



DEPARTMENT OF BUSINESS, OCCUPATIONAL AND PROFESSIONAL REGULATION
BUREAU OF CONSUMER CREDIT PROTECTION
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ADVISORY RULING #85
DECEMBER 31, 1985

December 31, 1985

Re: Refinancing Balloon Obligations

A creditor has posed several questions regarding the rate and terms to be applied to the refinancing of balloon obligations made pursuant to fixed and variable rate instruments.

Consumer credit transactions containing balloon features became permitted as of September 19, 1985 by enactment of P.L. 1985, c. 113. This new law repealed and replaced §3-308 of the Code and provides in pertinent part:

4. A schedule of payments may require a final payment not substantially equal to all other periodic payments if the contract evidencing the consumer credit transaction gives the consumer the right to refinance the amount of the final payment on terms at least as favorable, including, but not limited to, the rate of finance charge and periodic payment amount, as those specified in the original consumer credit transaction, in order to fully amortize the obligations.

Before addressing a variety of refinancing scenarios under this section, there are two preliminary matters about §3-308's operation that should be discussed. First, it should be made clear that although §3-308 deals with refinancings, they are not of the type addressed by §2-504. That latter section addresses unanticipated or unplanned for refinancings of obligations, and allows for an increase in rate of 1% upon refinancing. Section 3-308(4), on the other hand, deals with partially-amortizing obligations in which there is a planned for opportunity to refinance. This section imposes a stricter rule of allowing no increase in rate at the time of refinancing of the balloon.

Second, creditors should keep in mind §2-308's restrictions on loan durations and earnings when designing transactions with balloon features. While §2-308 was amended by the same public law that modified §3-308(4) (P.L. 1985, c. 113), such that §2-308 now starts with the phrase "Except as provided in §3-308...", the amendment was not intended to nullify §2-308's proscriptions. Rather, the amendment was simply to provide an exception to §2-308's general requirement that all loans be repayable in "substantially equal installments," a requirement that is obviously inconsistent with a statute that allows for balloon payments.

With those preliminary matters now disposed of, four different scenarios will be presented to illustrate the operation of §3-308(4) with various instruments. In each case the critical question to be addressed is how the phrase "terms at least as favorable" is to be interpreted.

In this regard the Bureau has determined that "terms at least as favorable" cannot be interpreted to mean that each and every term of a transactions has to be the same as, or more favorable than, those terms of the original transaction. Clearly, some terms of a transaction are derivative in nature, determined from other, more significant contractual provisions. One of those is the amortization schedule, which is a function of the amount financed, the rate of interest and the monthly repayment amount. Because the amounts financed in the pre-balloon and post-balloon phases of the transaction can, and likely will, be different, the amortization schedules of the two phases will necessarily be different if the annual percentage rate and periodic payment amount remain the same. Mandating the pre-balloon repayment schedule on the post-balloon phase might reduce the consumer's monthly payments (if the balloon is smaller than the earlier amortized amount) but it would also result in an increase of the overall finance charge.

Although there is no legislative history to specifically identify legislative intent, logic, and the purpose behind the original balloon payment prohibition, both dictate that such a result is neither intended nor desired. First, as noted above, §2-308 restricts the amortization period of some loan transactions. Obviously, the Legislature would not design a refinancing scheme that could run head on into another statutory prohibition. Second, the principal focus of balloon transaction regulation is to prevent situations in which consumers are faced with a large, unaffordable or unfinancable payment to discharge a balloon. If refinancing at the same or better rate and periodic payment amount are guaranteed, such situations will never materialize. The concern was not with repayment periods, but rather with rates and periodic payment amounts. In light of this focus, as well as the other statutory realities regarding loan duration, it is entirely appropriate to exclude the amortization schedule from among those transactional terms that must be "at least as favorable" in balloon transactions.

Several different balloon refinancing scenarios will now be considered.

1. Fixed-fixed. This is the simplest situation. A fixed rate instrument with a balloon feature may be refinanced with another fixed rate instrument that bears the same or lower rate and the same or smaller periodic payment amount.

2. Variable-variable. Again, this is a relatively simple situation. If a variable rate instrument with a balloon feature is refinanced, all critical terms and conditions (rate adjustment range, index, change frequencies, limits, starting rate, periodic payment amount, etc.) must be at least as favorable as those applicable to the original transaction. The continuation of the terms in the pre-balloon phase into the post-balloon refinancing is obviously the easiest and cleanest way to comply with §3-308(4). If change does occur, particularly is less easily evaluated terms such as index, the Bureau will expect creditors to maintain in their files for Bureau review written analyses demonstrating that the change results in terms that are still "at least as favorable" to the consumer as those applicable to the pre-balloon phase.

3. Variable-fixed. Although §3-308(4) by its language seems to address only fixed rate instruments with balloon features, it is clear variable rate instruments were contemplated. Section 3-310 permits the use of such instruments, and predated the recent amendment to §3-308. The Legislature was thus aware of §3-310 when it amended §3-308 and thereby intended the two sections to be read harmoniously. In light of this, the language "terms at least as favorable" in

§3-308(4) must include refinancing balloons at a rate that could have legally been charged under the original variable rate instrument. The most rational choice of rate when converting to a fixed rate, however, and the one that squares most with the parties expectations and understandings of the variable rate instrument, is the rate prevailing when the balloon matures, regardless of whether or not this is higher or lower than the rate at origination. Because the rate at the time the balloon matures is within the range of rates originally disclosed, it is among those rates that are "at least as favorable" to those applicable to the original transaction. Consequently, choice of that rate comports with the statute's requirement.

The only other term that would have a bearing on the conversion to a fixed rate instrument is the monthly payment amount. Again, to comport with the statute, this must be at least as low as the periodic payment amount at the time of the balloon.

4. Fixed-variable. A fixed rate instrument with a balloon feature may be refinanced with a variable rate instrument provided the variable rate is capped so as not to exceed the fixed rate that controlled the first obligation. All other relevant terms and conditions must be at least as favorable as those applicable to the original fixed rate transaction.

/s/ Robert A. Burgess
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Superintendent

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