

## NCUA LETTER TO CREDIT UNIONS

NCUA LETTER NO. 120

DATE: January 1991

TO THE BOARD OF DIRECTORS OF THE FEDERALLY INSURED CREDIT UNION ADDRESSED:

There is increasing public concern that financial institutions may be making errors in calculating, disclosing, and notifying borrowers of interest rate adjustments on adjustable rate mortgage loans. We wish to bring this issue to your attention, since rate adjustment errors can have an adverse impact on a federal credit union's earnings, require the adjustment of accounts that have been charged improperly, or even result in legal actions.

Adjustable rate mortgage loans (ARM) made by federal credit unions to members are subject to Regulation Z, Truth in Lending, which requires that a borrower receive timely adjustment notices that contain, among other things:

- information about interest rates;
- index values;
- the contractual effects of the adjustment; and
- the new payment due after the adjustment.

To satisfy Regulation Z requirements, information contained in the notices must agree with the underlying contractual obligation. Also, the notices must be complete and sent within the required timeframes.

Contractual adjustment errors can be caused by:

- using an index different from that described in the contract;
- an index from the wrong date or time period;
- an inaccurate rounding method;
- incorrect application of adjustment caps;
- generating an incorrect payment from an index;
- calculating the new payment based on an incorrect principal loan balance; - entering loan data incorrectly into the computer at the time the loan was originated;
- incorrectly selecting the interest rate or change date at the adjustment date; or
- using a computer system that is not equipped to handle a credit union's volume of mortgage products, indices, or adjustment formulas.

The effect of many of these errors can compound over time and can affect all adjustable rate mortgage and

consumer loans originated. These errors may be considered breaches of contract and may expose the credit union to legal action.

Each federal credit union should perform a review of its adjustable rate loan system to ensure that interest rate information is correctly ascertained 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. Also, a system for the on-going testing of adjustments should be in place to ensure that adjustments continue to be made correctly.

We are increasing the scope of our compliance examination activity in this area to provide assistance to you. If you have not performed a review of your ARM adjustment procedures recently, we strongly encourage you to have either your compliance officer, internal audit department, supervisory committee, or independent auditor conduct a review. Any review should include documentation indicating the basis for interest rate adjustments made to your ARM loans, showing whether changes have been made consistent with the underlying contracts.

If you find that you have made errors in the adjustments for interest rates which have resulted in interest overcharges on adjustable rate loans, you should have in place a system to correct the overcharges and properly credit the borrower's account for any interest overcharges.

If you have any questions concerning this letter, please contact your National Credit Union Administration regional office.

For the National Credit Union Administration Board,

Roger W. Jepsen  
Chairman