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The California Mortgage Market**

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**Krannert Graduate School of Management
Purdue University**

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**AN ECONOMIC ANALYSIS OF
THE "DUE ON SALE" CLAUSE IN
THE CALIFORNIA MORTGAGE MARKET**

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INTRODUCTION AND SUMMARY

Two recent decisions of the California Supreme Court have drastically changed the standard mortgage contract used in the State of California. In the case of *Tucker v. Lassen Savings and Loan Association* in 1974 the court decided that automatic enforcement of a "due on sale" clause when property is sold on installment contract constitutes an unreasonable restraint against alienation, i.e., it inhibits the salability of the property. On August 25, 1978, in the case of *Wellenkamp v. Bank of America et. al.*, the Court extended its earlier decision and held that automatic exercise of the "due on sale" clause in an outright sale of property is also an unreasonable restraint on alienation. These decisions have immediate and significant implications for the availability and pricing of mortgage loans in the State of California and, to the extent that the California decisions are harbingers of actions in other states, around the country.

California stands alone in its negative view of the "due on sale" clause. Virtually every other state has either explicitly or implicitly recognized the useful role served by the "due on sale" clause in fixed-rate mortgage loans in times of high and volatile interest rates. While the "due on sale" clause once primarily served as a control on the credit worthiness of new home owners assuming mortgages, it is now used to limit the expected maturity of fixed-rated mortgage loans. This limits the amount of insurance against interest rate fluctuations which is sold to the borrower in a fixed-rate mortgage. California's restriction on the use of the "due on sale" clause is in vivid contrast to its progressive attitude on the use of alternatives to the fixed-rate mortgage, particularly the variable-rate mortgage. By permitting innovative new mortgage loans on the one hand but at the same time restricting important terms of the standard mortgage contract, the state courts and regulators have created one of the most unusual mortgage markets in the country. The question at issue concerning this market is whether the right to form fixed-rate mortgage contracts with the "due on sale" clause, like the right to contract for VRM's, is in the consumers' best interests.

This report examines the economics of the "due on sale" clause in a mortgage loan, with particular emphasis on the role of the "due on sale" clause in the California mortgage market. Although economists have written extensively on the mortgage market in California and throughout the nation, very little attention has been directed explicitly toward the "due on sale" clause. While this inattention is explicable, it is unfortunate because the Court in evaluating the "due on sale" clause has had no well received economic analysis upon which it could rely. As a result, in restricting the use of the "due on sale" clause it has unwittingly deprived consumers of the right to use a valuable form of mortgage contract. This report contains an economic analysis of the "due on sale" clause which demonstrates why unrestricted use of the clause is in the interest of both borrowers and lenders. In addition, the report indicates a need for potential legislative action restricting the imposition of fixed charges in conjunction with exercise of the "due on sale" clause.

The report is divided into four chapters, the first of which provides an overview of the California mortgage market. It documents the types and sizes of institutions in the market and characterizes the economics of mortgage lending in a time of high and volatile interest rates. It is pointed out that the primary source of funds for mortgage borrowers is savings and loan institutions which are compelled to obtain funds with short maturities but make loans with long maturities. The basic problem for an efficient mortgage market is explained as one of intermediating across time.

Chapter 11 is devoted to analysis of the pricing of fixed-rate mortgage contracts with and without the "due on sale" clause. It is demonstrated that, other things being constant, a fixed-rate mortgage without the "due on sale" clause will have a higher price because it insulates the borrower against fluctuations in interest rate to a greater degree than does a mortgage which includes the clause.

Chapter III summarizes the history of the "due on sale" clause in the California courts. In addition, the economic basis of the arguments used by the Supreme Court in the *Wellenkamp* decision is critically evaluated. It is argued that

the Court's decision reflects a lack of understanding of the pricing of fixed-rate mortgages. Specifically the Court's decision does not appreciate the fact that the right to a specific interest rate is a product which is sold in the market place. The "due on sale" clause defines the characteristics of the product and, therefore, the price that it will command.

The fourth chapter of the report examines the economic impact of restricting use of the "due on sale" clause. First, it is argued that because there are existing mortgages which were priced on the assumption that the "due on sale" clause could be exercised, ex post restrictions on the exercise of the clause create a boon for current property owners but penalize lenders. It should be noted that new buyers of property receive no benefit. Second, it is argued that mortgage rates will increase for fixed-rate loans deprived of the "due on sale" clause. Third, it is argued that this hurts the vast majority of consumers who probably would have otherwise preferred a fixed-rate loan with a lower rate and the "due on sale" clause because they are now forced to choose between the variable-rate mortgage and the fixed-rate loan without the clause. Finally, it is argued that such restrictions could only be justified if lenders could use the "due on sale" clause to take unfair advantage of consumers. The only serious opportunity for such a practice lies in the ability to extract prepayment penalties in conjunction with exercise of the "due on sale" clause.

CHAPTER I

CALIFORNIA SAVINGS AND LOAN ASSOCIATIONS AND THE PROVISION OF MORTGAGE CREDIT

The savings and loan industry is both the nation's and California's largest supplier of residential home mortgages, and it is the only major financial intermediary which is constrained by law and regulation to employ its assets in residential mortgage lending. Because of its inability to shift into or out of residential mortgages, this industry is the most heavily affected by the "due on sale" clause decisions. This chapter explores the nature of savings and loan associations and their financial profile in the State of California. It also provides a review of the financial services involved in residential mortgage markets. The financial functions performed by mortgage lending associations will be examined and an analysis made of the mortgage instrument in terms of the economic questions raised by the recent California Supreme Court decisions concerning the "due on sale" clause.

California Savings and Loan Associations

In California, as in the balance of the nation, the single largest provider of mortgage loans for owner-occupied dwellings is the savings and loan business. Because of its dynamic nature in terms of economics and demographics, the State of California has traditionally led the nation in mortgage lending activity. In 1976, of approximately \$77 billion of mortgage loans made by insured savings and loan associations in the United States, more than 23 percent were handled by California firms.

Table I gives an indication of the assets in mortgage portfolios of California's savings and loan institutions as of December 31 of each year since 1973. As the table shows, the 1977 total assets of the associations domiciled in California were \$83.3 billion, \$55 billion of which were of those institutions licensed by the State of California. The involvement of savings and loan associations in the mortgage market is indicated by the \$70.7 billion of assets held in mortgages. Approximately 85 percent of all associations' total assets were committed to mortgage loans, while for state chartered associations the ratio was 86 percent or greater over the five-year period shown. When allowances are made for required working capital funds and legally required liquidity, the only major asset of California savings and loan institutions is their mortgage portfolio. The apparent demand for financial services provided by savings and loan institutions has been strong in California during the past five years. From 1973 to 1977, asset growth of these institutions averaged 15 percent per year, while the associated mortgage portfolios grew at an average rate of 14.5 percent. At a compound annual growth rate of 14.5 percent per year, California savings and loan associations are doubling their mortgage portfolios approximately every five years.

Because of the predominance of mortgage loans in the portfolio, interest from loans and contracts provides the majority of association income. In 1977, approximately 81 percent of gross operating income of associations was provided by interest on mortgage loans and contracts. It is interesting to note that while savings and loan associations held 85 percent of their assets in mortgage loans for 1977, these assets provided only 81 percent of the associations' income. Table 11 provides a recap of the interest earned on mortgage loans for the period 1973 through 1977. As the exhibit shows, yields on mortgage portfolios have been increasing in line with the generally increasing interest rates in the economy and the roll-over of lower yielding loans into newer, higher yielding loans. The average yield over the five-year period increased from 7.3 percent to 8.2 percent, or an increase of 90 basis points.

TABLE I
Assets and Mortgage Portfolios of
Insured California Savings and Loan Associations^a

	<i>Total Assets</i> <i>(bil. of dollars)</i>		<i>Mortgage Loans</i> <i>(bil. of dollars)</i>		<i>Mortgage Loans as a</i> <i>Percent of Total Assets</i>	
	Total	State Total	Total	State Chartered	Total	State Chartered
1973	47.1	21.8	41.1	28.0	87	88
1974	50.8	33.8	43.8	29.5	86	87
1975	58.0	37.6	49.1	32.5	85	86
1976	69.1	45.1	58.6	38.8	85	86
1977	83.3	55.0	70.7	47.5	85	86

^aFigures are as of December 31.

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSLIC-Insured Savings and Loan Associations 1973 through 1977*.

TABLE 11
Return On Mortgage Portfolios of Insured
California Savings and Loan Associations^a

	<i>Mortgage Loans</i> <i>(bil. of dollars)</i>	<i>Interest on loans</i> <i>(bil. of dollars)</i>	<i>Average Yield</i> <i>Percent</i>
1972	37.2	-	-
1973	41.1	2.87	7.3
1974	43.8	3.19	7.5
1975	49.1	3.56	7.7
1976	58.6	4.27	7.9
1977	70.7	5.32	8.2

^aYields are computed by dividing beginning and ending mortgage loan balances into two times interest on loans.

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSLIC-Insured Savings and Loan Associations 1972 through 1977*.

The greatest proportion of savings and loan association assets is invested in mortgage loans, and the largest single source of funds is savings accounts solicited from the general public. Of the approximately \$73.8 billion dollars of liabilities held by California associations at the end of 1977, \$66.9 billion were provided by savings accounts. Savings accounts supply about 80 percent of the funds to finance association assets. The majority of the capital costs of associations are incurred in purchasing savings balances. Table III shows the average cost of savings to California associations over the period 1973 to 1977. This cost has been rising on a basis similar to that of the yield on mortgage loans, and has grown from 5.6 percent in 1973 to an average cost of 6.5 percent in 1977. It is the spread between the cost of funds - which, to a large extent, is the cost of savings and the yields achievable on the mortgage portfolio which determines the ability of the savings and loan industry to satisfy the continued demand for mortgage funds.

The cost to associations of providing mortgage credit and savings services is reflected in the schedule of operation costs for California's savings and loan industry. Table IV shows operating costs for California associations for the period 1973 through 1977. As shown, there is some upward trend in the operating costs of these institutions, with 1977 levels amounting to 1.33 percent of mortgage loans and 1.13 percent of mortgage loans and 1.13 percent of assets. Average operating costs for the five-year period was 1.29 percent of loans and 1.11 percent of assets. Associations perform their intermediating function of obtaining savings and making mortgage loans at a cost of approximately \$1 per year for each \$100 of funds handled.

TABLE III
Cost of Savings of Insured
California Savings and Loan Associations^a

	<i>Savings Accounts</i> <i>(bil. of dollars)</i>	<i>Cost of Savings</i> <i>(bil. of dollars)</i>	<i>Average Cost</i> <i>Percent</i>
1972	35.7	-	-
1973	37.8	2.07	5.6
1974	39.4	2.33	6.0
1975	47.1	2.72	6.3
1976	57.1	3.31	6.4
1977	66.9	4.01	6.5

^aAverage costs are computed by dividing two times the cost of savings by beginning and ending savings accounts.

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSLIC-Insured Savings and Loan Associations 1972 through 1977*.

TABLE IV
Operating Expenses Insured
California Savings and Loan Associations

	Assets (bil. of Dollars)	Mortgage Loans (bil. of dollars)	Operating Cost (bil. of Dollars)	Cost as Percent of Loans	Cost as Percent of Assets
1973	47.1	41.1	.49	1.19	1.04
1974	50.8	43.8	.56	1.28	1.10
1975	58.0	49.6	.65	1.31	1.12
1976	69.1	58.6	.79	1.35	1.14
1977	83.3	70.7	.94	<u>1.33</u>	<u>1.13</u>
				1.29%	1.11%

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSLIC-Insured Savings and Loan Associations 1973 through 1977*.

TABLE V
Profitability of Insured California
Savings and Loan Associations

	Net Income (bil. of Dollars)	Assets (bil. of dollars)	Net Worth (bil. of Dollars)	<u>Net Income</u> Assets (percent)	<u>Net Income</u> Net Worth (percent)
1973	.38	47.1	3.28	.81	11.59
1974	.29	50.8	3.49	.57	8.31
1975	.33	58.0	3.72	.57	8.87
1976	.55	69.1	4.22	.80	13.03
1977	.82	83.3	4.76	<u>.98</u>	<u>16.53</u>
				.75	11.67

Source: Federal Home Loan Bank Board, *Combined Financial Statements FSLIC-Insured Savings and Loan Associations 1973 through 1977*.

A final picture of the financial positions of the California savings and loan associations can be drawn from examination of the profitability of associations over the past five years. Table V provides a record of net income as it relates to assets and net worth over the past five-year period. It shows a decline in profitability during the early part of the period, with a strong resurgence in 1976 and 1977. Over the five-year period, associations achieved a profitability level of .75 percent as a return on year-end assets and 11.67 percent on net worth.

The preceding illustrations concerning mortgages, savings, operating costs and profitability provide some background for discussing the economics of the "due on sale" clause and its effect on California's mortgage markets. The following section further investigates the nature of mortgage lending in California and, more specifically, the role of savings and loan associations.

Savings and Loan Structure in the State of California

Historically, there have been three major types of savings and loan associations operating in the United States, each subject to somewhat different regulatory constraints. These three types have been first, the mutual savings and loan association chartered by the federal government and having no capital stock holders. Ownership of this type of association is vested in the savings account holders, and in some states also the association's borrowers. While questions of federal preemption have been raised in the State of California, generally speaking federal mutual associations are supervised and regulated by the federal government. The principal regulators are the Federal Savings and Loan Insurance Corporation and the Federal Home Loan Bank Board. The second major type of savings and loan association is the state chartered mutual association, which is similar in its organization to the federally-chartered mutual, but which has as its chartering authority the state in which it is domiciled. These associations are subject to the jurisdiction of the state savings and loan, or financial, commissioner, and in the case of insured associations, to the Federal Savings and Loan Insurance Corporation. The third type is the state stock association, which is chartered by the individual states and the organization of which is similar to that of commercial banks or other ordinary corporate concerns having common stock holders as the final and residual owners. In a net financial sense, one of the major differences between the mutual and stock forms of organization is that a common stock dividend is never paid by mutual institutions. The stock form of organization is, of course, entitled to pay a dividend if earnings are available, and it commonly does so. In the State of California, as of December 31, 1977, there were 165 federally-insured savings and

loan associations. Seventy-four of these were federally-chartered, eight were state mutual associations, and 83 were state stock associations. Recently, while the federal government has not chartered new stock associations, it has allowed mutual (federal and state) associations to convert to a capital stock type of association on a limited basis.

Financial Services of Savings and Loan Associations

In accepting savings deposits and making mortgage loans, savings and loan associations and other mortgage lending thrift institutions are actually performing a number of financial services. Savings and loan associations belong to a group of institutions known as financial intermediaries. A financial intermediary is a financial institution or an individual taking a position between the original sources of investment capital and its final use for real investment. George G. Kaufman in his work "Financial Intermediaries and Variable Rate Mortgages,"¹ describes four types of intermediation performed by mortgage lending institutions. These are (1) denomination intermediation, (2) maturity intermediation, (3) risk intermediation, and (4) interest rate intermediation.

Denomination Intermediation

In performing denomination intermediation, mortgage lending institutions assemble funds through savings accounts and other debt obligations of various denominations and make mortgage loans of various denominations. In the absence of a financial intermediary, an investor would be required to invest the amount of mortgage funds which a borrower wished to borrow, or a borrower would have to be willing to borrow the amount which an investor had available to lend. Because of denomination intermediation, savings accounts are available in any denomination from \$1 to millions of dollars. Certain accounts require denominations of at least a minimum fixed amount, but in general a complete array of denominations is available to the saver. A borrower is able to borrow the amount of funds which he requires for a project without concern for the amount savers wish to save. The intermediary steps between the saver and the borrower and assembles or disassembles savings accounts and assembles or disassembles borrowers so as to profitably employ all savings funds available and clear the mortgage markets.

Maturity Intermediation

Mortgage lenders - and savings and loan associations in particular - are perhaps best known for their maturity intermediation. In plain language, the maturity intermediation performed by savings and loan associations is accomplished by borrowing short and lending long. The liabilities of a savings and loan association vary from virtually demand liabilities to those having maturities of five to ten years with some exceptions, such as mortgage pass through securities, which have longer maturities. As of September 1977, insured savings and loans in the U.S. had 40 percent of their consumer savings accounts in demand type passbook accounts, though this has declined more recently, and over 77 percent of savings accounts had maturities of less than two years. All savings and loan associations obtain their funds through short-term sources, while their predominant use of funds is for long-term permanent mortgage loans having maturities in the range of 25 to 30 years. The demand for maturity intermediation is evidenced by the massive use of maturity intermediating institutions by both savers and borrowers. Maturity intermination allows those having excess funds to place them on deposit based on the saver's preferred maturity. Through the use of passbook accounts, the saver is able to earn an interest return on deposits of an uncertain maturity. For those having more highly specified expectations concerning their future need for funds and liquidity, specific maturities are offered. At the same time,

¹ Federal Home Loan Bank Board, "Financial Intermediaries and Variable Rate Mortgages," ed. George G. Kaufman, Invited Research Working Paper No. 16, August 1977, p. 7.

savings and loan associations through maturity intermediation are providing long-term, fixed-rate loans which remove from the borrower all interest rate risk and funds availability risk.

Risk Intermediation

Financial institutions reduce risk and improve the efficiency of money and capital markets. When financial intermediaries are federally insured institutions, risk intermediation is combined with insurance to further differentiate the risk of institution assets and liabilities. In offering mortgage credit, savings and loan associations provide loans on residential, commercial and other types of property. The risks associated with these loans include risk characteristics associated with the borrowers, the extent of exposure which the institution has on the loan, and the demand factors which determine the intrinsic value of the property which is used as security. The risk associated with an individual piece of property may be substantial and may exceed the risk which the saver would be willing to bear in a direct investment. The uncertainty or risk associated with a large portfolio of such mortgage loans is greatly reduced. Because of diversification and portfolio effects, the relative risk of the total portfolio will be substantially below the risk associated with individual loans. As a result of this, the financial institution can issue liabilities which have lower risk than the individual assets of the association. In order to further reduce the risk of liabilities issued by major financial intermediaries, federal agencies including the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation have been created to insure savers against financial loss. Deposits in federally insured savings and loan associations, up to the insurance limit, can be considered essentially as safe as direct investment in U.S. Government securities.

Interest Rate Intermediation

Interest rate intermediation exists when the period for which the interest rate is fixed on an association's liabilities differs from the period during which the interest rate is fixed on the association's assets. When a savings and loan association takes fixed-rate deposits and makes variable-rate mortgage loans it is performing interest rate intermediation. The best example of this is, of course, the issuance of variable-rate mortgage loans by state-chartered savings and loan associations in the State of California.

Competition for Mortgage Loans

While all savings and loan associations in the State of California have relatively similar powers in regard to the deposit liabilities which they may create, the recent decisions concerning the "due on sale" clause have substantially altered both the nature of the existing mortgage loans of state chartered associations and their ability to offer a full range of mortgage loans in the future. The three types of permanent residential mortgage loans which are offered by California savings and loan associations include (1) the fixed rate, fixed-term loan, (2) the fixed-rate, fixed-term loan including an enforceable "due on sale" clause, and (3) the variable-rate mortgage loan. The fixed-rate, fixed-term loan is made at a given interest rate for a given number of years and does not include the "due on sale" clause, or it includes a "due on sale" clause which has been rendered unenforceable by the California Supreme Court at state chartered savings and loans.

The fixed-rate, fixed-term loan with an enforceable "due on sale" clause is a loan for a specified maturity and a specified interest rate, as in the previous case. However, the loan may be called or its interest rate may be adjusted in the event that ownership of the property changes. The variable-rate mortgage, which has been pioneered on a large

scale by California institutions, incorporates a mortgage interest rate which may change from time to time based on an interest rate index.

State-chartered associations are allowed to make fixed-rate, fixed-term loans, but are not allowed to make fixed-rate, fixed-term loans which include a "due on sale" clause for the purpose of adjusting interest rates, and are not allowed to enforce such a clause in existing loans. State-chartered associations are allowed to make variable-interest rate mortgage loans. Federally chartered associations are allowed to make fixed-rate, fixed-term loans, and are allowed to include a "due on sale" clause for purposes of interest rate adjustment. Since January 1, 1979 federally chartered savings and loan associations with home offices in California have been authorized to provide variable interest rate mortgage loans.

The "Due on Sale" Clause in the Provision of Financial Service

The California Supreme Court, by its recent decision concerning the "due on sale" clause, has caused two important impacts on institutional mortgage lenders and their saving and borrowing customers. First, the Court action has tended to hurt those who will be borrowing from state-chartered savings and loan associations in the future and from the equity security holders of those associations, and to benefit those individuals who currently have mortgage loans in place. Second, the Court has removed the right of state-chartered savings and loan associations to offer a full range of maturity intermediation.

The following chapters will examine the implications of these actions and their impact on existing and prospective savers and borrowers in California.

CHAPTER II

THE ROLE OF THE "DUE ON SALE" CLAUSE IN MORTGAGE LENDING

Introduction

The "due on sale" clause has served two basic functions in mortgage lending. Prior to the advent of high inflation rates and accompanying high, volatile interest rates in the 1960's, the "due on sale" clause was used primarily to insure that mortgages were not transferred to borrowers with high probabilities of default. That is, when a property was sold the mortgage was called due only if the new owner was viewed as uncreditworthy. However, as the economic environment in California and the nation changed from one of relatively stable prices and interest rates to one of high inflation and volatile interest rates, the principal role of the "due on sale" clause was transformed. It has become an important tool used by savings and loan institutions to control the expected maturity of their fixed-rate mortgage loans.

The principal objective of this chapter is to demonstrate the economic consequences for the pricing of fixed-rate mortgage loans which would follow from depriving mortgage borrowers and lenders of use of the "due on sale" clause. It will be demonstrated that without the "due on sale" clause mortgage lenders will have longer expected maturities on their loan portfolios than with the "due on sale" clause. As a result, lenders who promise a fixed interest rate for the life of the mortgages they issue will be committed to that fixed rate for a longer time period than if they issued mortgages with the "due on sale" clause. In effect, they will be issuing greater insurance against interest rate risk than was provided when they originated a mortgage incorporating a "due on sale" clause, in that, on average, borrowers will be insulated from fluctuations in market interest rates for a longer period of time. The increased insurance has a cost to the lender which, without other offsetting provisions in the loan contract, will have to be recovered from the borrower in the form of higher contract rates on fixed-rate mortgages. In this chapter no conclusions are drawn as to whether such changes will be in consumers' best interests (that is the subject of Chapter IV). This chapter merely points out the inevitable economic result of lengthening the average maturity of fixed-rate loans by the elimination of the "due on sale" clause.

This chapter is divided into two sections, with the first section presenting a discussion of the pricing of fixed-rate loan contracts when lenders acquire funds in short-term financial markets with fluctuating rates without use of a "due on sale" clause. The second section describes the impact on the pricing of these types of debt instruments when the maturity of the contract is lengthened through restrictions on the use of a "due on sale" clause. This section also points out that elimination of the "due on sale" clause would have the effect of increasing the contract rate on mortgage loans.

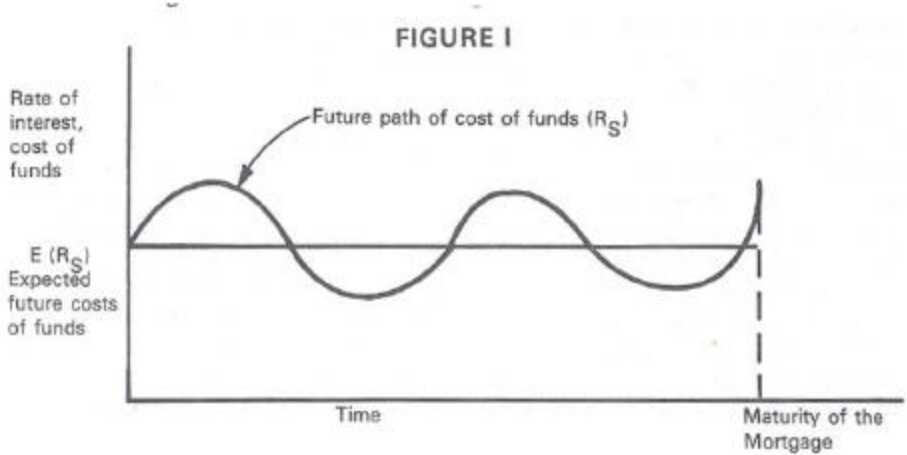
Pricing of Fixed-Rate Mortgage Loans

As discussed in Chapter 1, the economic fact of life for California savings and loan associations, and, in fact, for all savings and loan institutions in the country, is that they make loans with very long contract maturities but obtain funds with very short maturities. To a large degree this is because savings and loan associations are a unique type of financial institution created by legislative action specifically to provide mortgage loans financed largely by consumer savings. However, financial institutions in general provide a service which may be described as intermediating across time, i.e., borrowing short and lending long. But they only do so if they expect to make a profit from the provision of this risk-bearing service. Moreover, the larger the risks involved in such intermediation, the larger the price that will be demanded for long-term fixed-rate loans in a competitive market for intermediation.

In mortgage markets there are three basic determinants of the price demanded by lenders for intermediating across time by offering fixed-rate mortgage loans. These items are:

1. The risk aversion of lenders in the mortgage market, i.e., the premium that they demand to bear a specific amount of risk.
2. Lenders' expectations of the level and variability of future interest rates which are a proxy for their future cost of funds.
3. The extent to which legal, administrative or contract constraints increase or decrease the effect of variations in interest rates, e.g., rights of prepayment, prepayment penalties, etc.

In order to determine the impact of these factors on loan pricing, it is useful to consider a highly simplified mortgage market where lenders demand no premiums to accept risk, and where it is impossible for borrowers to refinance their mortgages if interest rates fall, i.e., there are infinite penalties for prepayment. Suppose also that lenders' costs of funds fluctuate in future periods and that lenders do not know with certainty what these future costs will be. A hypothetical path for the future cost of funds for a lender is illustrated in Figure 1. The curve in this figure exhibits no trend in the average cost of funds through time. Hence, lenders' expectations can be characterized in this simple case as being independent of time, such that lenders expect that the cost of funds will not increase or decrease through time. However, they do not know for sure what the cost will be in any particular future period.



Under these simplifying assumptions, lenders in a competitive mortgage market will expect to break even if they price fixed-rate loans so that the rate demanded - which can be represented as R_L - will be equal to the expected future costs of funds, $E(R_S)$, plus the lenders' other operating costs. The curves in Figure 1 illustrate why lenders will price in this manner. The lender expects that when the cost of funds rise above the expected rate a loss will be incurred, but when the cost of funds falls below the expected rate a profit will be made. As long as the rate on the loan is equal to the expected future cost of funds plus a margin for operating costs, losses will just offset profits and the lender will expect to break even over the life of the mortgage.

TABLE VI
Prepayment Charge*
25 Year Loan
Nine Percent Interest Rate on \$10,000 Loan

<i>Year of Prepayment</i>	<i>Amount Prepaid</i>	<i>Prepayment Charge</i>	<i>Cost of Loan Over Period Held (percent)</i>	<i>Refinancing Rate at which Borrower has an Advantage from Prepayment (percent)</i>
5	\$9,327.00	\$330.00	9.53	8.66
10	\$8,274.00	\$282.00	9.19	8.43
15	\$6,625.00	\$208.00	9.08	8.28
20	\$4,043.00	\$ 92.00	9.02	8.04

*Assumes maximum prepayment charge allowed by federally chartered savings and loan associations. Prepayment charge of six months interest on the amount prepaid less 20 percent of the original loan balance. Figures in this table were calculated in the following manner, using as an example the 10-year prepayment.

1. Figure the payment on a 9%, 25-year loan with monthly payments having an original balance of \$10,000. The payment equals \$83.9196.
2. Figure the payoff at end of year 10. The payoff, or unpaid balance, at year 10 equals \$8273.92.
3. Figure prepayment penalty. Prepayment penalty equals \$8273.92 minus $(.2 \times \$10,000) \times .09 \times .5$ which equals \$282.32. Total for total payoff including the prepayment charge equals $8273.92 + 282.32$.
4. The interest rate over period the loan held equals that rate of discount which equates a stream of 120 payments of \$83.9196 + a terminal amount at month 20 of \$8556.24 to the original amount of the, loan, \$10,000. Rate equals a 9.1843 percent.
5. Breakeven or refinancing rate at which borrower has an advantage from prepayment is calculated by finding the rate of interest which equates the original payment of 83.9196 over a 15-year period to the amount which would have to be borrowed to pay off the original loan, \$8556.24. This rate equals 8.4327 percent. This approach assumes that only the outstanding balance of the original loan is refinanced and no additional borrowing occurs.

NOTE: Under California law, this table would be relevant only to prepayments made within the first five years of the mortgage. The calculations ignore any incentive to wait for the end of the five-year period when prepayment penalties apply.

The actual operation of the California mortgage market is complicated by the fact that the assumptions invoked to simplify the pricing decisions do not necessarily hold. It is important to see the impact on the lender's pricing decision of dropping these assumptions. First, in the actual marketplace for mortgage loans it is possible to prepay when interest rates fall. If borrowers incurred no prepayment penalty, then whenever mortgage rates fell borrowers would pay off their outstanding loans and refinance at the new lower rates. Hence, lenders would no longer be assured that the losses they incurred when their cost of funds rose would be balanced by profits made when rates declined. Profits would be reduced, or losses incurred, as borrowers refinanced when mortgage rates fell. It is important to recognize that mortgage rates will not perfectly follow fluctuations in the lenders' costs of funds. Mortgage rates will change only when expectations of future short-term interest rates change. When mortgage rates fall below existing contract rates, borrowers determine whether it is profitable to prepay by comparing the magnitude of prepayment penalties plus the cost of a new loan with the cost of maintaining the original mortgage. If prepayment penalties are very high, the expected losses from prepayments will be low and lenders will set prices as described above. If prepayment penalties are low, lenders will be compelled to increase the price they charge for fixed-rate loans to cover the expected losses from prepayment when new mortgage rates decline. Examples of the borrower's prepayment decision are presented in the Tables VI and VII. The tables indicate the interest rate decline that would be necessary for prepayment to be

profitable depending on the time to maturity of the mortgage and its original terms. It should be noted that California statutes now prohibit any prepayment penalties after a loan has matured for a period of five years.

TABLE VII
Prepayment Charge*
30 Year Loan
10.5 Percent Interest Rate on \$10,000 Loan

<i>Year Prepayment</i>	<i>Amount Prepaid</i>	<i>Prepayment Charge</i>	<i>Cost of Loan Over Period Held (percent)</i>	<i>Refinancing** Rate at which Borrower has an Advantage from Prepayment (percent)</i>
5	\$9,687.75	\$403.61	11.11	9.97
10	\$9,161.84	\$376.00	10.72	9.91
15	\$8,274.84	\$329.43	10.59	9.81
20	\$6,778.82	\$250.89	10.54	9.64
25	\$4,255.63	\$118.42	10.51	9.32

*Assumes maximum prepayment charge allowed by federally chartered savings and loan associations. Prepayment charge is six months interest on the amount prepaid less 20 percent of the original loan balance.

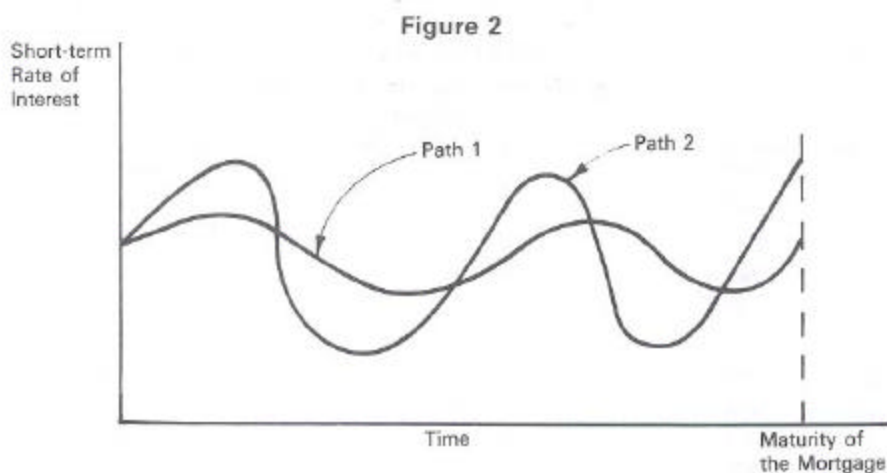
**Assumes that each borrower will refinance the unpaid balance and prepayment penalty over a period equal to the remaining maturity on the original loan. The breakeven interest rate is that which makes the monthly payment on the new loan equal to the payment on the original loan.

Figures for this table were calculated the same as for previous table.

NOTE: Under California law, this table would be relevant only to prepayments made within the first five years of the mortgage. The calculations ignore any incentive to wait for the end of the five-year period when prepayment penalties apply.

The tables present examples based on 30-year mortgages at 10 Y2 percent and 25-year mortgages at 9 percent.

The second simplifying assumption is that lenders demand no premium to accept the risk of insuring consumers against fluctuations in interest rates, or that lenders will be willing to accept additional risk without demanding additional compensation. If lenders demand to be compensated for the role of bearing risk, then they will demand higher prices for fixed-rate loans with increasing expected variability in short-term interest rates over the life of the loan. For example, Figure 2 illustrates two possible future paths for short-term interest rates which might be anticipated by lenders. These are drawn so that they both have the same average value, but Path 2 exhibits considerably more variability than does Path 1. If lenders expect that short-term interest rates may vary as much as illustrated by the second path they will view fixed-rate contracts as more risky than if they expected the variability illustrated in Path 1. Moreover, if lenders demand a compensation for risk bearing, then the higher variability will mean higher rates for fixed-rate loans.



Finally, the pricing decision will be more complicated if lenders expect that there will be an increasing or decreasing trend in interest rates over the life of the mortgage. If their expectations of interest rates are not the same in each time period or, more precisely, if the expected short-term rate is not independent of time, then the rate charged on the fixed-rate loan will be an average of the rates lenders expect will prevail over the life of the mortgage. If a lender had a perfect knowledge of the interest rate which would exist in each subsequent period, then the interest rate which he would need to charge for a loan of a given maturity would be the geometric average of the one period interest rates incorporated within the maturity. Table VIII shows the three-month treasury bill rate prevailing each January for the years 1967 through 1977. If a lender in 1967 had perfect knowledge of the interest rate for the next 11 years, and if these interest rates represented the basic cost of his funds, then the interest rate which he would have to have charged for a loan of any maturity in order to cover his basic cost of money could have been determined at the outset. In the example shown, if the loan were to be of a 6-year maturity, the interest rate which would have to have been charged would be 5.44 percent. Charging 5.44 percent for a loan of 6-years maturity would be precisely equal to making six one-year loans at the interest rate shown for the years 1967 through 1972. Similarly, if a lender were to make a loan for the entire 11-year period, the interest rate which he would have to charge to cover the basic cost of his money would be 5.61 percent, plus a premium for risk as discussed above. An important result of this is that if lenders expect rates to be increasing, interest rates will vary directly with the maturity of the loan.

Taken together, these considerations imply that the prices charged by competitive mortgage lenders for fixed-rate loans will be the sum of the following four factors: (1) the average of the short-term costs of funds that are expected to prevail over the life of the mortgage or $E(R_S)$, (2) a charge for the operating costs of the lender, (3) a premium for bearing the risk of variability in interest rates, P , and (4) a premium for the expected losses due to prepayments, L . This can be represented symbolically as:

$$R_L = E(R_S) + P + ? + L$$

TABLE VIII
Three Month Treasury Bill Rates for January

Year	Percent
1967	4.81
1968	5.09
1969	6.25
1970	8.02
1971	4.86
1972	3.65
1973	5.12
1974	7.42
1975	7.06
1976	5.18
1977	4.33

Source: Salomon Brothers, *An Analytical Record of Yields and Yield Spreads*.

An example will help illustrate the determinants of the price of fixed-rate mortgages. Suppose that over the life of the mortgage, lenders expect their future cost of funds to average eight percent, and that the expected variability of this cost or its variance will be three percent, i.e., it is likely to vary between five percent and 11 percent. Suppose also that in order to be compensated for accepting risk, lenders demand .5 percent on the contract interest rate on mortgages for each percentage point of variance in the future cost of funds. This means that lenders demand 1.5 percent compensation for the assumed risk of future interest rate fluctuations. Next, suppose that after lenders estimate the losses they expect to incur from prepayments they conclude that a .5 percent increase in mortgage rates will be required to offset this loss. Finally, suppose that operating costs represent 1.4 percent, which is close to their recent actual average (see Chapter 1). Under these assumptions, lenders would expect to break even if they offered mortgages at a rate of 11.40 percent (8 percent + 1.5 percent + .5 percent + 1.4 percent).

It is important to recognize that this pricing decision is based on forecasts of future events. The actual experience of a particular savings and loan association or of the savings and loan institutions in a region will depend on the actual cost of funds which materialize over the life of the loan. If costs of funds are below expectations, lenders will make exceptional profits. If actual costs are above expectations, they will incur losses. But the discipline of a competitive financial market will compel lenders to price mortgages so that they expect neither large gains nor losses.

Fixed-rate Loan Prices With and Without the "Due on Sale" Clause

The previous section develops the mortgage lender's pricing decision without explicit consideration of the role of the "due on sale" clause. In this section the effect of the "due on sale" clause is considered.

Prior to dealing specifically with the "due on sale" clause, it is useful to consider the effect of what will be termed a "neutral increase" in the expected maturity of the mortgage. A neutral increase in expected maturity refers to an increase which is not associated with either increasing or decreasing interest rates. That is, the increase in maturity is not due to either falling or rising rates triggering longer maturities.

A neutral increase in expected maturity will have two important effects on the mortgage lender's pricing decision. First, if it is assumed that it is more difficult for lenders to estimate the future cost of funds for periods far in the future than for immediately forthcoming periods, then an increase in the expected maturity will tend to increase the expected variability of interest rates. If lenders demand a premium to bear interest rate risk, this will lead to an increase in mortgage rates. Second, if lenders expect an increasing trend in interest rates (as has recently been the case), this will necessitate an increase in mortgage rates to cover the higher expected cost of funds of the longer maturity. Therefore, under these assumptions a neutral increase in expected maturity will tend to increase mortgage rates.

The elimination of the "due on sale" clause from mortgage contracts has the effect of increasing the expected maturity of loans. But the increase is not neutral in the sense described above. When a lender exercises its "due on sale" clause, except in instances where it is attempting to limit the probability of default, it does so when interest rates are rising. By so doing it limits the losses which will be incurred in its role as the bearer of interest rate risk. It should be noted that restricting the use of the "due on sale" clause has an effect similar to that of making prepayments less costly. The lower the required prepayment charge the less opportunity there is for profit by the lender when interest rates fall. The effect, therefore, of restrictions on the use of the "due on sale" clause is to cause interest rates on fixed-rate mortgages to increase sufficiently to offset the protection previously afforded the lender through his ability to invoke the "due on sale" clause.

This can be illustrated by considering an example of the pattern of anticipated prepayment with and without the "due on sale" clause. There are basically three factors which cause prepayments of mortgage loans prior to their contract maturity: first, prepayment because of decreasing interest rates; second, prepayment demanded by the lender in times of rising interest through enforcement of the "due on sale" clause; third, prepayment induced by high inflation rates in the value of property. This latter type of prepayment may be motivated by a desire to borrow against the increased equity to finance other purchases, or it may be due to the need for a substantially larger mortgage to facilitate resale of the property assuming frictions in the market for second mortgages. If prepayments due to decreasing interest rates are ignored, a hypothetical pattern of prepayments for loans originating in a specific year can be plotted, as in Table IX.² If it is assumed, for example, that loans repaid within the first three years are not caused by inflation - induced increases in the value of property, then these payments will be a result of the exercise of the "due on sale" clauses. Elimination of the "due on sale" clause has the effect of shifting these prepayments into later years when inflation creates a demand for refinancing and thereby increases the average loan maturity.

This effect of the "due on sale" on loan rates can be illustrated using the example presented above. In that instance it was assumed that without a "due on sale" clause the mortgage rate would be determined as follows: eight percent for the expected future cost of funds, 1.5 percent for a risk premium for bearing interest rate risk, .5 percent for expected losses from prepayments, and 1.4 percent for operating costs. Suppose, for example, that lenders assume that with the privilege of access to the "due on sale" clause they can exactly offset the expected losses created by the option to prepay when rates decrease. Also, suppose that the decreased expected maturity reduces the riskiness so that lenders demand .25 percent less in compensation for risk. Given this example, mortgage rates would decrease from 11.4 percent to 10.65 percent due to introduction of the "due on sale" clause.

² Table IX is roughly consistent with recent prepayment experience. See James Boykin and John Phillips, "Implications of the 12-year Pre-payment Assumption," *Mortgage Banker*, November, 1976. It should be noted that available data does not permit precise estimates of the portion of prepayments resulting from the three causes discussed here.

TABLE IX
Hypothetical Prepayment Pattern on Mortgages

Years Since Origination	Percent Prepaid of Loans Originating in Year 0
1	10
2	10
3	10
4	5
5	5
6	5
7	5
8	10
9	10
10 or more	30

CHAPTER III
THE "DUE ON SALE" CLAUSE IN THE
CALIFORNIA COURTS:
SUMMARY AND EVALUATION

Introduction

A recent court action in California has made the "due on sale" clause a highly controversial issue in that state. It is the California Supreme Court's decision of August 25, 1978, in the case of *Cynthia J. Wellenkamp v. Bank of America, et al*, in which the Supreme Court decided that the "due on sale" clause in a mortgage loan exercised upon an outright transfer of real property solely for the purpose of adjusting the interest rate on the loan to prevailing market conditions constitutes an "unreasonable restraint on alienation" and, therefore, will not be permitted under California law. The Court limited the potential impact of this decision by ruling that it would have prospective effect only. That is, it held that the decision

. . . shall not apply when the lender, prior to the date that this decision becomes final, has either enforced the due-on clause, resulting in sale of the subject property by foreclosure or in discharge of the accelerated debt, or when the lender has waived enforcement of the due-on clause in return for an agreement with the new buyer modifying the existing financing.³

There are three earlier decisions by the California Supreme Court which directly affect the use of the "due on sale" clause. The Court itself has provided a useful summary of its decision in these cases:

Civil code section 711 sets forth the basic law on the subject and states simply that "*conditions restraining alienation, when repugnant to the interest created, are void.*" Our decision in *Coast Bank v. Minderhout* (1964) 61 Cal. 2k 311, recognized that this rule was not absolute in its application, but forbade only *unreasonable* restraints against alienation. In determining whether a due-on clause was unreasonable in *Coast Bank* we looked at whether the restraint was necessary to prevent impairment to the lender's security. We concluded that the restraint was reasonable in that case.

We next had occasion to determine whether a given restraint was unreasonable within the meaning of *Coast Bank* in *La Sala v. American Sav. and Loan Assn.* (1971) 5 Cal. 3d 864. The restraint involved in *La Sala* was a due-on clause which provided for acceleration of the maturity of the loan upon encumbrance of the subject property. In determining whether enforcement of this clause constituted an unreasonable restraint on alienation, we considered not only whether the restraint was necessary to prevent impairment to the lender's security restraint but also the effect that enforcement of the restraint would have on alienation. We concluded that enforcement of a due-on clause upon encumbrance of the subject property involved a significant restraint on alienation such as to preclude enforcement of the clause unless the lender could show that enforcement was reasonably necessary to protect its security. Three years later, in *Tucker v. Lassen Sav. and Loan Assn.* (1974) 12 Cal. 3d 629, we confronted the question whether automatic enforcement of a due-on clause upon the sale of the subject property by installment contract constituted an unreasonable restraint against alienation. Examining the principles developed in *La Sala* we recognized that a direct relationship exists between the justification for enforcement of a particular restraint on the one hand, and the *quantum of* restraint, the actual practical effect upon alienation which would result from enforcement, on the other. Thus, the greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for that enforcement. Applying this test in *Tucker v. Lassen Sav. and Loan Assn.*, supra, 12 Cal. 3d 629, we concluded that enforcement of a due-on clause upon sale of the property by installment contract involved a high quantum of restraint requiring a significant showing that enforcement was necessary to protect the lender's security.⁴

³ *Cynthia J. Wellenkamp v. Bank of America et al.*, L.A. 30776 California Superior Court No. 15974, California Supreme Court Decision (Manual, J), page 16.

⁴ *Ibid*, pages 5-7.

Much of the attention given the "due on sale" clause prior to the Wellenkamp decision dealt with issues surrounding the terms of the sale. Specifically, an important aspect of earlier decisions was the legitimate interest of the lender in guarding against waste or depreciation of the property and preventing default. This became an issue of some complexity because previous cases did not involve an outright sale of the property. However, given the Wellenkamp decision these issues are of substantially lesser importance. In the case of an outright sale, as in the Wellenkamp case, it is much easier to determine whether the lender's security is endangered. Therefore, the Wallenkamp case tended to focus attention on the question of whether the lender's interest in updating the return on outstanding loans is a justification for automatic exercise of the "due on sale" clause.

The question has arisen whether the recent decisions of the California Supreme Court apply equally to savings and loan associations within the state of California with federal - as opposed to state-charters. On November 1, 1979, the United States District Court of the Central District of California ruled on the issue of federal preemption of state law pertaining to the "due on sale" clause in the case of *Glendale Federal Savings and Loan v. David H. Fox, etc. et al*, and *Federal Home Loan Bank Board (Cross-Claimant) v. Richard T. Silberman*, as Secretary of the Business and Transportation Agency of the State of California (Cross-Claim Defendant). The court defined the central issue of the case as follows:

The crux of plaintiff's and cross-claimant's argument is that regulation of due-onsale clauses in the loan instruments of federal savings and loan associations is preempted by federal law, and that defendants therefore may not refuse to issue a public report under the Subdivided Lands Act on the ground that the notes and deeds of trust of Glendale Federal do not comply with provisions of California law governing due-on-sale clauses. Defendants contend that the laws of the State of California pertaining to exercise of the due-on-sale clause apply to federal- as well as state-chartered savings and loan associations located in California.⁵

The Court found that federal law does indeed preempt state regulation of federally-chartered savings and loans. Its statement of the decision is as follows:

Congress gave the (Federal Home Loan Bank) Board wide discretion to select or reject any state practices as it deemed necessary or desirable in arriving at a uniform federal savings and loan system. Nothing in the (Home Owner's Loan) Act or its legislative history suggests the Bank Board was to be bound by or subject to any particular state practice or regulation . . . The language, history, structure, and purpose of the Home Owner's Loan Act evidence a clear Congressional intent to delegate to the Bank Board complete authority to regulate federal savings and loan associations and to preempt state regulation. Whenever the Bank Board, pursuant to that plenary authority, promulgates a regulation governing an aspect of the operation of federal savings and loan associations, that regulation governs exclusively and preempts any attempt by a state to regulate in that area.⁶

But the U.S. District Court decision is now under appeal by the State of California.

The Supreme Court's Position in Wellenkamp v. Bank of America: Summary and Evaluation

The criterion applied by the Court in the Wellenkamp decision was to compare the "quantum of restraint" imposed by enforcement of the "due on sale" clause with the justification for enforcement. The larger the quantum of restraint, the more substantial must be the justification for enforcement.

⁵ *Glendale Federal Savings and Loan Association v. David H. Fox, etc., et al* C V 77-3Z74-WMB, United States District Court, Central District of California, (Byrne, M.) November 1, 1978, page 9.

⁶ Ibid, pages 12 and 13.

The Court held that there was a significant quantum of restraint in that in times of high inflation and interest rates new mortgage loans may not be available or may be extremely costly to the purchasers of homes. Therefore, to deprive sellers of the option to transfer their existing mortgage may preclude the sale of the home. The Court concluded that if the lender is willing to transfer the mortgage, but only at a higher rate, the seller may be damaged in that the value of his equity would decline. The Court stated these arguments as follows:

The availability of new financing often depends upon general economic conditions. In times of inflation, when money is "tight" and funds available for real estate loans are in short supply, new financing may be difficult, if not impossible, to obtain. The same result may occur when interest rates and the transactional costs of obtaining new financing are high, making it economically unfeasible for the buyer to acquire a new loan. When economic conditions are such that new financing is either unavailable or economically unfeasible, the seller and buyer will normally agree to a form of financing arrangement wherein the buyer will assume the seller's loan. In such circumstances, if the lender is unwilling to permit assumption of the existing loan, and instead elects to enforce the due-on clause, transfer of the property may be prohibited entirely, because the buyer will be unable to substitute a new loan for the loan being called due, and the seller will not receive an amount from the buyer sufficient to discharge that loan, particularly when the balance due is substantial. (See 1 Miller & Starr, *Current Law of Cal. Real Estate*, pt. 1 (1975 ed.) 3:65, pp. 435-436). Even when the lender is willing to waive its option to accelerate in return for the assumption of the existing loan at an increased interest rate, an inhibitory effect on transfer may still result. The buyer, faced with the lender's demand for increased interest, may insist that the seller lower the purchase price. The seller would then be forced to choose between lowering the purchase price and absorbing the loss with the resulting reduction in his equity interest, or refusing to go through with the sale at all. In either event, the result in terms of a restraint on alienation is clear.⁷

The Court further held that justification was not substantial, specifically denying that protection of the lender's rate of return on its loan portfolio was a valid justification for exercise of the "due on sale" clause. The Court's opinion is as follows:

Although we recognize that lenders face increasing costs of doing business and must pay increasing amounts to depositors for the use of their funds in making long-term real estate loans as a result of inflation and a competitive money market, we believe that exercise of the due-on clause to protect against this kind of business risk would not further the purpose for which the due-on clause was legitimately designed, namely to protect against impairment to the lender's security that is shown to result from a transfer of title. Economic risks such as those caused by an inflationary economy are among the general risks inherent in every lending transaction. They are neither unforeseeable nor unforeseen. Lenders who provide funds for long-term real estate loans should and do, as a matter of business necessity, take into account their projections of future economic conditions when they initially determine the rate of payment and the interest on these long-term loans. (See Note, *Judicial Treatment of the Due-On-Sale Clause: The Case for Adopting Standards of Reasonableness and Unconscionability*, supra, 27 Stan. L. Rev. at p. 1117.) Unfortunately, these projections occasionally prove to be inaccurate. We believe, however, that it would be unjust to place the burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property through the automatic enforcement of a due-on clause by the lender.⁸

Chapter 11 provides a basis for a proper economic evaluation of the Court's reason for its decision in the Wellenkamp case. The basic point made in Chapter 11 is that when a fixed-rate mortgage loan is agreed upon the borrower purchases insurance against interest rate risk. The price paid for such insurance and the amount of insurance obtained depend on the terms and the expected maturity of the mortgage contract. When lenders incorporate a "due on sale" clause which they expect can be exercised when property is sold and mortgage rates have risen, they thereby reduce the expected maturity and the expected cost to them of the loan. Moreover, in a competitive mortgage market, prices of fixed-rate loans with the "due on sale" clause will be lower than fixed-rate contracts which do not include the clause. With perfect disclosure of information both parties to the contract should understand that the borrower has the

⁷ Op. cit., Wellenkamp, pages 9-10.

⁸ Ibid, pages 13-14.

right to a guaranteed interest rate only as long as he owns the property, because this is the nature of the insurance contract he has purchased.

The Court's decision, therefore, raises the question: Who owns the right to the fixed-rate in a mortgage contract when the property is resold? The Court is certainly correct in concluding that higher mortgage interest rates have an "inhibiting" effect on the exchange of property. Moreover, the Court is clearly correct in concluding that in a time of rising mortgage rates, exercise of the "due on sale" clause will make financing more difficult than if it were not exercised. But the Court errs by not recognizing that if mortgage contracts are written and priced with the presumption of exercise of a "due on sale" clause, then the right of access to these advantageous terms of financing has not been sold to the borrower and hence cannot be resold to a new purchaser of the property. It should be apparent that this is not, as the Court asserts, a matter of placing the "burden of the lender's mistaken economic projections on property owners exercising their right to freely alienate their property." On the contrary, to restrict the exercise of the "due on sale" clause in contracts which have already been written and priced with the presumption of its use is to present a gift to borrowers with existing contracts, not to decrease the equity of homeowners who attempt to sell their property during a time when credit markets are tight. In addition, elimination of the ability to exercise the "due on sale" clause in newly written mortgage contracts will change the assumption under which mortgages are priced. Specifically, state-chartered California savings and loan associations have no choice but to price new fixed-rate mortgage loans on the assumption that, other than in the case of prepayment because of decreasing mortgage rates or due to an inflation-induced demand for larger first mortgages, mortgages will be outstanding until their contract maturity. This makes it inevitable that the effective price of housing would have to increase. Existing property owners who pass on their mortgage terms will demand compensation for doing so. In addition, new mortgages will be priced higher because of the longer average maturities.

It is necessary to emphasize the distinction between elimination of automatic exercise of the "due on sale" clause in existing mortgage contracts and in new mortgage contracts. Prohibition of the use of "due on sale" clause in existing contracts creates a boon for existing borrowers at the expense of lenders. This would seem to be unjustifiable without compensation for the owners of existing savings and loan institutions. Elimination of the "due on sale" clause in new mortgages deprives the marketplace of the use of this option in mortgage contracting. The question which arises is whether the marketplace will be best served by being deprived of this option.

There exists at least one legal review of the economic issues involved in the "due on sale" clause which was written after the Tucker decision but before Wellenkamp. Richard A. Epstein of the University of Chicago Law School has argued that it is inappropriate to view the "due on sale" clause as a restraint on alienation. His argument recognizes the basic economic question of ownership of the right to the fixed interest rate in a mortgage contract:

. . . the due-on-sale clause has been challenged as an unreasonable restraint on alienation. The concern is, however, quite misplaced, for it fails to distinguish between restraints on alienation that can be ousted by private agreement and those that cannot. In the latter case, the restraint may well have adverse social effects, by preventing the movement of real estate to its highest and best use. A restriction that may be undone, however, serves a quite different function. It only determines the distribution of the purchase price between the bank (as mortgagee) and seller (as mortgagor). The clause shifts to the bank the advantage from the increase in interest rates which would otherwise belong to the seller.⁹

Epstein goes on to point out that an examination of the actual nature of the transaction in the *Tucker v. Lassen* case provides excellent support for his position:

⁹ Richard A. Epstein, "Unconscionability: A Critical Appraisal," *Journal of Law and Economics*, Volume XVIII (2), October 1975, page 312.

The first point in the court's argument is that the clause functioned as a restraint on alienation. That view of the situation, however, was belied by the very facts of the case. Before the case had been decided, the three parties involved had provisionally renegotiated the terms of the sale. The buyer received the property as before, although he paid a higher rate of interest to the bank and a smaller sum to the seller. The clause had no effect upon the alienation of the property as such; and indeed the suit was brought by the seller in order to recapture that portion of the price that the clause deflected from him to the bank.¹⁰

It should be evident from the above discussion that title to the portion of the price in question rightfully belongs to the bank if the seller was a competent party to a mortgage contract which was priced on the presumption that the "due on sale" clause could be exercised.

Epstein raises the interesting and important issue that the "due on sale" clause should be evaluated not as a potential restraint on alienation but within the general context of the criterion of unconscionability. That is, the "due on sale" clause might be challenged in the courts on the basis that it is harsh, unconscionable or unjust. The thrust of Epstein's argument is that while the doctrine of unconscionability is the proper criterion by which the "due on sale" clause should be judged, the "due on sale" clause is not, in fact, unconscionable. Epstein makes a cogent case for not restricting the use of the "due on sale" clause per se. His argument raises an issue which becomes the focus of attention in the Chapter IV. The important question is whether there are practices of mortgage lenders which take unfair advantage of borrowers, and which the "due on sale" clause facilitates. If there are such practices then they might be deemed unconscionable and therefore deserving of restriction. However, to deserve restriction on an economic basis, such practices, if they even potentially exist, must serve no useful economic purpose and must be used principally for exploitation. Furthermore, given that legal restrictions on private contracting are costly to write and enforce, consumers should be protected from such practices only if they are incapable of protecting themselves, presumably due to lack of information or sophistication about the terms of their loan contract.

¹⁰ Ibid, page 312.

CHAPTER IV
THE ECONOMIC IMPACT OF THE CALIFORNIA
SUPREME COURT'S DECISION CONCERNING
THE "DUE ON SALE" CLAUSE

Introduction

This chapter examines the impact on both the borrowers and lenders in the mortgage industry of the restrictions on the use of the "due on sale" clause recently mandated by the California Supreme Court. The chapter is divided into two sections. In the first, the impact of restricted use of the "due on sale" clause on lenders, which has been developed in the previous two chapters, is summarized. In the second section, the impact of the Court's decision on mortgage borrowers is considered.

The basic argument presented in this chapter is that restricted use of the "due on sale" clause is in consumers' best interests only if mortgage lenders can use the "due on sale" to exploit consumers. It is argued that, without opportunities for exploitation, use of the "due on sale" clause provides an option in mortgage contracting which consumers value. It is further argued that the only apparent situation where consumers may be at a disadvantage is through the extraction of prepayment penalties and other fixed charges when the "due on sale" clause is exercised. This chapter concludes that if the opportunity for extraction of such fees is properly controlled by legislation, it will be in the best interests of mortgage borrowers to permit unrestricted exercise of the "due on sale" clause.

The Impact of Restricted Use of the "Due on Sale" Clause on Mortgage Lenders

In the previous chapter it was demonstrated that the principal impact on mortgage lenders of restrictions on exercise of the "due on sale" clause results from the fact that the clause is already incorporated in a large number of the outstanding loans of savings and loan associations in California. When these mortgage loans were initiated, the contract interest rate demanded was based on the assumption that the "due on sale" clause could be exercised if mortgage rates increased. This means that lenders were not selling the right to continued access to the fixed-rate in the mortgage contract to new owners of the property. If the terms of the contract are changed, *ex post*, by court or legislative action, such action has the effect of giving borrowers the right to sell to new owners continued access to the fixed-rate mortgage. Because they did not originally purchase this right, there has been created an arbitrary wealth transfer from lenders to *existing* borrowers.

There is also a potential harm to state-chartered California savings and loan institutions if they are deprived of use of the "due on sale" clause in new loans. Lenders would not themselves be directly hurt by being forced to write fixed-rate contracts without the "due on sale" clause if this change in available terms has no effect on loan demand. However, if this contract restriction induces consumers to demand fewer loans or if it is possible for borrowers to shift to other institutions which offer the "due on sale" clause, then there will be a further detrimental effect on California savings and loan associations. Because the restriction on the use of the "due on sale" clause applies only to state-chartered institutions in California (See Chapter III), consumers who prefer fixed-rate loans with the "due on sale" clause will find it advantageous to deal with federally-chartered rather than state-chartered institutions. This penalizes state relative to federally-chartered savings and loan institutions. Moreover, such a substitution may take place because the consumer is likely to perceive fixed-rate loans as being less expensive at federally-chartered institutions due to their use of the "due on sale" clause, but may not fully understand the reason for the difference. Such problems concerning consumer information are discussed in some detail below.

Lenders could be harmed further by the difficulties involved in selling in the secondary market mortgages which do not have the "due on sale" clause. Only mortgages with standardized terms can be sold in the secondary market and the "due on sale" clause is viewed, nationwide, as a standard part of the mortgage contract. This could be a particularly serious problem for California, which is a capital-short part of the country and, therefore, must continually attract capital from other regions to finance mortgages. The difficulties caused by issuance of a non-standard mortgage would not, of course, be limited to the savings and loan associations themselves. Ultimately, any added costs of using a non-standard mortgage would be passed on to the borrower.

The Impact of Restricted Use of the "Due on Sale" Clause on Mortgage Borrowers

If automatic use of the "due on sale" clause is restricted, then the options available to borrowers in choosing mortgage contracts will be similarly restricted. The question at issue is whether or not such restriction is in the borrowers' best interests. The position taken here is that legal restrictions on allowable mortgage contract terms are in the best interests of consumers only if it can be shown that such terms can be used by the lenders to take unfair advantage of the borrowers. Such opportunities, where they exist, usually result from differences in sophistication and access to information between borrowers and lenders.

In this section, two arguments are made regarding the justification for this contract restriction. The first is that at the equilibrium prices for alternative contracts, consumers apparently prefer fixed-rate contracts with the "due on sale" clause over fixed-rate contracts without this clause. In order to support this argument the relative advantages of the two contracts are compared and consumers' actual choices are examined. The second argument is that the only apparent opportunity to take advantage of unsophisticated borrowers arising from use of the "due on sale" clause is the ability to extract prepayment penalties and other fixed charges when exercising the "due on sale" clause.

In considering whether one would prefer to engage in a mortgage contract with or without a "due on sale" clause it is useful to begin by considering the circumstances under which one would be indifferent regarding the two choices. A reasonable argument can be made that as long as borrowers and lenders have equal access to information and, importantly, that borrowers have no special information about the duration of their ownership of the property, then they won't care whether or not a "due on sale" clause is included in their mortgage contract. Given these assumptions, consumers will be paying a fair price for the extra insurance against interest rate risk which is implicit in the contract without the "due on sale" clause. Hence, at that price, they would be indifferent as to its inclusion.

However, the assumption that borrowers have no special information about the duration of their ownership of the property is critical to this argument. The reason is that the "due on sale" clause has the effect of transferring wealth from those property owners who hold their property for relatively short periods of time to those who hold their property for longer periods. In effect, those people whose time of ownership is less than average subsidize those people whose time of ownership is greater than average. For example, if the average life of mortgages is seven years, then the individual who sells his property after two years has paid for five years of interest rate insurance that he does not use and, because of the "due on sale" clause, cannot resell. The individual who holds his property for 15 years receives eight years of interest rate insurance for which he did not pay. On the other hand, if both individuals had mortgage contracts without the "due on sale" clause they would each pay for a longer period of insurance but would be able to resell any unused portion. Without the "due on sale" clause there would be no wealth transfer based on the duration of property ownership.

If some borrowers in the marketplace expect that they will hold their property for a relatively short time they will avoid mortgage contracts with a "due on sale" clause to avoid the wealth transfer. In the extreme, if all borrowers had a firm notion of how long they would hold their property then all borrowers with expected duration's below the average would choose to not use a "due on sale" clause; and, as a result, the expected maturity of loans with a "due on sale" clause would increase. This would stimulate borrowers with even higher expected duration's to avoid the "due on sale" clause as the average maturity increased, until the market for mortgage loans with the "due on sale" clause collapsed. Therefore, in order for mortgage lenders to find it feasible to offer mortgage contracts with the "due on sale" clause, there must be a group of consumers which believes their duration of ownership will not be other than the market average. That is, a substantial portion of borrowers must not know that they will own their property for only a short time when they initiate their loan. If this were not the case, then borrowers would simply choose other types of mortgage instruments.

This argument about consumers' choice of alternative mortgage contracts presumes that lenders would in fact offer alternative contracts if the demand were evident. That is, consumers could not choose whether to utilize a "due on sale" clause if contracts without the "due on sale" clause were never available. This does not require that each lender offer every potential borrower a variety of contracts from which he or she can choose. The costs of offering nonstandard contracts and informing each borrower of the possible options makes this type of flexibility infeasible. What it presumes is that there is a competitive mortgage lending industry so that competing firms which perceive a potential demand will develop a product to satisfy that demand. The highly competitive nature of the mortgage lending industry in California makes it apparent that fixed-rate contracts without the "due on sale" clause have not been offered in that state in recent years because consumers would not be willing to purchase such contracts at the competitive prices lenders would demand for the increased insurance of interest rate risk. This argument is supported by the apparent willingness of lenders to offer contracts for which there is a clear demand at a competitive price for the industry. The recent evolution in California of variable rate mortgages makes it evident that the industry is willing to offer innovative contracts where consumers are willing to pay the competitive price for the contract.

Some might argue, instead, that unless it is possible to cite specific instances where lenders tried to offer fixed-rate mortgages without the "due on sale" clause and found no customers, one cannot conclude that consumers prefer mortgages with the clause. But this argument presumes that savings and loan associations effectively operate as a monopoly where they find it possible to extract monopoly profits from mortgages with the "due on sale" clause but not from mortgages without the clause. Under this assumption no savings and loan associations would offer contracts without the clause, in spite of a demand for such mortgages. There are two points which suggest that this argument has little relevance for the issue at hand. First, though it is not possible to directly consider the evidence on the state of competition in the California mortgage market here, the market appears to operate in an intensely competitive manner rather than as an effective monopoly. This means that the reason mortgage contracts have not been written at fixed rates without the "due on sale" clause is because, at the market price, there has been no demand. Second, even if collusive behavior could explain the lack of such contracts, the potential for excess profits must lie in the opportunity to extract fixed charges when the "due on sale" clause is exercised. Again, this suggests that the appropriate remedy lies in the imposition of appropriate restrictions on the extraction of such charges, rather than on the forms of contracts which the market is allowed to use.

It is also important to take note of the reasons consumers have given for choosing between fixed-rate and variable-rate mortgages. Survey evidence collected for the Federal Home Loan Bank Board's study, *Alternative*

*Mortgage Instruments*¹¹ suggests that the major motivation for consumers who choose the VRM over the traditional mortgage is the expected short duration of their ownership. These individuals indicate that they value the assumability feature of the VRM and do not expect to experience many increases in mortgage rates because of the expected short holding period. Such consumers could always have chosen to purchase a fixed-rate mortgage with long-term insurance of interest rate risk but they would have to pay a price which compensated the lender for bearing the increased risk of interest rate fluctuations.

This analysis indicates that consumers prefer fixed rate-loans with the "due on sale" clause to fixed-rate loans without this clause given the alternative equilibrium prices for these types of contracts. However, it is possible that consumers' choices have been based on imperfect information about the contracts they are choosing. Significant asymmetries in information between borrowers and lenders can create situations where lenders can take advantage of borrowers. There is one compelling argument, however, which suggests that this is not a significant issue regarding the use of the "due on sale" clause in the mortgage industry. Borrowers continue to use fixed-rate mortgages with the "due on sale" clause after having prior experience with it in previous purchases. In fact, the evidence collected for the Federal Home Loan Bank Board's study¹² suggests that some consumers find their experience with fixed-rate contracts to be somewhat more satisfactory than their experience with VRM's, as evidenced by the fact that a sizeable number of borrowers using a VRM indicate they plan to return to the fixed-rate mortgage.

The question which remains is whether it is in consumers' best interests to compel those who would like to obtain a mortgage with a fixed rate to forego the opportunity of obtaining a contract incorporating a "due on sale" clause. In order to justify restricting consumers' contracting options in such a way it is necessary to demonstrate that lenders can use the "due on sale" clause to take advantage of borrowers' relative lack of financial sophistication. There is a possibility for this kind of exploitation if potentially punitive provisions which are difficult for borrowers to understand can be included in the mortgage contract. Even in a highly competitive mortgage loan market this can be a substantial problem if it is difficult for competing lenders to explain to their potential customers the advantages of contracts which do not include such provisions.

There is one element that can be included in the fixed-rate mortgage contract which fits this characterization quite well. This is the clause which permits extraction of prepayment penalties when loans are prepaid due to exercise of the "due on sale" clause. As developed in Chapter 11, the useful purpose served by the prepayment penalty is that it limits the ability of borrowers to prepay loans when mortgage rates decline. As a result it limits the losses to which mortgage lenders are exposed and, therefore, reduces the price of the fixed-rate mortgage. The extraction of prepayment penalties in conjunction with the exercise of the "due on sale" clause serves no such useful purpose. This merely forces an additional payment from the property owner to the lender when the property is resold. Moreover, because the borrower may not fully understand the implications of the payment clause when the mortgage contract is initiated it may be quite difficult for competing lenders to persuade borrowers of the advantages of contracts which do not contain the right to extract prepayments in conjunction with exercise of the "due on sale" clause. Hence, even in a highly competitive market these kinds of provisions may be common. Any legislative action should, therefore, be directed at the right to demand prepayment penalties or impose other fees when the "due on sale" clause is invoked, rather than at restrictions on the use of the "due on sale" clause.

¹¹ Kent Colton, Donald Lessard, David Modest, and Arthur Solomon, "Natural Survey of Borrowers' Housing Characteristics, Attitudes and Preferences," in *Alternative Mortgage Instruments Research Study*, Donald M. Kaplan, ed., Federal Home Loan Bank Board, November, 1977, Volume 1, pp. iii-66.

¹² Gerald Albaum and George Kaufman, "Variable Rate Residential Mortgage: Implications for Borrowers," *Alternative Mortgage Instruments Research Study*, Donald M. Kaplan, ed., Federal Home Loan Bank Board, November 1977, Volume 1, pp. vi-29.