Opinion No. 76-22

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BY: OPINION OF TONEY ANAYA, Attorney General Harvey B Fruman, Assistant Attorney General

TO: Mr. Herbert H. Hughes, Commissioner of Banking, Department of Banking, Lew Wallace Building, Santa Fe, New Mexico

QUESTIONS

Question

May a New Mexico bank, savings and loan association or credit union make loans by the acceptance of notes which contain a variable interest rate clause?

Conclusion

Yes.

OPINION

*{*90}* Analysis

Certain lending institutions desire to make long-term loans secured principally by first mortgages on real estate. The loans would state a legal rate of interest but would contain a variable interest rate clause ("VIR") which would provide for an adjustment of the rate based upon an index or an indicator reflective of the general economy. The adjusted rate would at no time exceed the maximum permitted by law.

A VIR is one which provides that the interest on the balance of the loan, for its term, may be adjusted upward as well as downward. A VIR clause differs from an escalator clause in that the latter only allows for an increase in the interest rate. The result of a VIR clause is that the borrower would benefit during a period of deflation while the lender would benefit during an inflationary period. While the concept is certain to evoke arguments based on social and economic considerations, we are not approaching those considerations here.

We have examined the specific lending provisions of the statutes regulating the conduct of business of the financial institutions noted in the question, and we have likewise examined the statutory provisions relating to usury in general.

In our examination we have not found any legislative prohibition against the use of a VIR clause on long term loans secured with realty. We note, however, that in the case where an increase in interest is achieved by lengthening the maturity date of the loan to

allow more interest to be paid over the life of the loan, rather than by increasing the monthly payments, there are certain restrictions as to the maximum length of the loan period. See, for example, Section 48-22-21, NMSA, 1953 Comp. (1975 P.S.).

Additionally, we have not found any judicial decisions which relate to a VIR clause. The several cases reviewed which discuss an escalator provision have indicated that such clauses are not invalid per se where the escalated rates are not usurious and where the parties *{*91}* have contracted with the idea in mind that rates could be escalated and where they have agreed to the contractual clause. See **Campbell v. Gawart,** 46 Mich. App. 529, 208 N.W.2d 607 (1973). In this case the escalator clause was held to be invalid, however, not because it was invalid per se but because the court found that the specific legislative intent in the statute under review, which raised the legal interest rate, operated prospectively only and was inapplicable to previously executed contracts.

Of course, an essential factor relating to the validity of VIR clause would be that all required disclosures as to the terms of the loan be complied with.

The conclusion which we reach in this Opinion should not be understood as applying to, or as altering any specific statutory language to the contrary. See, for example, Section 48-17-43A, NMSA, 1953 Comp. (1975 P.S.), which prohibits a small loan business from charging a greater rate of interest than the rate charged on the original loan where the loan term is extended.