# The Variable Interest Note: An Answer to Uncertainty in a Fluctuating Money Market

*It has recently been urged that the variable interest note, having an interest rate that varies with the current value of money, can solve some of the problems of uncertainty that inhere in dealings in a fluctuating money market. This Comment examines the concept of the variable interest note, analyzes some of the legal and practical problems which may impede its full implementation, and concludes that, while there is some doubt about the negotiability of such an instrument, the only significant obstacle to its adoption may be consumer unwillingness to give up the relative security of a fixed interest rate.*

During periods of tight money, fixed rate long term loans place a "squeeze" on the major lenders because of the inflexibility of their interest rates. The lenders are locked into mortgages with a low rate of return, while depositors are demanding a higher interest rate as the open market rate ascends.

American lending institutions have traditionally employed devices such as discounts,[1] points,[2] service charges,[3] credit report fees,[4] finder's fees,[5] and credit life insurance[6] to increase their true rate of return on loans. These subterfuges were also intended to prevent bankers from being legally bound to a fixed rate of return while money costs in the market were increasing. Such devices however, by virture of The Truth in Lending Act,[7] must now be disclosed to the borrower. Therefore, the advantage gained by advertising a competitive rate and then actually receiving a greater one is lost. Recently, with interest rates fluctuating, some lenders have discussed the possible use

1. A term generally meaning the "taking of interest in advance." *See, e.g.,* Silver Sands, Inc. v. Pensacola Loan & Sav. Bank, 174 So. 2d 61, 66 (Fla. App. 1965).
2. A point "simply denotes a fee or charge equal to one percent (1%) of the principal amount of the loan which is collected by the lender at the time the loan is made." B. F. Saul Co. v. West End Park North, Inc., 250 Md. 707, 713, 246 A.2d 591, 595 (1968).
3. "[A] service charge is something which a bank requires a borrower to pay in order to have the loan . . . ." Dickey v. Bank of Clarksdale, 183 Miss. 748, 761–62, 184 So. 314, 316 (1938).
4. A charge to pay for the expense of preparing a credit check on the borrower.
5. A fee collected by a broker for his services in finding a lender who is willing to lend money to the borrower.
6. Decreasing term life insurance on the borrower with lender as beneficiary. In the event of the borrower's death, the loan will be paid out of the proceeds of the life insurance.
7. 15 U.S.C. §§ 1601–81t (1970).

of the variable interest note.[8] By using such a note, lenders hope that income derived from long term loans will keep a closer relationship to the current cost of money.[9]

The borrower, too, can suffer with a fixed rate mortgage. If he obtains financing while the cost of money is high, he will be forced to pay interest in excess of the market cost when that cost goes down.

The variable interest rate note provides a solution to the problems of both the lender and the borrower. By tying the interest rate to a proper index that fairly represents the current cost of money,[10] the concept provides for the borrower to pay higher interest when the costs of money are high and a lower rate when such costs are low. Accordingly, one more step is taken to eliminate uncertainty in financial dealings.

While the concept of the variable interest note has had limited acceptance,[11] it is still in its incipiency, and a number of practical as well as legal obstacles to its full implementation are readily apparent. It is the purpose of this comment to analyze and appraise the significance of these problems.[12] Its focus will be on Arizona law.

## I. Isolation of the Proper Index and Adjustment of the Loan

A major problem with the variable interest note is determining which index is

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8. Wall Street Journal, Mar. 25, 1970, at 14, col. 1; Federal Reserve Bank of Chicago, *Needed, Adaptable Home Mortgages*, Business Conditions, Apr. 1970, at 13; Address by Joseph F. Fahey, Jr., Senior Vice-President of the State National Bank of Conn., in Miami Beach, May 5, 1970.

9. Variable rate notes are not new. Contractual provisions tying the sum repaid to the value of gold coin were in common use at the time Bronson v. Rodes, 74 U.S. (7 Wall.) 229 (1868) upheld their validity until they were declared against public policy by a joint resolution of Congress on June 5, 1933. 31 U.S.C. § 463 (1970); *see* Guaranty Trust Co. v. Henwood, 307 U.S. 247 (1939) (upholding the constitutionality of the resolution and effectively prohibiting gold clauses). *See generally* Dawson, *The Gold Clause Decisions*, 33 Mich. L. Rev. 647 (1935); Nebolsine, *The Gold Clause In Private Contracts*, 42 Yale L.J. 1051 (1933).

10. W. Candilis & The American Bankers Ass'n, Variable Rate Mortgage Plans 21–24 (1971) [hereinafter cited as W. Candilis]; Federal Reserve Bank of Boston, *Variable Rates on Mortgages: Their Impact and Use*, New England Econ. Rev. Mar./Apr. 1970, *cited in* W. Candilis *supra* at 31–32; Wetmore, *Variable Rate Mortgages*, The Mortgage Banker, Mar. 1971, at 16; Wall Street Journal, Mar. 16, 1970, at 1, col. 7.

11. In Arizona, First Federal Savings & Loan Association is now using a variable interest note. Interview with Michael L. Rubin, Counsel, First Federal Savings & Loan Ass'n, in Phoenix, Oct. 20, 1971. In 1970, California enacted a statute setting forth the requirements for the validity of a variable interest rate in a mortgage, deed of trust, real estate sales contract, or any note or negotiable instrument issued in connection with them for the financing of property containing four or fewer residential units. Cal. Civ. Code § 1916.5 (West Supp. 1971).

12. An alternative to the variable interest rate, as a method for varying the rate of return during the life of the loan, calls for an increase or decrease in the amount of the principal, while the interest rate remains constant. *See* McManus, *Variable Mortgage Note: Route to Increased Housing*, 55 A.B.A.J. 557 (1969). This method appears to be of minimal appeal. Because the principal fluctuates, it almost surely runs afoul of the "sum certain" requirement for negotiability of the Uniform Commercial Code §§ 3–104, –106.

to be used. Possibilities include the discount rate,[13] the prime rate,[14] the Federal Home Loan Bank Board rate,[15] the United States Government taxable bond yield,[16] or the Consumer Price Index.[17] The index chosen should be one that can be quickly and precisely measured and which cannot be manipulated by either the debtor or the creditor to any appreciable degree.[18]

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13. The discount rate is "[t]he rate of interest at which a bank discounts notes, acceptance and bills of exchange and which varies according to money market conditions, according to the borrower, and maturity." G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE 199 (6th rev. ed. F. Garcia 1962).

14. For this discussion, prime rates refer to the "Federal Reserve Bank rediscount rates on eligible commercial paper and on advances to member banks secured by U.S. Government securities . . . ." *Id.* at 597.

15. The Federal Home Loan Bank Board rate is the rate of interest established by the Board in each of the 11 Federal Home Loan Bank Districts for new advances to "eligible thrift institutions of the savings and loan type, savings banks, and insurance companies engaged in long-term home mortgage financing." *Id.* at 244.

16. The United States Government taxable bond yield is that effective rate of interest received on Government Treasury Bonds with maturities of over 5 years. The Second Liberty Bond Act, 31 U.S.C. § 752 (1970), places a 4¼ percent ceiling on the coupon rate but the Treasury merely sells "at a price below par, to yield the investor any current rate of return above 4¼% which might be required by prevailing market conditions." G. MUNN, *supra* note 13, at 753.

17. The Consumer Price Index is prepared by the Bureau of Labor Statistics of the United States Department of Labor.

> [It] measures the effect of price change in the living costs of city wage-earner and clerical-worker families. It is calculated by comparing, from one period to the next (monthly), the cost of a "market basket" of goods and services usually purchased by this particular population group.
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> The quantity and quality of items contained in the market basket are held constant over the measurement period. The Consumer Price Index reflects, therefore, only "changes in prices"; it tells nothing about changes in the kinds and amounts of goods and services families buy, or the total amount families spend for living, or the differences in living costs in different places.

*Id.* at 157.

18. The changes in these five indicators over the past decade are set out below:

| Year | Discount Rate Federal Reserve Bank of New York | Prime Rate (Per Cent) | FHLBB Series New Homes (Effective Rate) | U.S. Government Taxable Bonds (Avg. Annual Rate) | % Change of Consumer Price Index |
|---|---|---|---|---|---|
| 1960 | 4 | 5 | N.A. | 4.02 | 1.6 |
| | 3½ (Jun. 10) | 4½ (Aug. 23) | | | |
| | 3 (Aug. 12) | | | | |
| 1961 | No Change | No Change | 5.98 | 3.90 | 1.1 |
| 1962 | No Change | No Change | 5.93 | 3.95 | 1.2 |
| 1963 | 3½ (July 17) | No Change | 5.84 (New Series) | 4.00 | 1.2 |
| 1964 | 4 (Nov. 24) | No Change | 5.78 | 4.15 | 1.3 |
| 1965 | 4½ (Dec. 6) | 5 (Dec. 6) | 5.81 | 4.21 | 1.7 |
| 1966 | No Change | 5½ (Mar. 10) | 6.25 | 4.65 | 2.9 |
| | | 5¾ (Jun. 29) | | | |
| | | 6 (Aug. 16) | | | |
| 1967 | 4 (Apr. 7) | 5½–5¾ (Jan. 26–7) | 6.46 | 4.85 | 2.8 |
| | 4½ (Nov. 20) | 5½ (Mar. 27) | | | |
| | | 6 (Nov. 20) | | | |
| 1968 | 5 (Mar. 22) | 6½ (Apr. 19) | 6.97 | 5.26 | 4.2 |
| | 5½ (Apr. 19) | 6–6¼ (Sept. 25) | | | |
| | | 6¼ (Nov. 13) | | | |
| | | 6½ (Dec. 2) | | | |
| | | 6¾ (Dec. 18) | | | |
| 1969 | 6 (Apr. 4) | 7 (Jan. 7) | 7.81 | 6.12 | 5.4 |
| | | 7½ (Mar. 17) | | | |
| | | 8½ (Jun. 9) | | | |

W. CANDILIS, *supra* note 10, at 8.

A study done by the American Bankers Association attacks this problem analytically.[19] The discount rate is considered too erratic; and as an instrument of monetary policy, it is intended to influence money markets rather than mirror conditions in the market. The prime rate also suffers from recurrent changes and may be considered by the borrowers to be within the manipulative control of the lender. The Federal Home Loan Bank Board rate is merely another mortgage rate "based on a survey of characteristics of mortgages originated by major institutional lender groups and is therefore unacceptable to borrowers as not truly 'neutral.' "[20]

The author of the bankers' study suggests that the variable interest rate could be tied to a combination of the United States Government bond yield and the Consumer Price Index.[21] The Government bond yield would reflect conditions in the capital market while being "neutral." The Consumer Price Index would incorporate the level of prices. Both of these indices are easily available to the consumer.

A further means of establishing an impartial index is to allow a governmental agency directly involved with the lending industry (*e.g.*, the Department of Housing and Urban Development, the Federal Home Loan Bank, or the Federal Reserve Board) to set a periodic rate to be used exclusively with variable interest rate notes. Under this plan the agency would be able to balance the inputs of money costs, market conditions, government policy, and the demands and needs of the public.[22] Such a government-imposed rate,

19. *Id.* at 7–12. The ideal situation would seemingly be a combination of the United States Government bond yield and the Consumer Price Index since it would reflect not only conditions in the capital market but would give approximate weight to the all-important effect the level of prices has on interest rates.

20. *Id.* at 8.

21.

VARIABLE MORTGAGE RATE, 1960–69

| Year | U.S. Government Taxable Bond Yields (A) | Percentage Change of Consumer Price Index (B) | Variable Mortgage Rate (A + B) |
|---|---|---|---|
| 1960 | 4.0 | 1.6 | 5.6 |
| 1961 | 3.9 | 1.1 | 5.0 |
| 1962 | 4.0 | 1.2 | 5.2 |
| 1963 | 4.0 | 1.2 | 5.2 |
| 1964 | 4.2 | 1.3 | 5.5 |
| 1965 | 4.2 | 1.7 | 5.9 |
| 1966 | 4.7 | 2.9 | 7.6 |
| 1967 | 4.9 | 2.8 | 7.7 |
| 1968 | 5.3 | 4.2 | 9.5 |
| 1969 | 6.1 | 5.4 | 11.5 |

*Id.* at 11.

22. The use of a government-imposed index presents an issue that is beyond the scope of this article: Could the holder of a note whose rate of return is decreased by such an agency or the debtor whose interest expense is being increased, charge that he is being deprived of property without due process of law? He could certainly argue that a given change is arbitrary, capricious, and unreasonable. *Cf.* Guaranty Trust Co. v. Henwood, 307 U.S. 247 (1939). On the other hand, what is the effect of an expressly and knowingly made consent to contract away constitutional rights?

however, might become an unnecessary political football and be used as a countervailing force against current trends.

Once the proper index to be used is determined, the next consideration is how often the index should be reviewed and adjusted. From the lender's point of view, excessive adjustments may cost more in book work than would be gained from the adjustment itself.[23] Moreover, the borrower will often require a period of time in which to plan his budget and put his financial affairs in order. Accordingly, the adjustment period probably should not be less than 6 months nor greater than 1 year. This period would allow necessary adjustments for such factors as the degree of risk and loan life. This interval could then be an essential element of the loan negotiation.

The maximum size of the adjustment over the life of the debt may also be included in the variable interest note. It has been suggested that an overall limitation of a 2 percent fluctuation in either direction be incorporated in the note.[24] This would be large enough to be workable, but small enough to prevent any catastrophic financial injury to either party. These considerations may also dictate that a maximum variation in any one adjustment period be contractually provided.

## II. USURY

If the usury limits are sufficiently high, varying interest rates pose no legal problems. The size of the adjustment range plus the dynamic nature of the index, however, raise the problem that usurious rates[25] will be charged when the stated rate of interest plus the adjustment exceed the usury limit.[26]

The rule in Arizona is that points or discounts charged to the borrower on a long-term loan must be carried over the entire length of the loan and included as interest.[27] This rule recognizes that reducing the amount received by the borrower results in his making, in substance, an immediate payment

23. *See generally* Wetmore, *supra* note 10, at 21. The advent of computers, however, may minimize this consideration.

24. Chicago Tribune, May 17, 1970 § 3A, at 1, col. 1. CAL. CIV. CODE § 1916.5(a) (West Supp. 1971), in authorizing variable interest notes for certain types of loans, requires that the adjustment interval be at least a 6 month period, and that the change in the rate be no greater than ¼ of 1 percent in any semiannual period. *See* note 11 *supra*. In addition the borrower has the option to retire the loan without prepayment charge within 90 days after a rate change is made.

25. The *Restatement of Contracts* defines usury:

> A bargain under which a greater profit than is permitted by law is paid, or is agreed to be paid to a creditor by or on behalf of the debtor for a loan of money, or for extending the maturity of a pecuniary debt, is usurious and illegal.

RESTATEMENT OF CONTRACTS § 526 (1933).

26. The variable mortgage rate computed by the American Bankers Association would be 11½ percent for 1969. *See* note 21 *supra*. The maximum rate of interest in Arizona is 10 percent per year for contracting parties. ARIZ. REV. STAT. ANN. § 44-1201(B) (Supp. 1971-72).

27. Altherr v. Wilshire Mortgage Corp., 104 Ariz. 59, 63, 448 P.2d 859, 863 (1968).

of the discounted sum. Yet, in Arizona there are certain costs which are directly attributable to the borrower and may be legally passed on to him by the lender without calculating them as part of the interest.[28] These excluded charges are related to the cost of taking out the loan rather than to its continued administration and the imposition of some of these charges has been limited by *Modern Pioneers Insurance Co. v. Nandin*.[29] The court there held that "[i]t was not the intent of the usury statute that the lender should be allowed to collect the maximum [interest] rate plus his overhead."[30] From this, it appears that the variable interest rate loan can only pass on the extraordinary cost of services rendered which are directly related to the making of the particular loan such as appraisal expenses, title-clearing, preparing and recording documents, insurance, and collection costs.[31]

The Arizona method of prorating loan costs over the entire length of the loan may prevent usury in a variable interest rate note.[32] It appears that as long as the average interest on the loan is below the usurious rate, temporary excesses will be overlooked through interest rate averaging. The possibility always exists that the borrower will default on the loan during a period of excess and that the rate being charged would be usurious. The averaging solution, however, is also applicable to this problem. The lender and borrower can agree that a periodic adjustment will be made, but that the total interest paid on maturity or early retirement will not exceed the statutory limit. Interim adjustments can be permitted so as to follow the index adopted.[33]

It has been suggested that the maximum extent of adjustment over the life of the loan can be included in the note so as to prevent severe financial hardship to either party.[34] The drafter of a variable rate note could include a "not greater than" proviso reciting the usury limit. This would be a simple cure for the usury problem which would not defeat the purpose of the fluctuating interest note.

## III. Impact of the Uniform Commercial Code

Widespread acceptance of a variable interest rate note will depend upon

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28. Grady v. Price, 94 Ariz. 252, 383 P.2d 173 (1963).
29. 103 Ariz. 125, 437 P.2d 648 (1968).
30. *Id.* at 132, 437 P.2d at 665.
31. *Id.* at 131, 437 P.2d at 664. *See also*, Strickler v. State Auto Fin. Co., 220 Ark. 565, 249 S.W.2d 307 (1952), where the lender tried to pass on 100 percent of his overhead to the borrower.
32. Altherr v. Wilshire Mortgage Corp., 104 Ariz. 59, 63, 448 P.2d 859, 863 (1968).
33. *See* Small v. Ellis, 90 Ariz. 194, 367 P.2d 234 (1961), where it was held that voluntary default with agreement for acceleration is not usury even though the cost at the default date would have been usurious. *See also* Annot., 84 A.L.R. 1283 (1933), which explains that acceleration of a legal loan is not usurious. Acceleration makes the total loan repayable sooner than the maturity date of the note.
34. Chicago Tribune, May 17, 1970, § 3A, at 1, col. 1.

many factors, one of which is negotiability.[35] This type of note seems best adapted for use with a real property mortgage because of its long-term nature. A mortgage is a security interest for money[36] and is not by itself a negotiable instrument.[37] However, the mortgage takes on the negotiable character of the note it is intended to secure.[38] This concept is stated in *Carpenter v. Longan:*[39]

> The note and mortgage are inseparable; the former as essential, the latter as an incident. An assignment of the note carries the mortgage with it, while an assignment of the latter alone is a nullity.[40]

In order for a note to be a negotiable instrument it must comply with the requirements of the *Uniform Commercial Code.*[41] Among other things, it must "contain an unconditional promise or order to pay a *sum certain* in money . . . . "[42] The "sum certain" requirement is explained further in the *Code,*[43] but the applicable sections are not very helpful in determining whether a sum payable carrying a variable interest rate is a "sum certain."

The official comment to section 3—106 seems to strike a severe blow to the negotiability of the variable interest note:

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35. Interview with Joe E. Burkhart, Vice President, Real Estate Loan Department, Valley National Bank, in Phoenix, Sept. 20, 1971. Mr. Burkhart stated that his bank would be hesitant to use variable interest notes if they could not be freely negotiated.

36. Steinfeld v. State, 37 Ariz. 389, 294 P. 834 (1930); Arizona Title Ins. & Trust Co. v. Hunter, 6 Ariz. App. 604, 435 P.2d 47 (1968).

37. Hayward Lumber & Inv. Co. v. Naslund, 125 Cal. App. 34, 13 P.2d 775 (1932).

38. *Id.;* LeBrun v. Prosise, 197 Md. 466, 79 A.2d 543 (1951).

39. 83 U.S. (16 Wall.) 271 (1872).

40. *Id.* at 274.

41. (1) Any writing to be a negotiable instrument within this Article must (a) be signed by the maker or drawer; and (b) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this Article; and (c) be payable on demand or at a definite time; and (d) be payable to order or to bearer.

    (2) A writing which complies with the requirements of this section is . . . (d) a "note" if it is a promise other than a certificate of deposit.

    Uniform Commercial Code § 3—104. *See also* 1 R. Anderson, Anderson's Uniform Commercial Code, § 3—104:3 (1961).

    It is not necessary that the exact language of the Code be followed in order to create a negotiable instrument; but a nonnegotiable instrument does not become negotiable merely because there is an expressed intent that it should be negotiable.

    *Id.* at 501 (footnotes omitted). *See* Pulaski County v. Ben Hur Life Ass'n, 286 Ky. 119, 149 S.W.2d 738 (1941); Munro v. City of Albuquerque, 48 N.M. 306, 150 P.2d 733 (1943); Brazos River Authority v. Carr, 405 S.W.2d 689 (Tex. 1966).

42. Uniform Commercial Code § 3—104(1)(b) (emphasis added).

43. (1) The sum payable is a sum certain even though it is to be paid (a) with stated interest or by stated installments; or (b) with stated different rates of interest before and after default or a specified date; or (c) with a stated discount or addition if paid before or after the date fixed for payment; or (d) with exchange or less exchange, whether at a fixed rate or at the current rate; or (e) with costs of collection or an attorney's fee or both upon default.

    (2) Nothing in this section shall validate any term which is otherwise illegal.

    Uniform Commercial Code § 3—106.

> The computation must be one which can be made from the instrument itself without reference to any outside source, and this section does not make negotiable a note payable with interest "at the current rate."[44]

"A note [made] payable with interest 'at the current rate'" resembles, at least in effect, the variable interest note. In addition, the directive that "[t]he computation must be one which can be made from the instrument itself without reference to any outside source . . . ," if read literally, is dispositive of the issue.[45] Nevertheless, it is submitted that several approaches may be taken to overcome the obvious problems presented and to make a variable interest note a negotiable instrument.

Within the same comment, the following language seems to militate against the rejection of interest payable "at the current rate":

> It is sufficient that at any time of payment the holder is able to determine the amount then payable from the instrument itself with any necessary computation.[46]

This comment emphasizes that the crucial moment in determining whether an amount payable is a "sum certain" is that point in time at which payment is due. Therefore, a holder of a variable interest note who can readily ascertain the exact inputs and compute the sum presently owing may well have a negotiable instrument.

The official comments to the *Uniform Commercial Code* may be consulted in determining its construction and application, but if text and comments conflict, the text apparently controls.[47] With this in mind, it is arguable that the *Code* language which states that "[t]he sum payable is a sum certain even though it is to be paid . . . with stated different rates of interest before and after default or a specified date . . ."[48] provides for negotiability of the properly drafted variable interest note. If great care is taken to state specifically the adjustment periods, percentage spread in each period, the maximum and minimum rate for the life of the note, and all the variables that will go into the computation of the index, the purpose behind the certainty of sum requirement may be realized while the note is still circulating in commercial circles.[49]

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44. *Id.* Comment 1.

45. *Id. Cf.* Waterhouse v. Chouinard, 128 Me. 505, 149 A. 21 (1930); Anderson v. Hoard, 63 Wash. 2d 290, 387 P.2d 73 (1963).

46. UNIFORM COMMERCIAL CODE § 3–106, Comment 1.

47. 1 R. ANDERSON, *supra* note 41, § 1–102:3.

48. UNIFORM COMMERCIAL CODE § 3–106(1)(b). *See also* 1 R. ANDERSON, *supra* note 41, § 3–106:3(2), at 509, where it is stated that "[a]ny change in rate does not affect the certainty."

49. *See, e.g.*, Farquhar v. Fidelity Ins., Trust & Safe Deposit Co., 8 F. Cas. 1068 (No. 4676) (C.C.E.D. Pa. 1878).

> An indefinite obligation is obviously unadapted to the exigencies of commercial paper, which derives its peculiar qualities from the intended freedom and facility of its circulation, and the consequent necessity that it should

Another approach to achieve negotiability may be to take advantage of the "within this Article" language of the *Code*.[50] It is intended to leave "open the possibility that some writings may be made negotiable by other statutes or by judicial decision," or by "any new type of paper which commercial practice may develop in the future."[51] A number of states have case law dealing with the "sum certain" concept.[52] Even if they take a narrow view of negotiability, specific legislative approval of a variable interest note might override the general *Code* requirements.[53]

A further obstacle to the variable interest note is FHA laws, which prescribe a maximum interest rate[54] making the use of a variable interest note impractical if not impossible. A change in federal law allowing their use with insured mortgages and participation in the federal secondary mortgage market would probably override any state law restricting their negotiability. Such new legislation, however, may be difficult to enact as Representative Wright Patman, Chairman of the House Banking Committee, considers a variable rate plan as "more or less a gambling scheme in which the home buyer is always the loser."[55]

In sum, if the variable interest rate note is not a negotiable instrument within the purview of section 3—104, a subsequent purchaser of the note would not have the rights of a holder in due course and would be exposed to all defenses against the original assignor.[56] When this danger is coupled with the potential problems of usury and truth in lending, secondary mortgage markets may understandably be hesitant to accept variable interest rate notes.[57]

## IV. 1968 FEDERAL TRUTH IN LENDING ACT

The Truth in Lending Act[58] is intended to require the lender to disclose completely all the costs of a loan to the borrower.[59] The intended effect of

> carry upon its face unambiguous evidence of the maker's liability, and should denote, with precision, how much the maker is bound to pay and the holder is entitled to receive.

*Id.* at 1069.

50. UNIFORM COMMERCIAL CODE § 3–104(1). *See* note 41 *supra*.
51. UNIFORM COMMERCIAL CODE § 3–106, Comment 1. For a discussion of the significance of these possibilities, see Sherman & Feeney, *An Examination of the Negotiability Concept of the Uniform Commercial Code*, 1953 WASH. U.L.Q. 297.
52. *Cf.* Annot., 45 A.L.R. 1075 (1926).
53. *See* CAL. CIV. CODE § 1916.5 (West Supp. 1971), where reference is made to a variable interest rate note as a "negotiable instrument."
54. 12 U.S.C. §§ 1709–1, 1713(c) (1970).
55. Wall Street Journal, Mar. 16, 1970, at 1, col. 7.
56. UNIFORM COMMERCIAL CODE § 3–305.
57. For a general discussion of the secondary mortgage market see G. LEFCOE, LAND DEVELOPMENT LAW 677–91 (1966).
58. 15 U.S.C. §§ 1601–81t (1970). *See also* Garwood, *Truth-In-Lending–Real Estate Transactions*, 87 BANKING L.J. 985 (1970).
59. 15 U.S.C. § 1605 (1970) sets forth the charges that must be included. *See also* Federal Reserve System Reg. Z, 12 C.F.R. § 226.4 (1971).

this law is to unveil many of the subterfuges previously used to increase the true rates of interest.[60]

One problem with using variable rate notes is that at the time the loan is made, it may be impossible to give adequate notice of the total credit charge. Although the total amount due is variable, it is urged that full explanation of the mechanics of the loan constitutes sufficient notice. The "*Miranda* warning" of the lending world should include the index to be used, minimum and maximum variance, adjustment periods, and both the minimum and maximum repayment that can be due if the loan were to go the full length at either extreme. This explanation would reveal all material items, the most important of which are the minimum and maximum debt limits. These limits would give a binding range to the debt. In addition, this disclosure, by stating the amount borrowed, seems to fit the legislative intent of "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."[61] Thus, so long as the lender makes a full and adequate exposition of the terms of the loan there should be no conflict with this act.[62]

## V. Impact of the Variable Rate Note

Lenders over the past few months have become increasingly enthusiastic about the advantages of variable rate loans.[63] The fundamental benefit to the lender is to have a loan which will not become unprofitable as the market price for money rises.[64] In addition, the borrower may also benefit since his interest cost may decrease during the life of the loan. The borrower, however, should be cognizant of the fact that he is an insurer against the lender's losses due to upward market variations within the permissible spread—a risk traditionally carried by the lender. This may indeed be a problem facing the borrower, especially in light of the situation where the cost of home mortgages has been increasing over the past several years.[65] One thing that

60. *See* page 600 *supra*.

61. 15 U.S.C. § 1601 (1970); *See generally* H.R. Rep. No. 1040, 90th Cong., 2d Sess. (1968).

62. There are exceptions to the broad coverage of the Truth in Lending Act. Loans to to businesses and governmental agencies acting as a borrower are exempt as it is expected that they have the expertise to protect themselves in negotiating loans. The main thrust of this act is to protect real property and consumer loans under $25,000. 15 U.S.C. § 1603 (1970). Accordingly, variable rate loans in these areas must meet the disclosure requirements.

63. *See* note 10 *supra*.

64. When old loans become unprofitable, new loans must make up the losses.

65. Average interest rates on conventional new home mortgages over the past decade:

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|---|---|---|---|
| 1960 | 6.21% | 1965 | 5.81% |
| 1961 | 5.99% | 1966 | 6.35% |
| 1962 | 5.93% | 1967 | 6.53% |
| 1963 | 5.82% | 1968 | 7.06% |
| 1964 | 5.80% | 1969 | 7.91% |

U.S. News & World Report, Apr. 27, 1970, at 90.

will certainly be needed is a considerable amount of consumer education. In the area of commercial loans, however, where the borrower is presumed to be reasonably sophisticated, the introduction of variable rates should proceed with relative ease.

It has been suggested that today, while interest rates are high, is the best time for the general adoption of the variable rate note.[66] Borrowers presume that their interest rate will go down,[67] and when it does there should be few complaints about the varied interest rate. But at the present time, only one lending insitution in Arizona is using the variable interest note.[68] Its first flexible interest rate mortgage was written in April 1970, but in the period ending June 25, 1971, such mortgages accounted for only 3 percent of all new home mortgages.[69] Nonetheless, it is expected that their popularity will increase because they afford the lender the ability to stay in the lending market longer since his portfolio of loans is fiscally current, allowing him to acquire more loan resources. His ability to increase the supply of lendable funds will aid the economy as a whole.[70]

Government policy is also of concern. Over the years the government has directly or indirectly influenced the housing market according to current needs. The Federal Housing Administration, for example, currently has a 7½ percent maximum limit for loans insured by them.[71] The 7½ percent maximum is misleading because "points" are paid by the seller and indirectly passed on to the buyer in the purchase price. It is submitted that it would be more forthright to set the rate limit higher and force disclosure of the true cost. The higher rate would give variable rate loans the slack necessary for adjustment.

Because the interest rate goes up automatically when the index is increased, variable interest arrangements have been criticized on the grounds that they can cause an economic chain reaction that runs counter to anti-inflationary governmental measures.[72] But this argument only applies to certain situations—

66. Wall Street Journal, Mar. 16, 1970, at 1, col. 7.

67. W. CANDILIS *supra* note 10, at 35.

68. Interview with Michael L. Rubin, Counsel, First Federal Savings & Loan Ass'n., in Phoenix, Oct. 20, 1971.

69. The note used by First Federal Savings calls for a semiannual adjustment period with interest to fluctuate no more than the variation in the Federal Home Loan Bank rate in the preceding 6-month period. *Id.*

70. Other suggestions for improving the lot of the mortgage industry are:

> [W]ider investment powers for savings and loans to give their portfolios more flexibility; new and improved secondary markets, so that mortgages would be a more liquid investment; [and] a standardized mortgage contract that would attract new investors, such as pension funds.

Wall Street Journal, Mar. 25, 1970, at 14, col. 2.

71. 12 U.S.C. § 1709–1 (1970), allows the Secretary of Housing and Urban Development to establish the maximum interest he finds necessary to meet the mortgage market until January 1, 1972, notwithstanding the maximum interest rate of 6 percent provided in 12 U.S.C. § 1713(c) (1970).

72. Hirschberg, *Index Value Clauses,* 88 BANKING L.J. 867, 878 (1971).

where index value clauses are used in labor contracts and when, in addition, "the government maintains full employment and when the economy is dependent on government activity."[73] Moreover, in an inflationary situation where the value of currency is depreciating, variable interest arrangements may encourage the application of funds to savings rather than present consumption, thereby somewhat lessening the inflationary impact.[74]

## VI. Conclusion

Variable rate loans are best suited to long-term loans where the possibility of market change is greatest. Under present conditions, the usuary rate is about two points above the market cost of money, allowing the variable rate some movement. Hopefully, the legislature will increase the usury rate as was done in Arizona in 1969[75] as the cost of money ascends to new highs. Aside from their doubtful negotiability under the *Uniform Commercial Code*,[76] the only major obstacle to general adoption of the variable note is the consumer. The final and yet unanswered question is whether the consumer will be willing to gamble rather than rely on the relative security that he has had before.

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73. *Id.* at 879.
74. *Id.* at 877–78.
75. Ariz. Rev. Stat. Ann. § 44–1201 (1956).
76. Uniform Commercial Code § 3–104.