

FEDERAL RESERVE BANK
OF NEW YORK

St. Louis No. 10375-A
August 24, 1990

ADJUSTABLE RATE MORTGAGE LOANS
Accuracy of Interest Rate Adjustments

*To the Chief Executive Officers of All State Member Banks
in the Second Federal Reserve District:*

There have been recent allegations in the press concerning the accuracy of interest rate adjustments being made to adjustable rate mortgage (ARM) loans by lenders that may result in the lenders' collecting rates of interest that are not consistent with the underlying contracts. At this time, it is not possible to draw firm conclusions as to the extent or magnitude of this alleged problem; however, we wish to bring this issue to your attention.

All ARM loans are subject to Regulation Z. Section 226.20(c) of that Regulation requires that a borrower receive timely adjustment notices that contain information about interest rates, index values, the contractual effects of the adjustment, and the new payment due after an adjustment.

Adjustment errors may be caused by a number of factors, such as use of an index different from that described in the contract or of an index from the wrong date or time period, an inappropriate rounding method, or an incorrect application of adjustment caps. Errors may also result from entering loan data incorrectly into a computer at the time the loan is originated or when the interest rate is adjusted, or by selecting an incorrect interest rate or changing data incorrectly when the interest rate is adjusted. These errors may be considered breaches of contract, and may expose the bank to legal action if the bank has overcharged customers.

We recommend that your bank review its ARM system to ensure that interest rate information is correctly determined and administered, and that rates are adjusted properly. Effective internal controls and procedures should be in place to ensure that all adjustments are made in accordance with the terms of the underlying contracts and that complete, timely, and accurate adjustment notices are being provided to borrowers. In addition, we urge you to maintain documentation indicating the basis for interest rate adjustments made to your ARM loans in the event questions are raised about whether these changes have been consistent with the underlying contracts.

Questions on this matter may be directed to our Compliance Examinations Department (Tel. No. 212-720-5914).

JAMES K. HODGETTS,
Chief Compliance Examiner.