: Warren, Gorham, Lamont, Inc., 1980).

Recent Developments Affecting the Due-on-Sale Clause

Many conventional mortgages have clauses requiring immediate payment of the entire mortgage debt upon sale of the home. The enforcement of these so-called "due-on-sale" clauses was restricted or challenged by state law, including court rulings, in eighteen states.* In these states, due-on-sale clauses were generally unenforceable and mortgages could be "assumed" from the previous owners by home buyers.

On June 28, 1982, the United States Supreme Court ruled that certain due-on-sale clauses could be enforced. Specifically, Federally chartered savings and loan associations could, in accordance with a 1976 Federal Home Loan Bank Board (FHLBB) regulation, require full payment on outstanding mortgages containing a due-on-sale clause if the property were transferred or sold. On October 1, 1982, the Congress enacted the Garn-St Germain Depository Institutions Act of 1982, which among other things preempts state laws restricting the enforcement of due-on-sale clauses. The measure was signed into law by President Reagan on October 15, 1982.

The act gives lenders the right to enforce due-on-sale clauses contained in real property loan agreements in most cases, notwithstanding state constitutional, statutory, and judicial restrictions on such enforcement. However, a state's restrictions on enforcement of due-on-sale clauses will continue to apply until October 15, 1985 to loans made by lenders during a "window period" specified as the period prior to the act's enactment when the state's restrictions were in effect. State legislatures may act prior to October 15, 1985 to regulate the terms of window-period loans made by non-Federally chartered lenders and, in so doing, can extend state restrictions on the enforcement of the loan's due-on-sale clauses to the period after October 15, 1985. Similar authority to regulate window-period loans is given to the Comptroller of the Currency with respect to national bank loans and to the National Credit Union Administration Board with respect to national credit union loans. No window period applies to loans by Federal savings and loan associations or Federal savings banks.

* The states are Arizona, Arkansas, California, Colorado, Florida, Georgia, Illinois, Iowa, Michigan, Minnesota, Mississippi, New Mexico, New York, North Dakota, Ohio, Pennsylvania, Utah, and Washington. For a state-by-state summary, see "Due-on-Sale—The National Picture", *Mortgage Banking* (October 1981), pages 24-27.

(This assumes the buyer is able to finance the $21,860 premium at a rate of 14 percent.) The assumable mortgage adds $21,860 to the value of that house.

Several factors reduce the value of an assumable mortgage below the present discounted value of the difference in payment streams between market-rate and low-rate assumable mortgages. First, tax considerations tend to reduce the value of an assumable mortgage. An individual not deducting interest payments from income is indifferent between two dollar-equivalent payment streams that have differing proportions of principal and interest. However, a home buyer deducting interest prefers a payment stream with a higher proportion of interest. Assumption of a low-rate mortgage involves trading off lower interest payments for higher levels of payments of principal. Thus, the value of the low-rate mortgage is less to high tax bracket buyers (itemizing deductions) than to lower tax bracket buyers.

Another factor to consider is the need to obtain funds in addition to the assumable mortgage. The remaining balance on an assumable mortgage might be substantially less than the value of the house because of repayments of principal and increases in home prices. A buyer assuming a mortgage might have to obtain a second mortgage to finance the difference between the value of the house and the remaining balance on the assumable mortgage, plus any premium paid for the assumable mortgage. A low-rate assumable mortgage combined with a second mortgage may entail a higher monthly payment stream for some period due to the shorter maturity of the assumed mortgage. This increased monthly payment stream may affect buyer qualification for a mortgage or create cash-flow problems, both of which would reduce the value of the assumed mortgage.[2]

Economic impact of due-on-sale enforcement

The buyers of homes that originally carried low-rate mortgages probably will be no worse off with the enforcement of due-on-sale clauses since the benefits of below-market-rate mortgages are likely to be replaced by lower housing prices.[3] The losers are the owners of houses in states that had prevented the enforcement of due-on-sale clauses, who are no longer able to capture the value of the low-interest mortgage when their houses are sold. In short, wealth is redistributed by more stringent enforcement of due-on-sale clauses. State actions restricting due-on-sale enforcement produced windfall gains to some home sellers at the expense of lending institutions. The Depository Institutions Act prevents this wealth transfer.[4]

Effects on the supply and demand for mortgage finance

The reduction of the number of mortgage assumptions is likely to have a stronger effect on the demand for mortgage funds by home buyers than on the supply of funds by lending institutions. The enforcement of the due-on-sale clause means that, when the holder of the low-rate mortgage sells the house, the existing mortgage is repaid in full. This results in a flow of funds to the lending institution. If the lending institution channels all these new funds into the mortgage market, the total supply of mortgage money is unchanged in the short run.[5]

Total demand for mortgage funds, however, is likely to be affected by more widespread enforcement of the due-on-sale clause. If a due-on-sale clause is enforced, the price of a house with a low-rate mortgage will not incorporate a premium attributable to the desirable financing. Thus, a smaller amount of financing would be required by buyers of existing homes with due-on-sale clauses. Initially, then, the total demand for mortgage funds would fall. If the supply of funds offered by lending institutions is unchanged, mortgage rates probably would be lower than they would be without the increased amount of due-on-sale enforcement.

Effects on thrift institutions

More rigorous enforcement of the due-on-sale clause should have a favorable impact on the earnings of the thrift industry. The approximately one million existing home sales in 1981 that involved assumption of a mortgage amounted to an estimated dollar volume of as-

[2] See "Accelerating Inflation and Nonassumable Fixed-Rate Mortgages: Effects on Consumer Choice and Welfare", Patric Hendershott and Sheng Hu, *Public Finance Quarterly* (April 1982), pages 158-84.

[3] If markets are efficient, the drop in the housing price should *exactly* compensate the buyer for the increased present discounted value of the payment stream from the market-rate mortgage. For empirical evidence that the value of the below-market-rate mortgage is capitalized into housing prices, see Kenneth T. Rosen, "Creative Financing and House Prices: A Study of Capitalization Effects" (University of California, Berkeley, Center for Real Estate and Urban Economics), Working Paper 82-52, August 1982.

[4] Those who gain from the Congressional action may have a lower or higher demand for housing than the wealth losers. For example, if the sellers of houses with low-rate mortgages had planned to use all their profits to buy more expensive houses and the gainers (*e.g.*, savings and loan association stockholders) invested all their gains in Treasury bills, then housing demand would fall when due-on-sale clauses are enforced. To the extent that beneficiaries of higher lending-industry profits are identical to the home sellers, the net wealth effect is diminished.

[5] This is a good assumption for thrift institutions, since most new lending by savings and loan associations and mutual savings banks is in the form of mortgages. This assumption may hold even for banks, if they wish to maintain a constant fraction of their asset portfolios in mortgages.

sumable mortgages of about $20.8 billion.[6] Since about 60 percent of the dollar volume of all mortgages made is held by thrift institutions, about $12.4 billion of mortgages from thrift institutions was assumed in 1981. This figure includes Federal Housing Administration and Veterans Administration (FHA/VA)-insured mortgages, which do not contain due-on-sale clauses. FHA/VA mortgages constituted about 20 percent of home mortgage debt in 1981, declining from about 30 percent in 1972. Allowing that 25 percent of mortgage assumptions in 1981 involved FHA/VA mortgages gives an estimate of about $9.3 billion in mortgages containing due-on-sale clauses which were assumed in 1981.

Data from the National Association of Realtors suggest that the average mortgage assumption made in 1981 was 4.3 percentage points below the market rate. If these assumed mortgages would have been replaced by mortgages at the then market rate, thrift revenues would have increased by 0.043 times $9.3 billion, or about $400 million.[7] This amounts to about 7 percent of their losses in 1981. For 1983, the increase in thrift revenues will depend on the difference between the level of market mortgage rates and the rate on mortgages which will have due-on-sale clauses enforced as a result of the Congressional action.

Another estimate of the effect of increased due-on-sale enforcement on thrift institution earnings is available from a Federal Home Loan Bank Board study. The FHLBB has estimated that the "potential earnings [gains] two years after a nationwide [enforcement] on due-on-sale clauses run from $1.0 billion to $1.3 billion for all Federal and state associations".[8] This estimate is somewhat larger than the one given above, but it is not far different since it is based on two years' worth of assumable mortgages being replaced by market-rate mortgages. The FHLBB has projected that, without these transfers, the number of savings and loan associations encountering "net worth deficiencies" would be about 17 percent higher than if the due-on-sale clause were enforced.[9]

Effects on the housing market

The enforcement of due-on-sale clauses could have a favorable impact on the housing market. As noted earlier, due-on-sale enforcement reduces the demand for mortgage money since the value of the below-market-rate assumable mortgage no longer need be financed by the buyer. This initially lowers the mortgage rate, making it less expensive to finance a home purchase. As a consequence, demand for housing should increase. The greater demand for housing increases its price and encourages new construction.[10]

Summary

The Garn-St Germain Depository Institutions Act, passed by the Congress in 1982, contains a provision which will enable many lending institutions to enforce due-on-sale clauses in mortgage contracts in states that had previously prohibited such enforcement. The major impact of the stricter enforcement of due-on-sale clauses will be a redistribution of wealth from owners of homes with mortgages (which had due-on-sale clauses restricted by state actions) to the lending institutions holding these mortgages. This transfer of wealth could amount to several hundred million dollars, depending on the amount by which market interest rates exceed contract rates on outstanding mortgages. In addition, the increased enforcement of due-on-sale clauses may well lower the rate on new mortgages, thereby increasing the demand for housing and stimulating home building.

[6] The following assumptions were made: (1) the average age of assumed mortgages was ten years and the initial maturity was twenty-seven years, (2) the initial sales price was $32,500, of which 78 percent was financed using a mortgage with a contract rate of 7.50 percent.

[7] The $400 million figure is an overestimate for at least two reasons. First, many mortgages with due-on-sale clauses have been renegotiated at higher rates when the underlying property was sold. The assumed mortgage is often combined with a second mortgage at a "blended" rate between the contract rate on the original mortgage and the market rate. These types of agreements may continue after the Congressional action. Second, some mortgages which are not FHA/VA insured do not contain due-on-sale clauses.

[8] "Final Report and Technical Papers of the Task Force on Due-On-Sale" (Federal Home Loan Bank Board, March 1982), page 2.

[9] These increased profits allow the thrift industry to compete more readily for funds and thus might increase the supply of money available for mortgage finance. This effect would reinforce the lowering of mortgage rates described in the previous section.

[10] The rise in the price of housing offsets some of the gain to new buyers from the lowered mortgage rate. Offsetting new construction is a possible reduction of the supply of existing homes. For any given market price of houses, the seller who had a low-rate formerly assumable mortgage obtains less on a home sale when a due-on-sale clause is enforced.

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