Credit
Research
Center

# WORKING PAPER NO. 48

## Legal Aspects of Variable Rate Financing

1983

Krannert Graduate School of Management – Purdue University

# LEGAL ASPECTS OF VARIABLE RATE FINANCING

**Carl D. Lobell and Sheldon Feldman***

**Abstract**

The high variability in interest rates in recent years has created a need for many creditors to restructure their lending terms to permit variable rates. The practice is increasing in popularity, especially in the home mortgage area, where legislators and regulatory authorities have recognized the need for rate flexibility more rapidly than in areas of consumer credit.

This paper summarizes concisely the panoply of regulations governing variable rate residential secured loans that have been promulgated for federally-chartered creditors by the Federal Home Loan Bank Board (FHLBB), the Office of the Controller of the Currency (OCC) and the National Credit Union Administration (NCUA). The NCUA has expanded the authority of federal credit unions to grant variable rate financing beyond real property transactions to any type of consumer loans. Further, the Alternative Mortgage Transactions Parity Act (AMPTA) of 1982 allows all classes, of "housing creditors" to offer variable rate financing to the extent that a federally-regulated lender is authorized to offer such financing. The legality of state-regulated transactions that do not qualify for the AMPTA authorization will depend upon the applicable state law. Since few states specifically authorize variable rates on nonhousing credit, it is necessary to identify provisions scattered in the statutes that may impede variable rate financing. For example, some states require substantially equal payments, while others prohibit compounding of interest or charging excessive interest. Such provisions could be violated by typical variable rate contracts, especially during periods of rising interest rates.

The final section of the study covers federal disclosure rules that apply to all forms of variable rate financing, both open-end and closed-end credit.

**LEGAL ASPECTS OF VARIABLE RATE FINANCING**

**Carl D. Lobell and Sheldon Feldman**

## I. Introduction

Large and relatively rapid fluctuations in interest rates during recent years has given rise to a need to make affected portfolios more responsive to the cost of money. This has led many creditors to restructure their lending terms to permit a variable rate. In the consumer area, variable rates began in the home mortgage market and are now expanding into such areas as automobile loans, open-end credit plans, and other shorter-term transactions.

### A. Difficult Choices

Any creditor's adoption of a variable rate program involves complex decisions, including choices of index, spread, rate adjustment options (both as to amount and frequency), and whether to permit negative amortization.

---

* Weil, Gotshal and Manges.

## B. Vague Legal Environment

Since variable rate transactions are relatively new, the laws that govern such arrangements are rarely definite or settled. Statutory impediments may arise in the areas of continuing lien priority, interest compounding or mandated level payments.

## C. Federal Regulations

Agencies regulating federal depository institutions have attempted to eliminate many of these legal issues by expressly authorizing adjustable rates for federally-chartered institutions in the home mortgage market and by preempting state provisions that impede or frustrate such transactions. State-chartered and non-regulated entities, such as finance companies-and mortgage bankers, were left to contend with the absence of express authorization to make variable rate loans until recent federal legislation preempted state law in connection with loans or credit sales secured by an interest in residential real property. Those creditors who make loans that are not secured by residential real property still are left with difficult questions concerning whether variable rate transactions are permitted under state law. Revised Regulation Z also affects variable rate lending by imposing new disclosure rules that require different disclosures depending upon whether the transaction is open-end or closed-end credit. This presentation will attempt to provide a general overview of the regulatory efforts and problems associated with variable rate financing.

# II. Federally-Chartered Creditors

Three agencies have issued regulations for federally-,chartered creditors: the Federal Home Loan Bank Board (FHLBB), 12 CFR S 545.6-2 (a); the Office of the Comptroller of the Currency (OCC), 12 CFR S 29; and the National Credit Union Administration (NCUA), 12 CFR S 701.21-6B. The FHLBB and the OCC regulations are limited to residential secured loans; the NCUA regulations govern unsecured loans as well as loans secured by the borrower's residence. The OCC regulation has recently been revised to provide lenders subject to that regulation with greater flexibility in making variable rate loans.

## A. Comparison of Adjustable Rate Mortgage Regulations

### 1. Definition

a. The revised OCC regulations (effective March 7, 1983, see 48 Fed. Reg. 9506-9514) require that Adjustable Rate Mortgages (ARMs) apply only to purchase money mortgages made on the security of one- to four-family dwellings. The regulation applies to financing or refinancing of the purchase but it does not apply to nonpurchase-money loans secured by real estate.

b. The FHLBB ARM regulations (47 Fed. Reg. 36612-36626) apply to loans on the security of homes or combinations of homes, business property, and farm residences and combinations of farm residences and commercial farm real estate.

c. The NCUA regulations (46 Fed. Reg. 38669-38680) define an ARM mortgage loan as one which permits the periodic adjustment of the rate of interest on the loan in response to the movement of an index which was agreed upon in advance by the borrower and the federal credit union, such loans must be secured by first liens on residential real property or cooperatives and be made on the security of one- to four family dwellings (for a discussion of NCUA's non-mortgage ARM, see para. 16, infra).

## 2. Adjustment Options

a. Under the OCC regulation, interest rate adjustments may be implemented through changes in the payment amount and/or the rate of amortization (i.e., the amount, if any, of each installment payment allocated to repayment of principal). This could result in negative amortization, i.e., where monthly payments fail to pay all interest earned, that interest is then added to the principal balance (this is discussed at para. 8, infra).

b. The FHLBB regulations provide for adjustments in the interest rate to be implemented through changes in the monthly payment amount, the outstanding loan balance, the loan term, or any combination of these variables (see para. 8, infra for discussion of negative amortization).

c. The NCUA regulations also require adjustments in the interest rate to be implemented through changes in the monthly payment amount, the outstanding loan balance, the loan term, or any combination of these variables which, as stated above, could result in negative amortization.

## 3. Indexes

a. OCC regulations originally required the use of either (a) the weekly or monthly average auction rates on 6-month T-bills; (b) the weekly or monthly average yield on Treasury securities adjusted to a constant maturity of 3 years; or (c) the FHLBB's average mortgage rate. As revised, the regulation adopted the flexibility permitted under the FHLBB regulations by permitting national banks to use any index that reflects market conditions that is readily available to, and verifiable by, the borrower and that is beyond the bank's control. Note that when a cost-of-funds index is used, a special disclosure must be used (see para. 13, infra). The revised regulation removes the requirement that the initial interest rate index be the most recently available value either at loan closing or when the bank commits to the initial rate. Now the bank has total flexibility in determining the initial index value.

b. The FHLBB regulations require lenders to choose an interest rate index or an index that measures the rate of inflation or the rate of change in consumer disposable income. The index must be readily available to and verifiable by the borrower and be beyond the control of the lender.

c. The NCUA, while recommending that the above-stated FHLBB principles be followed, believes that it is unnecessary to regulate in this area, although the agency will monitor the index selections through examination and consumer complaint programs.

## 4. Frequency of Rate and Payment Changes

a. OCC revised regulation removes the limits on the frequency of interest rate adjustments and the requirement that such adjustments be made at regular intervals. All that is required is that the changes be based on the most recently available index value as of either the date of notification or implementation, whichever is earlier, and shall be made at the intervals specified in the loan documents. This change increases the likelihood that negative amortization will occur. The OCC's revised regulation liberalized restrictions in this latter area as well (see para . 8, infra).

b. The FHLBB does not require that the payment amount be adjusted within a certain time period to a level sufficient to amortize the loan at the then existing interest rate and principal loan balance over the remaining term of the loan. However, there is some protection against negative amortization in that the loan balance must never exceed 125 percent of the original appraised value of the property during the term of the loan. An exception to this rule is made if the loan-to value ratio is a result of a change in a national or regional index that measures the rate of inflation. The FHLBB has also indirectly regulated the frequency of rate changes through its 30-day advance notice requirement before payment adjustment (see discussion at para. 13.b. regarding FHLBB disclosure requirements).

c. The NCUA addresses the issue of amortizing principal by requiring that, if the principal balance is adjusted in response to a movement in the index, the monthly payment must be adjusted at least every five years, to a level sufficient to amortize the loan balance at the then existing rate over the remaining term of the loan. Additionally, adjustments to the interest rate may be made "as frequently as monthly."

## 5. Maximum Adjustment Amount Per Adjustment Period

a. OCC regulation as revised eliminates all limits on the size of interest rate adjustments, as long as the change is made in accordance with the rules specified in the loan documents.

b. The FHLBB regulations are silent on the issue.

c. NCUA permits credit unions to set their own limitations on maximum rate adjustment amounts for an adjustment period. Additionally, it allows federal credit unions to set maximum rate adjustments for the duration of the loan.

## 6. Maximum Term

a. The revised OCC ARM regulations do not state a maximum term, however, 12 U.S.C. S 371 requires that national banks limit the term of a mortgage loan to 30 years, unless the loans fit within the 10% limitation in 12 U.S.C. 371(f).

b. The FHLBB regulations set the maximum term of an ARM loan at 40 years.

c. The NCUA regulations require ARM loans to have initial maturities in excess of 12 years and not exceeding 40 years.

## 7. Loan-to-Value

a. The OCC has no loan-to-value requirements specifically for ARMS, but the loan-to-value restrictions which apply to all real estate lending by national banks are applicable (see 21 C.F.R. S 7.2000, et seq.).

b. The FHLBB requires that, except in case of a refinancing, the home loan at the time of origination generally not exceed 90 percent of the value of the secured property. During the term of the loan, the loan-to-value ratio may increase above 90 percent but in no event may the loan balance exceed 125 percent of the original appraised value of the property unless in response to the inflation index or unless the loan contract provides that payments will be adjusted at least once every five years, beginning no later than the tenth year of the loan, to a level sufficient to amortize the loan at the then-existing rate over the remaining term of the loan. The 125 percent limitation does not apply to the portion of the loan balance that is interest received in the form of a percentage of the appreciation in the value of the secured property.

c. NCUA requirements state that an ARM loan shall not exceed 90% of value at the time of disbursement except where private mortgage insurance is obtained for the amount of the loan in excess of 90% of value. In such cases, the loan amount may equal up to 95% of value.

## 8. Negative Amortization and Other Adjustments to Loan Balance

a. OCC regulation as revised removes the restriction on the aggregate amount of negative amortization, but banks are required to set the installment payment at a level sufficient to begin reducing the outstanding loan principal no later than during the 21st year of the loan. As to national banks, the entire principal of the loan must be amortized without a substantial balloon payment by the end of the 30th year. State chartered banks need not comply with the regulation's requirement that ARM loans mature in 30 years. Instead, any applicable provisions of state law must be followed. Also, note that there are separate amortization and maturity requirements for real estate loans made by national banks(12 U.S.C. 371 and 12 C.F.R. 7.2125), which are currently under review as part OCC's general review of national banks' real estate lending powers (see proposed new rules in 48 Fed. Reg. 10068).

b. The FHLBB regulations set limits on the amount of negative amortization that can occur, but set forth two options. As a general rule, the loan balance may not exceed 125 percent of the original appraised value of the property. However, there are two exceptions to this rule. Savings & Loan associations may, regardless of the 125 percent limitation, "defer and capitalize" interest for a period of up to ten years after loan closing, provided the payment is adjusted to a fully amortizing level at five-year intervals thereafter. In addition, the 125 percent limitation does not apply to increases in the loan balance under price-level-adjusted mortgage (PLAMs). The FHLBB regulations permit PLAMs, under which an adjustment to the loan balance is made to reflect an increase or decrease in a national or regional index that measures the rate of inflation or the rate of change in consumer disposable income. This assures the lender that the value of the loan will stay current with the value of the dollar. The interest rate carried on a PLAN is equivalent to what the cost of borrowing money would be if no inflation were expected and is, therefore, lower than the interest rate on a conventional mortgage.

c. NCUA has no express requirement concerning negative amortization, leaving the issue to the credit union's contract. However, the requirement for readjusting the payment amount (discussed at para. 4.c., supra) does operate to place some limits on negative amortization.

## 9. Mandatory Downward Adjustment

a. The OCC regulation originally required a mandatory downward adjustment in the interest rate should the index fall, with certain exceptions. The revised regulation removes the requirement that limitations on interest rate changes be applicable to both increases and decreases. Thus, changes no longer have to be symmetrical.

b. The FHLBB does not expressly require mandatory downward adjustments. However, the regulations require that adjustments to the interest rate "correspond directly" to the movement of the index, subject to such limitations on the movement of the interest rate contained in the loan contract.

c. The NCUA requires a decrease in the interest rate where the index has moved downward, unless the decrease is less than 1/8 of 1%, exceeds a cap limitation, is offset by a previously permitted rate increase which was not taken or would reduce the interest rate below a minimum rate agreed upon in advance by the borrower and the federal credit union.

**10. Carry Over of Interest Rate**

a. The revised OCC regulations merely require adherence to the provisions in the loan documents, if any, regarding carry over of untaken interest rate changes to subsequent adjustment periods.

b. The FHLBB regulations are silent on this issue.

c. The NCUA regulations are also silent on this issue, although they arguably permit carry over of interest rate by implication.

**11. Prepayment Penalties**

a. OCC regulation as revised permits the imposition of prepayment penalties at any time, as long as the fees are disclosed, regardless of any state law provisions to the contrary.

b. FHLBB permits borrowers on loans secured by a home or combination of a home and business property to prepay their loans in full or in part without penalty at any time during the loan term unless the loan contract expressly provides for all of the following:
(i) a prepayment penalty;
(ii) an interest rate that, after loan closing and after any interest rate adjustment, remains fixed for a period of at least five years; and
(iii) only such increases in the loan balance as result from the deferral and capitalization of interest. Thus, prepayment penalties are not permitted on instruments that provide the association with protection against interest rate fluctuations.

c. The NCUA regulations are silent on this issue. However, 12 U.S.C. 1757(5)(A)(viii) provides that "a borrower may repay his loan, prior to maturity in whole or in part on any business day without penalty."

**12. Due-on-Sale Clauses**

a. The revised OCC regulations deleted the section of the ARM regulation that preempted state-law prohibitions on the enforcement of due-on-sale clauses, because there is now a statutory preemption of such clauses (S 341 of Garn-St. Germain Dep. Inst. Dereg. Act, discussed in subpara, c, infra).

b. The FHLBB under separate regulations (12 C.F.R. S 545.8-3 (f)) has expressly permitted federally-chartered savings and loans to exercise due-on-sale clauses. These regulations were recently upheld by the U.S. Supreme Court in a decision discussed in para. 14 below.

c. A federal credit union's ability to exercise a due-on-sale clause is now governed by section 341 of Title III of the Garn-St. Germain Act. Under section 341, a federal credit union may generally exercise a due-on-sale clause if the loan was made after October 15, 1982, or if the loan was made in a state that permitted the exercise of due-on-sale clauses; in states that prohibited the exercise of due-on-sale, a federal credit union may not generally exercise a due-on-sale clause in the case of a transfer that took place before October 15, 1982.

**13. Disclosure**

a. The revised OCC regulation requires that disclosures be given to the borrower at the time of loan application (this precedes the time at which RESPA and Reg. Z disclosures are to be provided) containing 11 items, including: (1) the fact that the rate may change and a description of the general nature of the ARM loan; (2) the index used and source where it is published; (3) a 10 year historical analysis of the index; (4) the frequency of rate and payment adjustments; (5) that the initial monthly payment differs from the fully amortizing payment, if applicable; (6) the basis on which any fees will be imposed; and (7) an example of the payment schedule. With regard to notice of interest rate changes, they must occur at the time of implementation or at least 25 days before imposition of a new payment amount and the same notice period (25 days) is required for changes in payment amount attributable to reasons other than interest rate changes. No model disclosure form is provided. There are additional specific disclosures required in the case of short-term demand and balloon mortgages.

b. Similarly, the FHLBB regulations require that a disclosure form be given to the borrower prior to accepting a loan application containing 11 items of information, including an explanation of the index, summaries of key terms, and an example of the operation of the type of ARM loan offered. The regulations require that notification of an ARM loan payment adjustment be given at least 30 but not more than 120 days prior to an adjustment or maturity of the loan.

c. NCUA's regulations state that disclosures are to be made in accordance with the Truth-in-Lending Act and Regulation Z (see discussion in part V infra).

**14. Preemption of State Laws**

a. To give all national banks, savings and loan associations and federal credit unions the flexibility needed to develop ARM instruments, all three agencies have promulgated regulations which purport to preempt any state law that restricts the ability or right of any federal institution to use adjustable rate mortgage loan instruments. As noted below, however, the scope of this preemption is unclear and is being defined in the course of judicial challenge to the regulations.

b. Preemption Challenged

(i) OCC regulation -- on July 10, 1981, a complaint was filed by the Conference of State Bank Supervisors (CSBS), in the United States District Court for the District of Columbia challenging the Comptroller of the Currency's authority to issue ARM regulations which preempt state law. CSBS claimed that state statutes regarding ARM lending are applicable to national banks, and that Congress has not delegated the Comptroller the authority to issue regulations preempting such state laws. Judge Gessell, in his opinion on February 11, 1982 (Conference of State Bank Supervisors v. Lord, 532 F. Supp. 694 (D.D.C. 1982)), upheld the Comptroller's authority to preempt such state laws on the ground that the regulations were within the scope of the powers granted by Congress. CSBS has appealed the decision.

(ii)FHLBB regulation -- the Bank Board in an earlier and separate regulation preempted the effect of state laws that prohibit due-on-sale clauses on federally-chartered S&Ls. The Board's authority to preempt was unsuccessfully challenged in Fidelity Federal Savings & Loan Association v.,De La Cuesta. On June 28, 1982, the U.S. Supreme Court in a 6 to 2 decision upheld the FHLBB's authority to preempt state law, indicating that the Bank Board clearly intended such preemptive effect, acted within its statutory authority and the fact that real property was a matter of special concern to the states did not lessen the Board's authority to act (50 U.S. L.W. 4916 (1982)).

(iii) The Supreme Court's decision in De La Cuesta argues well for the authority of not only the bank Board but the OCC and NCUA in such preemptive provisions.

15. While the flexibility permitted under the OCC, FHLBB and NCUA regulations appears very attractive on initial analysis, creditor counsel are advised to be prudent, particularly in selecting an independently verifiable index so as to avoid potential charges of illusory contracts, unconscionable terms, or unfair or deceptive practices. Similarly, caution should be applied in permitting negative amortization and in selecting the interval and amount of rate adjustment.

**16. NCUA Consumer Loan Rules**

a. The NCUA has expanded the authority of federal credit unions to grant variable rate financing beyond real property transactions to any type of consumer loans in open-end and closed-end transactions. As such, this is the only federal regulation to expressly permit variable rates in non-residential loans (46 Fed. Reg. 38674-38675).

b. Under these regulations, the NCUA provides guidance only in the area of indexes. It encourages credit unions to use a simple index that is easily ascertainable, beyond the control of the credit union, and readily verifiable by the borrower. It does not prohibit federal credit unions from using their own cost of funds as an index, but does warn that they may be risking a lawsuit if they do.

c. Additionally, the regulation expresses the proposition that the individual credit union is best prepared to make loan adjustment decisions in light of its individual circumstances. Therefore, the frequency and the amount of loan adjustments are left to the discretion of the credit union.

## III. Non-Federally Chartered Housing Creditors

### A. Impediments under State Law

Until recently, in a number of states, the absence of express authority to make variable rate loans, coupled with various impediments in the existing statutes, made the legality of housing financing questionable for state-chartered lenders.

## B. Alternative Mortgage Transactions Parity Act of 1982

A solution to this problem for housing transactions was brought about by the enactment of federal legislation which expressly allows all classes of "housing creditors" to offer variable rate financing to the extent that a federally-regulated lender is authorized to offer such financing. Thus, Congress recently acted to give state-chartered institutions and other creditors extending credit secured by a residence parity with federally-regulated lenders by adding Title VIII to the Garn-St. Germain Depository Institutions Act of 1982. One purpose of this multi-faceted bill, signed into law on October 15, 1982, was to revitalize the housing industry by strengthening the financial stability of home mortgage lenders (Cong. Record, pH. 8096., et seq., September 30, 1982). Title VIII of this Act is entitled the Alternative Mortgage Transactions Parity Act of 1982 ("AMPTA"). The AMPTA is designed to remove the impairment of non-federally-regulated creditors in competing with federally-regulated banks, thrift institutions and credit unions. Specifically, the AMPTA authorizes all "housing creditors" to make, purchase and enforce "alternative mortgage transactions" so long as the transactions are in conformity with the regulations issued by the relevant federal agencies.

### 1. Coverage

The AMPTA applies to a loan or credit sale secured by an interest in residential real property, a dwelling, all stock allocated to a dwelling unit in a cooperative housing corporation, or a mobile home. A "housing creditor" is a depository institution (as that term is defined in S 510(a)(2) of the Depository Institutions Deregulation and Monetary Control Act of 1980), a lender approved by the Secretary of Housing and Urban Development for participation in any mortgage insurance program under the National Housing Act, or any other person "who regularly takes [sic?] loans, credit sales, or advances secured by interest in properties" referred to in the definition of "alternative mortgage transactions" (S 803(2) of Title VIII, Alternative Mortgage Transactions Act of 1982). Thus, while the avowed purpose of the new law is to give state-regulated "housing creditors" parity with federal lenders, the broad definition expands the federal law to any creditor who regularly takes a security interest in the buyer's or borrower's residence.

### 2. Continued Application of State Law

Congress did not intend to preempt the myriad of state laws regulating these state-regulated lenders. The AMPTA specifically provides that in order to qualify as a "housing creditor," a creditor previously subject to state law must continue to be licensed under state law and must remain or, if a new entrant, become subject to the state's applicable regulatory requirements and enforcement mechanisms (ibid). Thus, state-chartered banks making housing loans now have authority to make variable rate transactions in accordance with the OCC regulations; state-chartered credit unions may now do so in accordance with the National Credit Union Administration's regulations for federal credit unions; and all other housing creditors, such as mortgage bankers and finance companies, are authorized to do so in accordance with regulations issued by the FHLBB. Any state constitution, law or regulation that is inconsistent with the above-mentioned federal authorization is preempted. However, the AMPTA affords each state the opportunity to override the federal preemption if the state legislature does so expressly and within three years after the effective date of AMPTA. Any such state override would not, however, affect any variable rate transaction, including any renewal, extension, refinancing or other modification of a transaction, that was entered into after the effective date of AMPTA and before the state acted to override the federal preemption.

## IV. Non-Housing Credit -'Impediments Under State Law

Turning to state-regulated credit transactions that do not qualify for the AMPTA's authorization to extend variable rate credit, the legality of such transactions will depend upon the provisions of applicable state law. Few state statutes expressly prohibit or authorize variable rate financing. Thus, the task essentially involves identifying provisions which have the effect of restricting or prohibiting this type of financing. This kind of analysis is particularly difficult because the source of the impediment may be a judicial opinion construing a statutory requirement, rather than a specific statutory provision. To facilitate this task, set forth below is a brief review of some of the more common types of statutory provisions which may be construed as impediments to variable rate financing.

### A. Prohibitions Against Compounding

While more common in mortgage transactions such as "negative amortization" loans, where the interest above a certain level is added to the principal, it is possible in a non-housing variable rate financing transaction that an increase in the rate of interest will have the effect that the borrower's monthly payment will not be sufficient to avoid adding interest to the principal sum. The result is to compound interest and in states where a statute or case law prohibits the assessment of interest on interest, the legality of such variable rate loans will remain in doubt until the issue is judicially examined (e.g., this is the case in West Virginia; Waldron v. Pigeon Coal Co., 56 S.E. 97 (W. Va. 1907)). Judicial decisions in several states indicate that it is against public policy or statutory provisions to impose interest on interest. See McConnell v. Merrill Lynch, Pierce, Fenner &,Smith, Inc., 578 P.2d 1375, 146 Cal. Rptr. 371 (1978) where the California court found that compounding was not permitted in the absence of a clear disclosure that interest was to be imposed on unpaid interest. See also, Giventer v.. Arnow, 37 N.Y.2d 305, 372 N.Y.S.2d 63 (1975).

The federal preemption applicable to housing creditors would arguably not be applicable, because a state-mandated prohibition against compounding is not a state law which necessarily prohibits. variable rate financing. In other words, since it is possible to offer variable rate financing without compounding interest, assuming the absence of other state laws prohibiting varying payment amounts or extending the maturity of the debt, a question arises as to the extent of AMPTA's preemption and whether it would have any effect on state prohibitions against 'compounding. Thus, all creditors will want to carefully examine state law with respect to this and other limitations, discussed below, which may not be preempted by AMPTA.

### B. Challenge to the Index

The creditor's index may be challenged, particularly if it is an index which is within the creditor's control. In one case the transaction survived a challenge that the index had been fraudulently manipulated (Vanguard Investments v. Central California Fed. Sav. Ass'n, 68 Cal. App. 3d 950, 963-64; 137 Cal. Rptr. 635, 727 (1977)). In another, the transaction survived a challenge that the variable interest rate provision was illusory (Powell, v. Central California Fed. Sav. & Loan Ass'n, 59 Cal. App. 3d 540, 549-550; 130 Cal. Rptr. 635, 640-41 (1976)). Other cases have involved use of an institution's cost of funds as the index. When the rate was the call-money rate, which was set by factors not within the parties' control, the court gave implicit sanction to use of the index (McConnell v. Merrill Lynch, Pierce, Fenner & Smith, supra; O'Brien v. Shearson Hayden Stone, Inc., 90 Wash. 2d 680, 586 P.2d 830 (1978)). Several cases have involved the lender's own prime rate as an index and that index has consistently survived the challenge, either on the ground that it was sufficiently definite to meet a statute requiring interest to be "fixed in writing," or on the ground that it was sufficiently definite for contract purposes (<u>In re Le Blanc</u>, 622 F.2d

872, 878-79 (5th Cir. 1980) (Louisiana Law); Constitution Bank & Trust Co. V. Robinson, 179 Conn. 232, 425 A.2d 12618, 1270-71 (1979); State Nat'l, Bank v. Dick, 164 Conn. 523. 325 A.2d 235 (1973); Sailboat Apartment Corp. v. Chase Manhattan Mortgage and Realty Trust, 363 So. 2d 564 (Fla. Dist. Ct. App. 1978)). However, the creditor must look to applicable law that governs the transaction to be certain that the use of a particular index is not prohibited. When the index is "at the lender's discretion," some courts have rejected its use (Ellis Nat'l Bank v. Davis, 359 So. 2d 466 (Fla. Dist. Ct. App. 1978)). In any event, as will be discussed below, such an index will not qualify for variable rate disclosure under an open-end plan, if the transaction is subject to Regulation Z, because the rate must be tied to a particular index or formula which is readily verifiable (see FRB Official Staff Commentary to Regulation Z, S 226.6(a)(2); the original Commentary's requirement that the index be beyond the control of the lender was eliminated for open-end credit (it never applied to closed-end credit) when the Commentary was revised by the Board). On the other hand, virtually any readily ascertainable and objective external index will be upheld under state law (Kin-Ark Corp. v. Boyles, 593 F.2d 361 (10th Cir. 1979) (Texas law implicitly upholding a Chicago bank's prime rate as an index); Ryder Truck Rental, Inc. v. Kramer, 263 Ark. 169, 563 S.W.2d 451 (1978); Arneill Ranch v. Petit, 64 Cal. App. 3d 277, 134, Cal. Rptr. 456 (1977); Associated East Mortgage Co. v., Highland Park, Inc., 172 Conn. 395, 374 A.2d 1070 (1977). And see Moore v. Canal Nat'l Bank, 409 A.2d 679 (Me. 1979)). In a very recent case the court upheld a variable rate mortgage where the index was the prevailing rate charged in the community at the time, ruling that such a provision was bargained for and therefore enforceable (O'Connell v. Dockendorff, 415 So.2d 35 (1982)).

## C. Charging Excessive Interest

The question of the status of variable rate contracts when the rate exceeds, for a time, the rate ceiling or when there is a change in the Tate ceiling, can be a difficult one.

When the variable interest rate charged exceeds the ceiling, at least the following possibilities exist: (a) the lender may not collect any interest above the legal maximum in existence at the time of consummation; (b) the lender-may not collect interest above the legal maximum at the time of consummation but may provide for the recapture of uncollectible interest in the event the contract rate drops below that legal maximum; (c) the lender may collect interest above the legal maximum during part of the duration of the loan, so long as the parties contract in good faith and the total interest collected does not exceed the legal maximum at any particular time; and (d) the lender may continue to collect interest above the legal maximum as long as there is a reduction in the final payment or a recomputation and refund of any excess interest at the time the loan is repaid.

New York's usury statute (see S 501.4 and S 502.4a, N.Y. Gen. Oblig Law, Ch 24-A, Art 5) is an example of the first possibility mentioned above. It provides that in the case of a variable rate loan the increased rate "shall not exceed the rate of interest as may have been authorized by law at the time such loan was made" (this rule does not apply to demand loans in excess of $5000).

In the absence of a specific statutory provision, there is little or no basis on which to assess the risk that a variable rate provision will be incompatible with a particular change in rate ceiling which occurs after consummation of the transaction. However, it can be argued that such contracts should not be limited to the statutory ceiling in effect at the time of consummation. If the state legislature raises or lowers the ceiling during the term of the contract or if Congress preempts state interest ceilings on such loans, the new ceiling should apply at the time of any adjustment. For example, if the rate ceiling on a certain type of loan is 18% at the time the variable rate obligation is executed, but the initial adjustable rate is 14% (e.g., two points above prime), that rate should be adjustable to rates above 18% if the statutory ceiling is later lifted to 21%. But the converse should also apply: if the legislature lowers the ceiling to 15%, that should be the cap for the variable rate loan, even if the prime is at 16%.

## D. Other Statutory Problems

A statute which requires substantially equal payments would effectively preclude a variable rate transaction, unless the debt's maturity can be extended accordingly. Thus, the Michigan Attorney General recently ruled that a precomputed closed-end contract could not carry a variable rate because of the requirement in the Michigan statute that precomputed transactions must be "payable in successive monthly payments substantially equal in amount from the date of the contract to the maturity of the final payment" and if the contract provides for other than equal payments, the total finance charge must not exceed the return derived from that obtained from a contract which does provide for equal payments. Since it is impossible to know the return on a variable rate contract at the time it is consummated, the Attorney General concluded that variable rate precomputed contracts are not permitted (Opinion of Michigan Attorney General No. 6089, August 3, 1982, CCH Cons. Credit Guide ¶ 96,863).

Similarly, a state's prohibitions on balloon payments may be deemed applicable and have the effect of precluding variable rate loans since changes in rates may produce balloon payments if changes in payment amounts or extended maturity is not permitted. In Maine, the statute's prohibition of balloon payments was held to be inapplicable (Moore v. Canal Nat'l Bank, supra); the opposite result was reached in South Carolina (S.C. Dept. Cons. Aff. Ad. Interpretation No. 1.108-8017 (Dec. 19, 1980), cited in 5 CCH Cons. Credit Guide ¶ 97,252).

New York is an example of a state where variable rate closed-end credit transactions are not expressly prohibited, but they do not appear to be compatible with certain statutory provisions. For example, section 108.4 of New York's Banking Law, dealing with personal loans, requires that loans be repayable "in equal or substantially equal installments at regular periodic intervals . . ." and since the statute prescribes a fixed maturity (which varies depending upon the face amount of the loan) variable rate loans would not appear to be feasible.

Also, in the context of open-end credit, New York's Retail Installment Sales Act expressly prohibits an open-end creditor from raising the rate and applying the higher rate "to that portion of the outstanding indebtedness from month to month which represents indebtedness incurred . . . between January 1, 1981 and the effective date of such change specified in the first notice [of change in terms] mailed or delivered…S413.3(e) N.Y. Pers. Prop. Law). In other words, when the finance charge rate on an open-end account is raised for the first time, the higher rate can only be imposed on transactions that occur after the effective date of that first rate increase. At least as to the first rate increase under this provision, this would require the imposition of separate rates to each balance to which that rate pertained. Also, this section expressly forbids any increase in rate unless the creditor sends a notice to the customer at least 30 days prior to the effective date of the rate increase. The notice must state, among other things, that use of the plan after the effective date of the rate increase shall constitute acceptance of the change in rate. Since there is no accommodation in the statute for variable rate plans, the notice appears to be required. Sending such a notice in connection with each rate increase, of course, defeats one of the purposes of a variable rate plan. Thus, while these provisions do not expressly prohibit a variable rate plan, they have the effect of inhibiting the use of such a plan.

Creditors should also look to state security interest laws with, regard to priority ranking of additional loan advances received under open-end loan accounts. Also, while Title 9 of the. Uniform Commercial Code (as adopted in 49 states) recognizes. security for future advance transactions, real estate mortgages and deeds of trust are, generally not subject to the UCC. Thus, it is important to look to applicable state law regarding security interests, in order to determine whether real estate mortgages or deeds of trust we'll secure future advance loans.

## V. Federal Disclosure Rules

Once it has been established that variable rate financing is authorized, either expressly or implicitly by virtue of compatible statutory and/or regulatory requirements, the disclosures required for consumer credit transactions are fairly straightforward. They are found in Regulation Z, the federal regulation which governs, all consumer credit disclosures (12 C.F.R. S 226.6, fn. 12 (initial disclosures) and S 226.7, fn, 15 (periodic statement) for open-end creditors; S 226.18(f) for closed-end creditors). The only exception to following the disclosure rules in Regulation Z is that certain lenders, such as mortgage lenders subject to federal regulation, are permitted to substitute compliance with the variable rate regulations of other federal agencies for compliance with Regulation Z (see S 226.18, fn. 43). Those regulations are discussed in detail in part II of this outline.

### A. Open-End Credit

#### 1 . Definition

Open-end credit means consumer credit extended by a creditors under a plan in which:
a. The creditor reasonably contemplates repeated transactions;
b. The creditor may impose a finance charge from time to time on an outstanding unpaid balance; and
c. The amount of credit that may be extended to the customer during the term of the plan (up to any limit set by the creditor) is generally made available to the extent that any outstanding balance is repaid (section 226.2(20) of Reg . Z).

#### 2. Required Initial Disclosures

Stated briefly, creditors extending open-end credit must include in their initial Truth-in-Lending disclosures (generally these disclosures are part of the revolving credit agreement): (a) the circumstances under which the rate(s) may increase; (b) any limitations on the increase; and (c) the effect(s) of an increase. No "model" disclosures for variable rate open-end plans are found in Regulation Z (model disclosures for closed end transactions are provided). The Official Staff Commentary to Regulation Z does, however, contain a discussion of how an open-end creditor should disclose the plan when the rate is tied to an index or formula.

#### 3. No Change in Terms Needed

Compliance with the rules on variable rates is essential since otherwise the open-end creditor must comply with Regulation Z's rule for providing customers with a notice of change in terms in advance of any rate increase. This is required by 12 C.F.R. S 226.9(c). No such advance notice of change in terms is required if the prescribed disclosures are made and the rate increase is tied to a readily ascertainable index. Any other change in terms of a variable rate open-end credit plan (other than rate increases) will require a notice of change in terms pursuant to S 226.9(c) of Regulation Z.

## 4. Index

For purposes of Regulation Z, the index need not be a third party's index. For example, a bank is permitted to tie its variable rate loans to its own prime rate. It is important, however, that the index be capable of independent verification. An open-end plan whereby the creditor merely reserves the right to raise its rates or that provides that an employee's preferential rate will increase upon termination of employment, will not qualify as a variable rate plan (Official Staff Commentary to S 226.6(a)(2)-2).

## 5. Periodic Billing Statement Disclosures

Once an open-end creditor has made the requisite initial disclosures, the only additional disclosure must be on the periodic billing statement that is sent for each billing cycle (a "billing cycle" need not be monthly, but it must, under Regulation Z, be at least quarterly). The billing statement must disclose that the periodic rate(s) may vary (see 12 C.F.R. S 226.7, fn. 15). The billing statement sent by a variable rate open-end creditor must disclose each rate in effect during the billing cycle for which the billing statement was issued, but only the rate applicable to that cycle need be disclosed. If, for example, the current cycle's rate is 1.5% and the creditor will increase the rate to 1.8% effective on the first day of the next cycle, the higher rate need not be disclosed on the period statement for the current cycle.

## B. Closed-End Credit

## 1. Disclosures

Closed-end creditors (closed-end credit comprises all consumer credit other than open-end credit) must disclose, just as for open-end credit, (1) the circumstances under which the rate(s) may increase; (2) any limitations on the increase; and (3) the effect(s) of an increase. In addition, the closed-end creditor must give an example of the payment terms that would result from an increase. The creditor may provide either a standard example that illustrates the terms and conditions for that type of credit or an example that reflects the terms and conditions of the particular transaction. A model form in Regulation Z provides examples of ways in which the variable-rate disclosures may be made (Appendix H to 12 C.F.R. S 226).

## 2. Index

Unlike open-end credit, a closed-end variable rate plan need not be tied to a specific index. In fact, the increase can be purely discretionary. Also, unlike open-end credit, a closed end employee preferred-rate loan will qualify for variable rate disclosures (see Official Staff Commentary to S 226.18(f), para 5). See also Katz v. Bank of California, 640 F.2d 1024 (9th Cir. 1981), cert. denied., 50 U.S.L.W. 3248 (1981). In Katz, a Truth-in-Lending case, it was agreed that the mortgage rate would increase if the property ceased to be the borrower's permanent residence.

## VI. Summary

Variable rate financing offers a number of advantages for creditors and it is increasing in popularity, particularly in view of recent statutory and judicial developments which make the environment for such financing favorable. For certain types of transactions, such as mortgage loans, the rules for variable rate financing are quite specific, although they are different depending upon which governmental agency has promulgated the rules. In the area of transactions involving a security interest in the debtor's residence, state creditors now have express authority to make variable rate loans, if they follow certain applicable federal rules. Also, disclosures required by federal Truth-in-Lending must be followed, except for those creditors who are authorized to substitute compliance with similar requirements under another applicable federal agency's rules. Finally, before instituting a variable rate plan, careful analysis of state law must be undertaken to ensure that there are no requirements which may be incompatible with the plan, such. as prohibitions against unequal payments, balloon payments, extending maturity, and compounding of interest.

Acknowledgement: permission to use part of D. Edwin Schmelzer's outline (Variable Rate Loans and New Deposit Instruments, PLI, Oct. 1982) in preparing this outline is sincerely appreciated.