ADVISORY RULING #45
MAY 16, 1980

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Dear

You have requested an opinion from the Bureau concerning possible conflicts between the Maine Consumer Credit Code and variable rate consumer loan programs: (1) whether a variable rate feature in installment loans conflicts with the refinancing restrictions of Section 2-504 of the Code; and (2) whether a variable rate feature in an open-end credit program would require compliance with the change of terms procedures in Section 3-204 of the Code.

Closed-end loans. As you know, the basic rule of Section 2-504 is that an increase in the rate of a consumer credit transaction upon refinancing is prohibited except "...at a rate not exceeding by ¼% per year the rate charged in the original agreement and stated to the consumer pursuant to the provisions on disclosure." A recent Maine Law Court ruling has held that a properly disclosed variable rate feature in an installment loan contract does not come within the prohibition on rate increase in Section 2-504. Moore v. Canal National Bank, 409 A.2d 679 (Me. 1979). The facts of this case involved a bank employee whose rate for a consumer loan increased according to a variable rate feature in the installment note after leaving the employ of the bank. The Court was asked to rule the increase invalid according to the terms of Section 2-504. The Court noted that no definition of "refinancing" was given in the Code and turned to the policy behind the provision in order to interpret the section:

> "Section 2.504 is designed to cover primarily the common situation in which a consumer-debtor, unable to meet payments due under a loan, seeks to negotiate a refinancing that will reduce the size of each payment, or lengthen the payment intervals, and extend the period of the loan. In that type of case the object of the Maine version of section 2.504 is clearly to limit to ¼ per cent any increase of the annual percentage rate to prevent undue exploitation by the creditor of the debtor's necessity." At 687.

The Court reasoned that since a properly disclosed variable rate feature would not give rise to the exploitation of the debtor and there is no reason to suppose that the debtor will be surprised or aggrieved by a virtually automatic increase in rate, a variable rate feature is not a "refinancing" in the meaning given that term in Section 2-504. The Court also emphasized that this interpretation was in harmony with the disclosure rules and interpretations of Regulation Z and the Federal Truth in Lending Act.

This decision is viewed as controlling by the Bureau. Therefore, Advisory Ruling #9 which held that a variable rate feature was prohibited by Section 2-504 is overruled.

Several words of caution, however, should be emphasized. The Court in Moore emphasized that a number of "flipping" practices prohibited by subsections (1) and (2) of Section 2-504 must be observed by variable rate loans as well as single rate loans, i.e., the creditor must not treat the loan as prepaid or otherwise terminated at the time of the rate change. Ibid, at 687.

In addition, the provisions of Regulation Z 226.8(b)(8) must be complied with. See 42 Fed. Reg. 20455 (1977). The disclosures must be given in the single document provided to the consumer to satisfy all Truth in Lending disclosures (i.e., combined note/disclosure form or separate disclosure statement). It should be noted that the defendant bank in the Moore case failed to do this.

Open-end Loans. Section 2-504 on its face applies to any consumer credit transaction. However, the Bureau finds no merit in attempting to distinguish between open-end and closed-end transactions in interpreting the Moore case.

However, a different issue is posed by Section 3-204. This section mandates a minimum notice requirement to the consumer when the creditor desires to change the terms of any open-end credit account which may involve cost or penalty to the consumer. In addition, Section 3-204(2) prohibits an imposition of these new terms on unpaid balances incurred prior to the effective date of the change unless certain conditions are met.

The Bureau is faced with the same quandary which faced the Moore Court. Although there is no mention of variable rate loans in the Code, there is no reason to suppose this financing device to be prohibited. Although common in the commercial world, variable rate loans are a fairly recent development in the consumer lending industry. Their benefit from the creditor's viewpoint is clear - variable rate loans offer a more flexible rate instrument that can align the institution's loan portfolio with the prevailing cost of funds. The consumer loses a heretofore commonly assumed protection - a stable rate for a fixed period of time which allows for a planned expenditure (i.e., monthly payment) in light of anticipated income. The obvious benefit, however, for the consumer is that the rate may go down as well as up. It is only in the recent past that the volatility of interest rates may create a situation in which this is a realistic possibility. However, any policy judgment concerning the protections deserving the consumer are the province of the Legislation. The Bureau is not prepared to rule that Section 2-304 alone should form the basis for inhibiting the development of variable rate credit programs. Indeed, Section 3-204 makes it clear that the notice provisions are designed to insert protections when there is a "change of terms." The use of a variable rate feature, properly disclosed, is not, strictly speaking, a change in terms, but the implementation of terms already contained in the agreement.

This policy is in keeping with Regulation Z. Official Board Interpretation 226.707 sets forth the requirements for the proper disclosure of a variable rate in an open-end program. It specifically provides that if the creditor has disclosed that the rate is subject to change, the conditions under which such rates may be changed, and the maximum and minimum limits (if any) of such rates, the Regulation Z minimum notice provisions of 226.7(e) need not be complied with.

You should also be aware of a number of other provisions in the Code that will impact a variable rate program:

(1) In order for a creditor to offer loans in excess of 12¼%, the creditor must be supervised financial organization or obtain a license pursuant to Section 2-301. The Bureau will view the licensing requirement to be triggered if the contract has the capacity to exceed

the 12¼% rate, i.e., either the rate is stated at 12¼% or more or the variable rate feature would allow an increase in rate beyond 12¼%.

(2) Section 2-307(1) prohibits the taking of a security interest in land in a loan with an APR in excess of 18%. Again, the Bureau will focus on the capacity of the variable rate to exceed 18% in enforcing this provision.

(3) Section 2-308(3) prohibits a loan with a rate in excess of 18% from extending beyond 37 months unless the rate is reduced to 8% at the end of that period. Again, the Bureau will focus on the capacity to contract for a rate in excess of 18%.

(4) Section 2-401(3)(C) restricts the inclusion of unpaid finance charges as interest-bearing principal in a new loan and is applicable to a closed-end loan with a rate in excess of 12¼%. If the variable rate provision could result in a rate in excess of 12¼%, the Bureau will view the prohibition as applicable.

(5) The same reasoning will apply to Section 2-507 concerning the prohibition on attorneys' fees for loans in excess of 12¼%.

(6) The restrictions on certain types of credit insurance that may be offered the consumer in Section 4-104 also depend on whether the loan has a rate in excess of 12¼%. Note as well the credit insurance restrictions apply to credit sales, except open-end credit sales, and both open-end and closed-end supervised loans.

(7) Section 5-103 sets forth rules for deficiency judgments for credit sales and supervised loans.

The Bureau will closely monitor the development of the use of variable rate features in consumer credit transactions and urge consumers to shop carefully when offered such programs. Full and complete disclosures will obviously be an important ingredient in measuring the impact of variable rate transactions on consumers. We will also monitor the type of variable rate programs developed and possibly suggest legislative action to correct abuses. In this latter area, the Bureau will keep track of such issues as:

(1) the type of index relied upon by the creditor to trigger the rate change, whether it is internal or external and its responsiveness to national vs. local market conditions;

(2) the frequency of the change in rate;

(3) the maximum change in rate at any one time;

(4) whether or not a total maximum rate increase is established over the life of the contract;

(5) whether the creditor is committed to rate decreases and;

(6) whether the creditor discloses the effect of the maximum rate increase (or first "rollover") on monthly payments and finance charges.*****

I hope this responds to your request.

Sincerely,

/s/ Barbara R. Alexander

Barbara Reid Alexander
Superintendent

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***** AR #88 AMENDMENT

This Advisory Ruling is modified to the extent that the issues identified above as items the Bureau would examine to determine the fairness of variable rate instruments, have been supplanted by enactment of §3-310 (P.L. 1981, c. 138). This new section sets forth the disclosure requirements for variable rate instruments, and the treatment that will be accorded them vis-à-vis §§2-504 and 3-204 if properly disclosed.

7/14/86