DRAKE
LAW REVIEW

Volume 31 1981-1982 Number 1

# BALANCING THE INTEREST: THE CHANGING COMPLEXION OF HOME MORTGAGE FINANCING IN AMERICA

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## I. Introduction

Owning one's own home has long been part of "the American dream." Within the past decade, however, severe problems have hampered America's mortgage and housing industries, and unless satisfactory solutions are found, these problems well may foreclose home ownership for most young Americans. Mortgage credit has become exorbitantly expensive; availability of funds is limited and uncertain for both home buyers and home builders; "over the six years from 1970 through [sic] 1975, the proportion of American families able to afford medium-priced new houses declined from 55 percent of all families to approximately 40 percent."[1]

The disruption of the American housing market is a product of the "double digit" inflation of the last decade.[2] The tools of the American hous-

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1. Kaplan, *The Alternative Mortgage Instruments Research Study: An Interim Progress Report*, 10 Fed. Home Loan Bank Bd. J. 8, 9 (June 1977) [hereinafter cited as *Interim Progress Report*]; Kaplan, *The Alternative Mortgage Instruments Research Study: A Progress Report*, 9 Fed. Home Loan Bank Bd. J. 6, 7 (Oct. 1976) [hereinafter cited as *Progress Report*].

2. *See Interim Progress Report*, *supra* note 1. *See also* Berry, *The Variable Interest Note: An Answer to Uncertainty in a Fluctuating Money Market*, 1971 L. & Soc. Ord. 600; Giles, *The Effect of Usury Law on the Credit Marketplace*, 95 Banking L.J. 527 (1978); Hyer & Kearl, *Legal Impediments to Mortgage Innovation*, 6 Real Est. L.J. 211 (1978); Landers & Chandler, *The Truth in Lending Act and Variable-Rate Mortgages and Balloon Notes*, 1976 A.B.A. Foundation Research J. 35; McManus, *Variable Mortgage Note: Route to Increased Housing*, 55 A.B.A. J. 557 (1969).

ing market were not designed to operate in an inflationary economy. The standard fixed-rate mortgage instrument, the operating structure of savings and loan institutions, and the regulation of usurious interest, all function reasonably well in a stable economic environment with modest inflation, stable monetary policy and low, relatively unfluctuating interest rates. This article will examine these aspects of the housing industry and the suggested alternatives. It will explain the interaction between usury regulations and mortgage marketing, and illustrate that modifying mortgage instruments alone will not effectively resolve the financial problems facing the housing industry. Unless usury regulation is also modified, financing for both home builders and home buyers will remain restricted, and the housing "crunch" of the last decade will continue.

### *A. The Standard Mortgage Instrument.*

The standard mortgage instrument (SMI) was designed to function in a non-inflationary economy.[3] It is a long-term asset with both a fixed principal and interest rate. Typically, the standard mortgage contract provides for repayment of the secured loan over an established term of years at a fixed interest rate by a series of equal monthly payments.[4] The monthly payments are designed to pay all interest on the loan as it falls due, and to amortize (repay) fully the principal within the term of the loan.[5] The SMI ties the lender and borrower into an agreement throughout the life of the mortgage.[6] It ignores both the increase in income that young home buyers can expect and the likely increase in property value due to inflation.[7] A young family may pay a high percentage of its income to cover mortgage payments during the early years of the mortgage contract, and then pay a much smaller percentage of family income in later years when income has increased due to job advancement, inflation, or both.[8]

While the standard mortgage instrument places an onerous burden on young home buyers, it potentially wreaks even greater havoc upon the major home mortgage lending institutions. "The pecuniary sources of funds for residential mortgages are the major financial intermediaries: savings and loan associations (S&Ls), commercial banks, mutual savings banks, and life insurance companies."[9] These lenders hold nearly 73% of the residential

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3. *Progress Report, supra* note 1, at 8.

4. Hyer & Kearl, *supra* note 2, at 212; Washburn, *Alternative Mortgage Instruments in California*, 12 AKRON L. REV. 599 (1979).

5. Hyer & Kearl, *supra* note 2, at 217; Washburn, *supra* note 4.

6. *See Progress Report, supra* note 1.

7. *Id.* at 8.

8. *Id. See also* Cowan & Foley, *New Trends in Residential Mortgage Finance*, 13 REAL PROP. PROB. & TR. J. 1075-76 (1978); Hyer & Kearl, *supra* note 2, at 215.

9. Bjerg, *Home Mortgage Lending Under Iowa's Revised Usury Laws During a Tight Money Market*, 65 IOWA L. REV. 363, 365 (1980).

mortgages in the United States. Savings and loan associations alone hold more than 46% of residential mortgages.[10] Moreover, savings and loan associations, unlike the other financial intermediaries, are primarily mortgage lenders. Approximately 83% of their total assets are invested in mortgage loans.[11] Savings and loans draw their funds primarily from the savings deposits of individuals.[12] Thus, the mortgage interest rate return to the S&Ls (and to a lesser extent the other major mortgage lenders) must meet the institution's operating expenses and enable the institution to offer savers an attractive interest return on their deposits.[13]

Home loans carry high administrative costs. Therefore, lenders must charge initial rates sufficient to meet those costs.[14] Moreover, standard home mortgages are long-term, nonliquid assets. Lenders must charge a rate sufficient to compensate for the risk of borrower default.[15] Additionally, with inflation, the lender must add an inflation premium to the fixed mortgage interest rate charged. The inflation premium is meant to insure the lender a full return of principal and full compensation for its use throughout the

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At the end of the first quarter of 1979, the amount of mortgage debt on one-to-four-family dwellings held by major financial intermediaries was:

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| Savings and Loans | $377.6 billion |
| Commercial Banks | 136.2 billion |
| Mutual Savings Banks | 63.6 billion |
| Life Insurance Companies | 14.5 billion |
| Total held | $591.9 billion |

Figures obtained from 65 FED. RES. BULL. Table 1.56, at A41 (1979).

10. 65 FED. RES. BULL. Table 1.56, at A41 (1979). Savings and Loan Associations hold more than $377.6 billion of the $591.9 billion of mortgages held by the four major financial intermediaries. Other lenders, namely, private individuals, mortgage investment companies, real estate investment companies, and other small private investors, bring the total national mortgage debt on one-to-four-family dwellings to $815 billion. *Id.*

11. *Id. See also* United States League of Savings Ass'ns, Savings & Loan Fact Book 66, 80, and table 68 (25th ed. 1978).

12. *See* note 10 *supra.*

13. Comment, *Variable Rate Mortgages: the Transition Phase*, 61 MARQ. L. REV. 140-41 (1977).

To induce savings, federal savings and loan associations are permitted to offer interest rates above those of commercial banks. To induce mortgage lending, federal savings and loan associations are limited to making loans on real estate and given various tax incentives. Landers & Chandler, *supra* note 2, at 37 n.5.

14. Most state usury laws enumerate specific service charges which lenders may pass on to the home loan borrower, but forbid fees covering overhead expenses. Therefore, lenders must raise interest rates to meet these costs. "Nationally, the total of these initial expenses amount to slightly over 1.5% of the loan value and were responsible for raising the contract interest rate from 10.73% to an effective interest rate of 11.02% in September 1979." *See Interim Progress Report, supra* note 1. *See also* Bjerg, *supra* note 9, at 367 n.32; Landers & Chandler, *supra* note 2, at 41.

15. *See* Benfield, *Money, Mortgages, and Migraine—The Usury Headache*, 19 CASE W. RES. L. REV. 819, 826-27 (1968); Bjerg, *supra* note 9, at 367.

term of the mortgage.[16] The premium is not a significant factor in the mortgage interest rate during periods of mild inflation.[17] The predictive risk is much greater, however, during periods of rapid or variable inflation.[18] The lender then must be compensated not only for the expected inflation but also for the risk that the estimate of inflation will be incorrect.[19] New home loan borrowers then must pay highly inflated interest rates to subsidize the fixed low rates paid by earlier borrowers.[20] The disparate nature of S&L's assets and liabilities compounds the predictive risk problem. While S&Ls "lend long" in the mortgage market, they "borrow short" from their savings depositors.[21] With inflation, savings deposits are a low-yield investment. Savings and loan associations cannot raise the interest rate to compete with other higher yielding investments because a substantial portion of their mortgage interest returns is fixed at an artifically low, pre-inflation rate. Furthermore, Regulation Q restricts the interest rate that federal S&Ls can pay their depositors.[22] Thus, S&Ls cannot offer highly competitive deposit interest rates when inflation is much higher than anticipated or when short-term interest rates are highly volatile.[23] Their capacity to attract new savings depositors declines while revenue from mortgage interest fails to increase at the inflation rate.[24] "Profits decline and the institutions are forced

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16. *See* J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE 685 (4th ed. 1972); *Interim Progress Report, supra* note 1, at 8; Note, *Commercial Law: Aztec Properties, Inc. v. Union Planters National Bank, Purchasing Power Adjusted Loans*, 45 U. MO. KAN. CITY L. REV. 140 (1976).

17. Landers & Chandler, *supra* note 2, at 44.

18. *Id.*

19. *Id.*

20. Cowan & Foley, *supra* note 8, at 1077.

21. Savings and loan associations' savings deposits are generally payable on demand or on relatively short notice. Therefore, it is difficult for savings and loans to maintain a steady supply of lendable funds. Moreover, even if funds remain on deposit, the interest paid on savings accounts may change several times over the life of the standard mortgage they sustain. The mortgage interest rate, on the other hand, remains at the initial contract rate. Landers & Chandler, *supra* note 2, at 38.

22. Cowan & Foley, *supra* note 8, at 1077. Reg. Q, 12 C.F.R. § 526.1 (1981) proscribes the ceiling rate that federally chartered savings and loans may pay their depositors. State chartered savings and loans are generally subject to similar restrictions. However, in March, 1980, Congress eliminated federal restrictions on interest paid on savings accounts. Within six years, neither banks, credit union, nor savings and loan associations will be subject to federal interest regulation. Depository Institutions Deregulation and Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132 (1980) [hereinafter cited as Depository Act].

23. Hyer & Kearl, *supra* note 2, at 214.

24. *See* Comment, *supra* note 13, at 141. The author also notes that inflation in the housing construction industry acts as an additional disincentive to saving. As the cost of materials and labor rise, new housing construction declines. This, in turn, drives the price of existing housing up, and consumers are discouraged from saving to purchase a home at an inflated price. McManus notes a second possible disincentive to saving. He cites Irving Fisher's work, *The Theory of Interest*, for the hypothesis that as price levels accelerate, persons' fears of principal erosion increase, and their desire to hold money and money instruments decreases

to revert to additional debt financing to remain competitive. The mortgage portfolio, if valued at current market prices . . . can easily become less valuable than the liabilities required to finance it."[25]

The process of disintermediation, described below, further aggravates the problem. When deposit interest rates are no longer competitive, depositors close out or reduce their savings account balances and reinvest their funds in other markets such as Treasury bills, bonds, commercial paper, money market certificates, and certificates of deposit, all of which provide a higher rate of return than savings accounts.[26] When inflation erodes the mortgage interest return of S&Ls and increases their costs of competing for depositors' funds while decreasing the attractiveness of savings deposits as an investment, the potential borrower, even if willing to pay an inflation premium, may be unable to get funds. Lenders who are able, shift their funds into non-mortgage investments. Commercial banks allocate their funds to established commercial customers rather than consumer mortgagers. Commercial loans generally have shorter terms than standard home mortgages. Often commercial loans are excepted from state usury laws and, therefore, can provide higher interest yields. Moreover, such loans generally are subject to less government regulation, and thus, carry fewer transaction costs than home mortgage loans.[27]

Until 1980, federally-chartered savings and loan associations were limited by law to making loans on real estate.[28] Thus, they could not readily

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and shifts to more tangible assets that will appreciate in value as price levels increase. This shift makes less funds available for lending and thus, engenders higher interest rates. McManus, *supra* note 2, at 558.

25. Stansell & Millar, *How Variable-Rate Mortgages Would Affect Lenders*, 5 REAL EST. REV. 116, 117 (Winter, 1976). Federal savings and loans rely heavily on the Federal Home Loan Bank Board (FHLBB) for funds for new mortgages. Those new mortgages then must provide an interest return sufficient to pay back the sums borrowed as well as meet the other operating costs of the savings and loans. Bjerg, *supra* note 9, at 383.

26. 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., 163, 184 (1970); Comment *supra* note 13, at 141. One writer has noted that disintermediation is usually the result of the actions of those account holders having rather large deposit balances. Data gathered from 25 California savings and loan associations during a time of high market interest rates (calendar year 1974) showed no disintermediation in accounts with balances below $5,000, but very strong disintermediation in accounts with initial balances above $25,000. During this period, 14% of the highest yield accounts—those with deposits of $40,000 or more—were closed out; another 16% of them were drawn down to levels below $40,000. Goldman, *Disintermediation Under the Microscope*, 9 FED. HOME LOAN BANK BD. J., 13, 14-15 (Dec. 1975).

27. For example, commercial lenders are not subject to federal truth-in-lending, 15 U.S.C. § 1601, Reg. Z (1977), disclosure requirements. Most states have special foreclosure and redemption rights protecting home loan borrowers which are not extended to commercial borrowers. Moreover, about two-thirds of the states have a "corporate exemption" in their usury laws. Such exemptions prohibit corporate borrowers from raising the defense of usury.

28. Under the Depository Institutions Deregulation and Monetary Control Act of 1980,

shift to commercial lending during periods of "tight money" and rising interest rates.[29] As a consequence when the yield on mortgage assets was low, S&Ls rationed credit to eliminate high risk borrowers. They demanded higher loan-to-value ratios of mortgage borrowers and shortened the maturities of residential mortgages.[30]

During the past decade, economists and financiers have investigated new approaches to mortgage financing. Lenders sought alternatives that would eliminate the inflexible yield and predictive risk inherent in the standard mortgage instrument. Borrowers may desire mortgage instruments more closely mirroring their true income streams in adult life. A number of conveniences and inflation-related devices have been proposed.[31] Among the inflation-related devices are the Price Level Adjusted Mortgage (PLAM) and the Adjustable Rate Mortgage (ARM).[32] The PLAM indexes the principal of the mortgage in order to guarantee the lender a real rather than nominal return on the invested funds.[33] Indexing of the loan principal assures

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Pub. L. No. 96-221, Title IV, 94 Stat. 132 (1980), federal savings and loan investment authority was expanded substantially. In assessing the Act's impact on savings and loans, John M. Buckely, Jr., Director of the Office of Planning and Management Coordination of the Federal Home Loan Bank Board, however, states that while the new asset powers granted by the Act "will enhance the opportunity for savings and loans profitability, . . . these activities will not necessarily contribute to their ability to provide funds for mortgage lending." Buckley, *The S & L Environment in the 1980s*, 14 FED. HOME LOAN BANK BD. J. 19 (Jan. 1981).

29. *See* note 10 *supra*.

30. Loan to value ratio translates simply into a higher down payment. Thus, in periods of restricted credit, a young family will need to save substantially more, and substantially longer, before they can "afford" a mortgage loan. Where a low local usury ceiling compounds the interest return problem, savings and loans will often shift funds into mortgages and investments outside their own geographic area and, thereby, evade the local restrictions. *See* Section IV *infra*.

31. Convenience related alternate mortgage instruments (AMIs) include: (1) the graduated payment mortgage (GPM) which has monthly payments initially lower than those of a comparable SMI, but scheduled to increase later (the graduate rate, term of graduation, and interest rate are fixed for the term of the loan); (2) the flexible loan insurance program (FLIP) which has early reduced loan payments effected through supplements deducted from the loan down payment; (3) graduated payment/variable rate mortgage, a combination of the GPM and the VRM, which has both a varying interest rate and a set payment increase schedule throughout the loan term.

32. The term, "adjustable rate mortgage," is a generic term describing a variety of mortgage instruments in which the interest rate on the principal is tied to an index. A significant portion of the research for this article centered on variable rate mortgages (VRM) since these are the oldest, most widely used form of ARM. In a more narrow sense, the term also describes those mortgage instruments national banks may promote under regulations adopted by the Comptroller of the Currency on March 27, 1981. 48 Fed. Reg. 18,932-18,947 (1981) (to be codified in 12 C.F.R. § 29).

33. The distinction between "nominal" and "real" is vital in understanding the development of new mortgage instruments. "Nominal" refers to current dollars while "real" variables are those in constant dollars or in real commodity purchasing ability. For example, nominal interest rates equal the current dollar return from interest payments. Real interest rates are interest return measured as constant purchasing power, that is, nominal interest less the rate of

the lender that the funds advanced to the borrower will maintain their constant purchasing power.[34] The risk of wrongly predicting the rate of future inflation shifts to the borrower, who will pay back more nominal principal when inflation has made each dollar worth less, and will pay back less should deflation make each dollar worth more.[35] Legal issues arising from the use of indexed principal loans have focused on whether the predictive risk can properly be shifted to the borrower, and whether doing so renders the transaction either usurious or against public policy as violative of the federal Gold Clause Resolution, or both.[36]

Adjustable rate mortgages approach the problem of predictive risk by tying the interest rate on the principal to an index. "[I]nstead of remaining constant throughout the term of the loan, [the interest rate] varies proportionately with some standard indicator to which . . . [it] . . . is tied. Adjustments are made to the interest rate to reflect changes in the indicator at periodic intervals . . . ."[37] The risk is shifted to the borrower, and the lender is assured that he will receive "the flexible 'going rate' of interest on his money throughout the term of the loan."[38] Legal issues arising from the introduction of ARMs focus on whether borrower-consumers' interests will be safeguarded adequately and whether ARMs will be practicable in those states having low usury ceilings.[39]

## II. Legal and Economic Objections to PLAMs

### *A. Loan Cost Uncertain*

The PLAM provides for a fixed interest rate tied to a principal that

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decline in the value of the dollar with which the nominal rate is paid. Hyer & Kearl, *supra* note 2, at 213.

34. The Consumer Price Index (CPI) is commonly designated as the measure of constant purchasing power. The CPI is an "index measuring the change in the cost of typical wage-earner purchases of goods and services expressed as a percentage of the cost of these same goods and services in some base period, called also Cost-of-Living Index." Webster's Third New International Dictionary 490 (Unabridged 1961).

35. *See* Cowan & Foley, *supra* note 8; Landers & Chandler, *supra* note 2; McManus, *supra* note 2; Note, *Indexing the Principal: The Usury Laws Hang Tough*, 37 Pitt. L. Rev. 775 (1976) [hereinafter cited as *Indexing the Principal*].

36. *See* Section II *infra*.

37. Cowan & Foley, *supra* note 8, at 1079.

38. Strum, *Real Property Law Section Committee on Mortgages: Report on the Variable Rate Mortgage*, 47 N.Y. St. B.J. 112 (1973). The ARM was originally also proposed as a means of preventing disintermediation; that is, by allowing savings and loans a more flexible, short-term rate yield on the mortgage returns, the associations would be able to offer deposit yields competitive with those on other investments. *See, e.g.*, Cowan & Foley, *supra* note 8; Landers & Chandler, *supra* note 2. One report suggests, however, that in Great Britain, where ARMs are the principal mortgage lending instrument, their use has not "eliminated problems of accelerated savings outflows during period of tightening financial conditions." Lasdon, *Investment and Finance*, 87 Banking L.J. 762, 763 (1970).

39. *See* Sections III and IV *infra*.

fluctuates with upward or downward movement of the Consumer Price Index (CPI) or another selected price index.[40] The object is to preserve the "real value" of the unpaid debt while maintaining a constant nominal interest rate.[41] Yet, before the PLAM can be widely utilized, it must overcome both legal and economic objections.

An important distinction between the PLAM and the SMI is that holders of SMIs know both the payment stream, that is, the periodic payments due throughout the amortization period, and the maximum cost of the loan at its outset.[42] Borrowers, thus, can plan to meet these costs. With the PLAM, however, the borrower's payment stream and total cost are uncertain. Planning to meet the cost changes is difficult and dependent upon either the borrower's nominal earnings increasing with inflation or his real earnings increasing with added work experience.[43] Neither of these events are certain at the outset of the loan; they are less certain for those borrowers approaching retirement or lacking marketable skills.[44] Therefore, unless these higher risk consumers were factored out during loan negotiation, entering a PLAM agreement would jeopardize the borrower's security and also substantially increase their loan default rate.[45] Thus, introduction of PLAMs will not aid low-income, high-risk consumers who are least likely to receive financing with a SMI.

### *B. Indexed Principal As Interest*

State usury statutes post a significant obstacle to PLAM implementation. Two recent cases hold that loans in which the principal increased with increases in the Consumer Price Index (CPI) were unsurious when the increase in principal together with the nominal interest rate exceeded the state usury maximum. In *Aztec Properties, Inc. v. Union Planters National Bank of Memphis*,[46] Aztec, a commercial borrower, agreed to repay a $50,000 loan "in constant United States dollars adjusted for inflation (deflation)" according to a formula tied to fluctuations in the CPI during the life of the loan.[47] The lender also charged interest at the Tennessee maximum of ten percent per annum.[48] On maturity of the note, Aztec repaid the $50,000 principal and $419.35 nominal interest, but refused to pay the $500 addi-

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40. Cassidy, *Price-Level Adjusted Mortgages Versus Other Mortgage Instruments*, 14 FED. HOME LOAN BANK BD. J. 3 (Jan. 1981); Cowan & Foley, *supra* note 8, at 1078.

41. Cowan & Foley, *supra* note 8, at 1085; McManus, *supra* note 2, at 558; Washburn, *supra* note 4, at 626.

42. Hyer & Kearl, *supra* note 2, at 222.

43. For a discussion of the terms "nominal" and "real", *see* note 33 *supra*.

44. Hyer & Kearl, *supra* note 2, at 222.

45. *Id. See also Indexing the Principal*, *supra* note 35, at 755.

46. 530 S.W.2d 756 (Tenn. 1975), *cert. denied*, 425 U.S. 975 (1976).

47. *Id.* at 757.

48. *Id.*

tional indexed principal due under the contract.[49] The bank brought suit and received a favorable judgment from the lower court.[50] On appeal, however, the Tennessee Supreme Court rejected the bank's argument that the indexed principal was not usurious interest, but rather a legitimate attempt to preserve the value of the loaned principal.[51] The court noted that the lender had long borne the risk of inflation in Tennessee, and that interest represents "compensation for the use of money and for bearing the risk that the borrower might not repay or the principal might depreciate in value."[52] It then held the "indexed principal" to be usurious interest.[53]

In a second recent case, *Olwine v. Torrens*,[54] the mortgage contained a repayment clause providing that the amount of principal owing would be increased or decreased by an amount equal to the difference between the average purchasing power of the dollar during July, August and September, 1958, and the average purchasing power of the dollar for the three months immediately preceding the date of repayment if the difference was greater than five points on the CPI.[55] Interest at the Pennsylvania maximum of six percent per annum was also charged.[56] In May of 1973, the borrower brought an equitable action seeking settlement of the mortgage.[57] The lower court found the clause violative of the Pennsylvania usury law and ordered the mortgage marked satisfied.[58] The lender appealed. The superior court affirmed. The court declared the lender's contention that the extra charge merely maintained the value of the principal and was, therefore, itself, principal "novel" but ignorant of "economic reality."[59] Citing various economic authorities, the court stated that the risk of inflation traditionally rests with the lender who, therefore, builds an inflation premium into the interest rate charged.[60] The court further reasoned that since the lender attempted to avoid the effects of inflation with the repayment clause, the additional sum constituted usurious interest when coupled with the maximum lawful interest rate charged on the loan.[61]

A number of commentators suggest that *Aztec* and *Olwine* were wrongly decided.[62] In *Aztec*, for example, the rate of inflation exceeded the

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49. *Id.*
50. *Id.*
51. *Id.* at 758.
52. *Id.* at 759.
53. *Id.*
54. 236 Pa. Super. Ct. 51, 344 A.2d 665 (1975).
55. *Id.* at 53, 344 A.2d at 666.
56. *Id.* at 52, 344 A.2d at 666.
57. *Id.* at 53, 344 A.2d at 666.
58. *Id.*
59. *Id.* at 54, 344 A.2d at 667.
60. *Id.* at 54-55, 344 A.2d at 667.
61. *Id.*
62. Note, *Indexed Principal: A Way Around Usury Laws?* 31 ARK. L. REV. 145 (1976); Note *supra* note 16, at 141.

Tennessee usury ceiling.[63] Therefore, even after receiving a 10% per annum interest payment, the lender lost eighty dollars of the loaned principal's real value.[64] Similar rulings against indexed principal clauses could increase lenders' reluctance to make loans during periods of high inflation. Arguments against holding indexed principal to be interest should, therefore, be examined. Arguably, no agreement to pay usurious interest existed in either case. In both *Aztec* and *Olwine* "[n]either party [to the contract] bore any risk of inflation or deflation; niether would have received a windfall resulting from repayment of principal different in value than the principal originally loaned. The lender required the borrower to repay no more than the value of the principal loaned."[65] Without such agreement, one of the necessary elements of usury, that the lender intended to charge excessive interest, may be lacking.[66]

Another principle of usury law is that the lender's intent upon entering the agreement determines whether the transaction is usurious.[67] Thus, the court must look to the circumstances surrounding the transaction before declaring it unlawful. In *Penn Mutual Life Insurance Co. v. Orr*,[68] the borrower argued that a contractual provision requiring the borrower to pay all taxes assessed against the lender by virtue of the loan made the loan usurious *per se* since the assessed amount and the designated interest charge together might exceed the lawful rate.[69] The court rejected the argument and declared the lender's intent controlling.[70] If at the time of contracting the lender knows the aggregate of nominal interest and assessed taxes will exceed the statutory interest ceiling, the loan is usurious.[71] If at the time of contracting, however, the lender believes the aggregate charge will be less than the lawful rate, the loan is not necessarily usurious.[72]

The *Orr* decision supports the finding of usurious intent in the *Aztec* and *Olwine* cases. In both cases, the lender exacted the maximum lawful interest rate in addition to assessing a charge attributable to the indexed principal.[73] The fact that neither lender actually intended an unlawful

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63. Note, *supra* note 16, at 142-43.

64. *Id.* at 141.

65. *Id.* at 142.

66. *See* Section IV *infra* for a full discussion of the traditional prerequisites for a finding of usury.

67. Abbot v. Stevens, 133 Cal. App. 2d 242, 284 P.2d 159 (1955); Penn. Mutual Life Ins. Co. v. Orr, 217 Iowa 1022, 1024, 252 N.W. 745, 748 (1934); Seebold v. Easterman, 216 Minn. 566, 13 N.W.2d 739 (1944).

68. 217 Iowa 1022, 252 N.W. 745 (1934).

69. *Id.* at 1026, 252 N.W. at 746-47.

70. *Id.* at 1026, 252 N.W. at 748.

71. *Id.* at 1027, 1028, 252 N.W. at 747.

72. *Id.*

73. Aztec Prop. v. Union Planters Nat'l Bank, 530 S.W.2d 756, 757 (Tenn. 1975), *cert. denied*, 425 U.S. 975 (1976); Olwine v. Torrens, 236 Pa. Super. Ct. 37, 53, 344 A.2d 665, 666 (1975).

transaction is an unavailing defense. Intent will be implied if the other elements of usury are found.[74] Thus, a court seeking to uphold an indexed principal loan, with a total charge greater than the lawful interest rate, must be convinced that other prerequisites of usury are lacking.

A transaction will not be found usurious unless the sum advanced is absolutely repayable.[75] Thus, the law permits the collection of otherwise usurious interest when repayment is "contingent upon the occurrence of a specified condition."[76] A number of commentators suggest that "risks of monetary fluctuation, bargained for in good faith . . . [are] . . . a proper cause for 'charges' in addition to usury maximums."[77] Yet, the contingency exception requires a risk greater than that normally undertaken by a lender.[78] Given that criterion, an indexed principal loan is not sufficiently contingent to avoid a usury violation. The contingency exception functions to allow the lender whose funds are in great jeopardy compensation commensurate with the risk incurred.[79] "A creditor who takes the chance of losing all or part of the sum to which he would be entitled if he bargained for the return of his money with the highest permissible rate of interest is allowed to contract for greater profit."[80] Thus, with indexed principal, the issue is whether the risk that the principal will decrease in value is sufficient to justify an exception from a finding of usury. After analyzing the issue, the court in *Olwine v. Torrens* found the contingency exception inapplicable.[81] The court declared depreciation in the value of the dollar a risk incident to every loan and, therefore, not especially hazardous; thus, outside the contingency exception.[82] The court cited the Restatement of Contracts section 527, comment a, for the proposition that the contingency exception requires reasonable certainty that the event diminishing repayment will occur and declared value deflation improbable and, therefore, too speculative to bring the *Olwine* transaction within the contingency exception.[83] While *Olwine* is only a superior court decision, its analysis of the applicability of the contingency exception to indexed principal transactions is consistent with the assumption that the lender bears the risk of inflation in financial transactions. Until usury laws more accurately reflect that risk in an inflationary economy, or until some of that risk is legislatively shifted onto the borrower, indexed

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74. *Indexing the Principal, supra* note 35, at 758. *See also* Section IV *infra.*

75. State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 555 (Iowa 1973).

76. Hyer & Kearl, *supra* note 2, at 226.

77. McManus, *supra* note 2, at 559. *See also* Strum, *supra* note 34, at 118; Note, *supra* note 16, at 142; *Indexing the Principal, supra* note 35, at 759.

78. Hyer & Kearl, *supra* note 2, at 226. *See also* discussion, Section IV, Parts E(4)-(5) *infra.*

79. *Indexing the Principal, supra* note 35, at 759.

80. Restatement of Contracts, Explanatory Notes § 527, comment a, at 1025 (1932).

81. Olwine v. Torrens, 236 Pa. Super. Ct. at 37, 37-38, 344 A.2d 665, 667-68 (1975).

82. *Id.* at 38, 344 A.2d at 668.

83. *Id.*

principal loans will conflict with low usury ceilings.

### *C. Compound Interest*

If the amount by which the principal in a PLAM increases is considered interest, PLAMs may violate state statutes prohibiting compound interest. Compounding of interest occurs when accrued interest is added to the principal, and interest is charged on the new principal balance.[84] In a PLAM, a constant interest rate is applied to a fluctuating principal.[85] If courts consider principal increases to be interest, then the constant interest rate is partially assessed against other interest hidden within the increased principal. Some courts have held that adding unpaid interest to the principal of a new or renewal loan is not unlawful under statutes proscribing compound interest.[86] Moreover, after default on interest payments, an agreement to add the unpaid interest to the principal and charge interest on that balance is valid.[87] Arguably, a PLAM consists of a series of renegotiated contracts in which the borrower defers immediate payment of the increased principal and allows it to be added to the unpaid balance.[88] Under this analysis, the PLAM is analogous to interest default agreements held non-violative of statutes forbidding compound interest, and should be upheld.[89] Courts have traditionally considered mortgages to be one long-term agreement, however, and it is unlikely that a court unsympathetic with indexed principal agreements would accept this argument.[90]

The problem of compound interest also arises when adjustable rate loan agreements permit an increased interest charge to be added to the principal of the loan. The new adjustable rate mortgage regulations issued by the Federal Home Loan Bank Board on April 30, 1981, allow interest rate increases to be reflected in additions to principal.[91] The regulations state that they are promulgated pursuant to the Board's authority to regulate all aspects of the operations of federal savings and loan associations, and as such are "preemptive of any state law purporting to address the subject of a federal association's ability, or right to make, purchase, participate, or otherwise deal in adjustable mortgage loans, or to directly or indirectly restrict such ability or right."[92] The Board argues that the "preemption has the ef-

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84. Hyer & Kearl, *supra* note 2, at 227.

85. Cassidy, *supra* note 40, at 3, 6; Cowan & Foley, *supra* note 8, at 1078; Washburn, *supra* note 4, at 626.

86. Hyer & Kearl, *supra* note 2, at 227.

87. R. KRATOVIL, MODERN MORTGAGE LAW AND PRACTICE, § 139, at 90-91 (1972). *See also* Ragon v. Day, 46 Iowa 239 (1877); Wilson v. Dean, 10 Iowa 432 (1860); Gower v. Carter, 3 Iowa 244 (1856).

88. Hyer & Kearl, *supra* note 2, at 227.

89. *Id.*

90. *Id.* at 228.

91. 46 Fed. Reg. 24148, 24152 (1981).

92. *Id.*

fect of precluding the application of the laws of approximately thirty states prohibiting the charging of interest on interest."[93] Since the regulation also amends regulations relating to other alternative mortgage instruments to include a similar preemption, it is probable that any Board authorization of PLAMs would also preempt state laws prohibiting compound interest.[94] Whether the Board may properly preempt state law is an issue beyond the purview of this article.[95]

### *D. Indexed Principal and the Federal Gold Clause Resolution*

Indexed principal was held a violation of the federal Gold Clause Resolution in *Aztec Properties v. Union Planters National Bank.*[96] "Gold Clauses" requiring that the loan principal be repaid in "gold coin of present weight and fineness" were frequently incorporated into 19th century loan agreements.[97] The " 'immutable' quality of gold guaranteed restoration of the full value loaned."[98] In response to the great depression of the 1930s, however, Congress devalued the dollar in relation to the gold standard, and restricted the private ownership of gold.[99] As part of a program to offset foreign devaluation in terms of gold and to maintain parity between United States gold and paper currency, Congress passed a joint resolution outlawing gold clauses.[100] The resolution declared against public policy all agreements obligating "payment in gold or a particular kind of coin or currency . . . or in an amount of money of the United States measured thereby."[101] It further declared all obligations "discharged upon payment, dollar for dollar, in any coin or currency which at the time of payment is legal tender. . . ."[102]

The Gold Clause Resolution was upheld in *Guaranty Trust Co. v. Henwood*,[103] in which railroad bonds sold in 1912 for dollars were contractually repayable either in gold or, at the holder's option, in designated foreign currencies. In a bankruptcy reorganization proceeding, bond holders asserted their right to be repaid in Dutch guilders.[104] The lower courts held repay-

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93. *Id.* at 24151.

94. *Id.* at 24152.

95. *See* Licata, "*Variable-Rate Mortgages Under Illinois Usury Law: A Case of Preemption*," 62 CHI. B. REC. 12 (1980) (discussion of the preemption issue).

96. 530 S.W.2d 756 (Tenn. 1975).

97. Cowan & Foley, *supra* note 8, at 1087; McManus, *supra* note 2, at 560; Strum, *supra* note 38, at 116.

98. McManus, *supra* note 2, at 560.

99. 31 U.S.C. § 463 (Supp. I 1977). *See also* McManus, *supra* note 2, at 560; Note, *Inflation and Indexing-Usury in Commercial Loans: Aztec Properties, Inc. v. Union Planters National Bank*, 11 TULSA L.J. 450, 457 (1976).

100. McManus, *supra* note 2, at 560.

101. 31 U.S.C. § 463 (Supp. I 1977).

102. *Id.*

103. 307 U.S. 247 (1939).

104. *Id.* at 249.

ment in guilders a violation of the Gold Clause Resolution and ordered payment of the face amount of the bonds in dollars.[105] The United States Supreme Court affirmed and emphasized that the Gold Clause Resolution "unmistakably stamped illegality upon both outstanding and future contractual provisions . . . [requiring] . . . payments by debtors in a frozen money value rather than in a dollar of legal tender current at date of payment."[106] The *Aztec* court cited the above proposition from *Guaranty Trust* to support *Aztec's* holding that indexed principal clauses by varying the total dollars needed for repayment violate the Gold Clause Resolution.[107]

Authorities suggest that *Aztec* was wrongly decided and that the Gold Clause Resolution does not bar indexed principal clauses.[108] *Aztec* extended the prohibitions of the Gold Clause Resolution further than *Guaranty* or other previous cases. Previous cases all proscribed repayment provisions which were linked to the value of gold or foreign currencies.[109] *Aztec* forbade provisions linked to the domestic Consumer Price Index.[110] Likewise, *Guaranty Trust* prohibited binding a debt obligation to a "frozen money value."[111] An "index clause fluctuates continually with changes in prices of commodities and services."[112]

Indeed, contrary to the *Aztec* analysis, indexed principal clauses may complement the underlying purpose of the Gold Clause Resolution. The Resolution sought "to maintain at all times the equal power of every dollar, coined or issued by the United States, in the markets and in payment of debts."[113] Index clauses require repayment of the exact value of the funds borrowed as qualified by the index.[114] Thus, the purchasing power of invested funds remains uniform despite nominal dollar fluctuations. Such uniformity promotes investments security and the economic stability the Gold Clause Resolution sought to create.

### *E. Inflation and Index Clauses*

Both PLAMs and ARMs have been censured for having an inflationary impact. Critics contend that these devices cause chain reaction price spirals

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105. 98 F.2d 160, 166 (8th Cir. 1938).

106. 307 U.S. at 252.

107. 530 S.W.2d at 560-61.

108. Note, *supra* note 62, at 149-50; Note, *supra* note 99, at 457; Note, *supra* note 16, at 148.

109. Hyer & Kearl, *supra* note 2, at 230; Note, *supra* note 62, at 149; Note, *supra* note 16, at 146.

110. 530 S.W.2d at 761.

111. 307 U.S. at 252.

112. Note, *supra* note 99, at 457. *See also* Hirschberg, *Index Value Clauses*, 88 BANKING L.J. 867, 877 (1971); Hyer & Kearl, *supra* note 2, at 230; McManus, *supra* note 2, at 560.

113. 31 U.S.C. § 463 (Supp. I 1977).

114. *See* Note, *supra* note 16, at 142.

which thwart governmental anti-inflation measures.[115] The argument is only valid, however, when virtually all segments of the economy are indexed and the government maintains full employment while heavily regulating the economy.[116] Under such circumstances, an increase in the cost of living entails an increase in salaries which entails further increases in prices. Both Brazil and Israel have fully-indexed economies.[117] The experience has proven especially destructive in Israel.[118] In an effort to reduce its 100% plus inflation rate, that nation recently adopted the biblical shekel which has exchange value of one-tenth the pound note which it replaced as the national currency.[119] Brazil's experience with indexing appears to have been more successful. In Brazil, costs are calculated in units of purchasing power rather than in currency amount,[120] a fact which may diminish the psychological impact of inflation.

The economy of the United States differs substantially from those of both Israel and Brazil. Here, most index clauses arise on private arrangement, and their use, while coming in employment and leasing contracts, does not permeate the economy.[121] Thus, any chain reaction resulting from mortgage indexing would be less pronounced than in a fully-indexed economy. Furthermore, in an inflationary economy, indexing of mortgage principal would decrease the amount of money available for discretionary spending and, thereby lessen the inflationary impact of accelerated goods consumption.[122]

## III. Adjustable Rate Mortgages

### *A. An Assessment of the ARMs Utility*

Initially, ARMs appear to give lenders more flexible mortgage portfolios and less risk of wrongly predicting future inflation while unfairly depriving borrowers of the certainty of debt load and interest rate characteristic of the SMI. Yet, when their use is properly regulated, ARMs may represent a viable alternative to the SMI for consumers as well as lenders. Indeed, ARMs offer both advantages and disadvantages to lenders and borrowers. Several factors must be considered if a proper balance between the interests of both groups is to be achieved.

ARMs have two primary disadvantages for the home mortgage borrow-

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115. Hirschberg, *supra* note 112, at 878. *See* Berry, *supra* note 2, at 610.

116. Berry, *supra* note 115, at 611; Hirschberg, *supra* note 112, at 878-79.

117. *See* Cowan & Foley, *supra* note 8, at 1086, Hirschberg, *supra*, note 112, at 878-79; Washburn, *supra* note 4, at 626.

118. *See* Hirschberg, *supra* note 112, at 878-79.

119. *Id.*; *Facts on File*, 1980 at 151 (D)(1).

120. One commentator reports that mortgage credit is more stable and more easily available in Brazil since the adoption of price level indexing. Cowan & Foley, *supra* note 8, at 1086.

121. *See* Berry, *supra* note 115, at 610, 611; Washburn, *supra* note 4, at 627.

122. Berry, *supra* note 115, at 611.

ers: (1) They fail to provide a stable payment to income ratio; and (2) with continuing inflation and accompanying interest rate increases, they may be more expensive than a fixed rate mortgage.[123] Yet, if a primary advantage of the SMI is that monthly payments are fixed over the life of the loan,

> [a] . . . major inadequacy of the traditional level-payment mortgage instrument is that it provides no flexibility to meet diverse borrower financial needs and requirements. It is, for example, unable to accomodate changing patterns of family income. It ignores the rise in income which most homebuyers are likely to enjoy over their working years, and also the likely increase in the market value of residential property due to inflation.[124]

The ARMs are a means of adding diversity to the mortgage market.[125] When ARMs were first proposed, it was widely suggested that they would be offered at a lower initial rate than SMI, and would, therefore, be more financially attractive to the borrower.[126] But, in California, where variable interest mortgages have been widely offered since February 1, 1975, the initial rate has not been lower.[127] Generally, ARM loans are more easily assumable by qualified second buyers upon resale of the home, an important factor in those jurisdictions where due-on-sale clauses have been outlawed.[128] Moreover, most ARM regulations and loan contracts are expected to prohibit or allow for only a small prepayment penalty.[129] Ease of loan assumability and waiver of prepayment penalty make sale of the home easier and more profitable.[130] Therefore, those homebuyers who are fairly mobile, and thus not terribly concerned about future payment increases, are particularly attracted to ARMs.[131]

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123. Cowan & Foley, *supra* note 8, at 1081; Smith, *Reforming the Mortgage Instrument*, 9 FED. HOME LOAN BANK BD. J. 2, 7 (May 1976).

124. *Interim Progress Report, supra* note 1, at 8-9.

125. Graduated Payment Mortgages also provide greater payment flexibility and correlation to real household earning power than does the SMI.

126. *See* Cowan & Foley, *supra* note 8, at 1080; Landers & Chandler, *supra* note 2, at 51; Comment, *supra* note 13, at 143.

127. Riedy, *VRM's in California; the Early Experience*, 9 FED. HOME LOAN BANK BD. J. 14, 16 (March 1976). Riedy suggests that whether a VRM is offered below the interest rate for a SMI is a function of short run credit availability in the mortgage market. When funds are widely available, the rate differential may be offered as an incentive for consumers to assume VRMs; with tightened credit, the VRM is apparently offered on a "take it or leave it" basis. One commentator suggets that rate differentials are unlikely because "the savings and loan lender feels a constant pressure to maximize profits to meet passbook saving obligations. Therefore, it cannot sacrifice current profits with the expectation of gaining a potentially higher level of profits in the future." Epley, *Can Variable Rate and Fixed Rate Mortgages Co-exist?* 5 REAL EST. REP. 119, 120 (1976).

128. *See* Cowan & Foley, *supra* note 8, at 1080-81.

129. *See* Cowan & Foley, *supra* note 8, at 1080.

130. *Id.*

131. Kaplan, *Alternative Mortgage Instruments: Now May be the Right Time!*, 10 FED.

"When interest rates are uncertain or money is tight an ARM may be more easily available than a conventional loan."[132] Thus, the ARM may be more attractive to young families who need or want housing immediately. The hypothetical family an ARM would most attract under those circumstances would have a present income disproportionately lower than their anticipated future income. For example, one family wage earner might be outside the labor force for educational reasons or because he had chosen to remain home with young children. Such a family could expect a rise in earning capacity that would offset future interest increases. While it may appear contradictory, this family also would likely believe that fairly severe inflation was to be a permanent condition in the American economy. Expectations about the security of funds placed in savings and the stability of home availability and prices would affect the choice of mortgage instrument. A family that expects inflation to erode the purchasing power of its savings and to accelerate already spiraling housing costs might well be attracted to an ARM. They might trade the stable payment stream of the SMI for the certainty of immediate home ownership.[133] (This is particularly likely to be true where interest rate increases on ARMs are limited by contract or regulation to five percent or less. Presumably, a family saving the funds needed for the higher down payment required for SMIs in times of credit rationing could experience similar interest rate increases while working to acquire the funds.)

Finally, ARMs potentially aid mortgage borrowers generally:

> [C]hanges in interest rates are reflected in changes in all outstanding variable rate loans so that the burden of interest rate shifts is not entirely borne by new borrowers. Thus, variable rate mortgages should eventually result in lower average rates for new loans because lenders will not be forced to charge new borrowers high interest rates so that, in effect, they subsidize borrowers who have below market loans.[134]

The primary advantage of ARMs, namely, that ARMs shift some of the

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HOME LOAN BANK BD. J. 14, 16 (November 1977).

132. Cowan & Foley, *supra* note 8, at 1080-81.

133. One writer has suggested that consumers anticipating continued inflation will always either choose a SMI or simply delay their housing purchases until the interest cycle has bottomed. Epley, *supra* note 127, at 120. The assumption presupposes SMI and ARMs will be equally available and will offer identical terms during times of credit rationing. It is more likely that a higher loan to value ration will be the "trade-off" demanded of the borrower seeking a SMI while the possible rate increase will be the "trade-off" demanded of the borrower considering a ARM. Which of these "trade-offs" is more palpable will be a function of the individual borrower's life circumstances. The second assumption presumes that consumers believe the interest cycle will "bottom out." That does not appear to be a prevalent view in contemporary America. Indeed, if one accepts the Fisher hypothesis, see note 24 *supra*, some consumers facing accelerating inflation will scramble to buy housing simply because it is a tangible asset which is likely to increase in value.

134. Cowan & Foley, *supra* note 8, at 1081; Smith, *supra* note 123, at 2, 6.

risk of inflation to borrowers and provide more flexible mortgage portfolios for lenders, has already been discussed.[135] On the other side, lenders argue that restrictive regulation governing ARM implementation will make these loans more costly to administer than standard mortgages.[136]

### *B. ARM Regulation*

Utilization of ARMs involves a number of practical and legal problems which are best resolved through provisions in the enabling legislation or accompanying administrative regulations. Among the issues to be determined are: (1) What index is to govern rate changes; (2) What method of changing the rate will be adopted; (3) Whether rate changes will be optional or automatic; (4) Whether maximum and minimum limits upon rate changes will be established; and (5) Whether borrowers will be given special rights stabilizing their position upon rate changes.[137] Additionally, borrowers should receive disclosures sufficient to assure their understanding of the obligation to be undertaken before contracting for an ARM. Parts B, C and D of this section review these issues.

#### *1. The Index*

The index to which the variable interest rate is tied must satisfy several criteria. It "should reflect accurately long-range changes in the cost of funds available to the residential lender."[138] Because "the home mortgage competes against other lending alternatives for the financing agency, the index might also reflect prevailing interest rates on nonmortgage loans."[139] Additionally, the index should not be subject to lender control and should be relatively stable.[140] A too volatile index creates bookkeeping and administrative problems for lenders and potential budgeting problems for borrowers.[141] More significantly, too frequent changes may reflect sudden short-term conditions unrelated to long-term economic trends, and, thus, would create unnecessary instability in the mortgage instrument.[142] An index subject to lender manipulation would be inherently unfair to the consumer-borrower who has only limited bargaining power in the mortgage transaction. For this

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135. *See* Section III, Part A *infra*.

136. *See* Thompson, *All Quiet on the Western VRM Front: First Rate Hike Produces Little Consumer Reaction*, 11 FED. HOME LOAN BANK BD. J. 10 (October 1978).

137. *See* Cowan & Foley, *supra* note 8 at 1079-81; Landers & Chandler, *supra* note 2 at 51-59.

138. Cowan & Foley, *supra* note 8, at 1079. *See also* Landers & Chandler, *supra* note 2, at 53-54.

139. Landers & Chandler, *supra* note 2, at 53. *See also* Strum, *supra* note 38, at 113.

140. *See* Cowan & Foley, *supra* note 8, at 54; Stansell & Millar, *supra* note 25, at 118.

141. Limitations on the frequency of rate changes would also work to stabilize borrowers' payment rates. *See* Section III, Part B, *infra*.

142. *See* Strum, *supra* note 38, at 113.

reason, an index based upon the prime rate of the lender or tied to the amount of deposits in a particular institution would be objectionable.[143] Prime rates in both national and regional money markets tend to be more volatile than average conventional mortgage loan rates.[144] Saving deposit rates would be far too subjective and not truly reflective of general costs of funds in a given locality.[145]

The Federal Housing Authority (FHA) or Federal Home Loan Bank Board (FHLBB) Average National Mortgage Rates are also potential indices.

> The Federal Home Loan Bank Board bases its national average . . . rate on a sample survey of major institutional lender groups including mortgage companies. The Federal Housing Authority bases its national mortgage average rate on its field office opinion of typical interest rates for new home mortgages in the specific area.[146]

One commentator considers these "objective and easily discernible" indications of developing trends in the mortgage interest rate market; another submits they are not genuinely neutral since they average individual lender's charges.[147] A third commentator, evaluating the Consumer Price Index (CPI) as a potential rate indicator, denotes that the CPI measures current inflation while interest rates indicate anticipated inflation.[148] Therefore, use of the CPI as an index could result in ARM interest rates non-reflective of other lending market yields.[149] Since both the FHA and FHLBB's national averages mirror already existing mortgage interest rates, the same danger arises if they are adopted as ARM indices. (The CPI, itself, is also considered a poor ARM index because it measures changes in many aspects of the economy not directly related to the money market.)[150]

The weighted average cost of funds (WACF) for lenders in a given geographic area is published by the Federal Home Loan Bank.[151] The WACF, as computed semiannually by the Federal Home Loan Bank of San Francisco, is the index used by both California's state and federally chartered S&Ls.[152] It has the advantage of being a very stable index which reflects tender costs.[153]

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143. Landers & Chandler, *supra* note 2, at 54.
144. Berry, *supra* note 115, at 603; Strum, *supra* note 38, at 113.
145. Strum, *supra* note 38, at 114.
146. *Id.*
147. *See, e.g.*, Berry, *supra* note 115, at 603; Strum, *supra* note 38, at 114.
148. Stansell & Millar, *supra* note 25, at 118.
149. *Id.*
150. Strum, *supra* note 38, at 118.
151. Cowan & Foley, *supra* note 8, at 1080.
152. Washburn, *supra* note 4, at 219.
153. Cowan & Foley, *supra* note 8, at 1080. Interestingly Donald Kaplan, Chief Economist and Director, Office of Economic Research, has recommended that the WACF *not* be the ARM index. Kaplan asserts that WACF would be affected by deposit rate control policy, and

The yield rate on intermediate-term government bonds is also a good index choice. It would be a neutral rate that also accurately measures money market conditions. Moreover, unlike a short-term rate, it would be less volatile because it would not reflect erratic fluctuations in monetary policy.[154]

### 2. *Rate Changes*

Changes in the interest rate on an ARM must be implemented in ways which satisfy both lender and borrower needs. Increases in rates should be optional for the lender. The lender then can make a business decision as to whether the additional revenue yield from the higher rate would offset the administrative costs involved in implementing the increase.[155] Rate decreases, however, should be automatic. Borrowers may have been induced into accepting an ARM by the possibility of downward rate revision.[156] Likewise, the borrower-consumer has neither the bargaining power nor the leverage to enforce a downward rate adjustment. Nor is he in a position to monitor rate trends; therefore, the lender should be required to give him regular notice of index behavior.[157]

"The desire for stability both in the investment portfolio of the lender and in the periodic obligations of the borrower demand that there be some limitation on the extent to which the interest rate can . . . vary."[158] Increases in rates, therefore, should be limited by statute.[159] Allowable rate increases should be "large enough to be workable, but small enough to prevent any catastrophic financial injury to" the borrower.[160]

Limiting the frequency of rate adjustment will also stabilize the ARM transaction. Too frequent intervals between changes would hamper the borrower's ability to plan financially for rate increases and might unnecessarily subject borrowers to temporary or aberrational market conditions.[161] There-

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therefore, might inhibit efficient conduct of that policy. Also, the WACF has shown little downward movement. Use of such an index might mislead borrowers into expecting rate reductions that are highly unlikely. *Interim Progress Report, supra* note 1, at 19.

154. *See* Berry, *supra* note 115, at 603; Stansell & Millar, *supra* note 25, at 118; *Indexing the Principal, supra* note 35, at 762-63.

155. Most ARM regulations require that lenders give borrowers 30 to 90 days notice before implementing rate changes. Some require that such notice also disclose the interest rate current on a SMI. All require that the borrower be given some option as to how the rate change will be implemented. Notice disclosure and provision for borrower to select among rate change options create added costs for lenders. Lenders should be allowed the option of foregoing rate increases if these would prove too costly.

156. *See* Landers & Chandler, *supra* note 2, at 58.

157. *Id.*

158. Strum, *supra* note 38, at 117.

159. While one commentator has suggested that rate decreases should also be limited, this policy has never been implemented. *Id.*

160. Berry, *supra* note 115, at 604.

161. *Id. See also* Cowan & Foley, *supra* note 8, at 1080; Landers & Chandler, *supra* note 2, at 57; Strum, *supra* note 38, at 117.

fore, it is recommended that rate adjustments be allowed no more frequently than semi-annually.[162]

There are a number of ways in which an ARM rate change can be implemented. The lender may adjust the monthly payment to reflect the changed interest charge, or he may adjust the maturity term of the loan or the principal balance. Under the first approach, the monthly payment rises and falls with the interest rate and the loan will be fully amortized within its original term. When rates increase, lenders will prefer this approach. "[T]he longer maturity approach would exacerbate the liquidity problem variable rates were supposed to solve, and also, would not provide associations with adequate funds for new mortgage lending."[163] With the extended maturity approach, payments remain constant, but more dollars are allocated to payment of interest and fewer to payment of principal. It takes longer to repay the loan; the lender's cash flow remains unchanged; and the flexibility ARMs were designed to achieve is lost.[164] Borrowers, on the other hand, may prefer to extend loan maturities upon rate increases. That approach eliminates the risk that payments will become higher than anticipated. Loan extensions cannot be used to adjust all possible rate increases, however. Eventually monthly interest charges could exceed the original monthly payment and the loan would never be repaid.[165] Generally, the regulations have resolved these conflicts by allowing the parties to choose the method of rate change, but then limiting the number of years by which the loan term may be extended.[166] But, FHLBB regulations issued in April, 1981 restrict neither the method of rate change nor the number of years the loan may be extended.[167] Lenders argue that, under the new regulations, "market forces" will operate to protect borrowers from excessive rate changes and unduly long amortization periods.[168]

Lender and borrower interests are reversed when rates decline.[169] "Ordinarily, the lender will prefer to decrease the maturity of the loan, to keep the same number of dollars flowing into the institution. . . . This is necessary if the interest rates the lender must pay have not declined, and in any

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162. *Id.* (all authorities).

163. Landers & Chandler, *supra* note 2, at 55.

164. *Id.* at 55-56. *See also* Stansell & Millar, *supra* note 25, at 117. Eventually, cash flow would be greater since more mortgage loans would be outstanding at any given time. However, the lead time required for this result is too great to aid lenders with long term assets and short term liabilities.

165. Strum, *supra* note 38, at 115. *See also* Epley, *supra* note 127, at 120, 121. Adjusting the term would have most appeal to those borrowers who had fixed incomes or who were highly mobile and, therefore, are little concerned with fully amortizing their loan.

166. *See* 12 C.F.R. § 545.6-2C (1979); CAL. CIV. CODE § 1916-5(a) (Deering Supp. 1980); IOWA CODE § 535B.9 (1981).

167. 46 Fed. Reg. 24,148, 24,152 (1981).

168. *Id.* at 24,150; Federal Home Loan Bank Board Fact Sheet: Adjustable Rate Mortgage Loans, at unnumbered p.1 (1981).

169. Landers & Chandler, *supra* note 2, at 56.

event, it provides more cash for new loans."[170] Many borrowers, on the other hand, would prefer lowered payments since these would provide added dollars for discretionary spending.[171]

The third method of implementing an ARM rate change involves adjusting the principal balance of the loan while changing neither the original interest rate nor the term of the loan.[172] The monthly payment would then be adjusted so that the loan could be repaid within its original term.[173] This method is not widely used, and would encounter legal difficulties similar to those of the PLAM.

Regardless of the method of rate change chosen, the borrower's rights should be safeguarded. The borrower should be permitted to prepay the loan without penalty rather than accept a higher rate charge. He should be allowed sufficient time between notice of the rate change and its implementation in order to budget for the increase.[174] He should have easy access to full information concerning the rate change. Without such protection, the borrower will not be a full and informed participant in the transaction.

### 3. *Disclosure Requirements*

Truth-in-Lending legislation has two general objectives: (1) to provide consumers with basic information concerning financing transactions, and thereby, (2) to enable them to make informed choices as to whether to accept the financing arrangement offered.[175] With ARMs, disclosures are important at two separate times: (1) at the inception of the transaction, and (2) when changes are imminent.[176] Consumers considering an ARM loan need to know its potential cost; the cost of a comparable SMI securing the same principal; minimum and maximum rates of interest charge permitted; frequency of rate change; and available methods for implementing the rate change. These elements should be disclosed during the initial negotiation of the loan. Furthermore, a rate change materially alters the term of the original mortgage contract. The information should, therefore, be disclosed again prior to a rate change.[177] The potential new payment rate and the necessary addition to the term of the loan also should be disclosed prior to a rate change. Without such information, the borrower cannot meaningfully exercise options as to how the change will be implemented. Consumers should be told when and how they may exercise their option and what other substan-

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170. *Id.*
171. *Id.*
172. Strum, *supra* note 38, at 116.
173. *Id.*
174. *See also* Landers & Chandler, *supra* note 2, at 58.
175. *Id.* at 64. Whether truth-in-lending legislation actually accomplishes these objectives is not within the purview of this paper.
176. *Id. See also* Comment, *supra* note 13, at 145.
177. Landers & Chandler, *supra* note 2, at 77-78; Comment, *supra* note 13, at 147.

tive rights arise upon a rate change.

Federal regulation of ARM mortgages is governed by the federal Truth-in-Lending Act[178] (TIL) as amended by the federal Truth-in-Lending Simplification and Reform Act of 1980.[179] The Act requires disclosure of: (1) the annual percentage cost of credit; (2) the amount and timing of payments; and (3) any prepayment penalities imposed upon the borrower.[180] The Federal Reserve Board is charged with implementing TIL, and, through Regulation Z, applies the act to consumer transactions.[181] The Federal Reserve Board substantially revised Regulation Z to conform to the amendments found in the Simplification Act.[182] The Simplification Act and revised Regulation Z generally take effect March 31, 1982.[183] Several differences between disclosures required in variable interest transactions under the older and the revised versions of Regulation Z are significant. Under the older Regulation Z, the lender initiating a variable interest loan had to disclose: (1) that the annual percentage rate could increase and the conditions under which an increase was possible; (2) the index governing the increase; (3) any limitations on the increase; and (4) the means by which the increase could be affected.[184] Under the revised Regulation Z, the lender must disclose: (1) conditions under which an increase is possible; (2) any limitations on the increase; (3) the effect of an increase; and (4) an example of the payment terms that would result from an increase.[185] The revised regulation is unclear as to how detailed or realistic the example of payment terms on rate

178. Consumer Protection Act, 15 U.S.C. §§ 1601-1681 (1976). "TIL applies to all creditors who regularly extend consumer credit, and therefore applies to all savings and loans, whether state or federally chartered." Note, *Adjustable Interest Rates in Home Mortgages: A Reconsideration*, 1975 WIS. L. REV. 742, 751.

179. Title VI, Depository Act, *supra* note 22. For a full discussion of the changes implemented by the Simplification and Reform Act, *see* Replansky & Kauffman, *The Truth in Lending Simplification and Reform Act of 1980: A New Deal for the Creditor*, 13 U.C.C. L.J. 200 (1981). The Simplification Act repealed section 129 of the Truth in Lending Act, 15 U.S.C.A. § 1639 (West Supp. 1980) relating to consumer loans and rewrote section 128(a) of the Truth-in-Lending Act, 15 U.S.C.A. § 1638(a) (West Supp. 1980) to incorporate all disclosures required either for consumer loans or closed-end consumer credit transactions. *See* Replansky & Kauffman, *supra*, at 209; [1980] CONS. CRED. GUIDE (CCH) ¶¶ 11-1651, 11-1654.

180. The Real Estate Settlement Procedures Act, 15 U.S.C. §§ 2601-2617 (1976), also governs real estate credit disclosures. The Act requires that standard cost disclosures (developed by the Secretary of HUD in consultation with the Administrator of Veteran's Affairs, the Federal Deposit Insurance Corporation, and the Federal Home Loan Bank Board) be made available to the borrower at or before settlement of the real estate transaction. 15 U.S.C. § 2603 (1976).

181. *See* 12 C.F.R. § 226.1 (1980); CONS. CRED. GUIDE (CCH) Report 328, *Truth-in-Lending: Revised Regulation Z and New Regulation M* (April 7, 1981).

182. *See* [1980] CONS. CRED. GUIDE (CCH) Report 328, *supra* note 181.

183. Title VI, Depository Act, *supra* note 22, § 625a. The restitution provisions of the Simplification Act, *supra* note 179, however, took effect March 31, 1980. *Id.*

184. 12 C.F.R. § 226.8(b)(i)-(ii) (1979).

185. 12 C.F.R. § 226.18 (Rev. Reg. Z 1979).

increases must be. A lender who illustrated payment terms that would result from a ¼% increase in the interest rate may be in compliance with the regulation. Yet, when interest rates are volatile and the amount of rate increase is not strictly regulated, a far greater rate increase could occur. Without information relating to payment terms on a ½%, 1% or 2% rate increase, the borrower would be unable to realistically appraise his ability to repay a variable interest loan. Thus, more definitive rules governing the required payment term disclosure are necessary. The failure to require disclosure of the index to which the variable rate is tied is also a weakness of the revised regulation. Without knowledge of the index, the borrower can neither assess the appropriateness of a rate increase nor ascertain that the rate increase was mandated by events beyond lender control.

The old Regulation Z is unclear as to where or how disclosures are to be made, and as to whether the lender must reveal "the method of determining the index rate, the value of the index rate at the time of the loan, or the formula for altering the mortgage rate at the time of the loan."[186] The Simplification Act, however, incorporates provisions of the Real Estate Settlement Procedures Act[187] and requires that the lender give truth-in-lending disclosures either before consummation or within three days after receiving the borrower's written application for a mortgage loan, whichever is earlier.[188] Additionally, if the annual percentage rate of interest for the consummated mortgage in the transaction differs significantly from that disclosed at the time of application, the change must be disclosed no later than consummation or settlement.[189]

Under the Simplification Act, mortgage disclosures also must include the finance charge, the total payments and information stating whether the mortgage is assumable.[190] Neither Act nor the old or revised Regulation Z explicitly requires that the frequency of rate change and its automatic or optional nature be revealed.[191]

The old Regulation Z provisions also require that the lender disclose both the monthly payment increase possible and the increases in loan term

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186. Landers & Chandler, *supra* note 2, at 70-71.

187. 12 U.S.C. §§ 2601-2617 (1976).

188. Title VI, Depository Act, *supra* note 22, at 168; 12 C.F.R. § 226.19(a) (Rev. Reg. Z, 1979).

189. 12 C.F.R. § 226.19(b) (Rev. Reg. Z 1979). Significant change is defined as a variation from the quoted annual percentage *rate* of greater than ⅛ of 1 percentage point in a regular transaction or greater than ¼ of 1 percentage point in an "irregular transaction" as that term is defined in 12 C.F.R. § 226.22. *Id.*

190. Replansky & Kauffman, *supra* note 179, at 212; Title VI, Depository Act, *supra* note 22, at 168; 12 C.F.R. § 226.18(d), (h), (g) (Rev. Reg. Z 1979).

191. Landers and Chandler suggest a broad reading of "conditions," of change would require disclosure of this information. They then note that present FRB administrative policy does not justify such an expansive reading of the Act. Landers & Chandler, *supra* note 2, at 75-76. The FHLBB requires disclosure of these items. 40 Fed. Reg. 6,874 (1975).

possible, upon "a hypothetical immediate increase of one-quarter of one percentage point" in the rate charged.[192] The revised regulation contains no such requirement. The old Regulation Z states that if disclosures are properly made at the inception of the variable rate mortgage, any increase in the rate is a subsequent occurrence and not a refinancing.[193] Therefore, under the old regulation new disclosures are not required at the time of rate change implementation.[194] The revised regulation does not specifically address this issue.

The regulation, however, states that a reduction in the annual percentage rate of interest with a corresponding change in the payment schedule shall not be treated as a refinancing.[195] By implication, the specific exclusion of reductions in the annual rate from the definition of refinancing means that increases in the annual rate are refinancings requiring new disclosures to the borrower. The definition of "refinancing" supports this interpretation. Under the revised regulation, a refinancing occurs when an existing obligation is satisfied and replaced by a new obligation undertaken by the same borrower.[196] Payment of all amounts due under a former rate schedule would satisfy all borrower obligations under that schedule. An increase in the rate schedule, unlike a decrease, would impose a new obligation on the borrower.

It should be noted that, in the case of federally authorized ARMs, the revised Regulation Z allows disclosures required by variable rate regulations of other federal agencies to be substituted for disclosures required under the revised regulation.[197] The FHLBB disclosure requirements for Adjustable Mortgage Loans, to be discussed *infra*,[198] are more stringent than those required under revised Regulation Z.[199]

### 4. *Federal Adjustable Rate Regulation*

Since first implemented in 1979, Federal Home Loan Bank Board adjustable rate regulations have changed rapidly. The Variable Rate Mortgage (VRM)[200] permitted a loan instrument which incorporated many of the consumer protections discussed above. The Renegotiable Rate Mortgage (RRM)[201] permitted a loan instrument which allowed wider interest rate

192. 12 C.F.R. § 226.8(b)(8)(iii)-(iv) (1979).

193. 12 C.F.R. § 226.8(b)(8)(iv) (1979).

194. 12 C.F.R. § 226.6(g) (1979). *See also* Landers & Chandler, *supra* note 2, at 78; Comment, *supra* note 13, at 149; Note, *supra* note 178, at 754.

195. 12 C.F.R. § 226.20(a)(2) (Rev. Reg. Z 1979).

196. *Id.* § 226.20(a).

197. *Id.* § 226.18(f) n.43.

198. *See* Section III, Part 4, Subpart C.

199. *See* Section III, Part B, Subsection 5 *infra*.

200. 12 C.F.R. § 545.6-4(c) (1981).

201. 12 C.F.R. § 545.6-4a (1981). *See also* Kanner, *Renegotiable Rate Mortgages*, 9 REAL EST. L.J. 55 (1980).

fluctuations and more frequent interest rate adjustments than the VRM. The Adjustable Mortgage Loan (AML)[202] regulation revised adjustable rate regulation by rescinding former VRM and RRM regulations and replacing them with more flexible regulations authorizing a variety of adjustable mortgage instruments. The AML regulation permits lenders to design variable interest loan instruments suiting the lender-perceived needs of individual financial institutions.[203] An understanding of the VRM and RRM regulations is helpful in assessing the merits of current AML regulations.

*a. VRM Regulation.* The VRM regulation[204] incorporated a number of consumer protections. The mortgage interest rate was indexed to the average cost of funds for all savings and loan associations whose accounts are insured by Federal Savings and Loan Insurance Corporation.[205] Semi-annual computations of the index are published in the *FHLBB Journal.* The interest rate could not change during the first year of the loan.[206] In subsequent years, no more than one annual change was allowed.[207] The minimum permissible change was one-tenth of one percent; the maximum was one-half of one percent.[208] The total rate increase during the term of the mortgage could not exceed 2.5 percent.[209] Downward adjustments were mandatory; upward adjustments optional.[210] Changes could be accumulated and taken later or be used to offset subsequent changes.[211] When the rate increased, the borrower could: (1) extend the maturity term of the loan (by an additional one-third of the original term); (2) prepay within ninety days without prepayment penalty; or (3) accept an increased monthly payment.[212] Rate decreases had first to be used to reduce the maturity of loan (but never below the original term); and then could be used to reduce monthly payments.[213]

The notice of interest rate change had to be given at least one month before the change became effective and had to state: (1) the old and new rates; the old and new index rates; (2) any accumulated rate changes; (3) the current monthly payment; (4) current loan term; (5) available options, if an increase, including the potential monthly payment and proposed increase in the term of the loan; and (6) if the rate had decreased, a description of how

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202. 46 Fed. Reg. 24,148-53 (1981).
203. *Id.* at 24,149.
204. 12 C.F.R. § 545.6-4(c) (1981).
205. *Id.* § 545.6-4(c)(4)(v).
206. *Id.* § 545.6-4(c)(4).
207. *Id.*
208. *Id.* § 545.6-4(c)(4)(iv).
209. *Id.*
210. *Id.*
211. *Id.*
212. *Id.* § 545.6-4(c)(4)(v).
213. *Id.* § 545.6-4(c)(4)(vi).

the decrease would be applied.[214]

The VRM regulations required initial disclosures more specific and more explicit than those required under either Regulation Z. Prospective borrowers were given materials "explaining in reasonably simple terms" the VRM offered and a comparable SMI.[215] These materials included: (1) a side-by-side comparison of differing interest rates and other terms; (2) payment schedules for both the VRM and the SMI; (3) a "worst case" schedule for the VRM showing every maximum increase at the time it could first occur, the highest possible payment during the loan term, and the total cost over the term of the loan, including a statement that maturity extension would increase total VRM costs; (4) information regarding the index used; (5) a description of the borrower's options upon rate increase; a prominently displayed statement of the borrower's right to elect a SMI; and (6) the title, telephone number, and address of a Federal Home Loan Bank officer whom borrowers could question regarding the disclosures.[216]

Additionally, no more than 50% of any federal S&L's home mortgage loans by dollar amount made or purchased in any calendar year were permitted to be VRMs.[217]

*b. RRM Regulation.* Lenders felt that VRM interest rate regulation was too restrictive and consequently too costly to administer.[218] They argued that the VRM was not a feasible alternative to SMIs in an economy in which interest rates are highly volatile.[219] In response, the FHLBB in 1980, approved the issuance of renegotiated rate mortgages (RRMs).[220]

The renegotiated rate mortgage is a limited form of the roll-over mortgage, a short-term loan with a long-term amortization period in which interest rates and payments are periodically renegotiated. Under the FHLBB regulations then promulgated, interest rates on RRMs could be renegotiated every three to five years with a maximum increase of one-half a percentage point per year and five percentage points over the life of the loan.[221] Upward rate adjustments were optional; downward adjustments were mandatory.[222] The rate adjustment was tied to the national average contract rate for all major lenders on previously occupied homes.[223] The rate is published monthly in the *FHLBB Journal*.[224] Rate adjustments of less than ½% could

214. *Id.* § 545.6-4(c)(4)(vii).
215. *Id.* § 545.6-4(c)(5).
216. *Id.*
217. *Id.* § 545.6-4(c)(2)(ii).
218. *See* text accompanying note 136 *supra.*
219. *Id.*
220. 12 C.F.R. § 545.6-4a (1981).
221. 12 C.F.R. § 545.6-4a(b) (1981).
222. *Id.* § 545.6-4a(c)(3).
223. *Id.* § 545.6-4a(c)(1).
224. 46 Fed. Reg. 24,152 (1981).

not be carried over to the next adjustment period.[225] Borrowers could repay the loan without penalty at the end of the initial loan term.[226] Only nominal document processing costs could be charged to the borrower upon loan renewal.[227] Lenders were required to notify borrowers ninety days before the end of the loan term of any rate change upon renewal.[228] Such notification included: (1) the date on which the balance of the loan was due and payable; (2) a statement that the loan would be renewed automatically at the rate stated unless the borrower paid the balance by the due date; (3) the new monthly payment; (4) a statement that the borrower could prepay the loan without penalty at any time after the original loan became due; (5) any documentation costs to be charged; and (6) the name and phone number of a savings and loan association employee able to answer borrowers' questions concerning the notice.[229] Initial disclosure to the RRM loan applicant included: (1) an explanation of the differences between an RRM and a SMI; (2) a "worst case" example indicating the maximum possible rate increase and monthly payment calculated as if such increase were effective upon first renewal; (3) an explanation of how the association would determine the effective rate at the end of each loan term; and (4) an estimate of potential renewal costs. Disclosures were required to accord with a form specified by the RRM regulation.[230]

Lenders were permitted to offer only RRMs.[231]

*c. AML Regulation.* The maximum increase of one-half a percentage point per year and five percentage points over a thirty-year loan permitted under the 1980 federal RRM regulation presented a reasonable balance between borrower and lender needs in a loan instrument. Consumers were protected from the unrestricted volatility that characterized balloon note mortgages in pre-depression America. Lenders, on the other hand, could readily adjust the interest yields from mortgage loans to reflect their current cost of funds. The FHLBB's regulation authorizing RRMs, as well as its regulation authorizing VRMs, was superseded on April 30, 1981 by a new regulation authorizing a variety of AMLs.[232] The new regulations, discussed below, are far more flexible than either the VRM or the RRM regulations, restrict neither the amount nor the frequency of rate adjustment, and provide fewer express consumer protections.

The new regulation defines an adjustable mortgage loan (AML) as any loan which permits adjustment of the interest rate.[233] Adjustments may be

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225. 12 C.F.R. § 545.6-4a(c)(1) (1981).
226. *Id.* § 545.6-4a(b).
227. *Id.* § 545.6-4a(d).
228. *Id.* § 545.6-4a(e).
229. *Id.*
230. *Id.* § 545.6-4a(f).
231. *See id.* § 545.6-4a.
232. 46 Fed. Reg. 24,148-53 (1981).
233. *Id.* at 24,152.

made through changes in the payment amount, or through adjustments to the principal or the loan term, or through a combination of these methods.[234] The loan term, however, may never be greater than forty years.[235] Negative amortization, that is "an increase in the unpaid loan balance," is permitted.[236] Negative amortization occurs when the monthly payment is less than is needed to pay the interest due on the loan.[237] Negative amortization is most likely to occur with a "payment-capped" mortgage.[238]

> Under a payment-capped mortgage, the interest rate on the loan is adjusted to reflect changes in a specified index without any rate-change limitations. However, to avoid sharp increases in the monthly payment, changes in the payment are limited. . . .
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> . . . .
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> Under some payment-capped mortgage programs, the amount of the monthly payment remains constant over a period during which the interest rate changes. Therefore, interest-rate changes must be reflected by a change in the rate at which the principal is amortized. However, at the next scheduled payment adjustment date, the amount of the payment would be adjusted, to the extent permitted by the terms of the mortgage, to fully amortize the loan over the remaining term.[239]

Under the regulation, adjustments to principal are permitted only if the following conditions are met: (1) the original payment amount was sufficient to fully amortize the loan at the inception of the loan term; and (2) the payment amount is adjusted at least every five years to a level sufficient to fully amortize the loan at the then-existing interest rate and principal balance over the remaining loan term.[240] Interest-rate increases must parallel increases in the index selected.[241] The interest rate must decrease when the index rate decreases.[242] Rate increases are at the lender's option.[243]

The AML may be prepaid in full or part at any time without penalty.[244] A lender may elect to use any available index for interest rate adjustment.[245] The index selection, however, must be readily verifiable by the borrower and beyond the control of the lender.[246] The regulation lists the following as acceptable indices: (1) the national average mortgage contract rate for major

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234. *Id.*
235. *Id.*
236. *Adjustable Mortgage Loans*, FHLBB Fact Sheet 1, 2 (1981).
237. *Id.*
238. *Id.*
239. *Id.*
240. 46 Fed. Reg. 24,152 (1981).
241. *Id.*
242. *Id.*
243. *Id.*
244. *Id.*
245. *Id.*
246. *Id.*

lenders on previously occupied homes; (2) the average costs of funds to FSLIC-insured S&Ls; (3) the monthly average of weekly auction rates on United States Treasury bills with either a three-month or six-month maturity; and (4) the monthly average yield on United States Treasury Securities adjusted to a constant maturity of one, two, three, or five years.[247] The average contract rate and the average costs of funds are published in the *FHLBB Journal*.[248] The Treasury bill auction rates and the Treasury Securities yields are published in the *Federal Reserve Bulletin*.[249]

The borrower may not be charged any costs or fees in connection with any regularly-scheduled adjustment.[250] The borrower must be notified in writing of a payment adjustment at least thirty but not more than forty-five days before the adjustment becomes effective.[251] The notification must disclose the following: (1) the scheduled date of adjustment; (2) the outstanding balance as of the adjustment date; (3) the interest rate as of the adjustment date, the index value on which that rate is based, the period of time for which that interest rate will be in effect, the next following payment adjustment date, and the rate adjustment dates, if any, between the upcoming payment adjustment date and the next following payment adjustment date; (4) the adjustment date payment amount; (5) the dates, if any, on which the rate was adjusted since the last payment adjustment, the rates on each rate adjustment date, and the index values corresponding to each date; (6) the dates, if any, on which the outstanding principal was adjusted since the last payment adjustment, and the net change in the outstanding principal since the last payment adjustment; (7) the fact that the borrower may prepay without penalty; and (8) the title and telephone number of a S&L employee who can answer the borrower's questions about the notice.[252]

Initial disclosure must be made no later than at the time of loan application or upon the borrower's request.[253] The disclosure must be in the form specified by the regulation and must contain the following information: (1) a general explanation of an adjustable mortgage loan; (2) an explanation of the AML offered to the borrower including an explanation of the basic terms of the loan; (3) an example of the operation of the offered AML; (4) notice that no prepayment penalty is permitted; and (5) notice of fees to be charged in connection with or origination of the AML and that no fees may be charged in connection with any regularly scheduled adjustments initiated by the lender.[254]

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247. *Id.*
248. *Id.*
249. *Id.*
250. *Id.*
251. *Id.*
252. *Id.*
253. *Id.*
254. *Id.*

Since the AML regulation rescinded the VRM regulation, the VRM requirement that only fifty-percent of a S&L's home mortgages be VRMs is deleted; also the requirement that S&Ls offer consumers the choice of either a SMI or a VRM is deleted.[255] Thus, lenders may offer variable interest loans only.

*d. AML Assessment.* When the Federal Home Loan Bank Board issued its AML regulations, the Board asserted:

> [I]t is inconsistent and unsound to expose [savings and loan] associations to the impact of wide swings in the cost of funds . . . without providing associations with the power to attain complementary changes in the mortgage portfolio yield. The mortgage borrower is ultimately hurt by restrictions on mortgage loan instruments that discourage Federal associations from placing the bulk of their lending funds in residential mortgages. The borrower is also hurt by restrictions that make it difficult for associations, the dominant source of mortgage lending, to remain viable and compete effectively for funds *vis a vis* other savings competitors.[256]

Yet, while the AML regulations enable lenders to create loan instruments having interest rates which parallel the lender's costs of funds in a volatile money market, opponents of the regulations believe consumer-borrowers' interests are inadequately protected by the regulations.[257] The opponents argue that, in the absence of regulatory controls on the frequency and the amount of interest rate increases, "large interest rate increases, and consequent payment increases, might make it impossible for home buyers to meet mortgage payments,"[258] and that negative amortization could make repayment of principal impossible, particularly in communities where property values cannot be expected to appreciate.[259] The Board and lenders counter that "market forces" will compel the creation of loan instruments containing payment-caps and limitations on the frequency and amount of rate increases even though these are not mandated by the regulations.[260] They also argue that the absence of prepayment penalties and the disclosures required upon AML applications and rate adjustment enable consumers to freely and intelligently choose a loan instrument suited to their needs.[261] Whether market forces, freedom to prepay, and required disclosures adequately protect consumer interests depend on factors to be discussed below.

*(1) Market Forces.* The Board reasons that "competition and other fac-

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255. *Id.* at 24,148-49.
256. *Id.* at 24,149-50.
257. *See id.* at 24,148-49.
258. *Id.* at 24,149.
259. *Id.*
260. *Id.* at 24,150.
261. *Id.*

tors in the mortgage market will encourage lenders to compete on terms and conditions that will best serve all parties involved, and that the mortgage market is competitive enough to produce the appropriate constrains."[262] It cites consumer resistance to a totally unlimited mortgage instrument, simplification of loan underwriting, and pressure from mortgage insurers and secondary mortgage market purchasers as factors that will force lenders to offer loans with limitations beneficial to borrowers.[263] It argues that the need to avoid borrower default on the loan is another disincentive to limitless loans.[264] Other considerations, however, may weaken the Board's reasoning.

Consumer-borrowers may be unaware that alternative mortgage forms are available and, if aware that alternatives are available, may be unaware of which terms in the loan agreement most affect the consumers' interests. Such borrowers will neither "shop" for mortgage financing nor be able to effectively negotiate a loan agreement with a lender. Moreover, even those borrowers who are informed about the availability of other loan instruments and the importance of loan terms will probably lack the sophistication necessary to adequately evaluate several loan instruments. For example, lenders may select any rate index that is readily verifiable by the borrower and beyond the control of the lender.[265] The Board states that this provision provides an important consumer protection since it "effectively prohibits AML lenders from utilizing their own cost of funds or current mortgage rate as an index."[266] Lenders may choose that index which meets these criteria while still giving the highest loan yield possible, however.[267] Borrowers offered a number of facially similar loan instruments which are tied to different indices and lacking the economic sophistication of lenders, often will be unable to accurately evaluate which index better meets their needs. Likewise, borrowers may be faced with two loan instruments having identical maximum interest rates. One may provide for payment caps and negative amortization with adjustments to principal; the other may provide that all rate increases are reflected in increases in the monthly payment amount. Borrowers may be unaware that the projected increase in the borrower's income throughout the life of the loan, the mobility of the borrower, and the potential appreciated value of the home are the factors which should be considered in evaluating these loan instruments.[268] To counter these difficulties, consumer education concerning AMLs should be broadened. Lenders should be required

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262. *Id.*
263. *Id.*
264. *Id.*
265. *Id.* at 24,148, 24,152.
266. *Id.* at 24,149.
267. *See id.* at 24,148, 24,152.
268. A payment-capped mortgage with negative amortization and consequent adjustments to principal is most feasible for highly mobile borrowers who live in areas where property values likely will appreciate significantly. These borrowers can rely on the net gain upon sale of the appreciated property being sufficient to repay the loan's increased principal.

to provide a variety of materials which explain the following: (1) key terms in all AMLs; (2) the function of an index in an AML; (3) the significant features of the index to be considered when selecting an AML index; (4) the operation of the four suitable indices listed in the regulations; and (5) factors in the borrower's life style to be considered in choosing an AML loan instrument. These materials should be in a form and writing style which the average high school graduate could readily use and understand.

Whether borrowers will actually be able to select a loan instrument which satisfies their needs also will depend on the variety of loan instruments available. Ideally, borrowers will seek loan instruments tailored to their individual needs. Lenders, however, will find that standardized mortgage instruments have greater appeal to secondary market investors.[269] Terms in the mortgage instrument often will be predicated upon investor demands rather than borrower needs. These two are not wholly contradictory. Secondary market buyers may demand that interest rate increases and negative amortization be limited in order to assure that the borrower will be able to repay the loan.[270] Nevertheless, the need for a uniform loan instrument with investment yields sufficient to attract secondary mortgage market buyers will restrict consumer choice among AMLs; the limits dictated by investor demands will be far less stringent than those consumers would urge. An investor will seek rate increase limits which minimize the risk of borrower default while assuring the investor a lucrative return on his investment. The consumer-borrower will seek rate increase limits which assure that the borrower will be able to repay the loan while maintaining his present lifestyle. Thus, the limits investors would seek might be much higher than those which truly reflect consumer interests; and borrowers, whose individual ability to negotiate with lenders is limited,[271] would be "locked into" loans whose terms were dictated by investment interests.

An AML loan instrument whose major terms are dictated by market forces may have another undesirable effect. An AML only functions effectively when increases in the borrower's income parallel or exceed increases in the interest rate and the monthly payment or adjusted principal.[272] Borrowers whose real income will rise steadily over the life of the loan will be favored by lenders issuing AMLs.[273] The blue collar wage earner's real in-

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269. Holders of first mortgages often sell these to second layer lenders in order to liquidate assets and increase funds available for mortgage lending. Low or uncertain interest yield reduce the marketability of first mortgages. The two principal secondary mortgage lenders are the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. *See* Bjerg, *supra* note 9, at 336 nn. 25-26.

270. Hill, *How Floating Rates on Mortgages Affect Home Purchases*, Wall St. J., May 6, 1981, at 1, col. 6.

271. *See* Section IV, Part G *infra*.

272. Without such parallels, the mortgage payment would increasingly erode the borrower's real income.

273. *See generally* Hill, *supra* note 270, at 22, cols. 1, 3.

come generally peaks early in his career and, while inflation-related nominal increases may occur, that real income remains level from then until the worker's retirement.[274] In contrast, the skilled professional can expect his real income to rise steadily throughout his career.[275] Lenders, aware of this phenomenon, may refuse to issue AMLs to blue collar wage earners. Thus, in a mortgage market dominated by AMLs, home ownership could become the prerogative of the best educated, most financially secure segment of society.[276]

*(2) Disclosures Provided.* The disclosures required upon AML application are quite good. Several changes that would assure borrower understanding of the type of loan transaction contemplated should be implemented, however. The disclosure form states that an AML may differ from other mortgages with which the borrower is familiar.[277] Yet, the form does not explain how an AML differs from a SMI. Since most borrowers are familiar with the operation of a SMI, an explanation of how the operation of an AML differs from that of a SMI would enhance borrower understanding of the AML and would assure that borrowers comprehend the different economic risks inherent in an AML transaction. Similarly, the AML regulations do not require the lender to give a "worst case" example of the operation of the AML offered. Such an example was required under the VRM and RRM regulations.[278] A "worst case" example should be given. Consumers need to be aware of how great potential cost increases may be if they are to accurately assess whether the AML offered is feasible for them. Negative amortization and adjustments to principal should also be fully explained to borrowers. Until the recent advent of the alternative mortgage instruments, these concepts were alien to American home finance. Therefore, consumers may be little aware of their potential ramifications, and they must be instructed as to how repayment of the loan principal and interest will be affected by rate increases in an AML. The disclosure statement that "a loan could permit rate adjustments to occur more frequently than payment adjustments, limit the amount by which payments could be adjusted and/or provide for corresponding adjustments to the principal loan balance"[279] gives the consumer little actual understanding of these features of an AML. Therefore, if the AML which is offered permits negative amortization and adjustments to principal or both, a "worst case" example of the operation of these features should also be given to the consumer-borrower.

Disclosures upon rate adjustment are adequate, providing that initial disclosures are broadened to ensure that borrowers fully understand the

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274. *See generally id.*
275. *See generally id.*
276. *See id.*
277. 46 Fed. Reg. 24,148, 24,153 (1981).
278. 12 C.F.R. §§ 545.6-4(c)(5)(ii), .6-4a(f) (1981).
279. *Id.*

AML contemplated before entering the contract.

*(3) Absence of Prepayment Penalty.* When issuing the AML regulations, the Board stated:

> The Board has determined to permit AML borrowers to prepay their loans in full or in part without penalty at any time during the loan term. The Board believes that, since the AML regulation gives lenders broad flexibility in shaping rate-sensitive mortgage loan instruments, borrowers should be given maximum flexibility in locating alternative sources of financing should a particular interest rate or monthly payment adjustment prove excessively burdensome.[280]

While the sentiment expressed by the Board is laudable, whether the absence of a prepayment penalty is a meaningful consumer protection depends upon a number of factors beyond borrower control. Loan interest rates and payments will become excessive when available credit is limited and consequently index interest rates are volatile. These conditions will affect all mortgage lenders; therefore, more advantageous refinancing will not be available to the borrower. Moreover, should AMLs become standardized, a loan instrument better suited to the borrower's needs may not be available. In either case, borrowers could not refinance the loan and, without the ability to refinance the loan, the absence of a prepayment penalty has little real value.

## IV. Usury Regulation, Usury Defenses, and the Adjustable Rate Mortgage

As already indicated, the court's interpretation of usury statutes could seriously inhibit the use of PLAMs.[281] State usury restrictions and their judicial interpretation could have a similar adverse impact upon use of ARMs.[282] When the market interest rate is at or above a jurisdiction's legal

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280. 46 Fed. Reg. 24,148, 24,150 (1981).

281. *See* Section II *infra*.

282. Title V, Depository Act, *supra* note 22, § 501, at 161, provides that state restrictions on interest rates, discount points, finance charges, or other charges do not apply to loans, mortgages, credit sales, or advances which are: (1) secured by a first lien on residential real property, or secured by a first lien on stock in a residential cooperative corporation if the loan secured is used to purchase the stock, or secured by a first lien on a residential manufactured home; (2) made after March 31, 1980; and (3) described in section 527(b) of the National Housing Act, 12 U.S.C. § 1235f-50 (1976). The preemption does not apply to a loan, credit sale, or advance made after March 31, 1980, however, if after March 31, 1980, and before April 1, 1983, the state enacts usury legislation which overrides the preemption. *See* Heath, *Federal Usury Preemption Extended and Expanded*, 9 Prob. & Prop. 14 (Summer 1980). The usury issues remain viable, therefore, in states which have enacted legislation overriding the federal preemption and in those jurisdictions which will consider similar legislative action before April 1, 1983.

Arguably, the preemption of state laws "purporting to address the subject of a federal association's ability or right to make, purchase, or participate in the alternative mortgage instruments . . . or to directly or indirectly restrict such ability or right," 46 Fed. Reg. 24,148,

usury rate, lenders would be hesitant to adopt ARMs. Commentators have proposed a number of contract defenses designed to remove the taint of usury from a variable interest agreement.[283] These will be evaluated *infra*. An initial overview of the purposes and social and economic impact of usury statutes and of the elements of usury will promote understanding of the proposed defenses and their probable judicial acceptance or rejection.

### *A. Arguments Favoring Usury Regulation*

Usury statutes fix the maximum rate of interest that can be charged in financial transactions.[284] Arguments favoring usury legislation often focus upon the comparative bargaining power of lenders and borrowers.[285] Lenders have larger resources and more sophisticated knowledge of financial matters than borrowers.[286] They also have better access to information concerning market conditions and prices.[287] Therefore, the state must intervene to prevent lender over-reaching and exploitation of defenseless borrowers.[288]

### *B. Counter Arguments*

Arguments opposing usury regulation become significant when money is tight and interest rates are rising.[289] Under such conditions, low usury ceilings exacerbate the problems already present. Opponents of usury ceilings argue that regulation, therefore, is counterproductive and interferes with the normal market forces governing credit availability.[290] They argue that usury laws do not protect consumer-borrowers, but, rather, make credit less available for them.[291] When market forces of supply and demand dictate a higher interest rate than the local usury law will allow, lenders turn to investment

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24,150 (1981), could be read to preempt state usury statutes enacted after March 30, 1980. Such a result, however, would be inconsistent with the specific Congressional intent expressed in the Depository Act, *supra* note 22, which intent is that the states should be the final arbitrators of their own mortgages finance usury policies.

283. *See* Section IV, Part E *infra*.

284. *Indexing the Principal*, *supra* note 35, at 755.

285. Bowsher, *Usury Laws: Harmful When Effective*, 56 FED. RES. BANK ST. LOUIS REV. 16 (Aug. 1974).

286. *Id.* at 17; Giles, *The Effect of Usury Law on the Credit Market Place*, 95 BANKING L.J. 527 (1978); McNulty, *The Impact of Usury Ceilings on Home Financing*, 8 REAL EST. REV. 68 (Summer 1978).

287. *See* Giles, *supra* note 286, at 530.

288. *See generally* Benfield, *supra* note 15; Bowsher, *supra* note 285, at 16; Giles, *supra* note 286, at 527; McNulty, *supra* note 286, at 68; Merriman & Hanks, *Revising State Usury Statutes in Light of a Tight Money Market*, 27 MD. L. REV. 1 (1967).

289. *See, e.g.*, Merriman & Hanks, *supra* note 288.

290. *See* Bowsher, *supra* note 285, at 18; Giles, *supra* note 286, at 530; Shanks, *Practical Problems in the Application of Archaic Usury Statutes*, 53 VA. L. REV. 327, 329.

291. Giles, *supra* note 286, at 530.

sources not subject to interest rate restrictions.[292] Some will invest in jurisdictions without usury regulations or with regulations higher than market interest rates.[293] Others will shift to local investments exempted from usury regulations, or will ration credit to eliminate high risk borrowers.[294]

Nonprice criteria will then play a more significant role in the allocation of credit. Credit history, current financial assets, and perceived risk of default are means used to "weed" borrowers out of the money market.[295] Indeed, "[a]s market rates approach usury ceilings, venture or developmental credit . . . becomes limited" because lenders can no longer be compensated for the additional risk such loans entail.[296] Likewise, low-income consumers are denied credit because they are considered too poor a risk.[297]

In contrast, the volume of credit flowing to wealthy individuals and established businesses may be as great or greater under severe usury restrictions as under free market conditions.[298] Since low usury maximums prevent other individuals and firms from effectively competing for funds, a greater share of the available funds tend to flow to lower risk applicants.[299] The anti-competitive effects of these laws are thus spread from credit to product markets.[300]

### *C. Impact of Usury Ceilings in the Housing Industry*

The effects of usury restrictions are uniquely apparent in the housing industry. As indicated in the Introduction to this article, the added costs of home mortgage loans demand a higher return for the lender than needed

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292. Shanks, *supra* note 290, at 329.

293. Banks and savings and loans are restricted as to their lending markets, "usually to their own counties and nearly always to their home states." However, these lenders may lend funds to the Federal Reserve, purchase Treasury bonds and notes and commit free moneys to the Federal Funds Market. All of these are alternatives to investment in a local restrictive interest market. Giles, *supra*, note 286, at 533 n.28.

294. *See* McNulty, *supra* note 286, at 69.

295. Giles, *supra* note 286, at 529-30; McNulty *supra* note 286, at 69.

296. Bowhser, *supra* note 285, at 18-19.

297. Giles, *supra* note 286, at 530. One economist after studying the consequences of removal of the rate ceiling on federally insured mortgage loans in Canada hypothesized that the interest rate ceiling subsidized borrowers able to obtain the insured loans. Chief beneficiaries of this subsidy were upper and middle income borrowers. However, after ceilings were removed, the number of low-income borrowers receiving insured loans tripled (rising from 12.9 percent of the total in 1963-1967 to 30.0 percent in 1970-1973). Smith attributed the increase in low-income borrowers to the fact that on removal of the rate ceiling, lenders could charge interest sufficient to compensate for the added risks and administrative costs associated with loans to low-income borrowers. Smith, *An Analysis of the Effects of the Removal of the Yield Ceiling on Federally Insured Mortgages in Canada*, 32 J. OF FIN. 195, 196, 200 (1977).

298. Bowsher, *supra* note 285, at 19.

299. *Id.*

300. *Id.*

from commercial loans.[301] The extra costs alone are sufficient to restrain mortgage lending when money supplies are restricted and market interest rates are high.[302] The residential housing industry, therefore, experiences economic difficulties when low usury ceilings further restrain credit.[303]

As noted, when faced with low usury ceilings, many lenders will turn to alternative investments and, thus, reduce the supply of mortgage funds available.[304] Others, while continuing to accept residential borrowers, will resort to subterfuge to increase their yield from mortgage investing.[305] The lender will charge "points" to offset the nominal interest fees lost.[306] "A point is a charge equal to 1% of the principal that is imposed on either the buyer or the seller of the home at the inception of the loan."[307] Generally, points are prorated over the term of the loan to determine the effective rate of interest.[308] It is presumed that the loan will not be prepaid. The practice of charging and prorating points has several adverse consequences. First, if the points are charged to the seller, he is likely to increase the purchase price of the home and pass his added cost on to the buyer.[309] (If the seller is the home builder, he may choose to reduce the quality of construction to offset the costs of point charges.) Second, no part of the prorated charge is refunded upon early payment of the loan.[310] Thus, prepayment may produce a substantial penalty.[311] Third, points often mislead buyers who do not understand their effect on the interest rate.[312] These persons, then, are denied the option of seeking better credit terms elsewhere.

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301. *See* Introduction *infra*.

302. *Id.*

303. *See* Bowsher, *supra* note 285; Giles, *supra* note 286; McNulty, *supra* note 286; Shanks, *supra* note 290.

304. *See* notes 292-94, *supra*.

305. One must distinguish between interest subterfuges and the legitimate fees which lenders are permitted to pass to borrowers. Generally, fees or charges reasonable in amount in relation to specific services actually rendered, or real benefit conferred upon the borrower, will not be held to be interest. Cooper, *supra* note 26, at 172. Such permitted charges are often specifically enumerated by statute. In Iowa, costs arising from credit investigation, property appraisal, attorney opinions, abstracting, recording of title, inspection and surveying of the property, mortgage insurance, and termite inspection may be passed on to the borrowers. Collection for any other costs is prohibited. IOWA CODE § 535.8 (1981).

306. *See* Benfield, *supra* note 15, at 859-64; Bowsher, *supra* note 285, at 22; Bjerg, *supra* note 9, at 382-85.

307. Bjerg, *supra* note 9, at 382. *See, e.g.*, B.F. Saul Co. v. West End Park N., Inc., 250 Md. 707, 713, 246 A.2d 591, 595 (1968).

308. Bjerg, *supra* note 9, at 382. *See* Penn. Mut. Life Ins. Co. v. Orr, 217 Iowa 1023, 1026, 252 N.W. 745, 747 (1934); notes 371-75 *infra*.

309. Benfield, *supra* note 15, at 860; Bjerg, *supra* note 9, at 385. *Cf.* Robins, *The Effects of State Usury Ceilings on Single Family Homebuilding*, 29 J. OF FIN. 227, 229 (1974) (consequences when builder must absorb a discount).

310. Benfield, *supra* note 15, at 861.

311. *Id.*

312. *Id.*

The point system is only one way in which low interest ceilings adversely affect the home building industry. Low usury ceilings inhibit home construction.[313] Most home builders are small, "venture" capitalists.[314] Thus, when money supplies are restricted, many home construction firms cannot compete for credit. Others will receive inadequate funding and will be forced to reduce the quantity and quality of home construction. In addition, as mortgage lending becomes constricted, builders may fear that potential buyers will be unable to get mortgage loans. Builders then will voluntarily reduce the number of homes constructed.[315] Thus, even those buyers who are not rationed out of the home mortgage market may find their housing choices restricted and may be forced to accept housing of an inferior quality.

### *D. Elements of Usury*

The Iowa Supreme Court has explained:

> [S]tatutes . . . generally have been construed to define usury as consisting of four essential elements: (1) a loan or forbearance, either express or implied, of money or of something circulating as such; (2) an understanding between the parties that the principal shall be repayable absolutely; (3) the exaction of greater profit than is allowed by law; and (4) an intention to violate the law.[316]

At common law, a loan was an agreement by which one party transferred a sum of money to another who agreed to repay an equivalent sum.[317] Forbearance means that the creditor waits for payment after the debt becomes payable.[318]

The second element of usury, that the borrowers have an obligation to repay the principal absolutely, is seldom subject to dispute. On the other hand, when repayment of the loan is contingent upon the happening or nonhappening of some contingent event, either wholly within the debtor's con-

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313. *Id.*

314. *See* Cooper, *supra* note 26, at 181, 185.

315. A number of studies have confirmed the adverse impact of usury ceilings on residential construction. One study used cross-section data for a sample of 77 Standard Metropolitan Statistical Areas (SMSAs) for 1970. In areas where statutory rates were below market rates, the level of single family homebuilding was approximately 28 percent lower than in SMSAs where statutory rates were above market rates. Robins, *supra* note 309, at 228-29. In 1974, Mississippi and Missouri had usury ceilings set at 8 percent; the national average interest rate on FHA 30-year mortgages was 8.78 percent. In the first quarter of 1974, residential construction in those states was 34 percent below what it had been in the same period in 1973. Bowsher, *supra* note 285, at 19; Giles, *supra* note 286, at 583. *See also* Cooper, *supra* note 26, at 181; McNulty, *supra* note 286, at 71-72.

316. State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 555 (Iowa 1973).

317. Cooper, *supra* note 26, at 168.

318. State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 561 (Iowa 1973). Bjerg, *supra* note 9, at 376.

trol or outside the control of both debtor or creditor and that event occurs, a profit greater than the interest rate allowed will not be considered usurious.[319]

The third element, that the profit be greater than allowed by law, turns upon the meaning of the term "interest." Simply, interest is the compensation allowed by law and agreed to by the parties for the use or forbearance of money or as damages for its detention.[320] Unfortunately, what constitutes interest is often uncertain. In mortgage lending, some additional charges can legitimately be passed on to the borrower.[321] Moreover, it is important to note that a court, determining whether a transaction is usurious, looks to what the lender has charged and not what he has actually received from the borrower.[322] Therefore, non-payment of the usurious interest or payment to a third party provides the lender with no defense.[323]

The final element of usury requires an intentional violation of the usury law.[324] Under the majority rule, it is not necessary that both lender and borrower intend a usurious transaction; only the wrongful intent of the lender is necessary.[325] The court need not normally find intention; if the other three elements are present, the wrongful intent is conclusively presumed.[326] Therefore, courts examine the totality of circumstances surrounding the challenged transaction and its substance, not its form, to ferret out subterfuges concealing a profit greater than the law will allow.[327]

### *E. Adjustable Rate Mortgage Defenses to Usury*

State usury ceilings may inhibit widespread adoption of ARMs.[328] Flexibility of interest return is a prime purpose of ARMs.[329] When market inter-

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319. *See* text accompanying notes 320-23 *infra*.

320. Weinrich v. Hawley, 236 Iowa 652-59, 19 N.W.2d 665, 669 (1945).

321. *See* text accompanying note 293 *supra*. *See also* Bjerg, *supra* note 9, at 388-95; Shanks, *supra* note 290, at 334.

322. Hershman, *Usury and the Tight Mortgage Market*, 22 Bus. Law. 333, 338 (1967).

323. *See, e.g.*, Cottrell v. Southwick, 71 Iowa 50, 53, 32 N.W. 22, 24 (1887); Garth v. Cooper, 12 Iowa 364, 365-66 (1861); Campbell v. McHarg, 9 Iowa 354, 357-58 (1859).

324. Bjerg, *supra* note 9, at 378; Hershman, *supra* note 322, at 336; Shanks, *supra* note 290, at 341.

325. *See* State *ex rel.* Turner v. Younker Bros., 210 N.W.2d 550, 563 (Iowa 1973). *Contra*, Federal Trust Co. v. Nelson, 221 Iowa 759, 762, 266 N.W. 509, 511 (1936); Dickerman v. Day, 31 Iowa 444, 449 (1871).

326. Bjerg, *supra* note 9, at 378; Hershman, *supra* note 218, at 322; Shanks, *supra* note 217, at 290. This presumption can be rebutted by showing the lender's honest mistake of fact; but mistake of law will not negate usurious intent. Bjerg, *supra* note 9, at 378 n.127; Hershman, *supra* note 322, at 337.

327. Koek v. Wasson, 161 N.W.2d 173, 179 (Iowa 1968); Portch v. Krogman, 202 Iowa 524, 210 N.W. 612 (1926); Weaver v. Barnett, 110 Iowa 567, 569; 81 N.W. 771 (1900); Iowa Sav. & Loan Ass'n v. Heidt, 107 Iowa 297, 77 N.W. 1050 (1899).

328. *See* note 291 *supra*.

329. *See* Berry, *supra* note 115, at 600-01; Hyer & Kearl, *supra* note 2, at 211-12.

est rates are at or near usury ceilings, the contractual ability to vary the interest rate is unavailing.[330] Any attempt to increase the return rate would violate the usury statute.[331] Commentators have suggested means by which lenders potentially may avoid the charge of usury.[332]

### 1. *Saving Clauses*

Lenders may be able to avoid violating state usury statutes by drafting a "saving clause" in the loan instrument. Savings clauses provide that the lender will not charge interest at a rate greater than the lawful rate.[333] Such provisions do not resolve the ARM lender's dilemma. When usury ceilings are low, the ARM loan will be stalemated at the statutory interest level. Moreover, such clauses may complicate pricing of ARMs on the secondary mortgage market.[334] In addition, recent decisions have held loans to be usurious even when a savings clause was employed.[335]

### 2. *Usury Defenses*

Commentators have suggested a number of defenses the ARM lender could employ to challenge a charge of usury.[336] First among these is the "time of inception" test. "This test provides that if the interest rate at the inception of the loan is non-usurious, absent bad faith, the loan is non-usurious throughout its life, regardless of subsequent events."[337] Two cases that illustrate the operation of this test are *Wehrman v. Moore*[338] and *Kassing v. Ordway*.[339] In *Wehrman*, the parties agreed that in lieu of interest the lender would receive the profits from the sale of cars purchased at wholesale with the borrowed funds.[340] The profits exceeded the statutory 8% interest ceiling.[341] The borrower contended that the contract was usurious and brought suit to have it set aside.[342] The court held that the contract was not usurious unless made so by its terms at the time of its execution.[343] The contract was not usurious on its face and the plaintiff-borrower had made no

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330. *See* Hyer & Kearl, *supra* note 2, at 222-23. Cowan & Foley, *supra* note 8, at 1082.
331. Hyer & Kearl, *supra* note 2, at 223.
332. *See* Section III, Part e *infra*.
333. *See* Werner, *Usury and the Variable Rate Mortgage*, 5 REAL EST. L.J. 162 n.14 (1976); Hyer & Kearl, *supra* note 2, at 223.
334. Hyer & Kearl, *supra* note 2, at 223.
335. Werner, *supra* note 333, at 155-57 n.14.
336. *See generally* Washburn, *supra* note 4.
337. Washburn, *supra* note 4, at 628.
338. 186 Iowa 1124, 1132, 173 N.W. 154, 157 (1919).
339. 100 Iowa 611, 616, 69 N.W. 1013, 1015 (1897).
340. Wehrman v. Moore, 186 Iowa at 1131, 173 N.W. at 157.
341. *Id.*
342. *Id.* at 1127-28, 173 N.W. at 155.
343. *Id.* at 1132, 173 N.W. at 157.

showing of the lender's bad faith attempt to evade the law.[344] Indeed, the lender had housed the cars for the borrower until their resale.[345] His storage expenses brought his net profit below the statutory limit.[346]

In *Kassing v. Ordway*, the court ruled that a loan entered into at a higher legal interest rate may draw interest at the rate contracted for throughout its term even when the statutory interest rate is subsequently lowered.[347] Neither the *Wehrman* nor the *Kassing* decision suggests that the time of inception rule saves an ARM from a charge of usury. In *Wehrman*, the lender could not estimate the rate of profit when bargaining for the loan.[348] Moreover, he undertook the risk that extended storage of the autos would substantially reduce his return.[349] In *Kassing*, the subsequent reduction of the lawful interest rate was mandated by the legislature.[350] Therefore, the lender was properly excused from compliance.[351] His initial bargain was lawful and made in good faith.[352] The lender had no reason to believe the transaction would later become unlawful.[353] In a variable rate transaction, the lender, not a non-party to the agreement nor an outside circumstance, would mandate increased interest charges. Moreover, if the interest rate at the time of mortgage execution was at or near the statutory ceiling, courts could hold the lender acted in bad faith using the rationale that a rate exceeding the statutory ceiling would logically result from the stipulated right to increase the charge.

A charge of usury can be defeated by showing that evasion of the statute was neither expressly nor impliedly intended by the lender.[354] This defense is similar to the time of inception test;[355] both look to the facts and circumstances surrounding the initial transaction to determine the presence of usury.[356] In *Partch v. Krogman*,[357] the bankruptcy receiver challenged the right of a holder of a $5,000 note to be allowed depositors' status upon distribution of the insolvent bank's remaining assets.[358] The instrument by its terms was payable on demand.[359] The holder had been paid $50 interest in

344. *Id.*
345. *Id.* at 1131, 173 N.W. at 157.
346. *Id.* at 1132, 173 N.W. at 157.
347. Kassing v. Ordway, 100 Iowa at 616, 69 N.W. at 1015.
348. Wehrman v. Moore, 186 Iowa at 1132, 173 N.W. at 157.
349. *Id.*
350. Kassing v. Ordway, 100 Iowa at 616, 69 N.W. at 1015.
351. *Id.*
352. *Id.*
353. *Id.*
354. *See* text accompanying notes 316-27 *supra*.
355. *See* Washburn, *supra* note 4, at 628.
356. *See* Parch v. Krogman, 202 Iowa 524, 210 N.W. 612 (1926).
357. *Id.*
358. *Id.* at 525-26, 210 N.W. at 613-14.
359. *Id.* at 525, 210 N.W. at 613.

advance.[360] The receiver argued that since the holder could have presented the note immediately after its issue and demanded payment thereof while retaining the advance interest, the note was usurious and against public policy.[361] Therefore, its holder should be denied depositors' rights.

The appellate court stated that good faith and the absence of a corrupt intent will justify upholding a transaction suspicious on its face as being usurious.[362] Evidence in the record did not indicate that the holder and the bank had agreed that the holder should or could collect usurious interest by keeping the bonus interest and then demanding immediate payment of the deposit.[363] The court held that the fact that under unusual and unanticipated circumstances the instrument could be manipulated to yield excessive interest was "not of itself sufficient to establish a contract to pay [a] usurious rate of interest, which neither party to the transaction contemplated or intended."[364] In *Partch*, the receiver made no showing that the depositor intended to collect unlawful interest; nor could such interest be presumed from a reasonable interpretation of the circumstances surrounding the transaction.[365] On the other hand, a

> variable rate transaction entered into during a period of steadily rising interest rates, where increases are forecasted to continue, [probably] would result in a court's finding that the lender did in fact intend to extract . . . interest in excess of the maximum, notwithstanding the fact that the mortgage was made at a period when the . . . rate was less than . . . allowed by law.[366]

A case strongly supporting this reasoning is *Federal Trust Co. v. Nelson*.[367] In *Nelson*, the borrower contended the mortgage agreement was usurious because the borrower was to pay taxes levied on the mortgage as well as interest.[368] These charges together could exceed the legal rate. The appellate court affirmed a judgment for the lender.[369] The court reasoned that when the amount of taxes to be paid is subject to future determination by taxing authorities "over which the contracting parties have neither supervision, knowledge, nor control" and the agreed interest rate is *materially less* than the maximum legal rate, it cannot be presumed that the lender intended to collect a usurious profit.[370] *Nelson* suggests that a variable rate

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360. *Id.*
361. *Id.* at 526, 210 N.W. at 614.
362. *Id.* at 528, 210 N.W. at 615.
363. *Id.* at 528-29, 210 N.W. at 615.
364. *Id.* at 529, 210 N.W. at 615.
365. *Id.*
366. *See* Werner, *supra* note 333, at 162.
367. 221 Iowa 759, 266 N.W. 509 (1939).
368. *Id.* at 762, 266 N.W. at 511.
369. *Id.* at 763, 266 N.W. at 511.
370. *Id.* at 762, 266 N.W. at 511. *See, e.g.*, Penn Mut. Life Ins. Co. v. Orr, 217 Iowa 1022, 252 N.W. 745 (1934).

agreement will likely be held usurious if it is contracted for when the interest rate is near or at the legal maximum and when the lender has knowledge of conditions indicating that the market rate will soon exceed the legal rate. The lender may argue that selection of an index over which he has no control should save the agreement. Since the lender has both a superior bargaining position and superior knowledge of financial trends, the argument is likely to be rejected if market rates were rising when the ARM was negotiated.

### 3. *Interest Pro-Ration Over the Life of the Loan*

Proration or interest averaging may allow the ARM lender to avoid a charge of usury even though the index rate temporarily rises above the interest ceiling. Courts generally prorate loan costs over the life of the loan when determining whether the charge is usurious.[371] (The practice was discussed above in regard to loan "points".) The ARM lender would argue that if the average interest charge was below the statutory maximum, periodic excesses should not render the loan usurious.[372]

Proration of an ARM poses both practical and legal difficulties, however. With an ARM, every period between rate changes could be considered as a separate loan agreement subject to renewal if the borrower does not repay upon a rate increase. A court viewing each interval as a separate agreement and finding an interest charge greater than the statutory maximum probably would hold the loan usurious even if the average interest rate over the term of the loan would be below the statutory rate.[373] Moreover, with an ARM, the average rate of interest could not be ascertained until very late in the loan term.[374] Neither the lender nor the borrower could easily ascertain whether the agreement was usurious. Because the lawfulness of their agreement would remain questionable, both parties might find the resale value of their asset substantially reduced.[375] Neither home buyers nor secondary mortgagees would willingly assume an agreement of uncertain legality.

Statutory increases in the interest ceiling could further complicate interest averaging of ARMs. It is uncertain whether the old or new ceiling would govern the determination of whether the interest average was usurious; or whether the averages would need to be prorated over the separate statutory periods in determining the transaction's lawfulness.[376] Indeed, given the complexity and uncertainty of ARM rate proration, lenders are ill-advised to adopt proration as a means of avoiding usury restrictions.

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371. *See* Penn Mut. Life Ins. Co. v. Orr, 217 Iowa 1022, 252 N.W. 745 (1934).
372. Berry, *supra* note 115, at 605; Werner, *supra* note 333, at 158.
373. Hyer & Kearl, *supra* note 2, at 224-25; Werner, *supra* note 333, at 159.
374. Hyer & Kearl, *supra* note 2, at 224-25; Werner, *supra* note 333, at 159.
375. Werner, *supra* note 333, at 159.
376. *See* Landers & Chandler, *supra* note 2, at 50 n.33.

*4. Contingency Exception; Contingent Event*

The contingency exception permits the lender to charge a rate of interest greater than the usury limit if payment of such interest is contingent upon the occurrence of a stated condition.[377] Generally, the risk that the higher interest will be forfeited must be substantial, and the risk undertaken by the lender must be greater than that involved in ordinary loan transactions.[378] If the probability of the occurrence of the contingency on which diminished payment is promised is remote, or, if the contingency occurs, the diminution is slight as compared with the possible profit to be obtained if the contingency were not to occur, the transaction is presumed usurious.[379]

The argument that an interest rate exceeding the statutory rate was only contingent at the execution of the mortgage and that the lender took the risk of the interest return falling below the initial rate fails for a number of reasons. First, both parties to an ARM contemplate index movement with fluctuations in the money market.[380] Therefore, in an inflationary economy, if the initial interest rate were near the usury ceiling, and a "saving clause" did not prohibit increases exceeding the limit, the possibility of a rate decrease would be too remote to save the variable rate agreement. Moreover, the borrower's attorney could argue that the lender's decision to promote ARMs rather than SMIs demonstrated an implied intent to exceed the statutory limits. Presumably, a lender anticipating deflated interest rates would prefer a fixed interest income.

*5. Contingency Exception; Borrower Control*

A variant of the contingency exception provides that where the condition upon which increased interest will be demanded is within the borrower's control, the loan is not usurious. The underlying rationale is that a debtor who could, but chooses not to, remove himself from the transaction waives the protection of the usury laws.[381] An illustrative case is *Warren v. Ewing*,[382] in which the parties agreed that the borrower was to invest the loaned amount in public railroad lands. He was to sell the land within one year and repay the money advanced plus a twelve percent premium.[383] Both parties agreed that the 12% represented both interest and an additional profit compensating the lender for the risk that the land would not be re-

377. Hyer & Kearl, *supra* note 2, at 226.

378. *Id. See* discussion of contingency exception and the risk of inflation in indexing of principal under Section II *supra*.

379. RESTATEMENT OF CONTRACTS, § 527 (1932).

380. *See* notes 37-38 *supra*.

381. Hyer & Kearl, *supra* note 2, at 225; Werner, *supra* note 333, at 159. 91 C.J.S. *Usury* § 31, at 608-09 (1955).

382. 34 Iowa 168 (1872).

383. *Id.* at 169, 173.

sold.[384] The lands were not sold for several years.[385] In an action upon the loan, the borrower argued that during the first year of the debt, the lender was entitled to the 12% stipulated, but, thereafter, only to the legal interest rate.[386] The court held that the lender was entitled to 12% interest for the full period.[387] The court reasoned that either party could have enforced the contract specifically;[388] since neither did, neither could demand the court's added protection.[389]

Related cases hold that a penalty exceeding the legal interest rate imposed when the loan remains unpaid after its due date will not render a contract usurious. In both *Gower v. Carter*[390] and *Wilson v. Dean*,[391] the initial contracts stipulated that penalties would be charged if the loans were outstanding after the contract date.[392] Neither loan was paid punctually and the lenders imposed the stipulated penalties.[393] In actions upon the debts, the borrowers argued the penalties constituted usurious interest.[394] In both cases, the arguments failed. Indeed, the *Wilson* court adopted the language and reasoning of *Gower* in holding the disputed transaction non-usurious:

> If the contract had been performed by the defendants, and the money paid according to the tenor and effect . . . at the time the . . . [loan] . . . fell due, there would clearly have been no usurious interest paid. . . . The defendants then had it in their power to obviate the objectionable feature of the contract. . . . Where a party agrees to pay a sum of money by a day certain, and more than legal interest afterwards, by way of penalty, if such debt be not punctually paid, such agreement is not usurious.[395]

Applying this reasoning, a variable rate clause allowing the borrower to prepay the loan upon an increase in the interest rate would render the agreement non-usurious. Payment of the additional interest would then be within the borrower's control.[396] However, courts may well view ARM prepayment options as signicantly different from late payment penalties and not allow the prepayment theory to be used as a subterfuge for evading interest limits.[397] In periods of rapidly rising interest rates, the borrower's

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384. *Id.* at 173.
385. *Id.* at 170, 173.
386. *Id.* at 170-71.
387. *Id.*
388. *Id.* at 173-74.
389. *Id.*
390. 3 Iowa 244 (1856).
391. 10 Iowa 432 (1860).
392. Gower v. Carter, 3 Iowa at 245; Wilson v. Dean, 10 Iowa at 432.
393. Gower v. Carter, 3 Iowa at 245; Wilson v. Dean, 10 Iowa at 433.
394. Gower v. Carter, 3 Iowa at 245; Wilson v. Dean, 10 Iowa at 433.
395. Gower v. Carter, 3 Iowa at 252; Wilson v. Dean, 10 Iowa at 433.
396. Hyer & Kearl, *supra* note 2, at 225; Werner *supra* note 333, at 159.
397. Hyer & Kearl, *supra* note 2, at 225; Werner, *supra* note 333, at 160.

right to prepay is arguably illusory. If the interest rate increases, the borrower is unlikely to be able to refinance elsewhere at a lower rate.[398] New loan fees and other costs of refinancing may further prohibit exercise of the prepayment option. Furthermore, when economic conditions at the time of mortgage negotiation indicated accelerating market rates, the court may find an implied intent to charge unlawful interest.[399]

### *F. Contractual Stipulation of Usury Law to Govern*

Parties may stipulate a choice of law in order to avoid the usury restrictions of another jurisdiction.[400] This conflict of law rule was formulated in *Miller v. Tiffaney*.[401] In *Miller*, the two lenders, residents of New York and Ohio, brought suit in Indiana against the borrower, an Indiana resident.[402] The borrower contended that the note was negotiated in New York, but made payable in Ohio to evade New York's more restrictive usury statute.[403] The court held the contract valid, stating:

> Contracts made in one place to be performed in another . . . are to be governed by the law of the place of performance, and if the interest allowed by the law of the place of performance is higher than that permitted at the place of contract, the parties may stipulate for the higher interest rate without incurring the penalties of usury. . . . The converse of this proposition is also well settled. If the rate of interest be higher at the place of contract than at the place of performance, the parties may lawfully contract in that case also for the higher rate.[404]

In *Seeman v. Philadelphia Warehouse Co.*,[405] the United States Supreme Court affirmed the general rule it expressed in *Miller*. If further noted the "sometimes stated" qualification that "the parties must act in good faith" in stipulating the governing law.[406] The "good faith" qualifica-

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398. Strum, *supra* note 38, at 117.

399. Hyer & Kearl, *supra* note 2, at 225.

400. Hershman, *Usury and the Tight Mortgage Market-Revisited*, 24 BUS. LAW. 1127, 1135 (1969); Shanks, *supra* note 290, at 350.

> Although the mortgage, or deed of trust and questions relating thereto are governed by the *lex loci rei sitae*, this does not mean that the debt contract is also governed by this law, on the contrary, ordinary conflicts principles applicable to the law of contracts should, and ordinarily do govern questions relating to the debt, the mortgage is only collateral to the obligation.

*Id.* at 351.

401. 68 U.S. 298 (1 Wall. 1863).

402. *Id.*

403. *Id.* at 301-03.

404. *Id.* at 310. For cases applying these principles in national bank credit card transactions see *Fisher v. First Nat'l Bank, 538 F.2d 1284 (7th Cir. 1976), cert. denied* 429 U.S. 1062 (1977); *Fisher v. First Nat'l Bank*, 548 F.2d 255 (8th Cir. 1977).

405. 274 U.S. 403 (1927).

406. *Id.* at 408.

tion operates to prevent the evasion of the applicable usury law.[407] Parties are barred from establishing contract performance at a place having other than a normal relation to the loan transaction, and to whose laws the parties are not otherwise subject.[408]

The "good faith" standard requires that the state stipulated have some real relationship to the contract.[409] The Restatement (Second) of Conflict of Laws[410] attempts to delineate what relationships are substantial and numerous enough to validate a contract choice of law stipulation. The Restatement denotes the state where the borrower is domiciled and the states of performance and contracting as generally bearing a substantial relationship to the contract.[411] The Restatement qualifies its endorsement of the latter two locations, however, by stating that they must also have some other "normal and natural relationship to the contract."[412] Other significant contacts which, when found together or with one of the three substantial relationships, would validate a choice of law stipulation include: the domicile and principal place of business of the lender; the place of loan negotiation; the place where the note was dated and drawn; the place where the borrowed money is to be used; and the situs of land securing the debt.[413] Thus, established principles of conflicts of law indicate that the variable rate mortgagee could stipulate the law of a more favorable jurisdiction to govern the mortgage instrument.[414] The need for substantial contacts limits the usefulness of this approach for mortgage lenders. Further, the primary mortgage lenders, the S&Ls, are generally restricted to operating within their own states,[415] and few mortgage borrowers are sophisticated enough to seek lenders who may lend in a national market and whose "substantial contact" jurisdiction has a non-restrictive usury policy. Contract stipulation, therefore, now would be only rarely possible. Commentators suggest that interstate operation of savings and loan associations may result from plans to merge insolvent associations, however.[416] Even if this were to occur, home borrowers' general lack of business acumen raises several questions concerning whether choice of law stipulation should ever be permitted in mortgage contracts.

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407. *Id.*

408. *Id.*

409. *Id.*

410. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 203 (Proposed Official Draft, 1967-1968).

411. *Id.* comment to § 203.

412. *Id.*

413. *Id.*

414. *See generally* Hyer & Kearl, *supra* note 2, at 223; Shanks, *supra* note 290, at 250-54; Werner, *supra* note 333, at 156-57.

415. *See* note 293 *supra.*

416. Hill, *Bill to Aid Sick S & Ls Could Eventually Lead to Interstate Banking,* Wall St. J., May 21, 1981, at 1, col. 6.

### *G. Public Policy and Choice of Law*

The average home buyer stands in a substantially different position in relation to the mortgage lender than does the successful businessman who seeks a commercial loan. Generally, the businessman has negotiated other loans. He acts upon the advice of counsel. The established businessman is the preferred borrower in a restricted credit market, and, therefore, can bargain effectively for loan terms he desires. In contrast, the home buyer may never before have negotiated a major loan. He often will lack legal advice. He generally will be offered a standard mortgage contract whose terms are expressed only as clearly as truth-in-lending legislation requires. In a restricted credit market, he will have little opportunity to elect more favorable terms.

Arguably then, the home mortgage borrower cannot negotiate a choice of governing law. He must accept the choice stipulated by the lender. The lender will choose the law most advantageous to himself. Given this situation, special restrictions on contractual stipulation of governing law may be advisable in the home mortgage area. It is doubtful, however, that such restrictions would be upheld if challenged. The question has never arisen with regard to mortgage lending; but analogous questions involving interstate consumer credit card transactions have arisen.[417] In these cases, discussed below, the lender was permitted to charge the higher interest rate.

National banks may charge the maximum interest rate which state law permits any competing state chartered or licensed lending institution to charge.[418] A national bank is "located" in the state designated in its organization certificate.[419] In *Fisher v. First National Bank*,[420] the credit card holder was an Iowa resident. The national bank operating the credit card system was chartered in Illinois.[421] The holder brought suit arguing that Iowa borrowers could be assessed only the lower Iowa credit interest rate.[422] The Seventh Circuit Court of Appeals found for the defendant bank.[423] Applying the principles expressed in *Miller* and *Seeman*, the court held the higher Illinois interest rate governed all credit card loans made by the Illinois bank even if made outside Illinois.[424] The court then noted that the bank had also "existed" in Iowa and had Iowa allowed interest in excess of that lawful in Illinois, the bank would have been free to charge Iowa cus-

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417. *See* Fisher v. First Nat'l Bank, 538 F.2d 1284 (7th Cir. 1976), *cert. denied* 424 U.S. 1062 (1977); Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. 299, 310 (1978).

418. 12 C.F.R. § 7.7310 (1981).

419. Marquette Nat'l Bank v. First of Omaha Serv. Corp., 439 U.S. at 310.

420. 538 F.2d 1284 (7th Cir. 1976), *cert. denied* 424 U.S. 1062 (1977).

421. *Id.* at 1287.

422. *Id.* at 1284-85.

423. *Id.* at 1291.

424. *Id. See* Seeman v. Philadelphia Warehouse Co., 274 U.S. 403 (1927); Miller v. Tiffaney, 68 U.S. 298 (1 Wall. 1863).

tomers the hypothetical higher Iowa interest rate.[425]

The issue of governing interest rate on credit card transactions between a national bank and an out-of-state customer reached the United States Supreme Court in *Marquette National Bank v. First of Omaha Service Corp.*[426] Marquette National Bank was chartered in Minnesota, and was enrolled in the Bank Americard credit plan.[427] First National Bank of Omaha was chartered in Nebraska, and was also enrolled in the Bank Americard plan.[428] First National of Omaha solicited customers in Minnesota.[429] Marquette National brought suit against the competing Nebraska National Bank contending that the higher interest rates allowed by Nebraska law and charged Omaha's Minnesota customers violated Minnesota's usury statute.[430] The district court held that the National Bank Act's[431] authorization that a national bank may charge interest "on any loan" at the rate lawful in the state where the bank was "located" did not preempt the Minnesota usury statute.[432] The Minnesota Supreme Court reversed and held that Nebraska law controlled credit card transactions between First of Omaha and its Minnesota Bank Americard holders.[433] The United States Supreme Court unanimously affirmed, holding that under the National Bank Act, a national bank chartered in one state may charge its out-of-state credit card customers the interest allowed in its home state even when that rate exceeds the rate permissible where the customer is domiciled.[434] In dicta, the Court declared that while "exportation" of interest rates would significantly impair states' ability to enact effective usury laws, that impairment was implicit in the National Bank Act.[435] Under the Act, citizens are free to travel outside their home state and receive credit at foreign interest rates.[436] Any restrictions on such freedom, therefore, should come from the "wisdom of Congress," not the "judgment of [the] court."[437]

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425. Fisher v. First Nat'l Bank, 538 F.2d at 1291. *See also* Fisher v. First Nat'l Bank, 548 F.2d 225 (8th Cir. 1977) (classification of the place of the transaction held not to be controlling in determining the permissible interest rate to be charged Iowa barrowers holding credit cards issued by a national bank chartered in Nebraska).

426. 439 U.S. 299 (1978). For an Iowa case dealing with the same issue, see *State ex. rel. Turner v. First of Omaha Serv. Corp.*, 269 N.W.2d 409 (Iowa), *vacated and remanded for reconsideration* (memo), 449 U.S. 969 (1978), *judgment vacated per curiam*, 281 N.W.2d 452 (Iowa 1979).

427. 439 U.S. at 299, 304.

428. *Id.* at 299, 301, 305.

429. *Id.* at 299, 302.

430. *Id.* at 299, 305-06.

431. 12 U.S.C. § 85 (1976).

432. 439 U.S. at 306.

433. *Id.* at 306-07.

434. *Id.* at 310-11.

435. *Id.* at 318.

436. *Id.*

437. *Id.*

The holding in *Marquette National* would seem to invalidate any state attempts to restrict the interest rate chargeable in interstate mortgage transactions involving national banks. Such restriction would be preempted by the National Bank Act.[438]

Congress is also unlikely to restrict such clauses. Mortgage loan transactions more closely resemble consumer loans such as the credit card transactions at issue in *Marquette* and *Fisher* than commerical loan transactions.[439] Congress has not acted to restrict the "exportation" of interest rates in interstate credit card transactions. It is even less likely to act to restrict interstate mortgage lending. Indeed, the Congressional three-year preemption of state usury rates, even though allowing states to elect to reinstate such controls,[440] was an unprecedented encroachment upon the states' traditional prerogative in usury legislation,[441] and indicates Congress will act to free mortgage lending from unnecessary intrastate restraints. Each freedom would be lost if rate stipulations in interstate mortgage transactions were restricted. Therefore, lenders initiating interstate home mortgage transactions would be able to charge the higher available interest rate. Indeed, choice of law clauses are likely to become common when interstate loan transactions involve states, one of which has chosen to reinstate usury restraints and the other of which has not.

### *H. Proposed Alternatives to Fixed Usury Ceilings*

#### *1. Floating Usury Ceilings*

State usury ceilings were temporarily suspended by Congress for three months beginning January 1, 1980.[442] On March 28, 1980, Congress voted to abrogate permanently state usury regulations of home mortgages unless states re-enact their usury laws by 1983.[443] The Congressional action mandates that states re-evaluate their usury policies.[444] Undoubtedly, a number of states will retain some form of home mortgage interest regulation. Floating usury ceilings, when properly devised, balance the desire to regulate usurious transactions and the need to allow market forces to set interest rates. Floating usury ceilings tie the allowable interest maximum to various market interest rates.[445] Floating ceilings are intended to protect home borrowers from excessively high interest rates while avoiding the disruption of

438. 12 U.S.C. § 85 (1976).
439. *See* introductory discussion, Section IV, Part E *supra*.
440. Depository Act, *supra* note 22, § 601, at 161.
441. *See* Bjerg, *supra* note 9, at 366.
442. 12 U.S.C. §§ 371(a), 1735(f)-(7) (Supp. III 1979).
443. *See* note 290 *supra*.
444. *See generally id.*
445. *See*, Cooper, *supra* note 26, at 185; Giles, *supra* note 286, at 544; Lovati & Gilbert, *Do Floating Ceilings Solve the Usury Rate Problem?*, 61 FED. RES. BANK ST. LOUIS REV. (1979); McNulty, *supra* note 286, at 15.

home financing and home construction which results when usury ceilings inhibit market rate forces.[446]

Yields on long-term U.S. Treasury bonds and the Federal Reserve regional discount rate both have been used as indices for floating usury ceilings.[447] The Treasury bond rate presumably is "a fair indicator of what the overall value of money in the economy is at a given time."[448] However, federal fiscal policy as well as money market forces influence the treasury bond rate.[449] The Federal Reserve Open Market Committee decides how many and what types of bond issues will be offered for investment.[450] The government then holds weekly auctions of bonds and notes.[451] Investment returns correlate with the number and kind of government investment options available.[452]

The Federal Reserve Discount Rate also may be more responsive to federal administrative action than to money market forces.[453] Moreover, the Federal Reserve discount rate normally reflects changes in short-term market interest rates. Thus, the "point spread"[454] between the current discount rate and the allowable mortgage interest maximum would need to be sufficiently wide to permit standard mortgagees to charge an inflation premium sufficient to preserve their long-term investment. Mortgage lenders whose interest rate returns are tied to a yield index would be little affected by the discount rate's reflection of more volatile market rates. "Use of a floating usury ceiling will avoid problems in mortgage financing which . . . result with fixed ceilings only if the floating rate remains above the mortgage interest rate that would prevail in the absence of the usury ceilings."[455]

An effective floating interest rate must consistently remain far enough above the national average mortgage rate so that it neither interferes with market rates nor curtails funding for high risk borrowers.[456] Two recent studies assessed the potential for floating usury ceilings to remain above the national average by calculating the ceiling rates that would have been permissible between 1963 and 1979 in states that enacted floating ceilings be-

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446. *See* Cooper, *supra* note 26, at 185; Lovati & Gilbert, *supra* note 445; McNulty, *supra* note 286, at 15. Floating usury ceilings had been enacted in approximately one-third of the states prior to January, 1980.

447. Giles, *supra* note 286, at 544; McNulty, *supra* note 286, at 15.

448. Giles, *supra* note 286, at 544.

449. *See id.* at 544-45.

450. *Id.*

451. *Id.*

452. *Id.*

453. *See* Cooper, *supra* note 26, at 187; McNulty, *supra* note 286, at 19; Merriman, *supra* note 288, at 18.

454. A "basis point" represents one-tenth of one percentage point. Washburn, *supra* note 4, at 603.

455. McNulty, *supra* note 286, at 15.

456. *Id.*

tween 1974 and 1979.[457] The studies found that floating ceilings two and a half percentage points above yields on long-term treasury bonds or five percentage points above the Federal Reserve discount rate generally remain above the national average mortgage rate.[458] When these percentage ceilings are used, a lender may add a ½ % "risk premium" to interest charged high risk borrowers without violating the usury statute.[459]

Restrictions on the speed of adjustment of floating ceilings also impede the flow of credit.[460] The floating usury ceiling enacted in Iowa in 1978[461] restricted the adjustment speed by setting the usury ceiling quarterly at two percentage points above the yield on ten-year U.S. Treasury bonds. The implied usury rate calculations for Iowa were less than the national average mortgage interest rates for six months between January 1963 and 1979.[462] Had the ceiling rate changed monthly, the Iowa implied usury rate would have been below the national average rate for only one month of the calculation period.[463] New York's floating usury ceiling also allowed only quarterly rate changes.[464] It further restricted any rate increase to twenty-five basis points.[465] The implied ceiling rates for New York were equal to or less than the national mortgage interest rates for nineteen months between 1963 and 1979.[466] Minnesota's floating ceiling statute[467] specified monthly rate adjustment to a level two percentage points above the yield on ten-year Treasury bonds rounded to the nearest twenty-five basis points.[468] Rounding to the nearest twenty-five basis points skews the impact of the index rate. When long-term interest rates are rising, the rise in the usury ceiling is postponed; when long-term interest rates are declining, the decline in usury ceiling is also postponed.[469] During the calculation period, for example, the Minnesota ceiling is less than the national average for six months.[470] If the rate had not been rounded to the nearest twenty-five points, the ceiling would have been below the national average for only one month.[471]

Many states wishing to preserve usury regulation after the federal exemption will enact or re-enact floating usury ceilings. When the rate spread between the index rate and the usury maximum is extremely limited or the

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457. *Id.*
458. *Id.* at 19.
459. *Id.*
460. *Id.*
461. IOWA CODE § 535.2(3)(a) (1979) (effective until July 1, 1979).
462. *Id.*
463. *Id.*
464. *See* N.Y. BANKING LAW § 14a (McKinney 1971).
465. McNulty, *supra* note 286, at 18.
466. *Id.*
467. MINN. STAT. § 47.20(4) (1980).
468. *Id.*
469. *Id.*
470. *Id. See* McNulty, *supra* note 286, at 18.
471. *Id.*

speed of rate adjustment is restricted, floating ceilings cannot accurately reflect market forces or preserve credit for high risk borrowers. Thus, legislation authorizing floating ceilings should be carefully drafted to avoid continuing interference with reasonable mortgage credit forces.

### 2. *Unconscionability Standard*

A floating usury ceiling statutorily preserves the state's power to sanction excessive interest charges.[472] Some states may not re-enact any home mortgage interest ceiling, however. The Iowa General Assembly, on April 16, 1980, gave final approval to an interest rate law eliminating rate ceilings on home mortgage loans, and on real property improvements, business, farm or personal loans exceeding $35,000;[473] and it is currently difficult to assess whether the General Assembly will re-enact a home mortgage interest ceiling in its 1982 term.[474]

Legislative repeal of a usury law should not mean courts will condone truly excessive interest charges. Great Britain abolished its usury laws in the mid-nineteenth century. English courts are empowered to reform loan transactions and decrease the interest charge if the charge is found to be harsh and unconscionable.[475] Loans with an interest rate of more than 48% are presumed usurious unless the lender establishes that the charge is reasonable under the circumstances.[476] The English system has several advantages: (1) market rate and the judgment of the parties determine the interest charge but lender overreaching is penalized; (2) private circumvention of usury ceilings is unnecessary since high risk capital is available from licensed, regulated lenders; and (3) legislative classifications of allowable interest rates as well as judicial exceptions to interest regulation are minimized.[477]

Precedent for widespread American adoption of the English system can

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472. *See* Giles, *supra* note 286; Lovati & Gilbert, *supra* note 445; McNulty, *supra* note 286.

473. 1980 Iowa Acts ch. 1156, § 2. *See also* IOWA CODE § 535.10 (1981).

474. In 1981, the Iowa Senate passed an amended version of S.F. 509, an act removing the maximum finance charge limitation on consumer credit transactions pursuant to open end credit. The amended bill would have removed finance charge maximums in open ended consumer credit transactions. In the Iowa House, where much opposition to the bill was expressed, the amended bill was assigned to a subcommittee of the House Committee on Commerce and was never reported out of the subcommittee. While S.F. 509's passage would not have affected mortgage lending rates, the debate surrounding S.F. 509 centered on similar issues, for example, who, consumer or lender, should bear the risk of inflation. That the bill was unable to reach the House floor for debate indicates that legislative commitment to some form of interest rate controls in consumer transactions is still strong in Iowa.

475. Note, *supra* note 99, at 455.

476. *Id.*

477. *Id.*

be found in common law of Massachusetts and New Hampshire.[478] Neither state has a statutory usury ceiling.[479] Courts in both states use the common law "shocks the conscience of the court" standard to determine if an interest rate is usurious.[480] In *Manganaro Drywall, Inc. v. Penn-Simon Construction Co.*,[481] a written contract provided that the subcontractor would receive six percent per annum retroactive interest on the entire principal, $78,117.36, if the contractor failed to pay any installment when due.[482] The contractor defaulted after having paid $40,000.[483] The subcontractor brought suit to recover the remaining sum owing.[484] The contractor argued that the agreement between the parties "was unconscionable and void as contrary to public policy" because the retroactive interest charge disregarded the $40,000 paid on the principal.[485] The court held that the retroactive interest clause was neither unconscionable nor against public policy.[486] Looking to the circumstances of the case, the court noted that in return for its agreement to pay the retroactive interest, the defendant-contractor had received a $3,000 reduction of the amount of the claim, protection from immediate suit to collect the already overdue principal, and time in which to pay the reduced principal without interest.[487] Thus, there had been arms-length negotiation between "two substantial business firms," and the defendant could not use an unconscionability defense to deny the plaintiff-subcontractor the benefit of his bargain.[488]

While the *Manganaro* decision involves a business contract between persons of equal bargaining power, its reasoning illustrates the factors that courts using an unconscionability standard will consider in deciding whether a transaction is usurious. Inequality of bargaining positions, lack of arms-length bargaining, and the absence of fair consideration for the interest rate charged would all indicate a usurious transaction. The market interest rate and the credit worthiness of the particular borrower are other factors the court would consider. These factors might justify an otherwise excessive interest charge.

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478. *See* Hershman, *supra* note 400, at 1131.

479. MASS. GEN. LAWS ANN. ch. 107, § 3 (West 1958 & Supp. 1981). New Hampshire has no statute expressly permitting consensual interest rate ceilings. However, it only regulates interest charges on second home mortgages, N.H. REV. STAT. ANN. ch. 398-A:2 and loans of five thousand dollars or less. *Id.* ch. 399-A:2 (1967 & Supp. 1979).

480. *See* Hershman, *supra* note 400, at 1131.

481. 357 Mass. 653, 260 N.E.2d 182 (1970).

482. *Id.* at 655, 260 N.E.2d at 184.

483. *Id.*

484. *Id.*

485. *Id.*

486. *Id.* at 656, 260 N.E.2d at 185.

487. *Id.* at 656-57, 260 N.E.2d at 185.

488. *Id.*

*3. Administrative Regulation*

The unconscionability standard alone may police loan agreements sufficiently to prevent usurious transactions. Yet, if inadequacies do arise from wholly judicial regulation of interest rates, they will be more evident in home mortgage lending than in commercial lending. Home mortgagors are generally less financially sophisticated than commercial borrowers. The Home mortgage borrowers most likely to be charged excessive interest rates are low-income, high-risk persons. This group is also least likely to seek judicial redress for their grievance. A form of administrative policing of interest rates might better suit these consumers' needs. A complaint could be filed with a state agency such as the consumer protection division of the Attorney General's Office. A review by persons trained in both law and finance would determine whether the interest rate charged appeared excessive. The lender then would have the burden of showing that the rate was reasonable under the circumstances. Should he fail to do so, the contract could be reformed and an equitable interest rate charged. Administrative regulation would shift the burden of patrolling mortgage interest charges from consumers to experts who would better be able to assess and understand the economic conditions influencing market rates. Excessive litigation would be avoided, but administrative opinions would provide lenders standards with which to ascertain whether a proposed charge would be found excessive.

*4. Interest Regulation Analysis*

Major renovation of antiquated usury regulation is required before alternate mortgage instruments (AMI) may be fully implemented. Immediate assistance is needed. Any program proposed must gain rapid political acceptance. Costs should be minimal and, in an age of increasingly laissez-faire political philosophies, programs advocating added levels of governmental regulation should be eschewed.

Usury policy should accomodate the market forces which influence the availability and cost of funds for mortgage lending. Rescission of all state and federal usury regulation would accomplish this goal. Canada eliminated interest ceilings on federally insured mortgages in 1969.[489] After ceilings were removed, the number of low-income borrowers receiving insured loans tripled (rising from 12.9% of the total in 1963-1967 to 30% in 1970-1973).[490]

The increase indicates that on removal of the rate ceiling, lenders could charge interest sufficient to compensate for the added risks and administrative costs associated with loans to low-income borrowers.[491] Similarly, if rate ceilings were abolished in the United States, mortgage financing could com-

489. Smith, *supra* note 297.
490. *Id.* at 200.
491. *Id.*

pete effectively with other investments for available funds. Home financing would remain available to those able and willing to pay the prevailing interest rate. Unfortunately, total reliance on market forces may perpetuate the "boom or bust" cycles that have plagued the American housing industry. Large numbers of Americans still prefer to "sit out" periods of high interest rather than accept what they perceive to be an excessive interest rate. Those who do so are ignoring the impact of inflation on housing costs. The median sales price of newly-constructed homes rose by over five thousand dollars between 1979 and December 1980.[492] The added principal required for later home purchase offsets any lower interest rate secured.

Moreover, a moral rather than an economic view of interest charges is deeply embedded in American political tradition.[493] With only few exceptions, American legislatures have never been content to abandon interest rate regulation wholly to market forces.[494] A realistic mortgage financing policy must accommodate the American tradition of protective legislation interest ceilings exemplify. Total abolition of usury regulation, therefore, while economically sound, remains politically unacceptable in the United States.

Administrative regulation of interest charges represents a novel approach to the usury problem. It would accommodate market forces while assuring that consumer borrowers were protected from actual overreaching by unscrupulous lenders. Federal administrative regulation is unlikely in the neoconservatism of the 1980's, however. Political opposition to increased governmental spending and "additional bureaucratic red tape" could well thwart any attempted federal administrative regulation. Similar forces would operate at the state level. State agencies would be less able to offer salaries sufficient to attract professionals with the economic and legal expertise necessary to effectuate a successful program. Moreover, if market forces do dictate the interest rate, the number of actual usurious charges may be too few to justify creating an additional regulatory agency. Administrative usury regulation, like complete abrogation of interest rate regulation, remains politically unfeasible in the United States.

Model legislation, which recognizes that money is a commodity whose cost is largely controlled by market forces of supply and demand while accommodating the continued insistance upon legislative policing of potentially usurious interest charges is needed. Given the partial Congressional preemption of state usury statutes of March, 1980, federal legislation of home mortgage interest rates should be considered seriously. Federal legislation would assure uniform enactment and enforcement of rate regulation. It would reflect national monetary and housing policy rather than local

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492. Kaplan, *Office of Policy and Economic Research*, 14 FED. HOME LOAN BANK BD. J. ANN. REP. 19, 21 (1981).

493. *See* Shanks, *supra* note 290.

494. *Id.*

interests.

A federal regulatory program, on the other hand, would seriously encroach upon a traditional state police power.[495] (The March, 1980 Congressional preemption of state usury legislation is largely an "elective" preemption since states may reenact usury legislation before 1983. In effect, Congress gave the states notice that unless effective state legislation were enacted, additional federal intervention would occur.)[496] State surrender of usury regulation to federal control is unlikely. Uniform state legislation, however, would end the current motley of regulation.

An argument against uniform usury legislation is that national monetary policy and national money market forces should not dictate local lending policies. If nationally uniform usury regulation were enacted, borrowers in non-urban areas could be charged interest rates prevailing in New York, Chicago or other national money markets. If local borrowers were unable to pay the national interest rates, small communities would be drained of investment funds. The argument has limited merit. Banks and savings and loan associations usually are restricted to lending in "their own counties and nearly always to their home states."[497] These lenders may lend funds to the Federal Reserve, purchase Treasury bonds and notes, and commit free monies to the Federal Funds Market, however.[498] All of these alternatives to local investment are already utilized when too restrictive local usury regulation makes local lending unprofitable.[499] Model usury legislation providing for a floating interest rate ceiling tied to the Federal Reserve regional discount rate, moreover, would not unduly hinder local lending. Presumably, the regional discount rate reflects local market forces. Local borrowers must compete regionally for available funds. A floating usury ceiling tied to the regional discount rate would reflect market realities in a given geographic area. Allowable interest rates would mirror local response to national money market conditions. As discussed previously,[500] a floating ceiling five percentage points above the Federal Reserve regional discount rate would not interfere with market interest rates and would allow lenders to charge a one-half percent "risk premium" to high-risk borrowers. Restrictions on the speed or rate of adjustment of the floating ceiling should not be implemented. These impede the flow of credit and skew the impact of the index rate. Information concerning current regional discount rates is readily available; thus, whether a particular interest charge is unlawful can easily be ascertained.

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495. *See generally id.* at 327-34.
496. *See generally* note 290 *supra.*
497. *See* note 146 *supra.*
498. *Id.*
499. *See* Section IV, Part B *supra.*
500. Section IV, Part H, Subpart 1 *supra.*

## V. Conclusion

Standard mortgage instruments fix the interest rate for the term of the loan. In a highly volatile money market, a SMI lender may find the cost of funds far exceeds his investment return and makes further mortgage lending unprofitable. Adjustable Rate Mortgages allow the lender's investment return to parallel market costs more closely and offer potential solutions to mortgage credit deficiencies in an inflationary economy. Unduly restrictive usury statutes fix interest ceilings far below the market demand rate and, thereby, hamper use of AMIs. Such usury ceilings further retard housing growth by channeling credit from higher risk mortgage and home construction loans, subject to usury regulations, to lower risk commercial loans to established businesses which are less likely to be subject to usury regulations. Thus, any program to revitalize mortgage lending in the United States must loosen the shackles of both the Standard Mortgage Instrument and antiquated usury statutes.

Any program to revitalize mortgage lending, however, also must consider the differing bargaining power and economic sophistication of the consumer-borrower and the commercial lender. The Congressional three-year exemption from state usury ceilings and the Federal Home Loan Bank Board's adoption of the Adjustable Mortgage Loan regulations should make mortgage lending a more secure investment for the lender; a mortgage market wholly controlled by market forces may ill-suit the needs of less sophisticated, less knowledgeable borrowers, however. An attempt should be made to assure that consumers understand the operation and impact of the AMI considered before they agree to enter the transaction. If such increased awareness is not sufficient to protect consumer interests, borrower safeguards, such as limitations on the amount and frequency of rate change, and a limitation on the amount of negative amortization allowed, should be reinserted into the AMI enabling legislation. State legislatures choosing to enact mortgage lending interest rate limits before April 1, 1983 should consider the unique impact of strict usury regulation on the housing industry. Any limitations should be elastic enough to mirror the market interest rate volatility of an inflationary economy.