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Federal Deposit Insurance Corporation Division of Depositor and Consumer Protection

Quarterly Newsletter

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Adjustable Rate Mortgages – Disclosure Considerations

Over the last several years, there has been an increase in financial institutions offering Adjustable Rate Mortgage (ARM) products for a variety of reasons, including the introduction of the Ability-to-Repay Rule, the rising interest rate environment, and the elimination of riskier ARM features, such as prepayment penalties and negative amortization. An ARM is defined as a closed-end consumer credit transaction secured by a consumer's principal dwelling in which the annual percentage rate may increase after consummation.

Given the increased availability of these products, we wanted to discuss some of the distinct regulatory requirements of ARMs. This article addresses areas of common mistakes and concerns with ARM products identified by the FDIC during recent examinations. The information in this article may help provide banks with useful insights as they offer ARM products to their customers.

Regulation Z, which implements the Truth in Lending Act (TILA), generally requires payment change and initial interest rate adjustment disclosures for ARMs with terms of greater than one year. There are general rules governing the distribution of these disclosures; however, the rules provide several exceptions.

A summary is detailed in the following table.

For ARMs…	§1026.20(c) Ongoing Interest Rate Adjustment Disclosure Notice Due…	§1026.20(d) Initial Interest Rate Adjustment Disclosure Notice Due…
General Rule: ARM Disclosure Notice Requirements	60 – 120 days before the first payment at the adjusted level is due for each rate adjustment causing a payment change	210 – 240 days before the first payment at the adjusted level is due for the initial adjustment
If the first payment at the adjusted level is due within the first 210 days following loan consummation	60 – 120 days before the first payment at the adjusted level is due for each rate adjustment causing a payment change, but only if the new interest rate disclosure required by §1026.20(d) at consummation was an estimate	At loan consummation

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Adjustable Rate Mortgages – Disclosure Considerations (Continued)

For ARMs…	§1026.20(c) Ongoing Interest Rate Adjustment Disclosure Notice Due…	§1026.20(d) Initial Interest Rate Adjustment Disclosure Notice Due…
Frequently adjusting ARMs: If uniformly scheduled interest rate adjustments occur every 60 days or more frequently	25 – 120 days before the first payment at the adjusted level is due for each rate adjustment causing a payment change	Follow timing requirements above
ARMs originated prior to January 10, 2015 with short lookback periods (i.e., the adjusted interest rate and payment are calculated based on an index figure available less than 45 days prior to the adjustment date)	25 – 120 days before the first payment at the adjusted level is due for each rate adjustment causing a payment change	
ARMs adjusting soon after closing: ARMs with first rate adjustment within 60 days of closing and the initial disclosure provided at closing contained an estimated interest rate	For the first adjustment to this type of ARM, as soon as practicable, but not less than 25 days before the first payment at the adjusted level is due. Subsequent ongoing notices depend on the future scheduled interest rate adjustments according to this table	

Historically, many ARM loan contracts reference the index change date as "the most recent index figure available as of the change date" or "the most recent index figure available as of the date 45 days prior to the change date." The timeframe FIs utilize to review an index is commonly referred to as the lookback period. Examiners have identified a number of instances, where FIs have confused the disclosure delivery timeframe of 60 days with the lookback period in the loan contract, or have thought that the 60 days took precedence over the lookback period. Additionally, some FIs have sent the payment change disclosures 60 days prior to the rate change date instead of prior to the first payment due date with the new rate and payment, resulting in the application of an incorrect index value. Let's look at a couple of examples.

Loan Contract Calls For:	Example 1	Example 2
Loan Contract Date	May 1, 2016	October 12, 2013
Rate Change Frequency	Annually	Annually
Date of Index for Rate Change	45 days before each change date (May 17)	As of the change date (November 15)
Rate Change Date for Loan	July 1	November 15
New Payment Due Date	August 1	December 15
Delivery Time of Disclosure	May 17 – June 2	November 15 – 20

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Adjustable Rate Mortgages – Disclosure Considerations (Continued)

Example 1:

The index figure available on May 17 should be used for the rate, as this is 45 days prior to the change date of July 1. According to the regulation (shown in the first table in this article), the disclosure must be provided at least 60, but no more than 120, days prior to the first payment due date at the new rate (between April 3 and June 2 in this example). However, since the index first becomes available on May 17, the payment change disclosure cannot be sent prior to May 17. As a result, the institution could provide the change disclosure any time during the period of May 17 (the date the index value becomes known) to June 2 (the latest date that the disclosure can be sent) to be compliant with the rules. Examiners have occasionally seen the payment change disclosure provided on May 2 (or 60 days before the rate change date), resulting in the application of an inaccurate interest rate (using an index on May 2 instead of May 17) on the loan.

Example 2:

In this example, there is no lookback period included in the loan contract that was originated prior to January 10, 2015; therefore, according to the regulation, the payment change disclosure is to be provided at least 25, but no more than 120, days before the due date of the first payment at the adjusted rate. The appropriate index value would be the index available on November 15. In this example, the disclosure would need to be provided no later than November 20 (25 days prior to the due date of the first adjusted payment). Examiners have found in some similar instances, FIs have been following the 60-120 day delivery period in these scenarios, which again resulted in the application of inaccurate index values.

Another area where examiners have observed violations relates to the content of the payment change and initial interest rate adjustment disclosures. TILA defines the required elements of these disclosures, including the requirement to provide some information in a standard table format as found in Appendix H-4 of Regulation Z. Some of the required language is contract specific, such as the name of the index used and where it can be found; therefore, FIs need to carefully enter this specific information within their templates or vendor systems. In some instances, FIs have not used the required tabular format for these disclosures or have not set up templates properly to disclose all required information. When deficiencies have been identified, they often relate to the failure to include the specific index used to calculate the interest rate, as well as where the index value can be located. Additionally, in some instances, banks have included an incorrect or incomplete index name. Section 6 of the Consumer Financial Protection Bureau's Small Entity Compliance Guide provides some additional details, including model and sample forms.

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Adjustable Rate Mortgages – Disclosure Considerations (Continued)

Three additional areas of concern identified by the FDIC during examinations are:

1. Failing to timely update index values in core processing systems and software applications

When index values change, financial institutions (FIs) must ensure that systems are updated in a timely manner to ensure that disclosures contain accurate information and meet both regulatory requirements and the terms of the loan agreement. For instance, many FIs are using the Constant Maturity Treasury (CMT) index values based upon the weekly average. These values are generally published weekly on Mondays. In some cases, examiners have identified FIs waiting to update index values on their systems until later in the week, such as on a Thursday or Friday. This practice of delaying the implementation of index changes can cause potential consumer harm, depending upon when a consumer's rate is set to change. For example, let's assume the CMT index changes on Monday; however, the FI fails to update their system with the updated index until Friday. If this FI has a loan with an interest rate tied to the CMT index that has a rate change date that falls on Wednesday of that same week, the most recent available index would not be applied to the loan (due to the delay in the system update). In this situation, the system would likely apply the index value from the previous week, which could be lower or higher than the correct contract rate.

Additionally, examiners have found instances where FIs have used multiple systems, loan platforms, and loan contracts to originate ARMs and failed to update all of the systems or account for variations in contract language. This can result in discrepancies between the loan contract, disclosures, and applied rate changes. The application of an interest rate that is inconsistent with the customer's loan contract or disclosure can lead to customer harm. In these instances, restitution may be due to the customer.

2. Misinterpreting loan contracts and applying life-of-loan floor rates

If FIs are using numerous versions of loan contracts, it is important to understand the language in each loan contract, specifically pertaining to life-of-loan interest rate limitations. Recently, an issue was discovered with loan contracts disclosing a minimum and maximum interest rate that can be applied at the <u>first</u> change date. However, the contracts only included additional language for a maximum rate on all future rate changes, but did not address a continued minimum or floor rate. Some FIs have misinterpreted these contracts to apply the initial floor rate for the entire loan term. This practice has the potential for consumer harm when variable interest rate values decline below the inappropriately applied floor rate. It is important that FIs are aware of their contract language and ensure operating system parameters mirror the contract language.

3. Misunderstanding fully-indexed, discounted, or premium rate ARMs

FIs often originate ARMs with an initial interest rate that is not based on the fully-indexed interest rate, resulting in a discounted or premium rate transaction. In some instances, the discount or premium is unintentionally created when the bank is attempting to match the initial interest rate in the promissory note to the rate that was disclosed on the customer's Loan Estimate provided at application time. While offering a discount or premium rate transaction is permissible, the calculation of the annual percentage rate and disclosure of these ARMs can be a little more complex than a traditional fully-indexed ARM, sometimes causing confusion that results in inaccurate information being provided to the customer. Examiners have identified instances where the bank was unaware that they originated a discounted or premium ARM, resulting in miscalculations of the annual percentage rate or the failure to properly disclose the fact that the initial rate was not based on the index in the contract.

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Adjustable Rate Mortgages – Disclosure Considerations (Continued)

Regulation Z[1] states that when creditors use an initial interest rate that is not calculated using the index or formula to be used for later rate adjustments, the disclosures should reflect a composite annual percentage rate based on the initial rate for as long as it is charged and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation. An example of the calculation of a discounted variable rate loan is included below.

> *A 30-year loan for $100,000 is extended with no prepaid finance charges and rates determined by the Treasury bill rate plus 2 percent. Rate and payment adjustments are made annually. Although the Treasury bill rate at the time of consummation is 10 percent, the creditor sets the interest rate for one year at 9 percent, instead of 12 percent according to the formula. The disclosures should reflect a composite annual percentage rate of 11.63 percent based on 9 percent for one year and 12 percent for 29 years.*

Hopefully, this article provides some helpful perspective on areas where compliance with ARM disclosures can go wrong, so that FIs can consider whether it is appropriate to review their programs to ensure that these areas are properly addressed. Maintaining a strong compliance management system that includes effective oversight, procedures, training, and monitoring helps ensure that ARMs are offered in a manner that is compliant with applicable laws and regulations and reduces the risk of consumer harm.

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[1] Official Interpretations to 1026.17(c)(1)-10.

April: A Time to Help People Improve their Financial Skills and Confidence

April is National Financial Capability Month, a time when many public, private, and nonprofit organizations highlight consumer education resources and tools. If your bank is planning activities for this month or beyond, did you know that the Money Smart product family has expanded in recent years?

The FDIC's financial education tools can help people of all ages build their financial knowledge and skills to achieve brighter financial futures. The tools include:

- Money Smart for Adults, which was recently updated in late 2018. This instructor-led curriculum provides participants with practical knowledge, skills-building opportunities, and resources they can use to manage their finances with confidence.

- Money Smart for Young People, offering age-appropriate lesson plans for educators along with guides for parents and caregivers.

- Money Smart for Older Adults, developed with the CFPB to raise awareness among older adults and their caregivers on how to prevent elder financial exploitation and encourages advance planning.

- Money Smart for Small Business, developed with the U.S. Small Business Administration to provide useful information for new and aspiring entrepreneurs.

Want to learn more? Start at www.fdic.gov/education. From there, you can download Money Smart or review ideas on how to use it. Also available through that website are tools that can help you connect financial education to youth employment or youth savings programs.

Tell me more about the updated version of Money Smart for Adults!

The 14 new modules feature design improvements along with new content, activities, and modules that are influenced by instructional best practices and other research, including:

- New content on topics such as ABLE accounts for people with disabilities, managing through income volatility, and person-to-person payments.

- Expanded coverage of credit, including coverage of topics such as building productive credit histories, managing credit cards, and strategies to manage debt.

- "Try It" activities to use during training and "Apply It" activities for instructors to incorporate during training or encourage participants to use after training.

- A "Take Action" section in every module that encourages participants to identify at least one thing they plan to do because of the training.

Community Affairs Upcoming Events

April 9: Interagency Bankers' Roundtable: Opportunities in Economic Development. Roundtable will be held in Orlando, Florida, and is presented by the FDIC and OCC. Contact Community Affairs Specialist April Atkins at aatkins@fdic.gov.

April 10: Interagency Forum on Hurricane Michael Disaster Recovery: A Follow-up on Housing and Small Business Needs. Presented in Panama City, Florida by the FDIC, OCC and Atlanta FRB. Presentation is for bankers, CDFIs, long term recovery agencies, and local government. Contact Community Affairs Specialist John Olsen at jolsen@fdic.gov.

April 19: Florida JumpStart, FDIC & Atlanta FRB Youth Banking Symposium in Miami, Florida. Presented by the FDIC and the Atlanta FRB for bankers and financial educators. Contact Community Affairs Specialist April Atkins at aatkins@fdic.gov or Community Affairs Specialist Terry Lee at tlee@fdic.gov.

April 27: Hurricane Michael Disaster Recovery Resource Fair. Presented by FEMA, Florida Emergency Management and federal resource partners. To be held in Marianna, Florida for bankers, nonprofits, and local government. Contact Community Affairs Specialist John Olsen at jolsen@fdic.gov.

April 30: CRA Bankers' Roundtable: Expanding Internet Access and Rural Broadband Opportunities. Presented in Tifton, Georgia, by the FDIC and OCC. Contact Community Affairs Specialist Elaine Hunter at ehunter@fdic.gov.

May 5: Advancing Economic Inclusion in Appalachia Bankers' Roundtable. To be presented by the FDIC in Birmingham, Alabama. Contact Community Affairs Specialist John Olsen at jolsen@fdic.gov or Community Affairs Specialist Victor Galloway at vgalloway@fdic.gov.

May 21: Advancing Economic Inclusion in Appalachia Bankers' Roundtable. To be presented by the FDIC in Charleston, West Virginia. Contact Community Affairs Specialist Victor Galloway at vgalloway@fdic.gov.

June 4: Community Redevelopment Bankers' Roundtable. To be presented by the FDIC and OCC in Lake Wales, Florida. Contact Community Affairs Specialist April Atkins at aatkins@fdic.gov.

Recent Publications

Financial Institution Letters

- *Prepaid Accounts Rule: Interagency Consumer Compliance Examination Procedures (FIL-9-2019)*
- *Issuance of Final Rule on Loans in Areas Having Special Flood Hazards—Private Flood Insurance (FIL-8-2019)*
- *FDIC Extends Comment Period Related to the Request for Information on the Deposit Insurance Application Process (FIL-7-2019)*
- *Voluntary Private Education Loan Rehabilitation Programs (FIL-5-2019)*
- *Banker Webinar: Update on the Standardized Export of Imaged Loan Documents Initiative (FIL-4-2019)*
- *Regulators Encourage Institutions to Work with Borrowers Affected by Government Shutdown (FIL-1-2019)*

FDIC Press Releases

- *FDIC Encourages Consumers to Set Financial Goals and Learn More about Options for Saving* (PR-11-2019)
- *FDIC Extends Comment Period Related to its Request for Information on the Deposit Insurance Application Process* (PR-7-2019)
- *Joint Release/New Rule Covers Private Flood Insurance* (PR-6-2019)
- *FDIC Issues List of Banks Examined for CRA Compliance* (PR-5-2019)
- *Joint Release/Regulators Encourage Institutions to Work with Borrowers Affected by Government Shutdown* (PR-2-2019)
- *FDIC Issues List of Banks Examined for CRA Compliance* (PR-1-2019)
- *Joint Release/Agencies Issue Statement on Financial Institutions Issuing Loans When National Flood Insurance Program is Unavailable* (PR-106-2018)
- *Joint Release/Agencies Release Annual CRA Asset-Size Threshold Adjustments for Small and Intermediate Small Institutions* (PR-100-2018)