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**VARIABLE RATE MORTGAGES: TEXAS SAVINGS &
LOAN ASSOCIATIONS AUTHORIZED TO OFFER
FLEXIBLE FINANCING ALTERNATIVES**

SCOTT R. WORTHEN

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I. INTRODUCTION

Savings and loan associations have been under considerable pressure to raise interest rates on deposits to compete with more attractive savings and investment alternatives.¹ Such pressure, combined with investment portfolios composed primarily of fixed rate, long-term mortgages bearing pre-inflationary interest rates,² seriously threatens the financial integrity

1. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 39 (1976) (interest rates must be raised to compete with savings alternatives); Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 16 (1971) (savers withdraw deposits when interest rates are not competitive); Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349, 1353 (1974) (funds from savings accounts are deposited into higher yielding money market instruments).

2. The average interest rate on mortgages held by Federal Savings and Loan Insurance Corporation (FSLIC) insured savings and loan associations for the last half of 1979 was 8.95%. The average rate on new conventional mortgages nationwide for May, 1980, was 13.91%. See Kaplan, Smith & Associates, Inc., *Texas Mortgage Markets* (table 2) (Aug. 29,

of the associations.³ To alleviate this situation, the Savings and Loan Section of the Texas Finance Commission⁴ and the Savings and Loan Commissioner of Texas⁵ have recently promulgated regulations allowing State chartered associations⁶ to offer three forms of variable interest rate mortgages.⁷ Variable rate mortgages (VRMs) are designed to provide relief to Texas savings and loan associations by allowing adjustments of interest rates on a short-term basis. As a result, proponents contend problems currently threatening savings and loan associations will be diminished.⁸

1980).

3. See, e.g., Follain & Struyk, *Homeownership Effects of Alternative Mortgage Instruments*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XIV-1 (1977); Friend, *Summary and Recommendations*, in I STUDY OF THE SAVINGS AND LOAN INDUSTRY 1, 3-7 (1969); Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349, 1353 (1974). The financial integrity of the savings and loan association is upheld by maintaining a balance between income received from mortgage investments and money paid out as interest on savings accounts. When assets and liabilities are balanced, the association generates sufficient revenue to pay competitive rates on deposits, while meeting overhead expenses and recouping a reasonable profit. Raising interest rates on deposits, however, creates an imbalance because mortgage revenue, fixed over a long term, is unable to respond to short-term money market fluctuations. Consequently, the problem facing the association is similar to that facing many Americans—expenses are increasing, while income remains constant. Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 16 (1971).

4. TEX. REV. CIV. STAT. ANN. art. 342-103 (Vernon 1973). The Finance Commission of Texas, composed of a six member Banking Section and a three member Savings and Loan Section, acts in an advisory capacity to the Commissioner of each respective division. *Id.* The Savings and Loan Section is charged with responsibility for issuing rules and regulations governing all associations operating in Texas, except federally chartered associations. *Id.* art. 342-114.

5. *Id.* art. 342-205 (Vernon 1973 & Cumm. Supp. 1981). The Savings and Loan Commissioner is appointed by the Finance Commission. *Id.* art. 342-205 (Vernon 1973 & Cumm. Supp. 1981). The Commissioner's responsibilities include supervision, regulation, and rule making powers. *Id.* art. 342-205(d) (Vernon 1973).

6. Of the 324 savings and loan associations in Texas, 255 are state chartered. TEX. SAV. & LOAN DEP'T, FIFTY-FIRST ANNUAL REPORT OF SAVINGS AND LOAN ASSOCIATIONS (1980).

7. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) (variable interest rate mortgage); Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) (roll over mortgage); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980) (adjustable rate mortgage). A variable rate mortgage (VRM) is a mortgage which provides for short-term adjustments in the contract interest rate, rather than providing a fixed rate which remains constant over a long period of time. See Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 15 (1971). Texas chartered associations also may offer any mortgage instrument authorized for federally chartered associations. See TEX. REV. CIV. STAT. ANN. art. 852a, § 5.04 (Vernon 1964); *id.* art. 342-114 (Vernon 1973). See generally Project, *Tie-In Statutes and Parity Regulations and Their Constitutionality*, 11 AKRON L. REV. 503, 503 (1978). Two forms of variable rate mortgage are authorized for federal associations. See 12 C.F.R. § 545.6-4(a) (1980) (renegotiable rate mortgage); *id.* § 545.6-4(c) (variable rate mortgage).

8. See, e.g., Hyer & Kearn, *Legal Impediments to Mortgage Innovation*, 6 REAL EST.

The argument supporting introduction of variable rate mortgages is understandable. Savings and loan associations (S&Ls) provide the majority of home mortgage loans.⁹ Acting in an intermediary capacity between saver and borrower,¹⁰ capital for long-term mortgage lending is generated through relatively short-term deposits.¹¹ This phenomenon of "borrowing short and lending long" creates unique problems for S&Ls.¹² Specifically, the process known as "disintermediation" constitutes one of the major problems plaguing S&Ls.¹³ The majority of funds deposited in S&Ls may be withdrawn at will or on short notice.¹⁴ When savings devices such as commercial paper and government notes bear higher rates of interest

L.J. 211, 212-14 (1978) (attack problems by changing mortgage format); McKenzie, *Macroeconomic Simulations of Variable Rate Mortgages*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XV-1 (1977) (VRMs will increase direct earnings and promote deposits); *Board Proposes Variable Rate Mortgages for Federal S&L's*, 8 FED. HOME LOAN BANK BOARD J. 3, 3 (Mar. 1975) (increased income will allow greater deposit retention and new mortgage loans).

9. At the end of 1979, S&Ls held 52% of mortgages nationwide on one-to-four family housing units, compared with 17% commercial banks, 12% mortgage pools, 11% other holders, 6% government agencies, and 1% life insurance companies. *Statistical Series*, 13 FED. HOME LOAN BANK BOARD J. 49, 66 (table S.5.5) (Aug. 1980).

10. Friend, *Summary and Recommendations*, in I STUDY OF THE SAVINGS AND LOAN INDUSTRY 1, 3-4 (1969). S&Ls generate capital by attracting savings deposits. This capital is then channeled into home mortgage loans. *Id.* at 3-4.

11. *Id.* at 3; see Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 38 (1976). Standard mortgage loans are typically for a term of 25 to 30 years. See Comment, *Variable Rate Mortgages: The Transition Phase*, 61 MARQ. L. REV. 140, 141 (1977). In contrast, savings devices such as certificates of deposit and money market certificates have a maximum term of 30 months. See Kaplan, Smith & Associates, Inc., *Texas Mortgage Markets* (table 4) (Feb. 11, 1980).

12. Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 38 (1976).

13. Goldman, *Disintermediation Under the Microscope*, 8 FED. HOME LOAN BANK BOARD J. 13, 13 (Dec. 1975) ("one of the most serious problems affecting the savings and loan industry"); see Hyer & Kearn, *Legal Impediments to Mortgage Innovation*, 6 REAL EST. L.J. 211, 213 (1978) (disintermediation may lead to bankruptcy); Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349, 1353 (1974) (disintermediation produces serious crises for S&L industry). The term "disintermediation" refers to a movement of funds from depository institutions to other investment alternatives caused by higher interest rates paid on the investment alternatives. Goldman, *Disintermediation Under the Microscope*, 8 FED. HOME LOAN BANK BOARD J. 13, 15 (Dec. 1975).

14. See Pickering, *Changes in S&L Savings Account Structure: October 1974-March 1975*, 8 FED. HOME LOAN BANK BOARD J. 20, 21-22 (July 1975). As of December, 1979, 53% of S&L deposits nationally were either in passbook accounts or six month money market certificates. Kaplan, Smith & Associates, Inc., *Texas Mortgage Markets* (table 4) (Feb. 11, 1980). 44.5% of deposits were in certificates of deposit with a maturity of one year or less. *Id.*

than savings accounts,¹⁵ depositors withdraw funds to invest in higher yielding assets.¹⁶ In order to compete with more lucrative savings and investment alternatives, S&Ls must increase rates paid to depositors.¹⁷ Interest ceilings imposed by the federal government,¹⁸ however, prevent S&Ls from offering competitive rates on passbook accounts.¹⁹ Therefore, more aggressive use of market-sensitive liabilities, such as indexed certificates and jumbo certificates of deposit (CDs) is necessary to increase funds.²⁰

15. Compare Kaplan, Smith & Associates, Inc., *Texas Mortgage Markets* (table 2) (Aug. 29, 1980) (July, 1980, interest rate on six month Treasury Bills of 8.06%) with Riordan, *Office of Policy and Economic Research Report*, 13 FED. HOME LOAN BANK BOARD J. 28, 38 (April 1980) (July, 1980, increase in passbook account ceiling from 5¼ % to 5½ %).

16. See, e.g., Marcis, *The Savings and Loan Industry in the 1980's*, 13 FED. HOME LOAN BANK BOARD J. 3, 3-4 (May 1980) (net outflow of dollars in 1966 and 1974-75 due to higher interest rates paid on alternatives); Riordan, *Office of Policy and Economic Research Report*, 13 FED. HOME LOAN BANK BOARD J. 28, 38 (April 1980) (three year decline in savings receipts caused by rise in rates on competing investments); Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349, 1353 (1974) (shift of funds to instruments bearing higher interest rates).

17. See 40 Fed. Reg. 6870 (1975) (must pay higher interest rates to attract or retain deposits).

18. 12 C.F.R. § 526.3 (1980) (commonly referred to as Regulation Q). The Federal Home Loan Bank Board (FHLBB), in consultation with the Board of Governors of the Federal Reserve System and the Board of Directors of the Federal Deposit Insurance Corporation, had the power to set limits on amounts of interest which a S&L can pay depositors. Federal Home Loan Bank Act of 1932, 12 U.S.C. § 1425b(a) (1932). This power was transferred to the Depository Institutions Deregulation Committee in order to gradually phase-out interest ceilings. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 203, 94 Stat. 142, as amended by Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

19. 12 C.F.R. § 526.3 (1980). See generally Hyer & Kearn, *Legal Impediments to Mortgage Innovation*, 6 REAL EST. L.J. 211, 213-14 (1978); Verkuil, *Perspectives on Reform of Financial Institutions*, 83 YALE L.J. 1349, 1353 (1974).

20. See Riordan, *Office of Policy and Economic Research Report*, 13 FED. HOME LOAN BANK BOARD J. 28, 36-38 (April 1980). The S&L industry is currently undergoing a revolution in the manner in which new funds are raised. See *id.* at 36. S&Ls have shown increasing reliance on money market certificates, mortgage-backed bonds, and marketable short-term notes to raise capital. See Marcis, *The Savings and Loan Industry in the 1980's*, 13 FED. HOME LOAN BANK BOARD J. 3, 3-4 (May 1980). See generally Adams, *The Thrifts Seek Capital With Mortgage-Backed Bonds*, 6 REAL EST. REV. 38, 38-42 (1976). The introduction of negotiable order of withdrawal (NOW) accounts allows S&Ls another tool to raise funds. NOW accounts, checking accounts which bear interest, became available January 1, 1981. Federal Deposit Insurance Act, 12 U.S.C. § 1832a (1950), as amended by The Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 303, 94 Stat. 146, as amended by Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647; see Wall Street Journal, Oct. 4, 1980, at 39, col. 4. Additionally, section 204(a) of the Depository Institutions Deregulation Act of 1980 will phase out ceilings on all deposits over a six year period. See Depository Institutions Deregulation and Mone-

A second difficulty plagues S&Ls. Although alternative market-sensitive devices are available,²¹ S&Ls are restricted in utilization of them due to the market-insensitive nature of their assets.²² S&Ls derive income from interest paid on standard fixed rate mortgage loans.²³ During stable economic conditions, this income is sufficient to pay competitive rates to depositors and realize a profit.²⁴ Today, most S&Ls investment portfolios, however, consist of a substantial number of mortgages made when interest rates were at a lower level than present rates.²⁵ S&Ls, therefore, lack the necessary funds to pay competitive rates due to existing, long-term,

tary Control Act of 1980, Pub. L. No. 96-221, § 204(a), 94 Stat. 143, as amended by Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

21. See Marcis, *The Savings and Loan Industry in the 1980's*, 13 FED. HOME LOAN BANK BOARD J. 3, 3-4 (May 1980) (new devices result of FHLBB innovations and private initiatives); cf. Riordan, *Office of Policy and Economic Research Report*, 13 FED. HOME LOAN BANK BOARD J. 28, 38 (April 1980) (compares performance of alternative devices).

22. See Hyer & Kearl, *Legal Impediments to Mortgage Innovation*, 6 REAL EST. L.J. 211, 213-14 (1978) (fixed rate mortgage portfolios limit response to rising interest rates); Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 39 (1976) (S&Ls are financially incapable of offering highly competitive rates); McKenzie, *Macroeconomic Simulations of Variable Rate Mortgages*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XV-1 (1977) (fixed income from mortgages insufficient to compete for funds). Long term mortgage loans are insensitive to market pressures because of the fixed rate of contract interest. While interest paid to depositors fluctuates according to competitive pressures, income from mortgage investment portfolios is locked in at a constant rate. See generally Spolan, *The Case For Variable Rate Mortgages*, 1 REAL EST. REV. 15, 15-16 (1971).

23. 40 Fed. Reg. 6870 (1975). The FHLBB estimates that 90% of a S&L's income is obtained from interest paid on mortgage portfolios. *Id.* These portfolios are composed of standard mortgages. Boykin & Phillips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 84 (1978). A standard mortgage (SM) is a "self amortizing, level payment, fixed-rate mortgage [which] has been the primary mortgage credit vehicle for single-family homes since 1934." *Id.* at 84. See also Duffy, *The Character of Mortgages of Real Estate in Texas*, 12 S. TEX. L.J. 129, 129-33 (1970).

24. See Kaplan, Marcis & Cassidy, *AMIRS: An Overview and Summary*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 2-3 (1977). The standard mortgage was designed to function in a stable economy. See *id.* at 2. A stable economy is characterized by little or no inflation, low interest rates, and consistent monetary policy. See Kaplan, *A Progress Report—The Alternative Mortgage Instruments Research Study*, 9 FED. HOME LOAN BANK BOARD J. 4, 4 (Sept. 1976). While the standard mortgage functions well in a stable economy, its format is inadequate for an inflationary economy. See Boykin & Phillips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 83-84 (1978); Kaplan, Marcis & Cassidy, *AMIRS: An Overview and Summary*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 2-3 (1977).

25. Compare Kaplan, Smith & Associates, Inc., *Texas Mortgage Markets* (table 2) (July 30, 1980) (average interest rate of 11.43% on new mortgages for last half of 1979) with *Statistical Series*, 13 FED. HOME LOAN BANK BOARD J. 49, 62 (table S.4.10) (Aug. 1980) (average interest yield of 8.95% on mortgages held for same period).

low interest mortgages.²⁶ Consequently, S&Ls are in a situation where the costs of short-term liabilities increase more rapidly than income from long-term assets.²⁷ Traditionally, S&Ls' only means of increasing income has been to charge new borrowers higher interest rates.²⁸ Confronted with higher rates, potential buyers are reluctant to purchase;²⁹ thus, the ability to combat disintermediation is further hampered.³⁰

II. VARIABLE RATE MORTGAGES—A PLAUSIBLE SOLUTION

Variable rate mortgages have been proposed as a means of establishing market-sensitive S&L investment portfolios.³¹ Designed to increase the flow of capital to S&Ls, proponents of VRMs contend their use will establish a more realistic market equilibrium within the home mortgage market.³²

26. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 38 (1976) (S&Ls cannot afford competitive rates due to standard mortgages yielding low interest rates); McKenzie, *Macroeconomic Simulations of Variable Rate Mortgages* in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XI-1 (1977) (fixed interest rates on mortgage portfolios return insufficient yields to allow competition for new funds); Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 16 (1971) (outflow of deposits due to narrowing interest spread between cost of funds and portfolio income).

27. *Compare Statistical Series*, 13 FED. HOME LOAN BANK BOARD J. 141, 149 (table S.4.8) (April 1980) (increase in average cost of funds from January, 1978, to December, 1979, of 1.17%) with *id.* at 150 (table S.4.10) (increase in interest return of only .56% for same period).

28. 40 Fed. Reg. 6870 (1975). S&Ls must raise rates on new mortgage loans sharply to help counteract increases in money costs. This effectively subsidizes earlier borrowers, who enjoy low interest rate mortgages, at the expense of new borrowers. *Id.*

29. Kaplan, Marcis & Cassidy, *AMIRS: An Overview and Summary*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 2 (1977) (cannot afford high monthly payments).

30. See 40 Fed. Reg. 6870 (1975) (fewer new loans aggravate already serious problems).

31. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 41-42 (1976); McKenzie, *Macroeconomic Simulations of Variable Rate Mortgages*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XV-1 to 2 (1977). Commercial banks already enjoy a position similar to that which VRMs would create for S&Ls. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 41 (1976). Banks, like S&Ls, depend on relatively short term deposits. The contrast is that the average mortgage loan is approximately ten years, while the average bank loan is for two and one half years. See Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 16 (1971). Thus, banks strike a balance characterized by short-term assets and short-term liabilities. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 41 (1976); Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 16 (1971). See generally Friend, *Summary and Recommendations*, in I STUDY OF THE SAVINGS OF LOAN INDUSTRY 1, 3-7 (1969).

32. See 40 Fed. Reg. 6870 (1975) (increased income to S&Ls would stabilize mortgage

While the interest rate on a standard mortgage (SM) remains constant throughout the life of the loan,³³ a VRM provides for periodic adjustments of the interest rate to reflect either the current cost of mortgage money or the movement of a predetermined index.³⁴ This capacity for fluctuation assures a mortgage yield in conformance with prevailing market conditions.³⁵ With assets no longer limited to a fixed rate, the "borrow short, lend long" structure would be modified to "borrow short, lend short."³⁶ A comparison of the SM and VRM reveals that both function similarly during stable economic conditions,³⁷ but the VRM alone has the capacity and flexibility to generate a steady flow of real income.³⁸ With income increased, S&Ls can provide more loans and higher interest rates to savings depositors, ensuring a steady source of mortgage funds.³⁹

Three forms of VRMs are currently available to Texas S&Ls: the varia-

market); Marcis, *The Savings and Loan Industry in the 1980's*, 13 FED. HOME LOAN BANK BOARD J. 3, 3-5 (May 1980) ("increase in mortgage credit due to VRM's favorable impact on mortgage lenders' earnings"); Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 16 (1971) (better earnings would establish balance in mortgage market).

33. See Friend, *Summary and Recommendations*, in I STUDY OF THE SAVINGS AND LOAN INDUSTRY 1, 3-7 (1969); Boykin & Philips, *The New Challenger: The Variable Rate Mortgage*, 8 REAL EST. REV. 83, 84 (1978).

34. See Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 4 (Aug. 1980); Comment, *Variable Rate Mortgages: The Transition Phase*, 61 MARQ. L. REV. 140, 142 (1977). See generally Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 44-46 (1976) (background discussion of indexed obligations); Steinherr, *Indexation of Monetary Assets and Credit Instruments*, in INFLATION AND CAPITAL MARKETS 149, 157-63 (M. Sarnot ed. 1977) (practical problems of indexation).

35. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 41-42 (1976). With mortgage yields indexed, portfolio income will rise or fall according to the movements of the current market indicator used as an index. See *id.* at 41-42.

36. See *id.* at 41-42.

37. Cf. Albaum & Kaufman, *The Variable Rate Residential Mortgage: Implications for Borrowers*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 29 (1977) (interest rates on VRMs had not changed after two years of use).

38. See McKenzie, *Macroeconomic Simulations of Variable Rate Mortgages*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XV-1 (1977). VRMs will have "direct earnings effect" due to increased income during periods of rising interest rates that a fixed rate mortgage can not provide. See *id.* But see Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 84 (1978) (VRM opponents claim SM functions better as long as inflation is stable).

39. See, e.g., 40 Fed. Reg. 6870 (1975) (FHLBB position that VRMs will allow better funding of mortgage market); Marcis, *The Savings and Loan Industry in the 1980's*, 13 FED. HOME LOAN BANK BOARD J. 3, 4-5 (May 1980) (higher earnings translate into more loans and mortgage credit); Comment, *The Variable Interest Rate Clause And Its Use In California Real Estate Transactions*, 19 U.C.L.A. L. REV. 468, 473 (1972) (more income to pay depositors and make mortgage loans).

ble interest rate mortgage (VIR) which provides for adjustment in relation to an index,⁴⁰ the roll-over mortgage (ROM) which is a series of short-term loans with adjustments made at the end of each term,⁴¹ and the adjustable rate mortgage (ARM) which constitutes a cross between the first two types.⁴² Although other forms of alternative mortgage instruments (AMIs) are available in Texas,⁴³ emphasis is placed on the VRMs because of their potential impact on the problems plaguing S&Ls.

A. *Variable Interest Rate Mortgage (VIR)*

The VIR is like the SM in that both are long-term mortgages.⁴⁴ The VIR's distinguishing feature is the allowance for adjustments in interest rates according to the movement of an external index.⁴⁵ No change in rate is allowed until one year after the date of the initial monthly payment and adjustments may be made no more frequently than once in a twelve month period.⁴⁶ The maximum yearly increase or decrease may be no greater than one half of one percent, with a total change over the life of the mortgage of no more than two and a half percent in either direction.⁴⁷

40. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979).

41. See Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

42. See Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

43. An alternative mortgage instrument (AMI) is a mortgage which differs in format from the traditional standard mortgage. In addition to the graduated payment mortgage (GPM) and VRMs, proposed AMIs include a deferred interest mortgage (DIM), a price level adjusted mortgage (PLAM), and a reverse annuity mortgage (RAM). See Kaplan, *Recommendations On Alternative Mortgage Instruments*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY I-1 (1977).

44. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979). A long-term mortgage has a term of generally 30 years. A long term is mandatory for the average buyer to be able to afford the monthly payments on a home. See 40 Fed. Reg. 6870 (1975).

45. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979). The index provided in the regulation is the "index of the average 'cost of funds to FSLIC insured savings and loan associations all districts' as computed by the Federal Home Loan Bank Board and published in the Federal Home Loan Bank Board Journal." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979). Thus, when the S&L's cost of money increases, as shown by the index, the interest rate on a variable interest rate mortgage (VIR) could be increased by the same percentage. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979).

46. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(1), 4 Tex. Reg. 3899 (1979). "[I]nterest rate adjustments (and loan payment charges resulting from them) may not be made more than once in any 12 month period, and the first adjustment shall not be made prior to one year after the date of the first regular monthly payment." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(1), 4 Tex. Reg. 3899 (1979).

47. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(2), 4 Tex. Reg. 3899 (1979). "[A]ny increase or decrease in the interest rate shall not exceed one-half (½) of one (1) percent per annum with a maximum net increase not to exceed two and one-half percent (2.5%) more than the original loan rate and in no event in excess of the legal rate applicable to the loan

Any increase allowed by the index is optional, while decreases are mandatory.⁴⁸

The Texas regulation on VIRs provides that the borrower shall receive notice in writing no less than thirty days prior to any rate adjustment.⁴⁹ The notice must contain data pertaining to the interest rate change.⁵⁰ Upon notification of an increase in interest rate, several options are available to the borrower. He may elect not to reply to the notice and simply allow monthly payments to increase reflecting the rise in interest rates,⁵¹ choose to maintain low monthly payments by requesting an extension of loan maturity of up to forty years,⁵² or pay the loan in its entirety within ninety days without incurring a prepayment penalty.⁵³

when made." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(2), 4 Tex. Reg. 3899 (1979).

48. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(3), 4 Tex. Reg. 3899 (1979).

[D]ownward adjustments shall be mandatory, but increases may be at the noteholder's option. The fact that an association may not have invoked a permissible increase, in whole or in part, shall not constitute a waiver of the association's right to invoke said increase at any time thereafter within the limits imposed by the subparagraph.

Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(3), 4 Tex. Reg. 3899 (1979).

49. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(5), 4 Tex. Reg. 3899 (1979). "[T]he borrower shall be notified by written notice of any rate adjustment at least 30 days before the date the new rate will begin." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(5), 4 Tex. Reg. 3899 (1979).

50. The notification to the borrower shall include:

- (i) current and new rates;
- (ii) old and new index rates;
- (iii) accumulated but unused rate changes, if any;
- (iv) current monthly payment and remaining maturity;
- (v) for increases, a description of borrower options, including the new payment and maturity if the loan is extended to the maximum; and
- (vi) for decreases, a description of the way the decrease will be applied.

Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(5), 4 Tex. Reg. 3899 (1979).

51. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(6)(c), 4 Tex. Reg. 3899 (1979). The borrower may "[n]ot respond to the notice, in which event monthly payments will be adjusted upward to reflect the higher rate." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(6)(c), 4 Tex. Reg. 3899 (1979).

52. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(6)(a), 4 Tex. Reg. 3899 (1979). The borrower may "request that loan maturity be extended up to a maximum of forty (40) years, (but not to the extent that monthly payments would be reduced below the original loan payment amount)." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(6)(a), 4 Tex. Reg. 3899 (1979).

53. Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(6)(b), 4 Tex. Reg. 3899 (1979). The borrower may choose "[t]o repay the loan within ninety (90) days after such notification, either in full or in part, without a prepayment charge, except where such collection is required by an agency created by federal law." Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(6)(b), 4 Tex. Reg. 3899 (1979).

B. *Roll-over Mortgage (ROM)*

The roll-over mortgage is unique in that it is not a long-term mortgage, but is a short-term loan or series of short-term loans.⁵⁴ Known as a "Canadian" or "balloon" mortgage, this instrument has been used extensively in Canada⁵⁵ and the United States prior to the Great Depression.⁵⁶ While the ROM is a short-term loan, payments of principal and interest are calculated to amortize the loan over a thirty year term.⁵⁷ The final monthly payment is a "balloon" payment consisting of the unpaid principal and interest.⁵⁸ At the end of the short-term, the borrower must pay the "balloon" or refinance the remaining indebtedness.⁵⁹ The lender may agree to guarantee the financing of additional short-term loans up to a maximum of forty years.⁶⁰ This guarantee may stipulate the interest rate will be adjusted at the time of roll-over⁶¹ and, if so stipulated, must state the

54. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). While every other mortgage design is based upon payment over a long term, the roll over mortgage (ROM) is a loan of short duration, payable within five years or less with a constant interest rate during this term. See Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

55. Unger, *The Canadian Mortgage Market and the Renegotiable Term Mortgage*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY VII (1977) (abstract).

56. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 43 (1976). Balloon mortgages became unpopular during the depression when borrowers, unable to refinance the balloon payment, had their property foreclosed on. The long-term fixed rate SM replaced balloon notes as the favored mortgage instrument. See *id.* at 43. See generally Samuelson, *An Analytic Evaluation of Interest Rate Ceilings for Savings and Loan Associations and Competitive Institutions*, in IV STUDY OF SAVINGS AND LOAN INDUSTRY 1563, 1567-69 (1969).

57. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

58. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

59. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). As an example, consider a \$50,000 loan for a period of 36 months at an interest rate of 13%. Monthly payments are calculated to pay off the loan in 360 equal monthly payments of \$552.94 each. Although calculated to pay off the loan in 30 years, payments are made for only 35 months with the 36th payment being a "balloon" payment of both principal and interest equaling \$50,052.55. This amount would have to be paid or refinanced. See *Alternative Mortgage Plans for State Chartered Associations—Canadian Roll-Over—Adjustable Rate and Payment* (May 20, 1980) (Tex. Savings & Loan League) (sample form using same calculations).

60. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). "[T]he association may give its guaranty to extend payment of the unamortized balance of the indebtedness for one (1) or more periods, for a maximum of four hundred and eighty-one (481) months from the date the loan is funded." See Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

61. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). The term "roll-over" refers to the time at which the short-term loan expires and either the new loan begins or the balloon becomes due. See generally Unger, *The Canadian Mortgage Market and the Renegotiable Term Mortgage*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY VII-6 to -8 (1977).

manner in which the adjustment will be determined.⁶²

C. Adjustable Rate Mortgage (ARM)

The adjustable rate mortgage is a long-term loan of up to forty years.⁶³ The ARM regulation provides that adjustments to the interest rate may be assessed at intermediate periods of between six months and five years⁶⁴ according to the Federal Home Loan Bank Board (FHLBB) index, or other index approved by the Texas Savings and Loan Commissioner.⁶⁵ The distinguishing feature of the ARM is that the actual modification of the monthly payment may not occur "except on the anniversary of the note, and not more often than once a year nor [sic] less often than once each five years."⁶⁶ While adjustments to the interest rate occur at the end of each intermediate period, increases or decreases in monthly payment will not be realized except on the stated anniversary of the loan.⁶⁷ In this way a roll-over period of between one and five years is either specified by

62. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). "Such guaranty may be conditioned on an adjustment of the rate of interest, if so, the loan documents shall clearly specify the manner in which such adjustment shall be made." Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). Presumably, rate increases could be tied to any index the S&L selected or could be adjusted in any manner the S&L chooses. Payment of closing costs is not addressed by the regulation and could be included or excluded as a condition of the guaranty to refinance. Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). Closing costs are the charges associated with processing of a new loan and may range from \$500 to \$1000. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 59 (1976).

63. Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

64. Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980). The intermediate periods, as determined by the parties prior to consummation of the loan, do not have to be of equal duration; for example, the first period may be six months and the remaining periods may consist of eighteen months. Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980). The adjustable rate mortgage (ARM) regulation was amended by allowing unequal periods to enable S&Ls to "batch" ARMs, thereby facilitating their sale in the secondary mortgage market. Interview with L.L. Bowman, III, Deputy Savings and Loan Commissioner, in Austin (September 30, 1980); see Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

65. Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

66. Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

67. See Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980). For instance, the first intermediate period could be specified as three years with ensuing periods of eighteen months and a roll-over point of every third year on the date of the anniversary of the mortgage. At the end of the first roll-over period the adjustment point and roll-over point would coincide. The second roll-over period would include two adjustments: one assessed mid-way through the period and the second assessed at the same time both adjustments are put into effect. Any variation upon this example within the regulatory constraints would be possible. See Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

the lender or agreed upon between the parties.⁶⁸ Furthermore, except for actual costs associated with making the adjustment, the lender is prohibited from charging closing costs on each adjustment.⁶⁹

D. *A Comparison*

In contrast with the VIR, the ARM has no fixed limit on the maximum increase or decrease in interest rates allowed for either the adjustment period or the life of the mortgage.⁷⁰ All ARM interest rate increases or decreases must be reflected solely in the monthly payments because extension of loan maturity is not allowed.⁷¹ Additionally, the ARM regulation lacks the VIR notification requirements imposed upon the lender regarding adjustments to the interest rate.⁷² The ROM also lacks the notification requirements and restrictions on interest rate adjustments present in the VIR regulation.⁷³ Further, the ROM is less restrictive than the VIR and ARM in that it is a short-term loan with no specified manner of affecting rate adjustments.⁷⁴

As a practical matter, the flexibility offered by the ROM and ARM virtually precludes use of the VIR.⁷⁵ With the ROM and ARM, the lender

68. See Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980). The ARM and ROM are similar in this regard, as each may have a roll-over period of between one and five years. The difference is that the ARM may have adjustments made in the interim period that would go into effect at the point of roll-over, while the roll-over point and rate adjustment always occur simultaneously with the ROM. Compare Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980) with Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

69. Tex. Fin. Comm'n, Rule 056.08.00.003(6)(iii), 5 Tex. Reg. 2997 (1980) "[N]o charges will be made by the association in connection with any adjustment of the interest rate or monthly payment except the reasonably determined costs to the association of making such adjustment." Tex. Fin. Comm'n, Rule 056.08.00.003(6)(iii), 5 Tex. Reg. 2997 (1980).

70. Compare Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980) (no maximum limits set) with Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) (maximum limit on each adjustment of .5% and total variation set at no more than 2.5%).

71. Tex. Fin. Comm'n, Rule 056.08.00.003(6)(iv), 5 Tex. Reg. 2997 (1980). "[T]he adjustment will be in an amount to amortize the unpaid balance of the loan within the remaining term." Tex. Fin. Comm'n, Rule 056.08.00.003(6)(iv), 5 Tex. Reg. 2997 (1980).

72. Compare Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980) (no notification requirements) with Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) (sets out specific notification requirements).

73. Compare Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) with Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979).

74. Compare Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) with Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) and Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

75. Although available since July 16, 1979, the VIR has rarely been offered and has proven unpopular with S&Ls because it favors the borrower, while the ROM and ARM are

may tailor the mortgage to meet market demands by setting the time period between rate adjustments, the maximum incremental change, and the total rate change over the life of the mortgage.⁷⁶ As market demands develop, the lender may adapt the mortgage accordingly.⁷⁷ Such flexibility is not characteristic of the VIR.⁷⁸

III. INDEX SELECTION

In order to determine adjustments of interest rates when an index is required, the lender must select the appropriate index or indexes to be used.⁷⁹ Since the Texas Savings and Loan Commissioner may approve alternative indexes upon application by individual S&Ls, the lender is not restricted to use of the FHLBB index.⁸⁰ As a result, several indexes may be offered to meet different market demands.⁸¹

more favorable to the lender. *Compare* Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) (favors borrower with disclosure requirements and maximum limits) *with* Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) (no disclosure requirements or maximum limits) *and* Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980) (no disclosure requirements or maximum limits).

76. *See* Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980). Although the regulations do not specify maximum limits, the Texas Savings and Loan League recommends that some maximum limit be placed in the contract to facilitate consumer acceptance of the formats. *Alternative Mortgage Plans for State Chartered Associations—Canadian Roll-Over—Adjustable Rate and Payment* (May 20, 1980) (Texas Savings and Loan League); *see* Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 86 (1978) (no limits politically intolerable).

77. *See* Rochester & Marcis, *National Survey of Current AMI Activity*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY II-1, II-4 to -6 (1977).

78. *Cf.* National Thrift News, Sept. 25, 1980, at 1, col. 1 (5% limit on federal RRM too low). *Compare* Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) *with* Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) *and* Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

79. *See* Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980). The ROM regulation does not specify use of an index, but one may be used. *See* Tex. Fin. Comm'n 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). *See generally* Steinherr, *Indexation of Monetary Assets and Credit Instruments*, in INFLATION AND CAPITAL MARKETS 149, 151-57 (M. Sarnot ed. 1977).

80. *See* Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

81. The Commissioner has approved several alternative indexes: the FHLMC Mortgage Participation Certificates, the Monthly National Average Mortgage Rate Index for All Major Lenders, the weighted average yield of accepted offers for four month conventional loan commitments under FNMA's Free Market Auction System, the average of the weekly net yield purchase quotations for conventional home mortgages by the FHLMC under its immediate delivery program, and the rate on the purchase of previously occupied homes in the FHLBB's most recent monthly national average. Indexes for GPM's and Rollovers Approved (Fall 1980) (unpublished circular by the Office of the Tex. Savings and Loan

Basically, there are two types of indexes: the cost of funds index and the mortgage rate index.⁸² The cost of funds index measures the current cost of money to the S&L as reflected by the amount of interest which must be paid to acquire such funds.⁸³ The mortgage rate index is an indicator of prevailing mortgage interest rates.⁸⁴ Index selection presents a problem, however, in that qualities desired by the lender are often less than favorable for the borrower.⁸⁵ Careful examination of alternative indexes should be made to determine the ones most suitable for the particular needs and market of the S&Ls.⁸⁶

IV. LEGAL CONSIDERATIONS

VRMs' legal ramifications will not become apparent until the instruments are in widespread use.⁸⁷ The basic differences between the SM and the VRM suggest possible legal complications which should be consid-

Commissioner).

82. See Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 5-6 (Aug. 1980). General criteria for an index include computation on a regular basis, computation by a reputable source, and public availability. See Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 85 (1978).

83. See Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 5 (Aug. 1980). The FHLBB index meets the criteria of reliability and availability, but is computed only twice yearly. See *id.* at 5. Ideally, an index should be computed on a monthly basis. See generally Field & Cassidy, *Simulation Analysis of Alternative Mortgage Instruments*, in II ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY, VIII-48 to -49 (1977).

84. See Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 6 (Aug. 1980). Examples of mortgage rate indexes are the Monthly National Average Mortgage Rate Index for All Major Lenders, the FHLBB's monthly national average of the purchase rate of previously occupied homes, and the index of FHLMC Mortgage Participation Certificates. These indexes are reliable and frequently computed, but may be difficult for the consumer to locate. See *Indexes for GPM's and Rollovers Approved (Fall 1980)* (unpublished circular by the Office of the Tex. Sav. & Loan Commissioner).

85. See Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 85 (1978). The lender will prefer an index which increases more readily than decreases, while the borrower obviously will prefer one which reflects decreases more readily. See Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 7 (Aug. 1980). The cost of funds index is less likely to turn downward or show any movement, while the mortgage rate index certainly will fluctuate up and down more readily. See *id.* at 7. For this reason, a lender would be better served by utilizing a cost of funds index when rates are at a high point and a mortgage rate index when rates are somewhat lower. See *id.* at 7.

86. See Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 4-7 (Aug. 1980).

87. See Comment, *Variable Rate Mortgages: The Transition Phase*, 61 MARQ. L. REV. 140, 145 (1977). Since VRMs are relatively new, little litigation concerning VRMs has occurred. See *id.* at 145. The Texas VRM regulations have been effective only a short time; consequently, the legal problems will not surface until more of the instruments are in use.

ered.⁸⁸ Without questioning the legal foundation for VRMs,⁸⁹ several significant issues which affect the VRMs are discussed.

A. Usury

Questions regarding VRMs and state usury ceilings have largely been answered by the recent federal preemption of state ceilings.⁹⁰ The federal usury moratorium renders all state ceilings inapplicable as of April 1, 1980, and continues until the state takes affirmative action to reinstate usury laws.⁹¹ The statute specifically provides, however, that the preemption will continue to apply to any VRMs executed during the moratorium, thus protecting such loans from future ceiling impositions.⁹²

Reimposition of a ceiling similar to that provided by previous legislation would impede the Texas mortgage market.⁹³ While VRMs made dur-

88. See Ege, *Legal Implications of the Alternative Mortgage Instruments*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XX (1977) (abstract) (study of legal considerations of AMIs); Hyer & Kearn, *Legal Impediments to Mortgage Innovation*, 6 REAL EST. L.J. 211, 220 (1978) (mortgage rules from legal point were designed for SM). The basic difference between a SM and a VRM is that a VRM borrower will not know for certain what the final cost of the loan will be. See Hyer & Kearn, *Legal Impediments to Mortgage Innovations*, 6 REAL EST. L.J. 211, 220 (1978).

89. See Barnett, *Alternative Mortgage Instruments: How to Maintain Secured Lender Status*, 96 BANKING L.J. 6, 9-10 (1979) (legality of mortgages with increases upheld).

90. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1), 94 Stat. 132, as amended by Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647. One of the primary concerns of commentators previous to the moratorium was the restraining effect of state usury laws on VRMs. See, e.g., Hyer & Kearn, *Legal Impediments to Mortgage Innovation*, 6 REAL EST. L.J. 211, 222 (1978); Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 39-40, 50 n.33 (1976); Werner, *Usury and the Variable-Rate Mortgage*, 5 REAL EST. L.J. 155, 158-62 (1976). The only question remaining is whether states will again enact low usury ceilings. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501(a)(1), 94 Stat. 132, as amended by Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647.

91. See Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, § 501 (b)(2), 94 Stat. 132, as amended by Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324, 94 Stat. 1647. States have until April 1, 1983, to enact new usury legislation. See *id.*

92. *Id.* § 501(b)(3)(B), 94 Stat. 132 (1980). This is in keeping with the general rule that usury ceilings are determined at the time the loan is made. See *Dodd v. Phoenix Mut. Life Ins. Co.*, 122 S.W.2d 679, 683 (Tex. Civ. App.—El Paso 1938, writ ref'd n.r.e.) (usury is determined at time mortgage is executed); *Seymoure Opera House Co. v. Thurston*, 45 S.W. 815, 817 (Tex. Civ. App.—Austin 1898, writ ref'd) (usury ceiling determined at onset of loan).

93. A similar usury ceiling for residential mortgages would, in effect, recreate the financial circumstances that led to modification of the prior Texas usury law. See *TEX. REV. CIV. STAT. ANN. art. 5069-1.07(d)* (Vernon Supp. 1979); Rawdin, *House Bill 409—Texas*

ing the moratorium would be unaffected, new VRMs would be subject to a maximum ceiling which effectively could limit their usefulness.⁹⁴ Legislative attention should be directed to possible alternatives. Options available include excluding S&Ls from state usury laws,⁹⁵ adopting a floating usury rate tied to an index,⁹⁶ or forbearance of legislative action pending study of the effects of the current moratorium.⁹⁷ Undoubtedly, any usury legislation should take into consideration possible effects on the mortgage market, as well as on the VRMs.⁹⁸

B. Disclosure Requirements

The Truth in Lending Act (TIL)⁹⁹ and Regulation Z,¹⁰⁰ its implementing regulation, govern disclosures which must be made when a mortgage is consummated.¹⁰¹ In addition to general disclosures,¹⁰² VIRs and ARMs

Raises the Ceiling on Residential Mortgage Loans, 33 Sw. L.J. 823, 835-45 (1979). See also Podell, *The Application of Usury to Modern Real Estate Transactions*, 1 REAL EST. L.J. 136, 136-38 (1972) (sets forth the methods of dealing with low usury ceilings).

94. See Ege, *Legal Implications of the Alternative Mortgage Instruments*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XX-39 to -47 (1977). The idea of a VRM is to allow the interest rate to fluctuate freely according to market pressures. An interest ceiling, if set too low, would destroy the purpose of a VRM. See *id.* at VIII-39 to -47.

95. See Cooper, *A Study of Usury Laws in the United States to Consider Their Affect on Mortgage Credit and Home Construction Starts: A Proposal for Change*, 8 AM. BUS. L.J. 165, 174-79 (1970) (nine states excluded S&Ls from state usury laws prior to usury moratorium).

96. See ALASKA STAT. § 45.45.010(b) (Supp. 1980). Alaska utilized a fluctuating usury ceiling tied to the discount rate of the Federal Reserve Bank for the 12th district. See *id.* § 45.45.2. The usury ceiling was adjusted four times yearly and kept 5% above the discount rate. See *id.* § 45.45.2.

97. Probably the wisest course of action would be to examine extensively the effects of the current moratorium prior to enacting usury legislation. In this way, determination could be made whether usury ceilings are actually necessary to protect consumer interests. See generally Rawdin, *House Bill 409—Texas Raises the Ceiling on Residential Mortgage Loans*, 33 Sw. L.J. 823, 835-42 (1979).

98. See generally *id.* at 825-40; Werner, *Usury and the Variable-Rate Mortgage*, 5 REAL EST. L.J. 155, 155-61 (1976).

99. 15 U.S.C. §§ 1601-1641 (1970). The purpose of the Truth in Lending Act (TIL) is to assist consumers in the "informed use of credit" by requiring disclosure of credit terms, thus allowing consumers to shop for credit. *Id.* § 1601.

100. 12 C.F.R. §§ 226.1-.10 (1980). Regulation Z is currently being revised and disclosure requirements for VRMs may be modified. See 45 Fed. Reg. 29702 (1980).

101. See generally Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 59-86 (1976).

102. See 12 C.F.R. §§ 226.1-.10 (1980). General disclosures include cost of credit, as stated in an annual percentage rate, and terms of credit, such as information about the amount of payments and overall finance charge. See *id.*

require three special disclosures¹⁰³ which must be complied with by federal and state chartered S&Ls.¹⁰⁴ The first required disclosure is that the annual percentage rate (APR) is subject to change, accompanied by specification of any index to be used and limitations imposed.¹⁰⁵ The second required disclosure is the method by which increases will be accomplished, such as by lengthening the maturity or increasing the amount of monthly payments.¹⁰⁶ The third required disclosure is that an example be provided the borrower to show the consequences of a one quarter percent change in the APR.¹⁰⁷ Noteworthy is the fact that such disclosures are required only at consummation of the original loan and not when interest rates are increased.¹⁰⁸

Pursuant to Regulation Z, the ROM requires different disclosures because the APR is not subject to change during the mortgage term.¹⁰⁹ The last payment of the designated term must be identified as a "balloon payment" since it is more than double the amount of a regular monthly payment.¹¹⁰ In addition, unlike the VIR and ARM, the conditions by which the "balloon payment" may be refinanced must be specified,¹¹¹ and new disclosures must be made each time the ROM is refinanced.¹¹²

103. *See id.* § 226.8(b)(8). The ARM may be disclosed under either section 226.8(b)(8) or section 226.3 of Regulation Z. *See* 45 Fed. Reg. 41437 (1980).

104. F.H.L.B.B. Memo. Rul. No. T-45d. This FHLBB ruling requires both types of associations to comply with disclosure provisions of Regulation Z. *See id.*

105. *See* 12 C.F.R. § 226.8(b)(8)(i) (1980). The lender must disclose "[t]he fact that the annual percentage rate is subject to increase and the conditions under which such rate may increase, including: (A) Identification of the index, if any, with respect to which such increase in annual percentage rate is tied; and (B) any limitation on such increase." *See id.*

106. *See id.* § 226.8(b)(8)(ii).

107. *See id.* §§ 226.8(b)(8)(iii)-(iv). Subpart (iii) refers to an example calculating an increase in monthly payments, while subpart (iv) refers to an example showing an increase in the number of monthly payments. *Id.* § 226.8(b)(8)(iii)-(iv); *see* 43 Fed. Reg. 42413 (1978) (methods of calculating examples). A typical example would be a \$40,000 loan at 8% interest payable in 360 monthly payments of \$293.61. A hypothetical immediate increase of ¼ % would increase payments \$7.00 to \$300.51 monthly. While the lender is free to disclose more information, the regulation requires only that the increase in monthly payments (\$7.00) be disclosed. *See* 43 Fed. Reg. 42413 (1978).

108. *See* 12 C.F.R. § 226.8(b)(iv)(1980) (subsequent occurrence and not a refinancing necessitating new disclosures).

109. *Compare* Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) (fixed interest rate but for short-term) *with* 12 C.F.R. § 226.8(b)(1980) (disclosures for loans with interest rates subject to increases) *and id.* § 226.3 (disclosures for loans with "balloon" payments).

110. *See* 12 C.F.R. § 226.3 (1980). A "balloon payment" is defined by the regulation as one which more than doubles the amount of a regular payment. *See id.*

111. *See id.*

112. *See id.* § 226.8(j) (ROM considered a refinancing requiring complete new set of disclosures).

C. Revision of Loan Documents

Loan documents must be revised in order to incorporate the unique features of VRMs.¹¹³ The VIR and the ARM promissory notes must reflect the variable rate feature, including when adjustments may be made, timing of notification of adjustments, and prepayment terms.¹¹⁴ The ROM promissory note must be changed to illustrate the shorter repayment schedule and the "balloon" payment.¹¹⁵ Any guaranty agreement to refinance the "balloon" should be included in the note.¹¹⁶

To preclude intervening lienholders from asserting priority over subsequent changes to a VRM lien, modifications to the deed of trust should be made.¹¹⁷ For the VIR and the ARM, the deed of trust should include a notice provision stating that the interest rate is subject to change.¹¹⁸ For the ROM, a standard deed of trust may be used,¹¹⁹ but when there is a guaranty agreement¹²⁰ it should be duly reflected in the document.¹²¹ In addition, an extension agreement must be recorded to assure priority of the first lien.¹²² If the extension agreement covers a period of more than four years, a new title policy is necessary at the time of roll-over to pro-

113. See Hailey, *Alternative Mortgage Instruments* 9 (September 25 & 26, 1980) (Mortgage Lending Inst. sponsored by the U. of Tex. Sch. of L. & the Tex. Mortgage Bankers Ass'n).

114. See *id.* app. A.

115. See *id.* at 13; *Alternative Mortgage Plans for State Chartered Associations—Canadian Roll-Over—Adjustable Rate and Payment* (May 20, 1980) (Tex. Savings & Loan League).

116. See Hailey, *Alternative Mortgage Instruments* 13 (September 25 & 26, 1980) (Mortgage Lending Inst. sponsored by the U. of Tex. Sch. of L. & the Tex. Mortgage Bankers Ass'n).

117. See *id.* at 8-9. See generally Comment, *Mortgages to Secure Future Advances: Problems of Priority and the Doctrine of Economic Necessity*, 46 Miss. L.J. 433, 433-49 (1975); Comment, *Mortgages: Priority of the Real Estate Mortgage for Present and Optional Future Advances*, 21 OKLA. L. REV. 79, 79-84 (1968).

118. See Hailey, *Alternative Mortgage Instruments* 8-9 (September 25 & 26, 1980) (Mortgage Lending Inst. sponsored by the U. of Tex. Sch. of L. & the Tex. Mortgage Bankers Ass'n). The Texas Savings & Loan League recommends use of the FNMA/FHLMC Uniform Deed of Trust. See *Alternative Mortgage Plans for State Chartered Associations—Canadian Roll-Over—Adjustable Rate and Payment* (May 20, 1980) (Tex. Savings & Loan League).

119. See *Alternative Mortgage Plans for State Chartered Associations—Canadian Roll-Over—Adjustable Rate and Payment* (May 20, 1980) (Tex. Savings & Loan League).

120. See Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

121. See *Alternative Mortgage Plans for State Chartered Associations—Canadian Roll-Over—Adjustable Rate and Payment* (May 20, 1980) (Tex. Savings & Loan League).

122. Hailey, *Alternative Mortgage Instruments* 14 (September 25 & 26, 1980) (Mortgage Lending Inst. sponsored by the U. of Tex. Sch. of L. & the Tex. Mortgage Bankers Ass'n); see TEX. REV. CIV. STAT. ANN. art. 5520 (Vernon 1968).

tect the lender's interest.¹²³

V. EFFECTS OF VRMs

A. *The Lender*

Effects of VRMs will not be felt until such instruments are integrated into S&L mortgage investment portfolios.¹²⁴ The primary impediment to this integration is borrower acceptance of the new mortgage formats.¹²⁵ An effective marketing campaign may be necessary to facilitate consumer understanding of the mortgages and to allow for their use and acceptance.¹²⁶ If successful, S&Ls should realize substantial benefits from the use of VRMs.

The most apparent benefit to the S&L will be the opportunity to adjust interest rates every several years thereby increasing income when market conditions so warrant.¹²⁷ This effectively will convert a portion of assets from a long-term to a short-term basis to comport more closely with short-term liabilities.¹²⁸ The attendant increases in income during periods of higher interest rates will allow S&Ls to compete more successfully for the savings dollar and avoid, at least partially, the ruinous effects of disintermediation.¹²⁹ This basic change in the S&L financial structure

123. See Hailey, *Alternative Mortgage Instruments* 14 (September 25 & 26, 1980) (Mortgage Lending Inst. sponsored by the U. of Tex. Sch. of L. & the Tex. Mortgage Bankers Ass'n).

124. See Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 48 (1976). Since S&Ls have portfolios composed primarily of fixed rate mortgages, it will take a substantial amount of time for the associations to incorporate the instruments in sufficient quantity to affect earnings. See *id.* at 48.

125. National Thrift News, Sept. 25, 1980, at 1, col. 1 (lack of national acceptance of federal RRM).

126. *Id.*; see Riedy, *VRM's in California: The Early Experience*, 9 FED. HOME LOAN BANK BOARD J. 14, 14-15 (Mar. 1976). When VRMs were introduced in California, lenders directed considerable effort toward marketing the *idea* of VRMs, as well as the mortgage itself. See Riedy, *VRM's in California: The Early Experience*, 9 FED. HOME LOAN BANK BOARD J. 14, 15 (Mar. 1976).

127. See 40 Fed. Reg. 6870 (1975) (increased income to S&L due to ability to increase rates).

128. Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 41-42 (1976).

129. See, e.g., 40 Fed. Reg. 6870 (1975) (adjustable interest rate mortgages to help combat disintermediation); Kaplan, Marcis & Cassidy, *AMIRS: An Overview and Summary*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 3 (1977) (improved flexibility would have ameliorated problems if used previously); McKenzie, *Macroeconomic Simulations of Variable Rate Mortgages*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XV-1 (1977) ("VRM portfolio will allow savings and loan associations to bid more aggressively for funds").

should promote a steadier source of funds for the home mortgage market and assure the viability of the S&L industry.¹³⁰

VRMs also may aid S&Ls by influencing consumers to borrow at current high rates in lieu of awaiting a downturn.¹³¹ Ordinarily, a borrower would incur a prepayment penalty and closing costs when refinancing to take advantage of lower rates.¹³² With a VRM, however, the interest rate is automatically lowered when rates decrease, sparing the borrower the expense of refinancing.¹³³

While the VRM affords S&Ls advantages, a possible detrimental effect should be considered. S&Ls should be careful to market the new instruments so as not to alienate the consumer.¹³⁴ Undoubtedly, the idea of a variable feature in a home mortgage is sufficiently foreign to borrowers to warrant an advertising program oriented to educate the consumer.¹³⁵ This will be especially true if S&Ls intend to rely exclusively on the new mortgage instruments.¹³⁶ Potential homebuyers faced with an instrument they do not fully understand may look to other lenders in hopes of finding a standard mortgage.¹³⁷

130. See 40 Fed. Reg. 6870 (1975). The primary purpose behind FHLBB proposal of VRMs is to "provide a larger and more stable flow of funds for home mortgage lending." See *id.*

131. Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 42 (1976) (VRMs as "marketing device" to encourage borrowers to buy during periods of high rates).

132. *Id.* at 42.

133. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(3), 4 Tex. Reg. 3899 (1979) (no refinancing charges); Tex. Fin. Comm'n, Rule 056.08.00.003(6) (iii), 5 Tex. Reg. 2997 (1980) (charge only actual expenses related to making interest rate adjustment). *But see* Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) (no prohibition against charging refinancing costs).

134. See Albaum & Kaufman, *The Variable Rate Residential Mortgage: Implications for Borrowers*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY VI-1 (1977) ("must be accepted by consumers on a broad scale"); Comment, *The Variable Interest Rate Clause and Its Use In California Real Estate Transactions*, 19 U.C.L.A. L. REV. 468, 480 (1972) ("serious problem of consumer acceptance").

135. See Riedy, *VRM's in California: The Early Experience*, 9 FED. HOME LOAN BANK BOARD J. 14, 14-16 (Mar. 1976). When the major California S&Ls began extending VRMs, a serious effort was made to educate consumers about the workings of the mortgage. Additionally, the VRM packages offered contained "extras" not required by state law, such as a lower initial rate, guaranteed periods without rate adjustments, and full assumability to a subsequent purchaser. This strategy was quite successful and resulted in VRMs comprising 58% of all new loans originated in 1975. See *id.* at 15.

136. See *id.* at 15 (four out of five of the major California S&Ls offered VRMs exclusively); National Thrift News, Sept. 25, 1980, at 1, col. 1 (many S&Ls in Ohio rely exclusively on RRM).

137. See Albaum & Kaufman, *The Variable Rate Residential Mortgage: Implications for Borrowers*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY VI-29 to -33 (1977) (borrowers preferring SMs generally did not comprehend completely VRM format).

B. *The Borrower*

Several practical aspects of VRM use should serve to benefit the borrower. The inherent flexibility of the new mortgage instruments allows S&Ls to offer a variety of mortgage packages.¹³⁸ The borrower will be able to shop for different indexes,¹³⁹ varied points of rollover,¹⁴⁰ and other "features"¹⁴¹ enabling selection of the most desirable combination of terms. The standard mortgage is uniform in its terms and generally does not allow the borrower to shop for more than the best interest rate.¹⁴² VRMs also offer the possibility of lower future rates, without refinancing if market conditions turn downward.¹⁴³ Borrowers as a class should benefit from VRMs in terms of having more mortgage money available to be lent as well as increased competition among S&Ls to market the most appropriate VRM for the individual borrower.¹⁴⁴

The obvious disadvantage to the consumer is partial assumption of the

To facilitate widespread acceptance, VRMs must be characterized as understandable and equitable. *See id.* VI-29 to -33.

138. *See* Kaplan, Marcis & Cassidy, *AMIRS: An Overview and Summary*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 203 (1977) (AMIs allow flexibility to meet consumer needs).

139. Indexes for GPM's and Rollovers Approved (Fall 1980) (unpublished circular by the Office of the Tex. Sav. & Loan Commissioner); *see* Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 4-7 (Aug. 1980).

140. The ARM and ROM may have a roll-over point of anywhere between one and five years. *See* Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980); Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). The borrower may shop for the roll-over point most suitable to his needs and income expectations. For instance, a borrower could shop for a roll-over point of two years, to coincide with expected pay increases. In this way, if rates did increase, the borrower's income would increase at approximately the same time. The VIR presumably could be arranged in a similar fashion. *See* Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979).

141. Additional "features," such as lower initial interest rate and easier assumability, may be offered by the S&L to enhance consumer acceptance of the new mortgages. *See, e.g.*, Riedy, *VRM's in California: The Early Experience*, 9 FED. HOME LOAN BANK BOARD J. 14, 14-16 (Mar. 1976); Comment, *The Variable Interest Rate Clause and Its Use in California Real Estate Transactions*, 19 U.C.L.A. L. REV. 468, 480-81 (1972); National Thrift News, Sept. 25, 1980, at 1, col. 1.

142. *See* Kaplan, Marcis & Cassidy, *AMIRS: An Overview and Summary*, in I ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY 2-3 (1977) (inflexibility of SM necessitates alternatives).

143. *See* Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979) (mandatory reductions without closing costs); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980) (mandatory decreases with only actual costs to S&Ls charged). *But see* Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980) (closing cost could be assessed).

144. *See* 40 Fed. Reg. 6870 (1975) (VRMs will increase amount of mortgage money available); Riedy, *VRMs in California: The Early Experience*, 9 FED. HOME LOAN BANK BOARD J. 14, 14-16 (Mar. 1976) (competition increased between S&Ls).

risk of increased future interest rates.¹⁴⁵ During inflationary periods, a fixed rate of interest on a home mortgage may be the most attractive feature of home ownership.¹⁴⁶ While the price of virtually everything else increases, standard mortgage payments remain constant.¹⁴⁷ The variable rate feature of the new instruments, however, will pass increases in interest on to the borrower in the form of higher monthly payments.¹⁴⁸

Another practical disadvantage may be exclusion of less affluent, potential homebuyers.¹⁴⁹ Before offering a VRM to a borrower, not only must his present ability to meet payments be scrutinized, his ability to cope financially with possible increased future payments also must be considered.¹⁵⁰ Consequently, borrowers not only have to qualify at present mortgage terms but also at terms which could be effected by an interest rate increase in the future.¹⁵¹

While the borrower may realize both advantages and disadvantages from VRMs, the issue remains whether the rights and remedies associated with the VRM offer the consumer adequate protection.¹⁵² The primary safeguard is disclosure under TIL and Regulation Z.¹⁵³ Although

145. See, e.g., Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 85 (1978) ("principal objective of VRM . . . to transfer part of the interest-rate risk from lender to borrower"); Groves, *Choosing the Right VRM Index*, 13 FED. HOME LOAN BANK BOARD J. 4, 4 (Aug. 1980) (partial transfer of risk to borrower); Spolan, *The Case for Variable Rate Mortgages*, 1 REAL EST. REV. 15, 17 (1971) (shift risk to borrower).

146. See Comment, *Adjustable Interest Rates in Home Mortgages: A Reconsideration*, 1975 WIS. L. REV. 742, 745-47 (1975).

147. See *id.* at 745-47.

148. See Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980); Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980). The VIR allows for both increases in payments and extensions of loan maturity. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979).

149. Landers & Chandler, *The Truth in Lending Act and Variable Rate Mortgages and Balloon Notes*, AM. B. FOUNDATION RESEARCH J. 35, 47-48 (1976).

150. See *id.* at 47-48 (excluding many persons on fixed income or those borrowers without potential for increased income).

151. See *id.* at 47-48. With these increases in rates come the possibility for serious increases in mortgage delinquency and foreclosure rates. See Boykin & Philips, *The New Challenger: The Variable-Rate Mortgage*, 8 REAL EST. REV. 83, 86 (1978). See generally Swan, *AMI Default and Foreclosure Analysis*, in II ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY IX-2 to -29 (1977).

152. See Boykin & Philips, *The New Challenger: The Variable Rate Mortgage*, 8 REAL EST. REV. 83, 86 (1978) (must be sufficient consumer protection). See generally Weinrobe, *Analysis of Consumer Safeguards for AMIs*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XXI-1 to -11 (1977).

153. See Weinrobe, *An Analysis of Consumer Safeguards for AMIs*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XXI-1 to -11 (1977).

compliance is enforced administratively through the FHLBB,¹⁵⁴ the consumer is largely left to fend for himself in the discovery of errors or violations.¹⁵⁵ The disclosures required under Regulation Z for VRMs, however, do not appear sufficient to allow the borrower to protect himself. The lender must disclose the "conditions" by which the rate may be increased and the index to be used.¹⁵⁶ Disclosure of where the index may be found and the method of calculating the rate increase is not required.¹⁵⁷ If the lender does not provide this information, the borrower is left with the problem of finding where the index is published, and then attempting to ascertain the method of computing any changes in his individual interest rate.¹⁵⁸ Clearly, if the borrower is to protect himself, he must be more fully informed of the actual operational method of figuring changes in interest rate.¹⁵⁹

In the event of a violation, the borrower has a cause of action for breach of contract as with any mortgage contract.¹⁶⁰ While the right of rescission under TIL does not apply to purchase money mortgages,¹⁶¹ the FHLBB has ruled that if a lender fails to properly disclose a variable interest rate feature, as with a VIR and ARM, any subsequent increase is void and must be rescinded.¹⁶² Additionally, TIL provides civil liability for failure to disclose,¹⁶³ as well as criminal sanctions for intentional violations.¹⁶⁴ Damages are limited to double the finance charge, but may not exceed \$1,000.¹⁶⁵ The successful plaintiff may also collect attorney fees.¹⁶⁶

The Texas regulations sparingly add to the federal protection of the

154. See 15 U.S.C. § 1607(a)(2) (1976).

155. *Jones v. Seldon's Furniture Warehouse*, 357 F. Supp. 886, 887 (E.D. Va. 1973) (allowing attorney fees to promote private litigation); *Ratner v. Chemical Bank New York Trust Co.*, 329 F. Supp. 270, 280 (S.D. N.Y. 1971) (scheme of section 1640 is "to create a species of 'private Attorney General' to participate prominently in enforcement").

156. See 12 C.F.R. §§ 226.3, 226.8(b)(8)(i) (1980).

157. See *id.*

158. See Weinrobe, *Analysis of Consumer Safeguards for AMIs*, in III ALTERNATIVE MORTGAGE INSTRUMENTS RESEARCH STUDY XXI-68 to -69 (1977).

159. See *id.* at XXI-91.

160. See 15 U.S.C. § 1610(d) (1976).

161. *Id.* § 1635(e). Where a security interest is obtained on the borrower's residence, TIL provides the borrower with the right to rescind the contract within three working days of either the consummation of the mortgage or the delivery of the disclosure statement. *Id.* § 1635(a). See generally Burnstein, *There's Truth in Lending, But Is There Right in Rescission*, 2 REAL EST. REV. 83, 84-90 (1972).

162. See F.H.L.B.B. Memo. Rul. No. T-45d.

163. See 15 U.S.C. § 1640 (1976).

164. See *id.* § 1611.

165. See *id.* § 1640(a)(1).

166. See *id.* § 1640(a)(3).

borrower.¹⁶⁷ Disclosure requirements are enhanced in that the VIR provides for disclosure which informs the buyer of old and new index rates and the corresponding interest rate changes upon every rate adjustment.¹⁶⁸ The borrower still must confirm the accuracy of the index data with an external source.¹⁶⁹ The ROM regulation provides only that the "manner" of adjustment be disclosed, with no explanation of the term.¹⁷⁰ No specific disclosures are required for the ARM.¹⁷¹

The Texas borrower possesses the right to prepay a VIR or ARM without penalty upon an upward adjustment of the interest rate.¹⁷² There is no provision in the ROM regulation preventing the lender from inserting a prepayment penalty clause in the instrument,¹⁷³ but as a practical matter, the reasons for a lender utilizing such a clause are not present with the ROM.¹⁷⁴

VI. CONCLUSION

Texas S&Ls have been authorized to offer VRMs to help solve problems peculiar to the industry. While today's inflationary economy may necessitate the use of such instruments, the Texas mortgage market will not realize their potential benefits until borrowers accept VRMs as a viable means of obtaining purchase money. The lack of restrictions within the VRM regulations indicate a need to incorporate terms more favorable to the borrower within each VRM transaction. In addition to the minimal state and federal disclosure requirements, it would be to the benefit of S&Ls to provide maximum information to borrowers in order to promote understanding and confidence in the new mortgage instruments. Undoubtedly, the success or failure of VRMs depends upon the restraint and

167. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979); Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

168. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(5), 4 Tex. Reg. 3899 (1979).

169. The regulation mandates lender disclosure, but to detect errors or violation, the borrower must have access to the index to confirm the accuracy of the S&L's data. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv)(5), 4 Tex. Reg. 3899 (1979).

170. See Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

171. See Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

172. See Tex. Fin. Comm'n, Rule 056.08.00.002(1)(iv), 4 Tex. Reg. 3899 (1979); Tex. Fin. Comm'n, Rule 056.08.00.003(6), 5 Tex. Reg. 2997 (1980).

173. See Tex. Fin. Comm'n, Rule 056.08.00.003(5), 5 Tex. Reg. 1852 (1980).

174. The purpose of a prepayment penalty is to discourage the borrower from repaying the principal before maturity, thereby depriving the lender of interest. See Comment, *The Variable Interest Rate Clause And Its Use In California Real Estate Transactions*, 19 U.C.L.A. L. Rev. 468, 481 (1972). Since the ROM is a short-term loan, the lender will receive the "balloon" payment within a short period of time and will lose little interest. *Id.* 481-82; see 12 C.F.R. 545.6-12(b) (1975).

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ingenuity demonstrated by individual S&Ls as they design and market their VRM packages.