



United States
General Accounting Office
Washington, D.C. 20548

General Government Division

GO-0236

October 30, 1990

The Honorable Richard G. Lugar
United States Senate

RELEASED

Dear Senator Lugar:

On October 10, 1990 we briefed your staff on the extent to which adjustable rate mortgages (ARMs) were being incorrectly adjusted as interest rates changed. This briefing was in response to your July 5, 1990 letter that expressed concern about the proportion of ARMs that were misadjusted and the consumer costs of misadjustments. Your letter asked us to review a study by John Geddes that estimated the extent of consumer overcharges on ARMs and to determine whether consumers can obtain restitution for ARM overcharges. In addition, it asked about the effects of incorrect ARM adjustments on the Resolution Trust Corporation and the federal budget. In subsequent discussions with Steve Fischer, we were also asked to review bank regulatory agency efforts to address these concerns.

Our review of Mr. Geddes' study and our discussions with federal agencies and market participants indicate that the extent to which ARMs are misadjusted and the associated consumer overcharges were not well documented. Some industry respondents and agency officials criticized Geddes' study and suggested that it exaggerated the extent of misadjustments. Our review of the study indicated that its estimates included adjustable rate loans other than ARMs and that the data used in the study may not be representative of the nationwide situation. Due to the lack of good data on the extent of ARM misadjustments, we were unable to estimate the impact on the Resolution Trust Corporation or the more general budgetary impacts.

Federal bank regulators are currently drafting examination procedures to determine the extent of ARM misadjustments. They expect to implement a consistent set of examination procedures for all federal bank regulators.

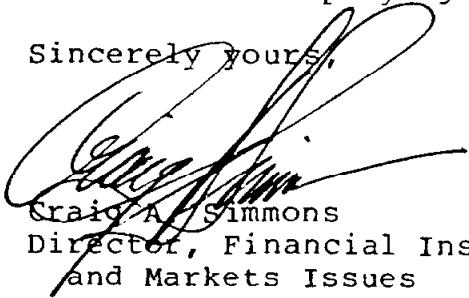
Federal regulators told us that the Truth-in-Lending Act probably does not require financial institutions to reimburse consumers if they had been overcharging borrowers. They also stated that mortgage servicers and certain other categories of mortgage holders are not necessarily federally regulated. Finally they indicated that, in some cases, restitution for overcharges might be required by them on safety and soundness

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grounds, and that more generally, restitution might be available through the state courts.

For a more extended discussion of our findings please see the enclosure accompanying this letter.

Sincerely yours,

A handwritten signature in black ink, appearing to read "Craig A. Simmons", is written over the typed name and title.

Craig A. Simmons
Director, Financial Institutions
and Markets Issues

Enclosure

ADJUSTABLE RATE MORTGAGES:
Potential Problems and
Regulatory Responses

RESEARCH APPROACH

In response to your request we asked four questions:

1. How extensively are ARMs misadjusted according to Geddes' study and is Geddes' study a reasonable estimate of the problem?
2. What causes ARM misadjustments?
3. To what extent are regulators, the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation¹, and others in the industry taking steps to ensure ARMs are correctly adjusted in the future?
4. To what extent are procedures in place to ensure that consumers and others can obtain restitution when ARMs are misadjusted, and what are the implications of restitution procedures for Resolution Trust Corporation funding or the budget?

To answer the four questions, we reviewed the Geddes study provided by Senator Lugar's staff and discussed the paper with Mr. Geddes several times. We met with the five primary regulating agencies (Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Fed), National Credit Union Administration (NCUA)). We also reviewed preliminary or draft examination guidelines developed by the regulating agencies. In addition, we met with three federally chartered corporations which have substantial involvement in the mortgage markets: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac) and Resolution Trust Corporation (RTC). We also obtained information from officials at the Department of Housing and Urban Development and the Federal Trade Commission. Last, we interviewed 18 private mortgage market participants.

¹The Federal National Mortgage Association and Federal Home Loan Mortgage Corporation are federally sponsored corporations that acquire mortgages from thrifts, mortgage bankers, and banks.

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In our analyses we were unable to estimate what proportion of ARMs were misadjusted or the aggregate costs of any misadjustments to the consumers. Agency officials told us that current information cannot be used as a basis to make such estimates. We were also unable to determine whether consumers could obtain restitution for misadjusted ARMs under current state and federal law. Cases are pending in the courts, and federal officials are still considering whether current laws can address the problems of restitutions to overcharged consumers. Last, because the extent of restitution required is unknown, we were unable to estimate the costs of restitution to the Resolution Trust Corporation or the federal budget.

GEDDES' CONCLUSIONS ARE QUESTIONED
BY MANY INDUSTRY PARTICIPANTS

In Mr. Geddes' study, he observed that numerous misadjustments existed and that the misadjustments did not consistently disadvantage either the lender or the borrower. However, he focused his estimates on the frequency of consumer overcharges and the associated costs of the overcharges.

Mr. Geddes estimated an \$8 billion cumulative borrower overcharge for ARMs and other types of adjustable rate loans due to errors in rate adjustments through the beginning of 1989.² Although this estimate may be imprecise, his basic observation that some ARM adjustment mistakes are taking place is supported by many of those interviewed. However, they generally suggested his estimate of the proportion of ARMs that are misadjusted was too large.

The Geddes paper that we were asked to review did not provide sufficient details to evaluate the analytical approaches and assumptions used to derive the estimates. Our conversations with Mr. Geddes helped us to understand the basis of his estimates by clarifying his assumptions and explaining his analytical approaches. Consequently, the following discussion of the validity of his estimates is based on both the original paper and our conversations.

His estimates are based upon an examination of 5,000 ARMs acquired by FSLIC after the failure of troubled thrifts located in the Midwest, supplemented by information pertaining to another 2,000 loans. According to Mr. Geddes, nearly 70 percent of the

²For simplicity we will use the term ARMs to include ARMs and other adjustable rate loans in the rest of this discussion.

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acquired mortgages and loans exhibited some error in the recalculation of the interest component of the monthly payment.

Through further analysis and discussion with industry professionals, Geddes approximated that 35 percent of all loans nationally had some error in their adjustments. Geddes estimated the outstanding balance of adjustable rate loans at thrifts to be \$463 billion at the beginning of 1989. To this amount he added \$300 billion representing loans originated and already paid off since 1979, when ARMs first appeared, thus estimating that about \$800 billion of loans might have been subject to incorrect adjustments. Based upon his calculations, his final estimate was \$8 billion of accumulated overcharges for the period from 1979 to the beginning of 1989. Also, Mr. Geddes estimated that a cumulative, more inclusive nationwide overcharge of \$15 billion at the start of 1989 (including both the \$8 billion above, as well as additional Truth-in-Lending violations of \$7 billion) would rise to \$65 billion at the beginning of 1996. Mr. Geddes recently suggested to us that these estimates may be only approximations of the present exposure and that the projected \$65 billion consumer cost in 1996 is probably too high, since recent publicity may make lenders more careful in the future. This would be consistent with industry comments that current efforts will lead to improved ARM servicing arrangements.

The majority of interviewees who had an opinion told us that Mr. Geddes' estimate of the error rate in adjustments was too high. However, only three analysts provided their own estimate. Two have estimated that about 20 to 25 percent of ARMs are incorrectly adjusted, and a third estimated a 31 percent error rate.

There are inherent difficulties in Mr. Geddes' nationwide extrapolation from a fairly small and possibly unrepresentative sample. His study contains ARMs held by mid-western institutions with borrowers located principally in the Midwest and Southeast. Furthermore, one interviewee commented that errors appeared to occur more frequently in the Midwest, where ARMs themselves are less common than in the West. Thus, it is difficult to determine the reliability of his nationwide estimates.

CAUSES OF MISADJUSTED ARMS

Those we interviewed suggested several reasons for ARM misadjustments. Their reasons fell into three broad categories:

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- Adjustments for monthly payments on ARMs are based on movements in an index of interest rates which can be misapplied.
- The mathematical computations for adjusting interest rates can be quite complex.
- Mortgage adjustments and payment processing is often done by a specialized computer-based processing firm. Communications problems can exist between lenders and those servicing the mortgages.

Some interviewees stated their belief that adjustment mistakes were usually accidental and not intentional. Furthermore, they suggested that these mistakes were as likely to favor the lender as they were to favor the borrower.

REGULATORS AND THE INDUSTRY ARE
INCREASING THEIR EFFORTS TO ENSURE
ARM ADJUSTMENTS ARE DONE CORRECTLY

Officials of the bank regulating agencies (Office of Thrift Supervision, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, National Credit Union Administration and the Federal Reserve Board) have considered or are implementing examination procedures to ensure that their respective regulated institutions properly service ARMs in the future.

The objectives of the regulators' draft examination guidelines are:

- determining the adequacy of the policies, procedures, and internal controls that ensure the accuracy of rate change adjustments on ARMs;
- determining that the institutions' employees are consistently applying guidelines;
- determining whether the loan servicing system is being tested by auditors or other staff; and
- determining whether the institutions' interest rate change adjustments are accurate and timely.

Based on these guidelines, the Fed, OCC and OTS may be able to determine whether the draft guidelines are sufficient to identify the scope of the ARM adjustment problem. Furthermore, a

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wide-spread use of the examination guidelines may permit the regulating agencies to estimate the proportion of ARMs that are misadjusted and the consumer overcharges at the institutions that they regulate.

Fannie Mae and Freddie Mac are major participants in mortgage markets and contract out the servicing of their ARM mortgages. Officials in these organizations told us that they carefully monitor the operations of their servicers. Their own internal accounting procedures determine the proper interest rate to be charged on each mortgage. Fannie Mae and Freddie Mac each told us that servicers rarely miscalculated changes in interest owed to them.

Fannie Mae and Freddie Mac officials told us that they require their servicers to properly administer the terms of each ARM contract and engage in responsible customer service. Nonetheless, both organizations agreed that the primary focus of their controls is on the amounts due to them from the servicer.

RTC holds the servicing rights to a large volume of ARMs which it has inherited from closed thrifts that it must resolve. RTC officials told us that they will instruct their managing agents to check for problems in monthly payment adjustments for these ARMs. In addition, RTC officials told us that their conservatorships often service ARMs for Fannie Mae, Freddie Mac or the Government National Mortgage Association -- a major holder of government guaranteed mortgages. To the extent that Fannie Mae and Freddie Mac are ensuring proper servicing of ARMs, RTC-connected ARMs are being properly serviced. Nonetheless, RTC officials told us that it is hiring servicers to determine the extent of any problem in RTC's portfolio and to ensure that its ARMs are being correctly serviced.

Some institutions that service mortgages are not directly overseen by bank regulating agencies. For example, mortgage bankers, who originated 17 percent of all adjustable rate mortgages between 1983 and 1989, are not all affiliated with a regulated bank or savings and loan. According to the Mortgage Bankers Association, a trade group, about 40 percent of the respondents to a membership survey reported that they were not affiliated with a regulated bank or savings and loan. As a result, regulatory oversight of such independent companies depends on state regulation, contract law, and the Federal Trade Commission. Thus even as federal regulatory oversight of ARM adjustments is increasing, a portion of the ARM servicing industry will not be directly affected.

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RESTITUTION PROCEDURES FOR CONSUMERS
ARE NOT NECESSARILY IN PLACE

According to the federal regulators whom we interviewed, the Truth in Lending Act probably does not require restitution by lenders (or servicers) to borrowers who have overpaid. Some federal bank regulators suggest that regulators may be able to require restitution under general provisions regarding safety and soundness. They argued that overcharging consumers could lead to lawsuits and possible adverse judgments. To prevent such outcomes they suggested that the regulators may be able to order restitution for overcharged consumers and proper servicing of ARM contracts.

According to federal bank regulators, state courts are a potential source of restitution or remedy for overcharged consumers, since mistakes could lead to breach of contract lawsuits. Nonetheless, the extent to which state courts can protect consumers from overcharges is unclear. An FDIC official said that FDIC's policy is to recommend that lenders reimburse consumers for overcharges but not attempt to collect undercharges. Despite this policy, the restitution process is unclear and cases are still pending.