April 27, 1984

Re: Impact of §3-310 on adjustable rate mortgage instruments with fixed-rate conversion options

The Bureau has received an inquiry concerning the characterization and treatment of an adjustable rate mortgage instrument with a fixed-rate conversion option under the Maine Consumer Code. Two questions were raised: does the exercise of the conversion option constitute a refinancing under the Code? Does the formula for determining the fixed rate conversion violate §3-310(1)(F) of the Code?

The instrument in question is a standard adjustable rate mortgage, the rate movement of which is tied to an index beyond the creditor's control. However, a provision in the mortgage note grants to the mortgagor the option, for the first five years of the contract, to convert the instrument to one bearing a fixed rate. The conversion option can be exercised by the mortgagor on the yearly anniversary date of the mortgage. Approximately 45 days prior to each anniversary date, the mortgagor is notified of his current rate, the new rate (as determined by the index), the new monthly payment and, during the first five years of the mortgage, his option to convert the loan to a fixed rate at the lender's then prevailing fixed rate loan rate. There are no costs to the mortgagor for exercising the conversion option.

1. Refinancing. The exercise of the conversion option by the consumer does not constitute a refinancing. At first blush this conclusion appears obvious in that §3-310(2) provides that a variation in the annual percentage rate of an instrument that is disclosed in accordance with the pro-visions of subsection (1) (of §3-310) is not a refinancing under §2-504. Reliance on this reasoning is misplaced, however, because the issue of whether an adjustable rate mortgage with a fixed-rate conversion option comports with the requirements of §3-310(1) has yet to be decided.

Guidance for answering this question is found elsewhere. Although the term "refinancing" is not defined in the Code, two recent Law Court decisions have addressed the definitional hole in the Code by providing their own interpretation of the meaning of that term. In Moore v. Canal National Bank, 409 A.2d 679 (Me. 1979), the Court concluded that refinancings "denote a transaction requiring some element of new bargaining between the parties," at 684. In the same vein, the Court in Bar Harbor Banking and Trust Company v. Superintendent of the Bureau of Consumer Credit Protection, 471 A.2d 292 (Me. 1984) adopted Webster's definition of "refinance" - "to finance something anew" - as the appropriate meaning of the term in the Code in light of the legislative intent behind §2-504, footnote 3, at 295. This approach is paralleled in Regulation Z. Section 226.20(a) declares a refinancing to have occurred "when an existing obligation...is satisfied and replaced by a new obligation undertaken by the same consumer." The Official Staff Commentary at §226.20(a)-1 further specifies that for a refinancing to occur "the new obligation must completely replace the prior one." Moreover, "a renegotiable rate mortgage that was disclosed as a variable rate transaction is not subject to new disclosure requirements when the variable rate feature is invoked" (Commentary at §226.20(a)-3).

Because the exercise of the conversion option is not the creation of a new obligation or the extinguishment of an existing obligation in that the conversion option is contained and disclosed in the original agreement, it is not a refinancing as that term has been defined. Because no refinancing is involved, there is no violation of §2-504 if the exercise of the conversion option results in an increase greater than what would have been permitted under that section.

2. Compliance with §3-310(1). Section 3-310(1)(F) of the Maine Consumer Credit Code provides that "In connection with a consumer credit transaction in which the annual percentage rate may vary during the term of the transaction, the creditor shall disclose...in writing before credit is extended...the identity of the index or method based on factors beyond the creditor's control that will be determinant of any increase or decrease in the annual percentage rate." (Emphasis added.)

While §3-310 is primarily a disclosure statute, subsection (1)(F) does express a substantive prohibition against the use of an index somehow controlled by the creditor. Initially, then, it would appear that the conversion option in the adjustable rate mortgage in question would violate §3-310(1)(F) because the fixed rate that the consumer could convert to is the creditor's own current fixed rate mortgage rate, something obviously within the creditor's control. However, a closer look at the intent of the statute and the dynamics of the conversion option itself compel a different conclusion.

While there is no formal legislative history on P.L. 1981, c. 138, the public law that enacted §3-310 in 1981, it is quite clear that the reason for mandating the use of an index for rate adjustment that was beyond the creditor's control was to instill consumer confidence in the propriety of variable rate instruments and a general sense of fair dealing. Corresponding regulations of the Federal Home Loan Bank Board in place at the time §3-310 was enacted recognized this fact and incorporated the requirement of the use of indices "beyond the creditor's control." Any index that was based on factors within the creditor's control could be manipulated for self-serving purposes.

In the instrument subject of this inquiry, the index rate at the time of conversion is the creditor's own rate for fixed-rate mortgages. However, because the option to convert resides solely in the mortgagor, the concerns §3-310(1)(F) was intended to address are not present - there is no way for the creditor to manipulate the rate to its advantage since the mortgagor has the ultimate choice as to whether or not to accept it. Although the creditor could, in theory, set its fixed-rate mortgage rate so high so as to prevent any rational person from converting to it and thereby "manipulate" the rate, because the fixed-rate conversion rate is the creditor's actual fixed rate mortgage rate competition will dissuade any lender from going to such ends. Because of where the choice resides in determining the rate that will govern the mortgage, the instrument complies with §3-310(1)(F) since choice in the mortgagor is tantamount to use of an index beyond the creditor's control.

Please be advised that the Bureau reserves the right to review any new instrument of this type of guarantee its compliance with §3-310.

/s/ Robert A. Burgess
Robert A. Burgess
Superintendent

RAB:as

*****AR #88 Amendment

Although the conclusion reached in this Ruling remains unchanged, the Bureau points out that the basis on which this decision was made has changed. By enactment of P.L. 1983, c. 720, §19, a new subsection 5 was added to §3-310 in which the Bureau was authorized to adopt rules governing alternative mortgage transactions. Such rules were adopted (Rule 250) effective March 25, 1985. Questions such as those posed in AR #75 for first lien mortgage loans would now be answered under Rule 250.

7/14/86