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ATTORNEY GENERAL
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SPRINGFIELD

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FILE NO. S-1297

FINANCIAL INSTITUTIONS:
Legality in Illinois of
Graduated Payment Mortgage
Program.

Timothy E. Griffin
Savings and Loan Commissioner
State of Illinois
160 North LaSalle Street
Chicago, Illinois 60601

Dear Mr. Griffin:

You have asked for an opinion on the legality in Illinois of home mortgage loans made by savings and loan associations under the Graduated Payment Mortgage Program sponsored by the United States Department of Housing and Urban Development. This program, established under 12 U.S.C. §1715z-10 (Supp. 1976), provides a constant rate of interest on each mortgage, but part of the interest accruing in early

years is added to principal and thus payment is deferred until later years when the borrowers' incomes are likely to be higher. In my opinion, such mortgages by savings and loan associations are permitted in Illinois.

Three possible legal problems in such a program should be considered: (1) the attachment of a lien for the new principal created out of unpaid interest; (2) legal restrictions on the compounding of interest; and (3) an Illinois statute prohibiting variable-rate mortgage loans.

The attachment of additional lien appears to present no problem under Illinois law, assuming the mortgage instrument states that it will secure future advances of interest-turned-into-principal. Section 39 of "AN ACT concerning conveyances" (Ill. Rev. Stat. 1975, ch. 30, par. 37a) provides in part that:

> "Every mortgage or trust deed in the nature of a mortgage shall * * * be a lien upon the real estate thereby conveyed situated in the county in which such instrument is recorded or registered, for all monies advanced or applied or which may at any time thereafter be advanced or applied thereunder on account of the principal indebtedness which such mortgage or trust deed shall purport to secure and including such other monies which may at any time be advanced or applied as are authorized by the provisions of such mortgage or trust deed or as are authorized by law * * *."

The case of Freutel v. Schmitz (1921), 299 Ill. 320, 323 states that:

> "* * * A mortgage may be taken to secure future advances, but it can only take effect as a lien from the time some debt or liability secured by it is created. * * *"

This is still the law in Illinois; see National Acceptance Co. v. Exchange Nat'l. Bank (1968), 101 Ill. App. 2d 396, 404.

With regard to the compounding of interest, Illinois courts in the past firmly held to the rule that, although a debtor already owing interest could agree to add that interest to principal and pay future interest on the whole, no agreement to add interest accruing in the future to principal would be enforced. See, e.g., Drury v. Wolfe (1890), 134 Ill. 294, 297; Bowman v. Neely (1894), 151 Ill. 37, 39, 40. However, a new judicial attitude seems to be shown in Joliet Federal Sav. & L. Ass'n. v. Bloomington Loan Co. (1970), 131 Ill. App. 2d 619, 622. The court described a method of adding unpaid interest to the outstanding loan balance and stated:

> "* * * This is not true compounding of interest. No Illinois case or statute has been cited which prohibits the practice in this case and we know

> of no public policy argument against it. To the contrary, Illinois Revised Statutes, Ch. 32, Sec. 800, provides that 'no interest * * * or interest on such interest * * * which may accrue to an association under the provisions of this Act, shall be deemed to be usurious.' By Section 703 of the same Act, this law is made applicable to Federal Savings and Loan Associations.
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Even if that holding was not a repudiation of the rule against compounding of interest, Illinois statutes exempt Graduated Payment Mortgage loans made under the provisions of the Illinois Savings and Loan Act from any such rule. Section 5-10 of that Act (Ill. Rev. Stat. 1975, ch. 32, par. 800) reads as follows:

> "No interest, premium, or interest on such interest or premium, or charge, which may accrue to an association under the provisions of this Act, shall be deemed to be usurious; and the same may be collected in the same manner as other debts in accordance with the laws of this State." (Emphasis added.)

In addition, section 4(l)(e) of "AN ACT in relation to the rate of interest, etc." (Ill. Rev. Stat. 1976 Supp., ch. 74, par. 4(l)(e)) states:

> "* * * It is lawful to charge, contract for, and receive any rate or amount of interest or compensation with respect to the following transactions:
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> * * *

> (e) Any mortgage loan insured or upon which a commitment to insure has been issued under the provisions of the National Housing Act, Chapter 13 of Title 12 of the United States Code;
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> * * *
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> "

Since the Graduated Payment Mortgage Program is authorized under the National Housing Act in Chapter 13 of Title 12, United States Code, loans under the program are exempt from the interest limitations in the Illinois Act.

Finally, the prohibition on variable-rate loans, in section 4(2)(d) of the same "ACT in relation to the rate of interest, etc." (Ill. Rev. Stat. 1976 Supp., ch. 74, par. 4(2)(d)) states:

> "No mortgage contract for the purchase of residential real estate entered into on or after January 1, 1977 shall contain any provision providing for any change in the contract rate of interest during the term of such mortgage."

This prohibition is not applicable to Graduated Payment loans, since their contract rate of interest does not change. The statute obviously was intended to prohibit a so-called variable rate loan, whose interest rate fluctuates with market rates; the statute does not prohibit deferring some interest and paying it later.

Since upon examination none of these legal provisions blocks Graduated Payment Mortgage loans made by savings and loan associations, I conclude that they would be legal in Illinois.

Very truly yours,

ATTORNEY GENERAL