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VARIABLE RATE MORTGAGES: THE TRANSITION PHASE

I. INTRODUCTION

As a result of the present nationwide economic fluctuations, every mortgage investment portfolio has a substantial number of loans which yield between six and eight percent. These rates are substantially lower than today's market and effectively reduce the yield on the average loan portfolio. Rising interest rates, particularly in the savings area, have brought the cost of lendable funds to a level which exceeds the yield on many mortgages. As a result, mortgage lenders are beginning to turn to loan transactions which include a variable interest rate feature in order to solve their financial dilemma. The existence of such a feature poses some complex problems which have not been adequately solved at the present time, although various attempts at resolution are being made.

Today, the savings and loan industry holds approximately fifty percent of all outstanding real estate mortgages in the United States. During the recent home building slump the S & Ls were faced with a problem somewhat peculiar to their industry. As a result of the recession, there was a decrease in new housing starts in conjunction with a concurrent increase in the price of existing housing. In addition, inflation prevented consumers from saving funds to purchase the now-inflated price of existing housing. This combination hit the savings and loan industry with a proverbial "one-two punch," and caused a stagnation in profit raising potential because the reduced savings by individuals resulted in a concurrent decline in mortgage lending abilities. This situation is unique to the savings and loan industry because S & Ls derive their lendable funds from short-term savings deposits, while their mortgage lending takes the form of long-term home loans. Approximately

1. [Hereinafter S & Ls].
3. As of January, 1975, total mortgage loans made by S & Ls were 15 percent lower than in January, 1974. Id. at 44.
ninety percent of the S & L's income is derived from interest on loans to borrowers, while the interest paid to savers represents the basic cost of money to the S & L. In order to maintain a stable financial operation, the difference between the borrowers' interest payments and the interest paid to savers must meet the S & L's operating expenses if the association is to remain profitable.\(^5\)

Loans given by S & Ls are most often in the twenty to thirty year category while savings deposits are typically a more short-term investment in the S & L. That discrepancy often creates an imbalance which constricts the S & L's lending abilities. When the economy fluctuates, this "lending long, borrowing short" quality impedes the S & L's ability to maintain a stable supply of funds for mortgage lending. The reason is that during periods of rapid inflation, the capacity to attract new savings is reduced while at the same time revenue generated by mortgage interest payments fails to increase at the same rate that the economy inflates.\(^7\) The result is a potentially crippling cash flow problem for S & Ls, and as one writer has noted, "[t]he associations in fact may face a savings outflow while, due to an inflation of the money supply, the demand for new housing is increasing."\(^8\)

Compounding the problem, the S & Ls are also faced with a problem called "disintermediation," which occurs when depositors take their money out of savings accounts and put it into higher yield investments or simply do not deposit it into savings accounts in the first place. In order to remain competitive for the savers' dollar, the S & Ls must raise the interest paid to savings depositors, thereby increasing the discrepancy between mortgage yield and interest expense.

The long-run problem thus faced by the home mortgage industry is to gain an increased base for revenue and retain competitiveness in the savings market without having to place the entire burden of the current cost of money onto new mort-
gages. The current answer to this dilemma is the variable rate mortgage.

The variable rate mortgage⁹ is a device which enables the S & L to change the interest rate according to the current cost of money, regardless of when the mortgage loan was originally consummated. In short, a VRM is a mortgage with a flexible interest rate that can be adjusted up or down in direct correlation with a formula¹⁰ that measures the current cost of money to the loaning institution. When this cost goes up, the creditor is allowed to pass this increase on to both existing and new mortgages. Conversely, when the cost of money decreases, so does the cost of the loan.

Proponents of the VRM feel that this kind of financing arrangement has a three-fold effect on the financial community. In the first place, with the addition of the variable rate feature, the flow of funds into home mortgage loan institutions becomes larger and less erratic, thereby ensuring a stable source of funds for prospective mortgagors.¹¹ Secondly, when economic changes mandate an increase in interest rates, such an increase can be absorbed on a pro-rata basis by both the existing and new

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9. [Hereinafter VRM].
10. For a discussion of the types of formulas that could be used, see Comment, Adjustable Interest Rates In Home Mortgages: A Reconsideration, 1975 Wis. L. Rev. 742, 762-65 [hereinafter cited as Adjustable Interest Rates].

The formula used by the Federal Home Loan Bank of San Francisco measures the weighted average cost of funds of its member associations. The figure is determined in a series of calculations:

The weighted average cost of funds is expressed as a percentage. The measure reflects the annualized interest payments that associations make on savings capital, FHLB advances, debentures, and other borrowings, expressed as a percentage of the average balances of savings capital, advances, debentures, and other borrowings outstanding during the six-month period. Relevant data for this calculation are taken from the associations' semiannual and monthly reports and include the following measures:

The total amount of dividends or interest paid (or payable) on all savings accounts during the six months, as well as total interest paid on FHLB advances (including commitment fees), on debentures, and on other borrowings. These numbers are summed and become the numerator of the cost calculation after doubling (annualizing).

In the Bank's calculation, the denominator consists of the simple average of the sum of the month-end balances of total savings capital, FHLB advances, and other borrowings (including debentures), for the six month-ends during the period.

The resulting fraction is calculated and presented as a percentage. Federal Home Loan Bank of San Francisco, Information Bulletin (August 18, 1977).

mortgages. In effect this terminates any so called "subsidy" the new mortgages may be required to provide to the already existing mortgages because of the lenders' need for compensation by a yield sufficient to cover the cost of lendable funds. Finally, it is argued that variable rates actually help to stabilize economic conditions by anticipating and adjusting to market fluctuations.

II. PRACTICAL AND LEGAL CONSIDERATIONS

Despite the positive effects propounded by the advocates of VRMs, the existence of an adjustable interest rate is not without its own special set of complications.

From the borrower's standpoint, entering into a mortgage containing a variable rate feature requires an answer to two immediate questions. First, the borrower must decide what practical benefits, and conversely, what burdens, would logically follow from such a provision. Second, the borrower should know, before the mortgage is consummated, how the increase will be put into effect. Since the answer to both of these questions depends upon the degree of disclosure made to the borrower at the time the lending agreement is consummated, the overall issue surrounding the VRM question deals with present state and federal disclosure requirements. As will be seen, answers in this area are still in the developmental stage.

A. Present Standards

In order to encourage consumer participation in VRMs, savings and loan associations are willing to offer features not readily available in fixed-rate mortgage agreements. While features available with a VRM may differ with the individual lending institution, generally, institutions offer one or more of the following:

1. Interest rate. Offered at 1/4 to 1/2 percent below the market interest rate for fixed-rate mortgages.
2. Loan to value ratio. Many institutions are willing to fi-

12. Id.
14. It should be noted that given the ability of the lender to escalate this rate under a variable rate clause, any initial rate discount could be easily submerged by a subsequent increase. As a result, the borrower would be well advised to determine the method of implementation of a rate increase, its potential frequency, and the maximum limits of potential changes prior to consummation of the agreement.
inance at a rate higher than the conventional mortgage; sometimes up to 95 percent of value.

3. Prepayment penalty. Eliminated if the variable rate is invoked and payment of the balance due is made within a specified time period (usually 90 days).

4. Guaranteed line of credit. May be available if the mortgagor determines he wants to take out a second mortgage, or simply refinance the first one.

5. Assumptions. Allowed without any concurrent increase in the interest rate.\(^\text{15}\)

While the use of the VRM does have potential advantages, the borrower should be aware of some of the uncertainties and variables now present with such a mortgage. In particular, the method and timing of the rate change should be determined prior to entering into this kind of agreement. Four basic methods have been proposed for implementing the rate change.

The first method treats a VRM as a series of short-term or demand notes. The mortgage is written as a short-term note, payable in three to five years, with a potential for conversion into a demand instrument or extension as further short-term notes. At each conversion or extension period, the lender could presumably reserve the right to activate the variable feature.\(^\text{16}\)

A second method allows a lender to change the interest rate at will. Here, the normal long-term mortgage contract is used, but with a provision that the rate can be varied upon notice to the mortgagor.\(^\text{17}\)

The third method puts an "income participation" provision into the mortgage agreement, giving the lender both a stated basic rate of return on the loan and a participation right in revenues produced by the property. Of course, this provision only applies to multifamily and commercial property, and "varies" the amount paid to the lender by giving him an interest in either gross or net income produced by that property.\(^\text{18}\)

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\(^{15}\) In some cases, due-on-sale clauses may be eliminated from VRMs because they will be unnecessary to protect the mortgagor's interest in a current rate of return. Proponents argue that the mortgagor will be able to transfer his loan more freely because of a variable rate. However, the borrower should determine whether his contract requires assumption fees when the mortgage is taken over by another party.


\(^{17}\) Id. This method would treat variable rate clauses the same as escalator clauses. However, the difference between the two is that a variable rate clause can decrease or increase the interest rate whereas the escalator clause only provides for increases.

\(^{18}\) Id.
The final method ties any increase (or decrease) in the interest rate to an “index,” which provides a standard that automatically results in a change in the interest rate according to a predetermined formula.\(^9\)

Of all four methods for activating the variable rate clause, the final “indexing” method represents the most even-handed way of dealing with variable interest rates, and allows the consumer an opportunity to determine in advance when the interest payments may be changed. This method is supported by a majority of the commentators,\(^2\) although the actual formula to be used is a matter of some debate at the present time.\(^2\) In any event, since the purpose of a variable rate clause is to adjust the interest payable to the lender according to his cost of money, any formula adopted should reflect this cost.\(^2\)

**B. Legal Factors**

Any attempt to deal adequately with the legal ramifications of the variable rate mortgage must take into consideration the various regulatory factors governing disclosure to the borrower. However, since the use of variable interest rates in mortgages is a relatively recent phenomenon, the state and federal authorities have not yet legislated extensively in this area. Neither has the judicial branch been involved in a great deal of litigation involving VRMs.\(^2\) Nevertheless, VRMs do pose serious questions as to the disclosure requirements necessary to enable the borrower to make reasonable choices regarding his or her borrowing source. Certain areas in particular raise troublesome questions, such as when the potential cost of the loan must be disclosed, how the variable feature will affect the borrower’s payment schedule, and when disclosure of the rate change must be made. As of yet, these questions have not been adequately answered.

The Federal Truth in Lending Act\(^2\) represents one of the

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19. Id. Such a rate-indexing formula seems to be the most feasible technique, both in terms of reliability and objectivity, and is the one proposed by the FHLBB. See 40 Fed. Reg. 6870, 6871 (1975).
20. See Landers & Chandler, supra note 7, at 44-46; Adjustable Interest Rates, supra note 10, at 764.
22. Id. at 762-65.
23. This writer has found only two cases dealing with variable interest rate issues. Both are discussed, infra at 152-59.
few pieces of nationwide legislation regulating VRMs. The express purpose of the Act is to provide consumers with meaningful disclosures so as to facilitate informed use of credit.\textsuperscript{25} While having little substantive impact on the validity of VRMs, TIL does require disclosure to the consumer of both the cost of credit, expressed as an annual percentage rate, and the amount and timing of payments and any prepayment penalties required of the borrower.\textsuperscript{26} In addition, Congress gave the Federal Reserve Board rule making ability to implement the provisions of TIL,\textsuperscript{27} which has been applied to general consumer credit transactions through the issuance of Regulation Z.\textsuperscript{28} Finally, the Act empowers the Federal Home Loan Bank Board\textsuperscript{29} to require compliance with the provisions of the Act by the savings and loan industry.\textsuperscript{30}

Surprisingly, TIL does not address itself to VRMs directly. Commentators have pointed out that the reason for this seeming oversight, which is best exemplified by the final Senate bill exempting first mortgage loans entirely from TIL coverage,\textsuperscript{31} is simply the result of a congressional belief that specific coverage was unnecessary. Apparently Congress reasoned that since TIL was designed primarily to require disclosure of interest rates in terms of an annual percentage basis, the fact that most mortgage lenders had already been doing this without the TIL mandate effectively negatived any reason for compelling them to do so in the future.\textsuperscript{32} However, Congress did finally provide for some administrative control by giving the FRB and the

\textsuperscript{25} 15 U.S.C. § 1601 (1970) establishes the purpose of the Act:

The Congress finds that economic stabilization would be enhanced and the competition among the various financial institutions and other firms engaged in the extension of consumer credit would be strengthened by the informed use of credit. The informed use of credit results from an awareness of the cost thereof by consumers. It is the purpose of this subchapter to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit.

\textsuperscript{26} 12 C.F.R. § 226.8 (1977).


\textsuperscript{28} Truth In Lending Regulations, 12 C.F.R. §§ 226.1 et seq. (1977).


\textsuperscript{30} The Federal Home Loan Bank Board is the regulatory agency for federally chartered savings and loan associations. 12 C.F.R. § 500.3 (1977).


\textsuperscript{32} Id.
FHLBB the power to promulgate regulations affecting mortgage lenders.\textsuperscript{33}

Although VRMs are considered a current financial necessity by some in order to insure a continued supply of mortgage funds, the existence of such clauses create serious complexities to a borrower attempting to make an investment within a limited income. The inadequacy of present regulations is manifested at two different times within the contractual period. From the consumer standpoint, an "informed use of credit" requires knowledge of both the annual percentage rate and the length of the loan. This data is readily supplied in the normal fixed rate mortgage since Regulation Z requires both to be described "before the transaction is consummated."\textsuperscript{34} However, because of the VRM's nature, the effect of the fluctuating interest rate varies the mortgage's elements: either there is an accompanying change in the amount of each payment or an extension in the number of payments required to retire the loan, or any combination of the two. For example, assume a borrower takes out a twenty-five year home loan of $30,000 at 8.5 percent interest. Given these rates, the borrower would be paying $241.57 per month. If, however, after three years the variable rate provision is invoked and the lender increases the interest rate to 9.5 percent, one of three things must occur: (1) the monthly payments will be increased to $260.49 (resulting in a 7.8 percent increase over the prior payment); (2) the term of the loan will increase; or (3) there will be a combination of these two factors. Regardless of the type of change effectuated, the credit terms of the original mortgage are materially changed, and TIL's purpose to inform consumers about the cost of their credit will have been thwarted unless a further disclosure is made prior to the effective date of the increase.\textsuperscript{35} Either type of change materially alters major terms of the original mortgage contract. Surprisingly, neither of these factors are required to be adequately disclosed by present law.

The present TIL Interpretation\textsuperscript{35} covering VRMs states the following:

\textsuperscript{34} 12 C.F.R. § 226.8(a) and (b) (1977).
\textsuperscript{36} This is an official Interpretation of 15 U.S.C. § 1634 (1970) which reads:
(a) In some cases a note, contract, or other instrument evidencing an obligation provides for prospective changes in the annual percentage rate or otherwise provides for prospective variation in the rate. The question arises as to what disclosures must be made under these circumstances when it is not known at the time of consummation of the transaction whether such change will occur or the date or amount of change.

(b) In such cases, the creditor shall make all disclosures on the basis of the rate in effect at the time of consummation of the transaction and shall also disclose the variable feature.

(c) If disclosure is made prior to the consummation of the transaction that the annual percentage rate is prospectively subject to change, the conditions under which such rate may be changed, and, if applicable, the maximum and minimum limits of such rate stipulated in the note, contract, or other instrument evidencing the obligation, such subsequent change in the annual percentage rate in accordance with the foregoing disclosures is a subsequent occurrence under §226.6(g) and is not a new transaction.\(^3\)

Two aspects of this interpretation should strike the reader. First of all, because subsection (b) requires disclosures to be made only “on the basis of the rate in effect at the time of consummation of the transaction,” the lender arguably does not have to disclose either the methods that will be used to implement the rate increase, or the amount of interest variation that can be invoked at any one time (even though the lender must “also disclose the variable feature”). As a result, at the time of consummation, the borrower does not know whether invocation of the variable rate would affect the monthly payments, the term of the loan, or both. Secondly, even though subsection (c) requires disclosure of the conditions for change,\(^3\) and the minimum and maximum limits of such change, subsection (c) also specifies that such change is a “subsequent occurrence under § 226.6(g) and is not a new transaction.” Because the Interpretation cross-references to

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38. Presumably, this means that the lender would have to disclose which of the four methods he would use to determine when the variable rate would be invoked.
section 226.6(g), it seemingly negates the ability of the borrower to require the lender to supply information regarding the effect of the variable feature at the time of invocation:

(g) Effect of subsequent occurrence. If information disclosed in accordance with this part is subsequently rendered inaccurate as the result of any act, occurrence, or agreement subsequent to the delivery of the required disclosures, the inaccuracy resulting therefrom does not constitute a violation of this part.39

Because of these regulations, the borrower can be denied information as to both the potential cost of the loan at the time of consummation of the loan, and as to the actual cost at the time of invocation of the variable feature. This conclusion is supported by judicial interpretation and leaves little hope for any immediate improvement. However, a recent FRB rule change and some proposed FHLBB rules could conceivably rectify the legislative oversight.

III. RECENT CHANGES AND CONSTRUCTION
A. Federal Reserve Board Regulations

Pursuant to its rule making ability, the Federal Reserve Board has promulgated an amendment to Regulation Z which requires all lending institutions executing VRMs to make certain standardized disclosures to borrowers.40 While this rule provides additional standards by which lenders present a more developed picture of the loan transaction to the borrower, the rule nevertheless falls far short of clear, categorical standards which are necessary in this area.

39. 12 C.F.R. § 226.6(g) (1977). There is a footnote to this section which reads:
Such acts, occurrences, or agreements include the failure of the customer or lessee to perform his obligations under the contract and such actions by the creditor or lessor as may be proper to protect his interests in such circumstances. Such failure may result in the liability of the customer or lessee to pay delinquency charges, collection costs, or expenses of the creditor or lessor for perfection or acquisition of any security interests or amounts advanced by the creditor or lessor on behalf of the customer or lessee in connection with insurance, repairs to or preservation of collateral or leased property.

While the import of this footnote would seem to negate application of § 226.6(g) to VRMs, recent case law has nevertheless so applied the section. See Herbst v. First Fed. Sav. & Loan Ass'n, 538 F.2d 1279 (7th Cir. 1976) discussed infra, at 152.

Basically, the FRB rule has five substantive disclosure requirements, only two of which are new. In pertinent part, the rule requires lenders to make a number of disclosures.

The operations of the VRM, such as the fact that the annual percentage rate is subject to increase, the conditions under which the rate may increase, and any limitations on the amount of the increase must be disclosed.\(^4\) This requirement is presently embodied in Interpretation section 226.810. In addition, this portion of the rule also requires disclosure of any index to which the annual percentage rate is tied.\(^2\) While this provision is new, pegging the increase to an index is not mandatory, which eliminates any opportunity for the borrower to forecast trends unless the lender actually uses an index.

The lender must also disclose the manner in which any change in the interest rate would be effected.\(^4\) This would apply to any increase in the dollar amount of the payments, the number of periodic payments, or the amount due at maturity of the loan. While not explicitly saying so, the rule implies that any combination of these factors should also be communicated to the borrower.\(^4\)

In the most interesting part of the new regulation, the lender is required to inform the borrower of the effect upon the amount of payment or number of payments of an estimated rate increase caused by a hypothetical immediate increase of one quarter of one percent, based on the periodic payment

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41. 42 Fed. Reg. 20455, 20456 (1977) (to be codified in 12 C.F.R. § 226.8(b)(8)(i)).

There is a footnote to the regulation which underscores the fact that the changes only apply to the mortgage transaction itself, and not to any penalty provisions: “For this purpose, the phrase ‘prospectively subject to increase’ does not apply to increases in the annual percentage rate upon such occurrences as default, acceleration, late payment, assumption or transfer of property.” 42 Fed. Reg. at 20456. Presumably, due-on-sale and due-on-encumbrance clauses would therefore not be affected by the regulation.

It should be noted that substitution of the word “increase” in the new rule for the word “change” in present Interpretation 12 C.F.R. § 226.810 reduces the amount of disclosures a lender will be required to make at the time of consummation. In addition, this new language presents both the borrower and the lender with the problem of determining when an “increase” occurs. For example, if the original interest rate of 8.5% is decreased by 0.5% one year, and increased by 0.5% at some later point, it is unclear whether this subsequent “increase” would be considered an actual increase.

42. 42 Fed. Reg. 20455, 20456 (to be codified in 12 C.F.R. § 226.8(b)(8)(ii)).

43. Id. (to be codified in 12 C.F.R. § 226.8(b)(8)(ii)).

44. The explanatory information part of 42 Fed. Reg. 20455 (1977) confirms that combinations of increases in the payment amount and maturity date would also have to be disclosed, although the rule itself does not explicitly say so.
amount and the original amount financed disclosed at the consummation of the original lending agreement if the obligation is repayable in substantially equal installments at equal intervals, and the amount financed would be affected by an increase in the periodic payment amount or conversely, by an increase in the number of periodic payments. While this provision requires more than any previous law, from a practical standpoint, it tells the borrower very little, because it is unusual for a lender to activate the variable feature immediately after consummation of the loan transaction. Thus, while the disclosure would effectively inform the borrower as to what a theoretical increase would entail, it makes no attempt to require disclosure of the actual cost of loans using the declining balance approach to calculate interest payments. Since most home loan transactions are computed on a declining balance method, the borrower is still artfully deprived of the actual cost of his loan at the time the variable rate feature is invoked. In addition, if the disclosure is worded inaccurately, the requirement may have the negative effect of creating the impression in a less sophisticated borrower that increases can only occur at the maximum rate of one quarter of one percent. Such an impression is not intended by the regulation.

Finally, the regulation only applies when the real property interest governed by the VRM is used as the customer's dwelling, and does not apply in other cases. Apart from the above-mentioned regulation, present law regarding changes in the annual percentage rate still governs. That is, a subsequent "increase" in the annual percentage rate is still considered to be a "subsequent occurrence" under present section 226.6(g), and is not considered a "refinancing" under section 226.8(j) as long as the other requirements of the regulation are met. Consequently, lenders are not governed by the new disclosure requirements when the variable rate is invoked. All disclosures need only be made prior to consummating the original lending agreement.

45. Id. at 20456 (to be codified in 12 C.F.R. § 226.8(b)(8)(iii) and (iv)).
46. The rule specifically exempts agricultural transactions, transactions in which the obligation is repayable in substantially equal installments which do not include repayments of principal, or transactions involving insurance agreements. Id. (to be codified in 12 C.F.R. § 226.8(b)(8)(iv)). The effect of the rule on loan transactions involving four-family housing and commercial property is unclear.
47. 42 Fed. Reg. 20455, 20456.
B. Herbst: The Federal Decision

In Herbst v. First Federal Savings and Loan Association,\(^4\) the Seventh Circuit Court of Appeals was confronted with the issue of VRM disclosure requirements under TIL. Seven different mortgagors who had taken out residential mortgages from the defendant prior to July 1, 1969\(^4\) brought parallel actions to recover for alleged disclosure requirement violations under TIL. Each mortgage note contained the language required by Wisconsin law\(^5\) regarding the lender's option to increase the

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48. 538 F.2d 1279 (7th Cir. 1976).
49. The effective date of TEL is May 29, 1968.
50. Wis. Stat. § 215.21(3)(b)(1973). This section was repealed effective June 12, 1976 by passage of 1975 Senate Bill 135, 1975 Wis. Laws, ch. 387. In its place, the Wisconsin Legislature enacted a comprehensive section dealing solely with VRMs; Wis. Stat. § 138.055 (1975) represents an excellent understanding of the problems which must be solved if VRMs are to become widespread:

Variable rate contracts

1. Required contract provisions. No contract between a borrower and a lender secured by a first lien real estate mortgage on, or an equivalent security interest in, an owner-occupied residential property containing not more than 4 dwelling units may contain a variable interest rate clause unless the contract provides that:

   (a) When an increase in the interest rate is permitted by a movement upward of a prescribed index, a decrease in the interest rate is also required by a downward movement of the prescribed index subject to pars. (b) to (f);

   (b) The rate of interest shall not change more than once during any 6-month period;

   (c) Any singular change in the interest rate shall not exceed the rate of $1 per $200 for one year computed upon the declining principal balance and the total variance in such rate shall at no time exceed a rate equal to $2.50 per $100 for one year computed on the declining principal balance greater or lesser than the rate originally in effect;

   (d) Decreases required by the downward movement of the prescribed index shall be mandatory. Increases permitted by the upward movement of the prescribed index shall be optional with the lender. Changes in the interest rate shall only be made when the prescribed index changes a minimum of one-tenth of one percent;

   (e) The fact that a lender may not have invoked an increase, in whole or in part, shall not be deemed a waiver of the lender's right to invoke an increase at any time thereafter within the limits imposed by this section;

   (f) The rate shall not change during the first semiannual period of the loan; and

   (g) The borrower may prepay the loan in whole or in part within 90 days of notification of any increase in the rate of interest without a prepayment charge.

2. Disclosures required. No lender may make a loan secured by a first lien real estate mortgage on, or an equivalent security interest in, an owner-occupied residential property containing not more than 4 dwelling units containing a variable interest rate provision unless it has clearly and conspicuously disclosed to the borrower in writing prior to execution of the loan documents:
interest rate. Pursuant to the terms of the notes, in September 1973 each plaintiff received notice that as of February 1, 1974, the interest rate would increase. The interest rate was actually increased, but the defendant did not deliver or show to the plaintiffs any disclosure form reflecting the terms of the loan at any time on or prior to February 1, 1974.

The court held that the lender's failure to make disclosure at the time the variable rate was invoked did not constitute a violation of either the state statute or federal regulations, and

(a) That the loan contract contains a variable interest rate;
(b) The index used in applying any variable interest rate changes contemplated in the note and its current base; and
(c) Any prepayment rights of the borrower upon receiving notice of any such change.

(3) Notice of interest adjustment. When a change in the interest rate is required or permitted by a movement in the prescribed index, the lender shall give notice to the borrower by mail, addressed to the borrower's last-known post-office address, not less than 30 days prior to any change in interest rate, which notice shall clearly and concisely disclose:
(a) The effective date of the interest rate change;
(b) The interest rate change, and if an increase, the extent to which the increased rate will exceed the rate in effect immediately before the increase;
(c) The changes in the index which caused the interest rate change;
(d) The amount of the borrower's contractual monthly principal and interest payments before and after the effective date of the change in the interest rate;
(e) Whether as a result of an increase in the interest rate a lump sum payment may be necessary at the end of the loan term; and
(f) The borrower's right to prepay the loan within 90 days after said notice without a prepayment charge if the notice required an increase in interest rate.

(4) Index. In determining any variable interest rate changes permitted under this section, a lender shall use either the index published by the federal home loan bank of Chicago based on the cost of all funds to Wisconsin member institutions or an index approved by:
(a) The commissioner of savings and loan, if the lender is a savings and loan association:
(b) The commissioner of credit unions, if the lender is a credit union;
(c) The commissioner of insurance, if the lender is an insurance company;
or
(d) The commissioner of banking for all other lenders.

(5) Applicability. (a) This section does not apply to loans or forbearances to corporations.
(b) This section applies only to transactions initially entered into on or after the effective date of this act (1975).

It should be noted that Wisconsin law governing lending practices of savings and loan associations does not apply to federally-chartered savings and loans doing business in this state. Kaski v. First Fed. Sav. & Loan Ass'n, 72 Wis. 2d 132, 240 N.W.2d 367 (1976).

51. The amount of rate increase was 1% for six of the plaintiffs and 0.5% for one of the plaintiffs.
in so doing clarified two aspects of the present law. First, the court read the disclosure requirements of 12 C.F.R. section 226.810 as pertaining solely to disclosures which must be made prior to consummating the loan transaction. Then, regarding disclosures at the time the variable rate is actually invoked, the court interpreted the final clause of section 226.810(c)\(^2\) to mean that any resulting inaccuracy in the original disclosure was not a violation of TIL requirements, even though the original disclosure made at the time of the transaction was rendered inaccurate by the adjustment in the interest rate.\(^3\) In so doing, the court properly pointed out that both TIL and section 226.810 are silent on the question of what disclosures need be made before the annual percentage rate is increased by implementation of the variable rate. Additionally, the court noted that because section 226.810 does not treat a subsequent change as a new transaction, "the implication is inescapable that if a transaction is not to be considered 'a new transaction,' it is not subject to the disclosure requirements."\(^4\)

The second aspect clarified by the Herbst court was the effect of TIL upon transactions consummated prior to TIL's effective date. Because the mortgages in Herbst were consummated prior to July 1, 1969, the court held that "a rule of substantial rather than strict compliance should be adopted,"\(^5\) and that a mere inadequacy of disclosure and the fact that the term "rate of interest" rather than "annual percentage rate" was used, should not result in liability to the lender since there was no burden to foresee the precise requirements of TIL prior to their promulgation. Consequently, a more liberal standard of substantial compliance was adopted.

At present, Herbst represents the only federal case testing the validity of VRMs under TIL regulations. However, Herbst is a transition case and therefore a portion of its ruling is necessarily an anomaly in the law. Because the mortgages were consummated prior to July 1, 1969, the court felt compelled to adopt a "substantial compliance" rule, rather than requiring strict compliance with TIL. However, prior cases construing TIL mandates have held strictly to the contrary:

\(^{52}\) 12 C.F.R. § 226.810(c) (1975).
\(^{53}\) 538 F.2d at 1282.
\(^{54}\) Id.
\(^{55}\) Id. at 1283.
Many of the requirements of the Truth-in-Lending Act are technical in nature, and the Court is not at liberty to deviate from them as it sees fit. Regulation Z unequivocally requires that necessary disclosures shall be written and made together on one document. The drafters of the legislation obviously felt that oral statements by creditors or piecemeal disclosures are not adequate to ensure the consumer's protection. Regardless of the wisdom or validity of that proposition, it is not this Court's prerogative to substitute its own view for that of Congress.65

Consequently, lenders consummating mortgages after July 1, 1969, should strictly comply with TIL requirements, for, as one court has pointed out, the laissez-faire era of caveat emptor is increasingly giving way to an ethic of caveat vendor.67 Nevertheless, Herbst retains a present validity by ruling that if lenders take into account the definition of "subsequent occurrence" in section 226.6(g), then the later adjustment in the annual percentage rate is not a "new transaction" under TIL and therefore requires no new disclosure to the borrower,68 as long as the requirements of section 226.810 are met.69 In this respect the Herbst decision comports with both the present law and the new rule, thereby ensuring its usefulness as future precedent. However, since the FRB has issued the additional "hypothetical increase" requirement, lenders should be wary of relying too heavily on the decision.

B. Powell: The California Decision

In Powell v. Central California Federal Savings and Loan Association,60 a plaintiff brought suit to invalidate variable rate provisions in three loans61 secured by deeds of trust on an apart-

57. Thomas v. Myers-Dickson Furniture Co., 479 F.2d 740, 748 (5th Cir. 1973).
58. Lack of need for disclosure at the time of invocation of the variable feature holds true even though 12 C.F.R. § 226.8(j) (1977) would seem to require otherwise:
(j) Refinancing, consolidating, or increasing. If any existing extension of credit is refinanced, or two or more existing extensions of credit are consolidated, or an existing obligation is increased, such transaction shall be considered a new transaction subject to the disclosure requirements of this part.
59. The Herbst ruling is consistent with Federal Reserve Board opinion letters in 5 CONS. CRED. GUIDE (CCH) ¶ 31,137 (June 27, 1974) and 5 CONS. CRED. GUIDE (CCH) ¶ 31,373 (April 19, 1976). However, some confusion does exist because of letters to the contrary; cf. letter in 5 CONS. CRED. GUIDE (CCH) ¶ 31,179 (November 14, 1974). Presumably, Herbst settles the controversy for the time being.
61. The first loan was executed on June 26, 1963 for $850,000 at 7% interest for 20
ment house. Two years and eight months after the plaintiff had taken out the last loan, the lender activated the variable rate clause, giving notice to the plaintiff that the interest rate on each loan would be increased by one percent. Through his attorney, the plaintiff asserted that the increase was invalid because the notes called for specific monthly payments which could not be increased without the borrower's consent. The lender claimed that the increase could be effected without raising the monthly payments. The plaintiff then filed suit to enjoin the lender from either increasing the maturity dates on the loans or requiring "balloon" payments at the end of the loan terms.

At trial, the plaintiff claimed federal regulations prohibited the defendant from increasing the monthly interest payments, but the trial court found for the defendant. Affirming the decision of the trial court, the California appellate court made several interpretations of federal law in holding the variable rate provision valid. First, the court held that since the notes specified a given maturity date, and given the fact that a federal regulation required the lender's installment loans to be repayable "within the contract period," the maturity dates could not be extended to satisfy invocation of the variable feature. However, although the maturity date could not be lengthened, the monthly payments could be increased to accommodate the variation in the interest rate. Apparently, the prior federal regulation existing when the loans were transacted between 1963 and 1967, and not as later amended, was applied.

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62. "Balloon" financing is an arrangement whereby the lender requires periodic payments of an amount that retires the mortgage in 20 to 30 years with the balance due as an increased amount over the normal periodic rate at the end of a 1 to 5 year period. Often, the debtor is required to refinance if he is unable to make the balloon payment. See 12 C.F.R. § 226.8(b)(3) (1977).

63. 12 C.F.R. § 541.14 (1977) is the present amended version of the regulation which at the time the plaintiff in Powell took out the loans, read as follows:

(a) Installment loan. The term "installment loan" means any loan repayable in regular periodic payments, equal or unequal, sufficient to retire the debt, interest and principal, within the contract period: Provided, however, That the loan contract shall not require any subsequent periodic principal payment to be greater than any previous periodic principal payment.

64. Id.

Consequently, the court concluded that the regulation only prohibited "any subsequent periodic principal payment" from being made greater than "any previous periodic principal payment." Since a raise in the monthly payments only increased the interest portion of the monthly payments, the court did not find a violation of federal regulations.

In response to the plaintiff's second allegation claiming a variation of the interest rate made the agreement illusory by making performance discretionary on the part of one of the parties, the court responded that "a contracting party's discretionary power to vary the price or other performance does not make the agreement illusory if the party's actual exercise of that power is reasonable." In terms of a VRM, the court construed "actual exercise" to mean a justification based on the prevailing interest rate paid to depositors. Invocation of the variable rate is therefore justified as long as there is a reasonable correlation between that increase and the cost of lendable funds. In this respect, the court used the financial necessity for inserting the variable provision in the original contract as the guideline to be used in determining when a single increase is "reasonable," which, impliedly, seems to require a "tie" between the cost of funds to the S & L and any increase in the interest rate, even though no individual index is required.

66. 59 Cal. App. 3d at 549, 130 Cal. Rptr. at 640 (emphasis in original).
67. Id.
69. In pertinent part, CAL. CIV. CODE § 1916.5 (West 1975) states the following:

Variable Interest; Requirements
(a) No increase in interest provided for in any provision for a variable interest rate contained in a security document, or evidence of debt issued in connection therewith, shall be valid unless such provision is set forth in such security document, and in any evidence of debt issued in connection therewith, and such document or documents contain the following provisions:

(1) A requirement that when an increase in the interest rate is required or permitted by a movement in a particular direction of a prescribed standard an identical decrease is required in the interest rate by a movement in the opposite direction of the prescribed standard.

(2) The rate of interest shall change not more often than once during any semiannual period, and at least six months shall elapse between any two such changes.

(3) The change in the interest rate shall not exceed one-fourth of 1 percent in any semiannual period, and shall not result in a rate more than 2.5 percentage points greater than the rate for the first loan payment due after the closing of the loan.
Like *Herbst*, *Powell* represents another transition case. Consequently, its holding that federal regulations only prohibit increases in principal payments applies only to those transactions consummated prior to the effective date of the amendments to the regulation cited. However, as to VRMs executed subsequent to December 8, 1975, the following FHLBB regulation applies:

(a) Installment loan. The term "installment loan" means any loan repayable in regular periodic payments sufficient to retire the debt, interest and principal, within the loan term. However, as to a loan secured by a home or a combination of home and business property occupied or to be occupied by the borrower, no required payment after the first payment shall be more, but may be less, than any preceding payment. 70

It should be apparent that the FHLBB has now made a conscious effort to distinguish between home loans and multifamily or commercial loans. While both categories are still subject to a 30 year term ceiling, 71 possible rate increases for each type of mortgage can still be absorbed. However, federally-chartered S & Ls are restricted in the type of loan they can execute if they desire to include a variable rate provision. That is, in order to include a variable interest rate in a home loan, a federally-chartered institution would have to execute a loan at an initial term of less than 30 years. Subsequent increases would be absorbed by extensions of maturity, while the amount of each payment would remain the same. 72 On the other hand,
because multifamily and commercial loans are normally obtained for investment purposes, the FHLBB has been less stringent in its regulations. Implementation of the variation can take the form of either an increase in monthly payments, or an increase in the maturity date of the loan, or a combination thereof. Presumably, the only limitation is the 30 year maximum term.

IV. PROPOSED RULES

Present regulations and case law do not establish clear guidelines protecting both lender and borrower interests in mortgage loans containing a variable feature. Present law subjects the lenders to expensive and prolonged litigation because of the failure of federal agencies to establish standardizing procedures, forms, and disclosure requirements. Further, borrowers are justifiably confused by the intricacies of the VRMs. Because of these problems, the FHLBB has promulgated proposed regulations which substantially solve both the disclosure and interest adjustment implementation problems.

The FHLBB proposed rules delineate eight substantive changes to present Parts 541 and 545 of the rules and regulations for the Federal Savings and Loan System. VRMs would be specifically authorized, but any adjustments to the interest rate (whether it be an increase or a decrease) could be made only in accordance with a FHLBB-approved index. A decrease in the index rate would result in mandatory decreases in the interest rate. Increases, however, would be optional, could not average more than 0.50 percent every six months, and would have a maximum ceiling of 2.50 percent.

for home loans, but decided not to implement such a change because of congressional opposition. 40 Fed. Reg. 51414, 51415 (1975).
75. Presumably, the index approved by the FHLBB would be a “cost of money” guide for the savings and loan industry. Whether there would be only one index for the whole country or several indices, each for a different section of the country, has not yet been determined. Nevertheless, the later approach would be the most reasonable since the market for housing and the cost of money in different parts of the country deviate from one another. There are twelve different Federal Home Loan Bank districts. Conceivably, each could publish an index for its own particular portion of the country. See 1976-77 U.S. Government Manual, at 512 for a breakdown of states in each district.
Similarly, an S & L would not have to decrease the rate more than 0.50 percent every six months. An S & L could choose to "save" and accumulate an increase, deferring the increase until a later period.

Increases or decreases could only be invoked in increments of 0.25 percent and without upward rounding.

Adjustments of the interest rate could be effected by increasing the loan term, increasing the monthly payments, or a combination of these two methods. Increases in the term of single-family dwelling loans would be allowed up to a maximum of 35 years.

The interest rate could be changed during any adjustment period to which the lender and the borrower agree, although the periods must be a minimum of six months long. However, any interest increase could not exceed the difference between the initial contract rate minus the initial index rate. This requirement effectively locks the lender into a scheme that establishes the maximum limits of any increase at the time the mortgage is executed.

Prepayment without penalty would be allowed whenever the contract interest rate exceeds the initial contract rate.

Written notice would have to be given to the borrower forty-five days prior to invoking the variable feature. The notice would be required to specify the amount of the interest rate adjustment, the effect on payments and/or the loan term, the effective date of the adjustments, and the allowance for prepayment without penalty. In addition, the notice would be subject to the mailbox rule.76

The S & L would have to comply with 12 C.F.R. § 226.810 regarding disclosure requirements at the time of executing the VRM.77

The FHLBB proposed rule goes further in establishing strict guidelines for VRMs than does the FRB rule. Even so, the two sets of rules complement each other to the extent that the FHLBB rule provides a numerical formula to be used in calculating the amount of change permissible, while the FRB rule

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76. For a discussion of the ramifications of the "mailbox rule" see CORBIN, CONTRACTS, § 78 (1967).

77. The reader should note that the new FRB rule repeals 12 C.F.R. § 226.810 effective October 10, 1977. Consequently, should the FHLBB rule be adopted, a new provision would have to take the place of this section of the proposed rule.
makes certain that these financial requirements are disclosed to the borrower at the time the mortgage is consummated. However, these two sets of rules seriously disagree regarding the disclosures that have to be made at the time of invoking of the variable rate. While the FHLBB rules require a 45 day prior notice of any change, including a specification of the adjustment, the effect on payments and/or maturity date, and the effective date of the change, the FRB rule treats increases as a "subsequent occurrence," which is not subject to further disclosures. Adoption of a dual disclosure period and regulation of both increases and decreases illustrates the true nature of a VRM. From a consumer standpoint, the proposed FHLBB disclosure rule goes much further than the FRB rule to inform the borrower as to the use of credit, since as a practical matter, when the rates of interest change, so do the terms and conditions of the original borrowing agreement.

V. CONCLUSION

Because of recent inflationary trends, the savings and loan industry has introduced the concept of interest rate variation into its home mortgage loans. It is thought that the VRM feature will provide a more stable flow of funds for mortgage lending, enabling the savings and loan institution to remain competitive in the lending field and reducing the extent to which savers and new borrowers subsidize the lower rates paid by existing borrowers. In these respects, the existence of variable interest provisions justify their use. However, if VRMs are destined to become a significant part of lending portfolios, the lenders must be required to disclose the overall effects of such provisions.

Due to the fact that present federal regulations and recent case law require only minimum disclosures of the elements involved in a VRM, today's borrower may be unfairly surprised when the variable rate is invoked. While the FRB has promulgated new regulations regarding VRMs, these rules fall short of meeting the clear standards proposed by the FHLBB and recently enacted on the state level in Wisconsin and California. Regulations which govern the amount and frequency of interest rate variation effectively enable the lender to present a more palatable loan agreement to the borrower. Further, in order to encourage proper use of credit, the FHLBB dual-disclosure period provides the borrower with needed information at two tem-
poral points within the contractual continuum. Such dual disclosure would indeed satisfy congressional desire for an informed borrowing public, and might enable the variable rate mortgage to transcend its transition phase and enter into maturity.

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