In Touch

ISSUE 5 2020

Official Publication of the Community Bankers Association of Kansas

6 KICKOFF!
A Football Fan's Guide to Portfolio Management

14 CAPITAL ASSESSMENT, CAPITAL PLANNING ARE CRITICAL AS CORONAVIRUS CREATES CHAOS

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”

JAY KENNEDY, FIRST NATIONAL BANK

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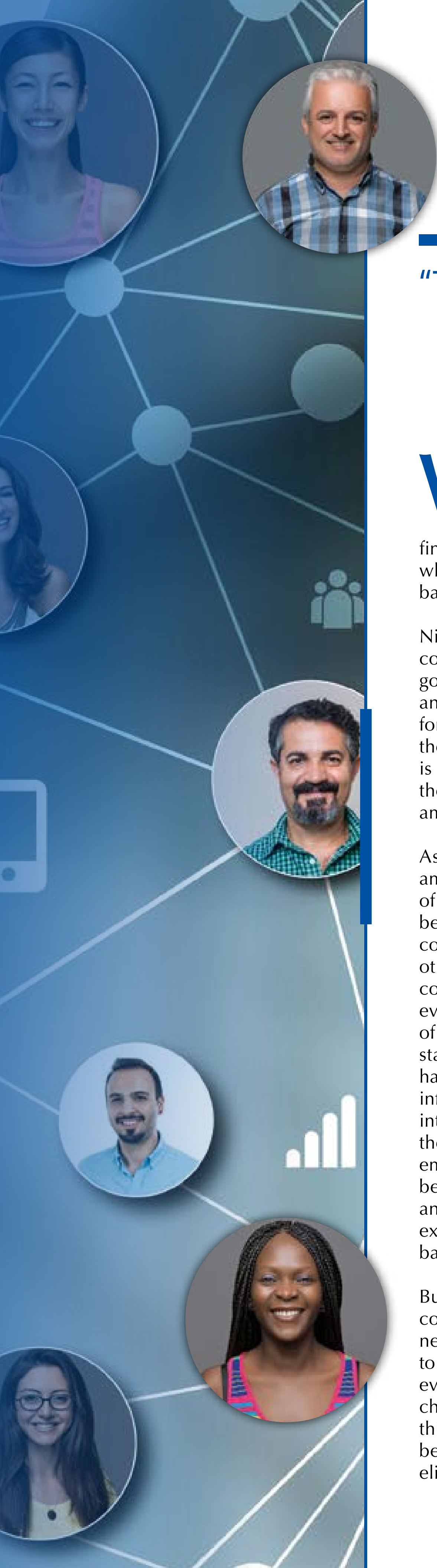
CONTENTS

Issue 5 | www.cbak.com

IN EVERY ISSUE:



FLOURISH

BY REBECA ROMERO

> "There's an undeniable sense of connection among us, and I've seen how community banks have responded."

What a different August this will be than in previous years. Yet, as much as things have changed, I find comfort in the fact that the core of what we do at ICBA and as community bankers is steadfast.

Ninety years ago, a founding group of community bankers rallied around the goals of maintaining their independence and protecting their communities. They formed ICBA to leverage the power of their collective voices. Our goal today is to continue in this vein, increasing the impact of community banks by amplifying your influence.

As we implement this mission virtually, I am continuously amazed at the strength of the community bank spirit. Despite being unable to come together in person, community bankers show up for each other and for their communities. Our community bank briefings provide evidence of this drive, with upwards of 1,500 bankers participating. ICBA staff provide overviews of the latest happenings to parse the must-know information, but it's through you, your interactions and your insights that the spirit of community banking truly emerges. In a time when it's never been more important to listen, learn and support one another, these calls exemplify the very nature of ICBA. We band together to ensure we all succeed.

But these calls aren't just for talking. We connect to access new opportunities, new ways of thinking and new solutions to support each other in this dynamic, evolving environment. Reflecting on the challenges we've faced this year, I can think of no point in history when we have been met with banking decisions that elicited such quick-turn, strategic action. Paycheck Protection Program planning, social distancing, remote working and more shook our business plans and day-to-day operational procedures and redefined how we work.

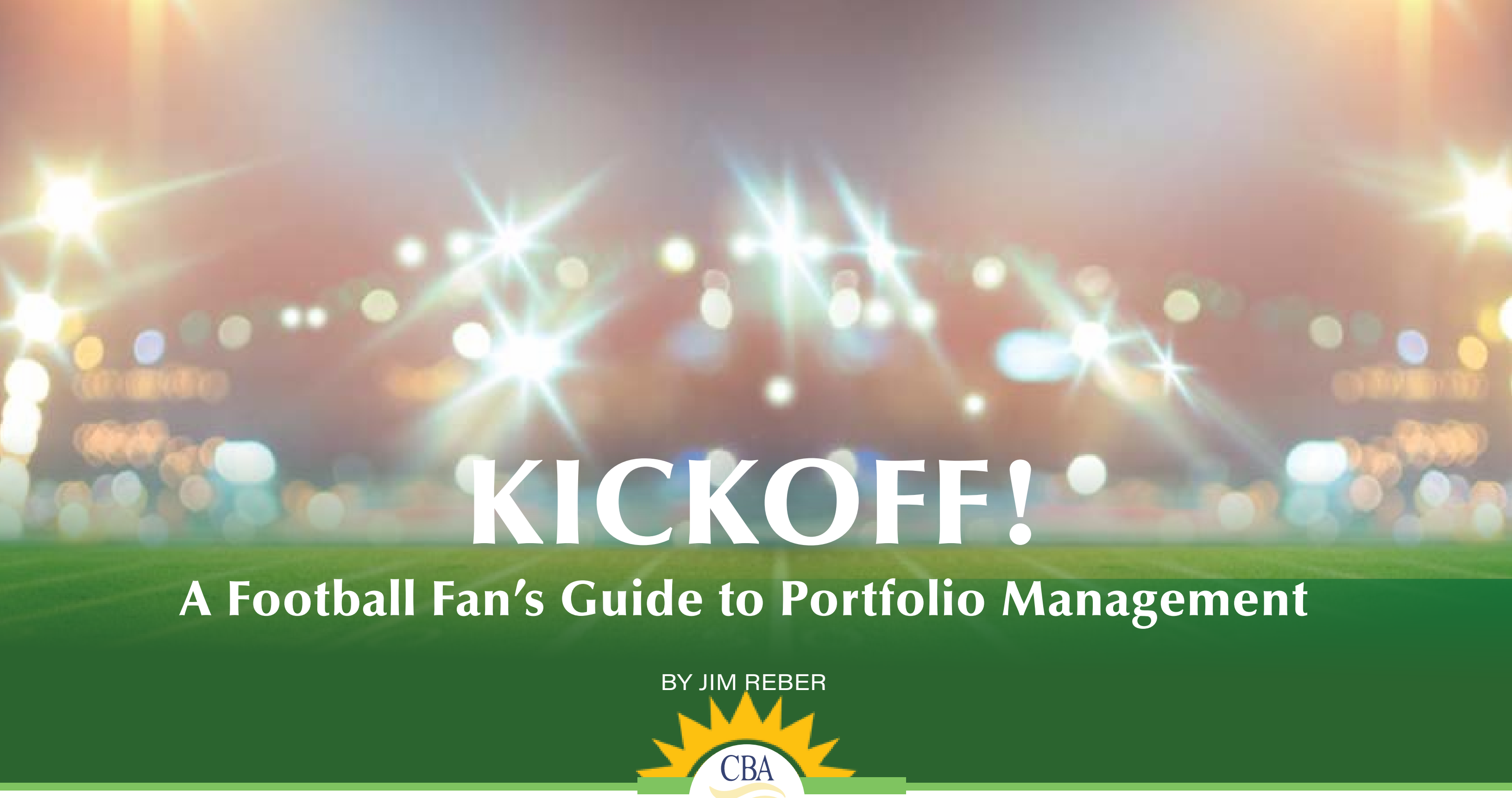
But despite this shift, our collective mission remains constant. We continue to come together to chart a path forward. That's why it's so powerful to have ICBA as a place for like-minded community bankers to convene, so we can define where we're heading as an industry.

There's an undeniable sense of connection among us, and I've seen how community banks have responded. Each of you has stepped up to an even greater extent and is moving forward with intensified purpose, and I hope you'll enjoy reading more of these stories of resilience, and of the passion behind our work, in this month's issue.

I am proud of what we, as a community of community bankers at ICBA, have been able to do. Together, we will continue to flourish for years to come.

What you need to know is this. As we consider the future, supporting the development of next-generation leaders remains a priority. That's why we've taken our LEAD FWD Summit online. We hope members of your team will join us virtually Sept. 21-22.

Connect with Rebeca @romerorainey



KICKOFF!

A Football Fan's Guide to Portfolio Management

BY JIM REBER

CBA Endorsed Partner

As the calendar turns to the fall, millions of Americans gear up for their favorite sport of football. Of course, with this being a year unlike any other, we're still trying to figure out what it will look like. Nonetheless, what better way to usher in the new football season than to relate common gridiron phraseology to its investment portfolio equivalent? Some of this may sound like a stretch for the sticks, but perhaps you can find a loose ball in the pileup. If so, hopefully, you can convert the takeaway into a visit to the sweet land of six.

Weight room

Many footballers prepare themselves for the season with frequent trips to the gym. There, they can make good use of barbells. Community bankers often utilize "barbells" to hedge their bets against rate movements. This strategy simply entails buying roughly equal amounts of very short-duration bonds and long-duration bonds. The definitions of "short" and "long" vary from buyer to buyer. In the end, the investor will be pleased with at least half of the holdings, regardless of whether rates rise or fall.

Run-pass option

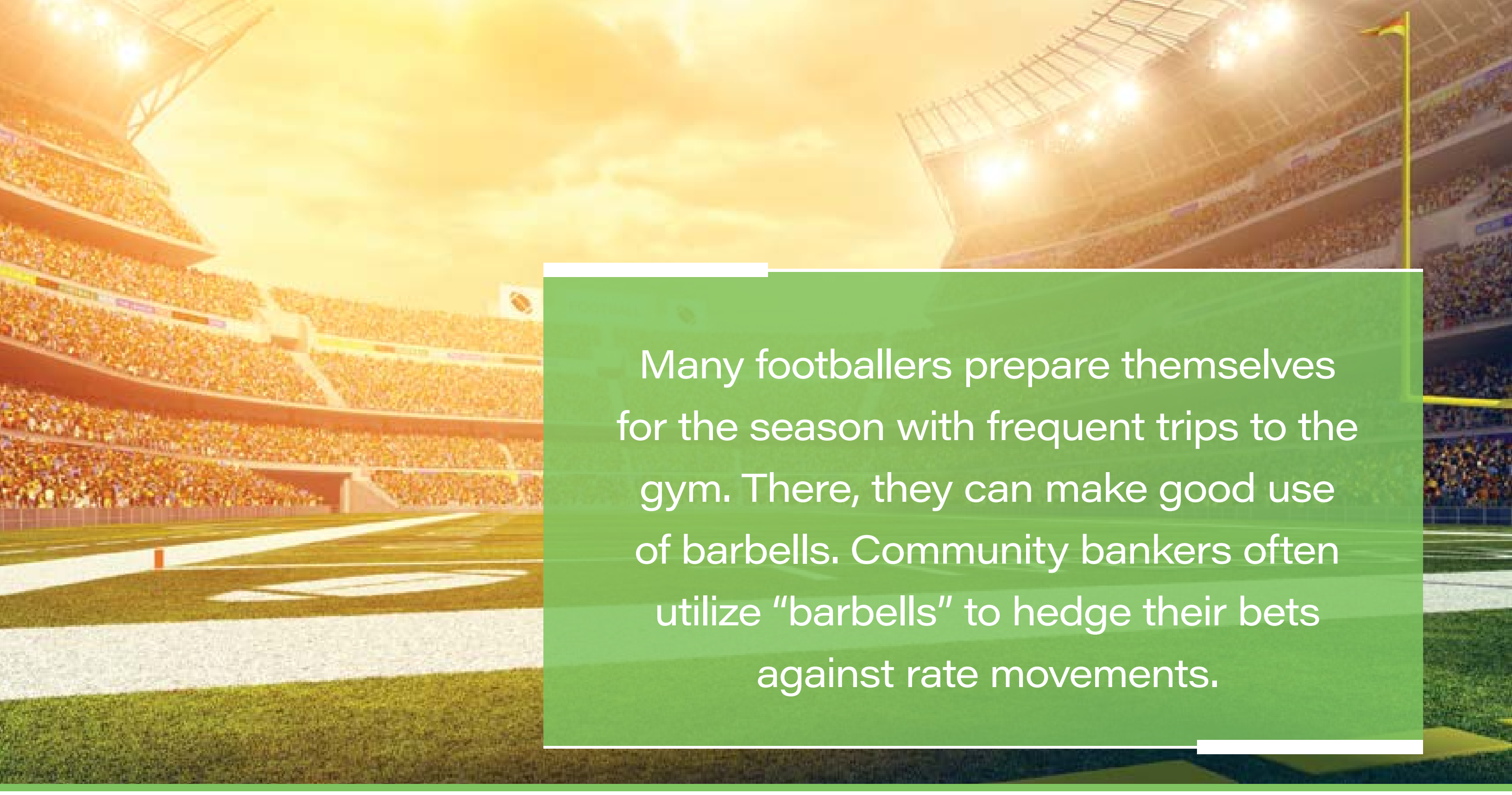
This recent innovation of play-calling gives the quarterback the ability to decide on the fly whether to run the ball or throw downfield. In a similar sense, investors can do the same with a do-it-yourself floater. Most municipal bonds in community bank portfolios have longer-than-average durations. Often, that is precisely the intention of the portfolio manager, as it may sync with the bank's interest rate risk posture. However, sometimes the manager decides the portfolio is longer than desired, in which case the DIY is called. This entails the execution of a pay-fixed interest rate swap to turn the asset into a receive-floating adjustable rate bond.

Lockdown corner

The best way to explain this is to lift the definition from Wikipedia: "These elite defenders cover an offensive receiver so effectively on either side of the field that the quarterback does not target the receiver being covered." To the community banker, this means owning assets that cannot be called away or converted to cash when interest rates are not favorable (e.g., now). The way to lock down your assets is to buy "bullets," which have no call features, or securities such as multifamily mortgage-backed securities (MBS) that have prepayment penalties or yield-maintenance provisions.

Man in motion

This term entails sending one or more offensive players running parallel to the line of scrimmage prior to the snap to better position them for the play. In investment management, its equivalent is the purchasing of newly issued bonds that have extended original settlement dates, which further coincide with upcoming maturities of bonds currently in the portfolio. This play has been especially beneficial in recent months,



> Many footballers prepare themselves for the season with frequent trips to the gym. There, they can make good use of barbells. Community bankers often utilize "barbells" to hedge their bets against rate movements.

as the amount of maturities and calls have outpaced new issuances, creating something of a scrum among investors.

Nickel back

Sometimes a team will insert a fifth defensive back into the lineup on obvious passing downs in order to give it a better chance of covering the potential pass receivers. This "nickel package" appears in balance sheet management in the form of match-funding assets and liabilities. If a community bank strategically adds assets through an acquisition or outright leverage, thought must be given to balancing the altered interest rate risk. Tools such as Vining Sparks' Performance Architect can quantify the new dynamics of the balance sheet, including the impact on capital, margins and earnings.

Fourth-quarter rally

The third quarter of the calendar year for broker-dealers is often a period of low volume. Some of it has to do with portfolio managers not taking time to identify beneficial portfolio opportunities until the figurative two-minute warning. This year especially, there are plenty of good reasons to be distracted. The bad news is that there are a lot of community bankers

who operate in a last-second mode. Late December is rarely a good time to be selling securities; it can, however, be a buyers' market. Make decisions early — 10 minutes to go in the game is still relatively early. Late fourth quarter comebacks are hard to pull off.

Go, team! ✸

Jim Reber (jreber@icbasecurities.com) is president and CEO of ICBA Securities, ICBA's institutional, fixed-income broker-dealer for community banks.

Webinar series continues

ICBA Securities and its exclusive broker-dealer, Vining Sparks, are hosting three webinars covering a range of topics in September, October and November to conclude its 2020 Community Banking Matters series. One free hour of CPE for each event is offered. To register, visit viningsparks.com or contact your Vining Sparks sales rep.

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Stockgrowers State Bank
Maple Hill

114 Years
Grant County Bank
Ulysses

114 Years
Bank of Commerce & Trust Co.
Wellington

110 Years
Union State Bank
Olsburg

36 Years
Community National Bank
Seneca

32 Years
Bankers' Bank of Kansas
Wichita

28 Years
The Trust Company
Manhattan

ANNOUNCEMENTS

First National Bank of Hutchinson is pleased to announce the addition of Jeff Fahler as executive vice president and chief operating officer. As COO, Fahler will oversee consumer banking, operations, information technology, marketing and business services while aligning all areas of the bank. "I'm excited to join such a well-respected and successful organization and look forward to working with the team to continue building on the bank's 144-year foundation," Fahler said.

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SHORT, SHARP, AND SPOTTY:

WHAT TO EXPECT FROM THE CORONAVIRUS RECESSION AND HOW COMMUNITY BANKS CAN HELP

BY NOAH YOSIF

It's official — the U.S. economy is in full-swing recession. While formal confirmation by the National Bureau of Economic Research is always appreciated, the signs were pretty obvious: social distancing grinding business activity to a near halt, skyrocketing weekly unemployment claims at both a state and national level, and, of course, market volatility erasing three years' worth of gains in a matter of weeks.

In fact, the NBER estimates this recession first started in February, making this newly reported contraction four months old.

With irrefutable evidence that the United States is in a recession, zealous market watchers are now searching for clues as to its size and scope. At ICBA, we took the liberty of crunching the numbers in search of some answers, and our conclusions point to a short, sharp, and spotty recession.

Figure 1 shows our forecast for economic growth in the near-term, indicating a V-shaped trajectory for recovery. While we expect the second-quarter GDP to contract by a record margin at 27.3%, we also anticipate a quick recovery that will enable the U.S. economy to expand once again by 2021.

These patterns are much different than what we saw in 2008, and in many recent financial crises to date, but for good reason. This recession, borne from the coronavirus pandemic, constituted an exogenous shock causing widespread financial disruption within every sector of the U.S. economy, as opposed to concentrated imbalances. As public health authorities continue to relax social distancing measures in the upcoming months, the U.S. economy is likely to rebound, with businesses and consumers once again free to operate with fewer restrictions.

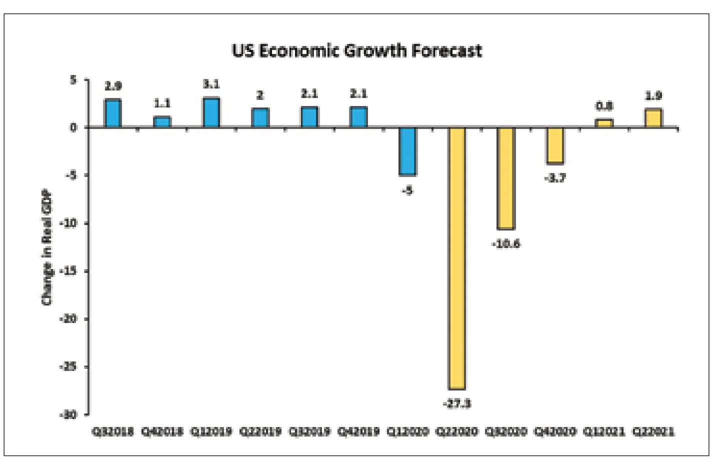


Figure 1: ICBA's U.S. Economic Growth Forecast (Source: ICBA)

The unique causal dynamics of this recession provide much credence to our calculations indicating a short recession and quick recovery, but they also hint at the probability of a more severe contraction as well. Because social distancing measures have pressured revenues via decreased business activity, employment has become the primary concern and consequence of this pandemic as companies seek to shore up additional capital.

Figure 2 demonstrates the severity of this recession as weekly unemployment claims filed within the first three months were 12 times higher than during the 2008 financial crisis. Because the coronavirus recession has caused financial disruptions in every sector of the economy, we can expect more severe declines in household income and consumer spending given its acute effect on employment.

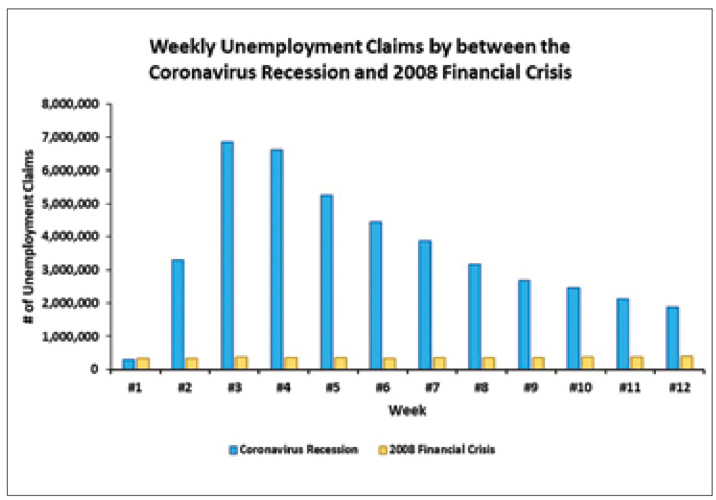


Figure 2: Weekly Unemployment Claims Between the 2008 Financial Crisis and Coronavirus Recession (Source: U.S. Department of Labor)

The expected extent of this pain is still ambiguous, in keeping with this year's theme of economic uncertainty, but will be unevenly distributed among localities, inducing a spotty recovery that varies between states and counties in timing, speed, and effect. Two factors that will have an outsized influence on their recovery will be the ongoing public health threat posed by the coronavirus and localities' financial position prior to the recession. Counties and states that had a healthy circulation of income between consumers and businesses prior to the recession will be well-positioned to weather a protracted crisis and recover at a quicker pace.

Figure 3 examines the average monthly income deficit by state, calculated as the average monthly wages lost from rising unemployment offset by state and federal unemployment benefits in April. Despite robust protections for unemployed workers, 28 states experienced an income deficit, while extended unemployment provisions implemented by the CARES Act, which are set to expire by the end of next month, provided a vital lifeline to 34 states by enabling them to recoup more than 50% of the difference. Because each state is in a unique position concerning mitigation of the coronavirus pandemic and consequent economic injury, there will not be a synchronized national recovery, and certain states will need additional assistance to fully heal.

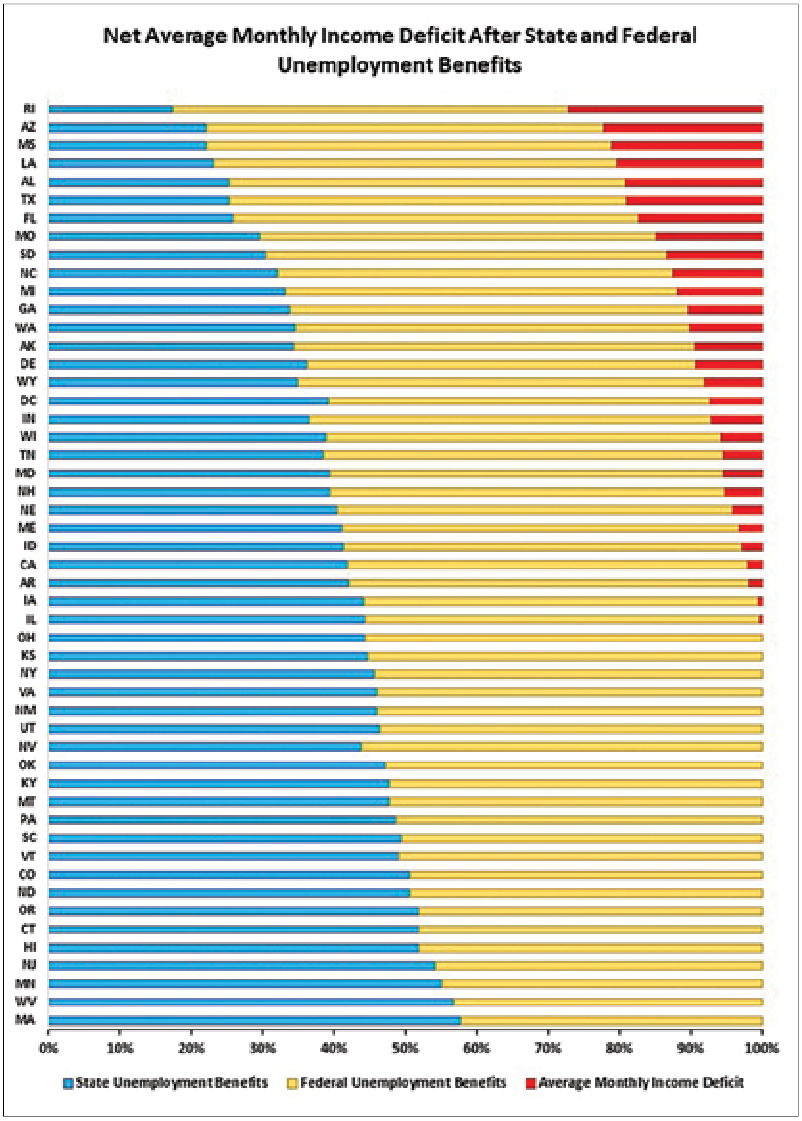


Figure 3: Net Average Monthly Income Deficit After State and Federal Unemployment Benefits (source: U.S. Bureau of Labor Statistics & U.S. Department of Labor)

While the current economic landscape may appear bleak at first sight, the data presents a strong case for cautious optimism as we press forward in these uncertain times in hopes of a brighter tomorrow.

As the coronavirus recession reaches its four-month mark, we continue to receive more data that provides greater clarity to the good, bad, and ugly of this contraction. On one hand, this recession will likely be much shorter than its predecessors given its origins as an exogenous, non-economic shock. But the financial pain inflicted on consumers and businesses will also set new records in severity, while the path to economic recovery is akin to geographic roulette, making for a disjointed and spotty return to normalcy. Many unknowns remain concerning the United States' eventual road to recovery, most of which depend on the ability of public health authorities to contain this outbreak via testing at a meaningful level until the development and distribution of a vaccine. In the meantime, we know that community banks continue to be a vital component to the recovery equation.

Community banks were the most prevalent conduit for small businesses seeking lifelines in operating capital via the Paycheck Protection Program, issuing nearly two-thirds of PPP funds, which were critical for mitigating further increases in unemployment and supplying households with much-needed income to weather declines in liquidity due to decreased business activity.

continued on page 12

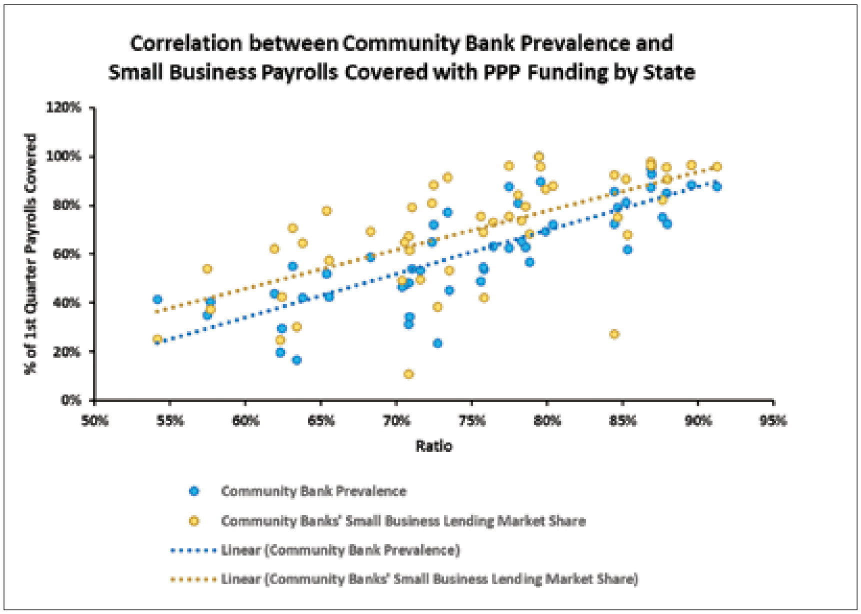


Figure 4: 1st Quarter Payroll Coverage via PPP Loans by State (source: United States Small Business Administration / Federal Deposit Insurance Corporation)

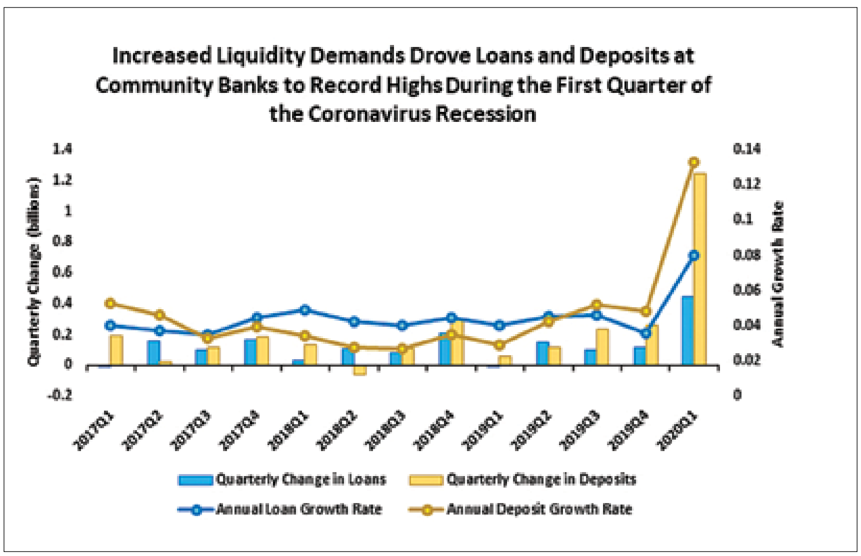


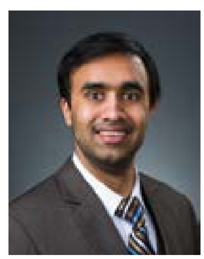
Figure 5: Loan and Deposit Balances at Community Banks (source: United States Federal Deposit Insurance Corporation)

continued from page 11

As **Figure 4** shows, states with a higher share of community banks received more PPP funding during the early stages of the current recession, with the top 10 states able to cover 20% more of their payrolls than the bottom 10 states. In addition, by performing their most basic functions, from accepting deposits to providing loans, community banks have been vital pillars of support to Main Street by facilitating a healthy circulation of capital to keep local economies in operation while social distancing measures have gone into effect. As shown in **Figure 5**, community banks posted major gains in deposits and loans during the first three months of this recession.

Upon closer examination of the data, it is clear that this current recession poses both significant economic threats and concurrent opportunities, from which to make the most of an inevitable economic phenomenon and to rebound on stronger footing and shoulder another decade's worth of expansion. In particular, the dynamics of this recession present major opportunities for community banks to facilitate a speedy recovery and mitigate its potential severity while serving as an important resource for localities at different stages of the healing process.

While the current economic landscape may appear bleak at first sight, the data presents a strong case for cautious optimism as we press forward in these uncertain times in hopes of a brighter tomorrow. ✷



Noah Yosif is ICBA assistant vice president of economic policy and research.

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CAPITAL ASSESSMENT, CAPITAL PLANNING ARE CRITICAL AS CORONAVIRUS CREATES CHAOS

BY MARY ELLEN BIERY, ABRIGO

CBA Associate Member

Stress testing and capital planning are important for financial institutions in good times. They are even more important in volatile times like these when the coronavirus and pressures on the energy sector result in a financial crisis.

Banks need to have an idea of what a recession might do to their allowance levels and capital ratios, and how those impacts could affect plans for dividends or other distributions. However, one challenge for financial institutions in 2020 is that the economy in recent years has been so strong that institutions' processes for capital analysis haven't faced a lot of pressure or scrutiny, according to Neekis Hammond, managing director of Advisory Services at Abrigo.

"There's been virtually no realized credit risk or seemingly realizable credit risk to a financial institution. This has resulted in theoretical assumptions for capital planning. Now, the stressed inputs are very real and very realizable," he said. Each year, the largest institutions must produce capital analysis and stress testing results for the Federal Reserve to show how they will fare during specific, simulated times of economic and financial stress, and to evaluate their capital adequacy assessment processes. Meanwhile, recognizing that other financial institutions are vital to their own communities, regulators also have a long history of requiring various stress tests on individual risk areas of other institutions. Institutions may regularly perform stress testing for strategic planning and managing capital ratios — the key performance indicators for a financial institution's safety and soundness.

"Now, the question for a financial institution is, what are reasonable default and loss estimates for a prolonged economic impact due to the global pandemic?" Hammond said. "Many institutions would have a difficult time supporting economic-based stress testing assumptions on their own due to capacity or confidence constraints. Obviously, there's a lot of uncertainty about how the economy will recover and how that might impact their dividend limits or even how to reflect that in models. We're not claiming to know what will happen; rather, we support sensitivity to changing conditions and produce multiple scenarios. The goal is to provide internal and external parties with a range of expectations. From there, they can have contingency plans."

Inspiring confidence through capital planning

In addition, Hammond noted, financial institutions already dealing with challenges associated with virtual staffing and the deluge of work associated with the Paycheck Protection Program must find the resources to manage heightened risk and incorporate uncertainty into risk models and budgeting.

"Every regulator is going to have elevated interest in credit risk in a

prolonged downturn," Hammond said. "Credit risk and the resulting impact is going to be a focus in every safety and soundness exam, and if you want to inspire confidence, your financial institution will already have conducted stressed capital planning."

Financial institutions need to determine whether updated scenarios may affect capital ratios so that management and the board can have assurances they will remain within "well-capitalized" levels, within management targets, or within targets tied to future strategic planning. These ratios also affect the institution's CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity, Sensitivity to market risk) rating, which can have multiple impacts on an institution and its plans.

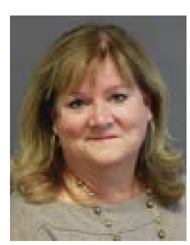
Because of the limited capacity to develop new assumptions and conduct stressed capital assessments while handling day-to-day operations, many financial institutions are turning to external advisors for assistance. "There are most certainly resource and staffing constraints," Hammond said. "Right now, it's like everyone's anthill has been stepped on. Everyone's managing the relationship, modifications and covenants, and they don't have time to generate a legitimate capital plan and stress test under multiple scenarios."

One model is key to accurate capital, allowance forecasts

When seeking assistance outside the financial institution, Hammond said, bank and credit union executives should consider utilizing the same advisor for any stress testing or credit-focused capital planning as they use for allowance of loan and lease losses to avoid producing irrational allowance estimates.

"Using the same model to produce estimates for your allowance and to produce results for stress tests is the best way to make sure your projections are meaningful," he said.

The alignment of critical assumptions and inputs is fundamental to developing accurate forecasts. Hammond said financial institutions working with an experienced advisor would be able to meet their needs for assessing capital this year while acquiring the tools to handle capital analysis and stress testing on their own in the future — even, as Hammond put it, "during stepped-on-anthill times." ✸



Mary Ellen Biery, Senior Writer and Content Specialist, at Abrigo. Abrigo is a leading technology provider of compliance, credit risk, lending, and asset/ liability management solutions that community financial institutions use to manage risk and drive growth. Visit abrigo.com/ intouch to learn more.

Retirement Plan Rollovers:

What Are My Clients' Options?

BY JODIE NORQUIST

The novel coronavirus pandemic has disrupted many aspects of our lives this year, with unprecedented business downturns or closings. Your clients may have found themselves suddenly unemployed as a result of COVID-19. Some may be fortunate enough to find new employment, while others remain without work. In either situation, these clients will likely have access to retirement plan assets, and they may be contemplating what they should do with them.

This can be a tough decision to make. It's important that your clients carefully consider all of their options before moving retirement plan assets anywhere. Under federal law, employers typically cannot force former employees to withdraw their retirement savings if their vested balance is more than $5,000, so some participants may choose to leave retirement assets in the former employer's plan. In this case, their retirement savings should remain safe, even if their previous company closes, and the retirement plan is terminated. Under these circumstances, the plan assets that are owed to them will be paid to them, in most cases, within one year.

Are They Eligible to Move Their Money?

As a courtesy to your clients, help them to determine whether they're eligible to move money out of their retirement plan. They must have a "triggering event" that allows them to withdraw their retirement plan assets. The most common events occur when an individual retires or terminates employment with the employer who sponsors the retirement plan. Encourage your clients to check with their plan administrator or to review their summary plan description to make sure that they meet one of the plans' triggering events.

Where Should Their Assets Go?

If your clients have access to their plan assets, simply "cashing out" may result in substantial taxes and penalties. Advise them to seek competent tax advice before taking a full distribution from their retirement plan. Rolling over retirement plan assets to an IRA or another retirement plan may offer benefits and may help preserve the growth of their tax-deferred investments. But making a sound decision — whether to roll over assets or to leave them where they are — involves many factors, so be careful not to make a recommendation to a client that could be considered investment advice.

Benefits of a Retirement Plan-to-Traditional IRA Rollover

If your clients decide to roll over their retirement plan assets into a Traditional IRA with your financial organization, reassure them that the assets will remain tax-deferred until they withdraw them. There might be other benefits, too.

- They may roll over their pretax assets into another retirement plan offered by a future employer.
- They can invest their IRA assets and continue to grow their tax-deferred earnings.
- As their IRA administrator, your financial organization may offer a higher level of service and more investment options that appeal to them.
- They can access their IRA assets at any time and possibly take penalty-free distributions, such as for disaster relief or first-time homebuyer expenses.

Benefits of a Retirement Plan-to-Retirement Plan Rollover

If your clients are changing employers, advise them to check with their new employer's plan administrator to make sure that their new company's retirement plan accepts rollovers from other plans. Some plans do not. If they decide to roll over retirement plan assets to their new employer's retirement plan, these assets will also remain tax-deferred until they withdraw them, as with an IRA. Your clients might consider other factors, as well.

- Rolling over their existing retirement plan assets into their new employer's plan can make it easier for them to track and manage their investments. Everything is under the same savings umbrella.
- Retirement plans may offer lower fees on investments and other transactions when compared with IRAs.
- Keeping assets in an employer-sponsored retirement plan may give more protection from their creditors.

How to Move Retirement Plan Assets

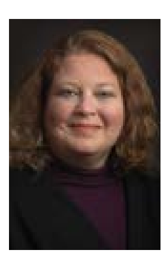
Your clients can move their assets through either a direct rollover or an indirect rollover.

With a direct rollover, the plan administrator will send a check or electronic payment "for the benefit of" your client but in the name of your financial organization or the new retirement plan. Normally, if a client must take a required minimum distribution (RMD) from the plan, the plan administrator will distribute the RMD to the client, and the rest of the eligible assets will be sent in the rollover.

NOTE: All RMDs due in 2020 are waived. If your clients withdrew a waived RMD in 2020, they have until the later of August 31, 2020, or 60 days after the distribution to roll over that amount. Future guidance may further extend this deadline.

With an indirect rollover, the plan administrator will distribute plan assets directly to your client, withholding 20% of pretax assets as a prepayment of federal income tax. A rollover to a new IRA or plan must happen within 60 days following the receipt of the asset, or taxation (and possibly penalties) may apply to the distribution.

Remind your clients that this is their money. The rollover decision is important, with many factors to consider. But people move their retirement assets all the time, and it's a relatively simple process. Your clients should carefully review the fees and investment options associated with each rollover option. And encourage them to talk with someone they trust — someone who has their best interests in mind.



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HANDLE ARM ADJUSTMENTS WITH CARE

BY WILLIAM J. SHOWALTER, CRCM, CRP
SENIOR CONSULTANT; YOUNG & ASSOCIATES, INC.; KENT, OHIO

Adjustable-rate mortgages (ARMs) have not been much of an issue for many banks and thrifts in recent years since fixed rates have been so low. But they are still an important tool for serving those customers who cannot meet the secondary market qualifications applied to most fixed-rate loans. Also, many institutions have a portfolio of existing ARM loans that they service. One potential complication for some lenders is the impending discontinuance of the LIBOR index, requiring them to find another comparable index for their ARMs.

ARMs were in the spotlight over 10 years ago because of problems in the subprime market. Many subprime products have variable interest rates, which shift the interest rate risk from lender to borrower. Besides the issues raised then over putting borrowers into inappropriate products, there also are concerns over errors in ARM rate changes.

Do an internet search for "ARM errors" or similar terms, and you will come up with numerous firms offering loan audit and information services to borrowers. These firms tell borrowers that their companies can correct ARM errors, bring loans into compliance and get the borrower a mortgage refund.

Background

The initial furor over these mistakes arose over a report on ARM adjustment errors prepared by a former Federal Savings and Loan Insurance Corporation employee in 1989. His assertions sent a tremor through the mortgage industry. The report concluded that miscalculations in periodic adjustments to rates on ARM instruments resulted in significant overcharges. He found ARM adjustment errors in about 50% of the loans he sampled. From these results, he estimated the potential overcharges to be up to $15 billion for ARMs nationwide at the time. This figure has been estimated as high as $50-60 billion in recent years.

The controversy was further stoked by a study from the Government Accountability Office (GAO), released in September 1991, which found between 20-25% of the ARM loans at the time contained interest rate errors. Such errors occurred when the related mortgage servicer selected the incorrect index date, used an incorrect margin or ignored interest rate change caps.

The damaging studies kept coming. In July 1994, Consumer Loan Advocates, a non-profit mortgage auditing firm, announced that as many as 18% of ARMs have errors costing the borrower more than $5,000 in interest overcharges. Also, another government study in December 1995 concluded that 50-60% of all ARMs contain an error regarding the variable interest rate charged to the homeowner. The study estimated the total amount of interest overcharged to borrowers was in excess of $8 billion. Inadequate computer programs, incorrect completion of documents, and calculation errors were cited as the major causes of interest rate overcharges.

Even though no other government studies have been conducted into ARM interest overcharges to date, the potential issue continues to simmer below the surface, and lenders need to be vigilant so that it does not erupt into a veritable supervolcano of enforcement actions and lawsuits.

Types of errors

The kinds of errors lenders are said to make in implementing ARM rate and payment adjustments run the gamut from calculation mistakes to carelessness, including:

- Mistakes in the original loan setup/data input
- Miscalculation of the payment amount
- Improper allocation of payments between interest and principal (amortization)
- Use of the wrong index
- Selection of an incorrect index value
- Application of incorrect interest rate caps
- Failure to adjust in some years
- Use of incorrect margins
- Improper rounding methods (e.g., rounding up instead of rounding to the nearest 1/8th of 1 percent)
- Math mistakes causing an incorrect rate
- Use of an incorrect loan balance

Banking regulators point out that these errors may be considered breaches of contract and could expose the financial institution to legal action.

Extent of errors

Since ARMs involve changing index values periodically and complex computer calculations, they seem to attract human and software errors. Mortgage audit firms point out that leading publications such as The Wall Street Journal, MONEY, Forbes and Newsweek have warned borrowers about miscalculations occurring in up to 50% of ARMs.

Adjustable-rate mortgages (ARMs) have not been much of an issue for many banks and thrifts in recent years since fixed rates have been so low. But they are still an important tool for serving those customers who cannot meet the secondary market qualifications applied to most fixed-rate loans.

The firms get borrowers' attention by pointing to figures of lender overcharges and borrower refunds like these:

- Average borrower refunds of over $1,500
- 21% of refunds ranging from $3,500 to $10,000
- 13% of errors exceeding $10,000

Reasons for errors

The calculation of ARM rate changes is a complex process, and errors can occur in a variety of ways. Add to this the fact that many lenders offer, and servicers support, a variety of ARM products with different rate adjustment intervals, indices, margins, and other terms. Another potential complicating factor is the widespread practice of transferring loan servicing, presenting another opportunity for human mistakes and software mismatches to cause errors. In addition, some of the mortgage audit firms assert that ARM rate and payment adjustment errors have been linked to:

- Lack of training, supervision and experience of loan servicing personnel
- Simple human error
- Computer data entry or software errors
- Clerical or calculation errors
- Fraud
- Sale or transfer of the loan to a different company
- Riders, handwritten changes, or other irregularities in the note
- Very complex calculations or use of an unusual index or interest rate
- Dissolution or merger of the original loan institution

How to avoid these problems

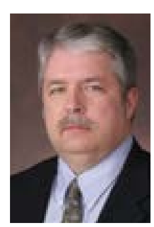
The federal banking supervisors began encouraging financial institutions back in 1991 to perform reviews of their adjustable rate loan systems to ensure that interest rate information is correctly ascertained and administered, and that rates are adjusted properly.

Banks and thrifts should have effective internal controls and procedures in place to ensure that all adjustments are made according to the terms of the underlying contracts and that complete, timely, and accurate adjustment notices are provided to borrowers. Also, a system for the ongoing testing of adjustments should be in place to ensure that adjustments continue to be made correctly.

A critical component of any successful loan servicing program, including correctly implementing rate and payment adjustments, is a thorough training regime for lending personnel involved in the process. Those involved must be given the appropriate tools — including knowledge — to succeed in their jobs.

Any review of ARM adjustments should include documentation indicating the basis for interest rate adjustments made to a lender's ARM loans, showing whether changes have been made that are consistent with the underlying contracts.

If a lender finds that it has made errors in the adjustments for interest rates, which have resulted in interest overcharges on ARMs, the supervisory agencies expect that you will have in place a system to correct the overcharges and properly credit the borrower's account for any interest overcharges. In general, undercharges cannot be collected from borrowers.



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