STATEMENT

On

CONSUMER SAFEGUARDS ON ALTERNATIVE MORTGAGE INSTRUMENTS

Before the

Commerce, Consumer and Monetary Affairs Subcommittee of the

House Committee on Government Operations,

U.S. House of Representatives

Presented by

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10:00 A.M.

Thursday, March 27, 1980

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You have asked for our comments on alternative mortgage instruments, including the need for consumer safeguards and the authority of the FDIC in this area.

First, the FDIC has no authority to promulgate regulations relating to consumer safeguards for mortgage loans.

Second, we examine insured State-chartered nonmember banks and supervise these institutions from the standpoints of safety and soundness and the requirements of Federal consumer law and other applicable law.

These two premises will be discussed in more detail later in this statement.

Thrift institutions, which are engaged primarily in mortgage lending, are currently facing a difficult situation in which their cost of funds has risen much more rapidly than the yield on their assets. Many mutual savings banks and other depository institutions have substantial portfolios of low-yielding mortgage loans. To improve their financial positions and their ability to serve the residential mortgage market and other customers, such institutions need new powers, and alternative mortgage instruments may be significant among them.

With the impending phase-out of interest rate ceilings, financial institutions face a new era of competition. In such an environment, mortgages with yields sensitive to changes in market interest rates would become increasingly important to thrifts striving to remain viable and competitive. Benefits also would accrue to small commercial banks which may have substantial mortgage portfolios.

Borrowers would benefit to the extent that alternative mortgage instruments serve to maintain the availability of mortgage funding during periods of high interest rates. Borrowers would have the consolation of knowing that as market interest rates go down, so will the rates on their mortgage loans. Further, borrowers have a stake in the viability of the institutions that serve as depositories and as the source of credit for purposes other than mortgages.

Within the context of these considerations, the FDIC believes that the marketing of alternative mortgage instruments should be accompanied by consumer protections, including two basic safeguards: first, that there be full and complete disclosure of all terms and conditions; and second, that to the extent possible the consumer have a choice between an alternative mortgage instrument and a fixed-rate mortgage.

Perhaps it would be useful to trace the background of alternative mortgage instruments.

BACKGROUND

The traditional fixed-rate fully amortizing mortgage has been the standard instrument for the financing of residential properties since the 1930s.

However, inflationary pressures of recent years and the sharp increases in interest rates have led to demand, particularly from lenders, for alternative mortgage instruments that shift at least part of the interest rate risk to the borrower.

The most common of these are the variable rate mortgage (VRM) in which the interest rate may vary, usually within fixed limits, during the life of the loan and the renegotiated rate mortgage (also called a rollover mortgage) in which the terms of the entire contract are rewritten at specified intervals, usually three to five years.

Variable rate mortgages have been used in Europe for some time and rollover mortgages have been the standard instrument in Canada since the 1960s. The Federal Home Loan Bank Board authorized federally chartered S&Ls to offer VRMs beginning last July. This action and the liberalization of State law have led to an increase in the number of State and federally chartered institutions offering VRMs. Rollover-type mortgages have had limited use in the United States, but lender interest in them is growing.

Conditions Leading to The Introduction of VRMs.

From the mid-1930s to the mid-1960s, interest rates were relatively low, and rate fluctuations remained within a fairly narrow range. This relative stability and the fact that mortgage rates compared favorably with other long-term interest rates promoted the profitability of thrift institutions and facilitated their role as primary suppliers of mortgage credit. These favorable conditions began to change in the mid-1960s when interest rates rose sharply. The traditional shape of the yield curve was inverted, i.e., short-term rates exceeded long-term rates. Deposit interest rate ceilings below short-term market rates precipitated an outflow of deposits and an increase in the cost of funds for thrift institutions. This brought on major disintermediation and disruption of housing finance, the first of a series of interest rate cycles that have characterized the past 15 years. The pattern of 1965-66 was repeated in 1969-70, 1973-74 and 1978 to the present, with each interest rate peak exceeding that of the previous cycle.

Over time, large commercial banks have substantially reduced their interest rate risk by tying rates on business loans to changes in the prime rate. Thrift institutions, lacking similar asset powers and flexibility, have remained vulnerable to rising interest rates. They have lent long and borrowed short. During previous periods of rising interest rates, thrifts were cushioned somewhat from the impact of market forces. Interest rate ceilings on deposits and the differential have to some extent insulated thrifts from rate competition with each other and with commercial banks. Thrifts also benefited from inertia and rate insensitivity on the part of depositors.

The effectiveness of these traditional barriers has diminished significantly in recent years. Money market rates have risen so high that they have caused major disintermediation. Savers have become more rate sensitive, and they have been moving their deposits to money market funds which are not subject to interest rate ceilings, to higher-paying instruments offered by institutions and to Federal securities. These flow changes have caused significant earnings problems for thrifts and have led to legislation now before Congress to phase out the outmoded interest rate ceilings and to phase in new asset powers for thrifts.

Variable Rate Mortgage Activity in the United States

Variable rate mortgages have only recently been offered and accepted in significant volume as a mortgage instrument in the United States. Most of such activity is centered in California.

Although a California State-chartered S&L offered VRMs in the mid-1960s, negative consumer response discouraged this effort. By the early 1970s a few State-chartered S&Ls had limited success with the instruments. Today, approximately two dozen State-chartered S&Ls, three national banks and two State-chartered commercial banks offer VRMs in California. An estimated $20 billion in VRM loans is outstanding in savings and loans in the State, most of it held by State-chartered institutions. The interest rate variability is tied to the Federal Home Loan Bank of San Francisco's cost-of-funds index for S&Ls in California. State law provides for a number of consumer safeguards. Semi-annual adjustments in VRM interest rates are limited to 25 basis points. Prepayment without penalty is permitted up to 90 days following notification of a rate increase, and borrowers must be given at least 30 days advance notice of an increase. In 1976, changes in California law provided borrowers with additional protection by placing a limit of 2-1/2 percentage points on the maximum increase over the life of the loan. In addition, lenders were required to offer borrowers (subject to certain limitations) the option of extending the maturity of their loan as an alternative to increased monthly payments.

Two midwestern States which specifically permit VRMs are Ohio and Wisconsin. Terms on VRMs offered in Ohio are very similar to those in California. Those offered in Wisconsin differ in that rate changes are not tied to a specific index. The more prevalent type of alternative mortgage instrument offered in Wisconsin is an "escalator clause" mortgage which provides for a constant rate over a three-year period after which the rate may be adjusted annually.

In New England a number of State-chartered mutual savings banks and commercial banks and other lenders, most notably in Massachusetts, offer VRMs or rollover mortgages. State law is is silent (or not very detailed) with respect to VRMs, and lenders base interest rate adjustments on a variety of indices, the most common being national or local mortgage rates.

Few other States have alternative mortgage instruments. Some State laws specifically prohibit VRMs. In many States uncertain legal authority may have discouraged the introduction of alternative mortgage instruments. Usury ceilings have precluded meaningful VRM lending activity in some States, since lenders are unwilling to make VRMs when interest rates are at or close to the usury ceiling. Finally, there was no nationwide Federal authority for VRMs until last year.

Federal Authorization of VRMs

The Federal Home Loan Bank Board authorized VRMs by regulation for federally chartered S&Ls nationwide effective July 1, 1979. This followed the December, 1978, action of the FHLBB to authorize

VRMs for federal S&Ls in California to enable them to compete with State-chartered institutions. The FHLBB's proposals to authorize nationwide VRMs in 1972 and 1976 had not been well received and were abandoned.

Under the 1979 FHLBB regulation, interest rate changes on VRMs offered by federally-chartered S&Ls are tied to the weighted average cost-of-funds for all S&Ls whose accounts are insured by the FSLIC. This index is computed semi-annually by the FHLBB and published in the FHLBB Journal. The first adjustment in interest may not occur within less than one year after the date of the first regular monthly payment. Reductions in interest are mandatory when the index declines by 10 or more basis points but increases are optional at the lender's discretion. FHLBB regulations permit a maximum increase of 50 basis points per year and a maximum cumulative increase over the life of the mortgage of 2-1/2 percentage points. Any increase not immediately imposed by the lender may be deferred to a later date or used to offset a decrease that otherwise would be mandated by a future decline in the cost-of-funds index.

Borrowers must receive a written notification of any rate adjustment at least one month in advance. Borrowers are permitted to prepay the mortgage without penalty for 90 days after notification of a rate increase. Federally-chartered S&Ls are prohibited from originating or purchasing in any calendar year more than 50 percent of their residential mortgage loans, by dollar amount, in variable rate mortgages.

FHLBB Proposal for Renegotiated Rate Mortgages

On January 7, 1980, the FHLBB published for comment a proposal to permit federal savings and loan associations to make, purchase, or participate in renegotiated rate mortgage loans on one-to-four family dwellings. The FHLBB is expected to issue a final regulation within the next few months. In the FHLBB proposal, interest rates could be increased by up to five percentage points over the life of the mortgage, but by not more than half a percentage point a year.

A few State-chartered commercial and mutual savings banks in the U.S. have offered rollover mortgages. But overall experience with VRMs and rollover mortgages in this country has been limited, and some of that experience has occurred during a period of particularly unstable market conditions.

SPECIFIC QUESTIONS

Mr. Chairman, you have asked a number of questions regarding the authority of this agency to regulate VRMs and rollover mortgages, various aspects of disclosure and our attitude toward specific provisions of regulations permitting these types of mortgage instruments.

Need and Authority

With respect to federal consumer protection, it would seem desirable to have minimum consumer protection requirements for VRMs and rollovers.

The FDIC has no broad legal authority to impose consumer protection and other regulatory limitations on the terms of variable rate or other mortgage instruments issued by nonmember insured banks.

The FDIC has responsibility for enforcing both the Truth in Lending Act and the prohibition in section 5 of the Federal Trade Commission Act against unfair or deceptive trade practices with regard to such institutions. However, both these Acts grant substantive rulemaking authority to the Federal Reserve as to all banks and, in the case of the Truth in Lending Act, as to other creditors as well. It seems clear, therefore, that the FDIC could not use either of these Acts to issue comprehensive substantive regulations imposing consumer protections or other limitations on variable rate or other types of mortgages. The FDIC could presumably proceed on a case-by-case basis under the Federal Trade Commission Act to bring administrative enforcement proceedings to prevent nonmember insured banks from issuing such mortgages in a manner the FDIC considered to be unfair or deceptive, even in the absence of any Federal Reserve regulations in point.

Conceivably, FDIC consumer protection regulations in the mortgage loan area could be premised on a finding that their utilization was in some respect an unsafe or unsound banking practice. It is difficult to conceive of circumstances under which such a finding could be made.

Monitoring

You asked about monitoring alternative mortgage instrument activity. We plan to continue our current practice of keeping up with changes in State law. As such changes result in a perceptible increase in the number of State non-member banks and mutual savings banks offering these instruments, we would expect to survey such activity. Consumer complaints would be handled through our regular process to determine if any laws or regulations which are on the books have been breached. We have discussed the experience of mutual savings and commercial banks in various meetings with industry groups.

Rate Changes

You asked for our views on the use of indices or other means of determining rate changes in alternative mortgage instruments. We would not favor provision for a future rate adjustment based on a lender's then-prevailing interest rate rather than some specific index. We believe the borrower should be informed regarding the precise basis for future rate changes at the time he enters into the loan.

We would favor rate adjustments based on an index of market rates. Experience with the cost of funds index thus far has not evinced serious problem. The cost of funds index has not moved as rapidly as market rates in the last two years, although index changes probably still have permitted maximum adjustments in VRMs. Even if interest rates begin to fall, the cost of funds index could move opposite the market for awhile, depending upon the proportion of passbook deposits and maturing certificates converted to instruments with substantially higher market rates than in earlier periods. Moreover, as interest rate ceilings are phased out, adjustments in VRMs based on market rates on the asset side would be more appropriate. For example, the index could be tied to the market rate on intermediate or long term Treasury securities.

With respect to other rate limitations, we are in accord with the concepts of the safeguards already contained in FHLBB regulations and some State regulations -- that is, permissible ranges of increases in the interest rate, both periodically and over the life of the loan; mandatory decreases and optional increases in interest rates; and others. However, we believe that any limitations must be reasonable within the context of the market. For example, too tight a limit on the range of interest rate adjustment might serve to discourage lenders from offering alternative mortgage instruments. The effect might be to curtail mortgage lending of any kind in a community.

If markets are competitive, disclosure is adequate, and borrowers are well informed, market forces should provide us with a variety of answers in this area. Some borrowers may be willing to take most or all of the interest rate risk, and if they do so in competitive markets, then initial interest cost should be appropriately less. If borrowers are not willing to accept certain types of loan provisions, I would expect lenders to adjust to this kind of market response, whether it is expressed through borrowers, builders, brokers or mortgage bankers.

Consumer Choice

You have asked about consumer choice and, in that connection, whether lenders should be required to make a minimum percentage of fixed-rate loans as a means of ensuring a free choice to the borrower. Consumer choice is important. Variable rate mortgages may not be suitable for some borrowers; others may see them as an opportunity. Under certain circumstances, a requirement for a minimum percentage of fixed-rate mortgages could run counter to consumer preferences and distort market pricing.

The ideal situation would be one in which competition would ensure that consumer preferences are reflected in the kinds of instruments offered by lenders and choice would be maintained by market forces. There are active participants in the mortgage market -- builders, mortgage bankers, real estate brokers, as well as lenders -- whose interests are served by the consumer getting what he wants. The question is whether these market forces are sufficient to ensure a free choice for the consumer or whether government regulation is warranted. Thus far, experience with alternative mortgage instruments in the United States has been too brief and too limited geographically to tell. More time is needed. Should experience suggest that consumer choice becomes too limited, then some Government remedy, which could be a minimum percentage of fixed-rate mortgages, will be necessary.

Other safeguards for the consumer should be built into the process of offering alternative mortgage instruments.

The borrower who faces potential increases in interest costs should not also be required to bear all additional incidental costs. Specifically, we recommend that borrowers be permitted to repay the loan on any renewal date without a prepayment penalty, that the renegotiated rate reflect the reduced risk of default associated with a renewed loan (viz., reduced loan principal, increased property value, and borrower's established record of repayment), and that grounds for refusal to renew be specified so that a lender cannot seize upon a technical default, such as a single late payment.

Disclosure for Informed Decisions

Adequate disclosure on alternative mortgage instruments is extremely important. At the least, the potential borrower should be told the finance charge, annual percentage rate and monthly payments for each quarter-percent increase in the interest rate on an alternative mortgage instrument. The borrower should be supplied with the same data for a fixed-rate loan so that he or she can compare. Further, the borrower should be made aware of all terms and conditions, including prepayment penalties, liability for future closing costs, special costs of a loan renewal and other material factors.

The FDIC has not undertaken a comprehensive program of public information on adjustable rate instruments since the situation is still evolving. Such instruments are offered in relatively few States, and terms and conditions vary according to State law.

OBSERVATIONS

The regulation of VRMs and rollover mortgages poses a dilemma for regulators. Financial markets tend to work best when there is adequate disclosure to all parties and when competition is sufficient to serve as the principal determinative force on the terms of any transaction. The question is how much Federal involvement is appropriate.

VRMs and rollovers are transactions that are more complicated than traditional mortgage or other consumer loans. There are more relevant provisions and eventualities. The individual homebuyer may be dealing with one of the most important financial transactions of a lifetime. Frequently, it will be a transaction in which the homebuyer has had little or no experience. It is very important that the buyer fully understand the transaction and his or her options.

CONCLUSION

In brief, Mr. Chairman, events are forcing us into a new era of mortgage instruments. The change is dictated by economic circumstances. We are in largely unexplored territory, and we should proceed cautiously. Consumers' rights must somehow be protected. Financial institutions, especially those which are the backbone of housing finance, are seeking the tools to enable them to function in the new environment. It is a delicate balance, but one that must be maintained.