Loan Guaranty: Revisions to VA-Guaranteed or Insured Interest Rate Reduction Refinancing Loans

Comments

to the

Department of Veterans Affairs

regarding

38 CFR Part 36

[Docket No. 2900-AR58]

87 Fed. Reg. 65,700 (Nov. 1, 2022)

by the

National Consumer Law Center
on behalf of its low-income clients

and the
Center for Responsible Lending

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1. Introduction

The National Consumer Law Center (NCLC) submits the following comments, on behalf of its low-income clients, along with the Center for Responsible Lending (CRL). We thank the Department of Veterans Affairs (VA) for the opportunity to comment on this proposal.

These comments address the proposed rule published on November 1, 2022.[1] VA previously issued an interim final rule to implement a new anti-churning statute Congress passed in 2018,[2] but VA deferred addressing the law's impact on Interest Rate Reduction Refinancing Loans (IRRRLs) to a later rulemaking.[3] VA now proposes updating the existing IRRRL regulation to reflect current statutory requirements.[4] The most important aspects of the proposed rule address the statute's recoupment requirement, the net tangible benefit test, and the seasoning requirement.

While we generally agree with the proposed changes, we recommend a related change to the Lender's Handbook to prevent abuse related to escrow accounts. In response to VA's question regarding the definition of "monthly payment" used for the seasoning rule, we recommend removing repayment-plan payments from the definition. We are also concerned by several other aspects of the rule that VA believes are required by statute.[5] Because VA does not believe it has authority to alter these provisions, we instead recommend studying them and collecting data to determine whether new legislation is required to prevent abusive practices.

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[1] 87 Fed. Reg. 65700 (Nov. 1, 2022).
[2] Pub.L. 115-174 (May 24, 2018), 132 Stat. 1296, codified at 38 U.S.C. § 3709.
[3] 83 Fed. Reg. 64459, 64460 (Dec. 17, 2018) ("VA is not addressing section 3709's impact on IRRRLs, but plans to do so in a separate rulemaking.").
[4] 87 Fed. Reg. at 65700.
[5] *See, e.g.*, 87 Fed. Reg. at 65703-704.

2. The rule is needed to prevent abusive IRRRLs.

The proposed rule limits when VA may guarantee or insure IRRRLs.[6] These loans are a form of streamlined refinancing that lets veterans refinance existing VA loans into new ones with lower interest rates. The regulations allowing lenders to make IRRRLs were first adopted in 1981[7] after Congress authorized the program the preceding year.[8] As implemented by VA, an IRRRL does not require an appraisal or credit underwriting.[9] In accordance with the VA loan program's goal of providing safe housing for veterans, "[t]he purpose of an IRRRL is to improve a veteran's financial position . . . ."[10]

In 2016 the Consumer Financial Protection Bureau released a report citing numerous complaints from veterans regarding aggressive and sometimes misleading attempts to convince them to refinance their VA mortgages[11] that were indicative of an abusive practice known as "churning." Loan churning is the repeated or serial refinancing of a borrower's mortgage for the benefit of the loan originator (such as a broker or lender) and with little to no benefit for the borrower.

Churning hurts borrowers because each time the borrower refinances, the borrower incurs new closing costs. Whether they are paid in cash or financed, those costs will be an unnecessary expense unless there is a clear benefit to the borrower from the transaction. Churning reduces the borrower's wealth through a transfer of cash or equity to the loan originator and others involved in the transaction without any offsetting improvement to the veteran's financial position, thereby undermining the purpose of the IRRRL.

Moreover, churning also hurts future borrowers who finance their home purchase using a government-backed loan. VA-guaranteed loans are typically pooled and securitized into Ginnie Mae mortgage-backed securities (MBS). The resulting MBS are then sold to investors.

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[6] 38 C.F.R. § 36.4307.
[7] *See* 46 Fed. Reg. 43667 (Aug. 31, 1981).
[8] *See* Pub.L. 96-385 (Oct. 7, 1980), 94 Stat. 1528.
[9] VA Lender's Handbook, VA Pamphlet 26-7, page 6-2 ("Generally, no appraisal, credit information or underwriting is required on an IRRRL, and any lender may close an IRRRL automatically.").
[10] 87 Fed. Reg. at 65700.
[11] Consumer Financial Protection Bureau, A snapshot of servicemember complaints: A review of issues related to VA mortgage refinancing (Nov. 2016), available at https://files.consumerfinance.gov/f/documents/112016_cfpb_OSA_VA_refinance_snapshot.pdf. *See also* Letter from Sen. Elizabeth Warren to Michael Bright (Acting Pres. and Chief Operating Officer of Ginnie Mae) (Sept. 6, 2017) (inquiring about churning and citing CFPB report).

Most mortgage loans in the United States can be prepaid by the borrower at any time. Prepayments increase when interest rates fall, as borrowers are able to refinance into a new mortgage with a lower interest rate. When loans with an above-market interest rate are prepaid, MBS investors lose the associated above-market interest income and must reinvest the proceeds at the current, lower interest rate. As a result, investors take the expected prepayment rate into account when they decide what to pay for Ginnie Mae MBS.

Churning causes the prepayment rate on VA-guaranteed loans to increase relative to investor expectations, which reduces investor demand for Ginnie Mae MBS and drives down the value of the securities. As MBS prices fall, the mortgage rate rises, and consequently new borrowers entering VA-guaranteed loans will pay a higher interest rate.[12]

Around the same time as the CFPB report, Ginnie Mae began to investigate unusually fast prepayments in its securities and created a joint "Lender Abuse Task Force" with VA to address the churning problem.[13] These efforts and their findings culminated in 2018 with the passage of section 309 ("Protecting Veterans from Predatory Lending") of the Economic Growth, Regulatory Relief, and Consumer Protection Act, which imposed new requirements on VA-backed refinancing loans.[14] VA issued interim final rules to implement the new requirements, effective February 2019.[15] Congress made some corrections to the Act following year.[16]

3. The definition of "monthly payment" should not include amounts owed as part of a repayment plan.

Under the proposed rule, the term "monthly payment," as used for the seasoning requirement, is defined as "the full monthly dollar amount owed under the note plus any additional monthly amounts agreed to between the veteran and the holder of the loan being refinanced, such as payments for taxes, hazard insurance, fees and charges related to late payments, and amounts owed as part

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[12] *See* Karen Jowers, Army Times, Experts: VA loan 'churning' can hurt vets … and the mortgage market (Jan. 10, 2018), available at https://www.armytimes.com/pay-benefits/2018/01/10/experts-va-loan-churning-can-hurt-vets-and-the-mortgage-market/.

[13] *See* Letter from Michael Bright to Sen. Elizabeth Warren (Sept. 14, 2017) (responding to Sen. Warren's inquiry about CFPB report and complaints), available at https://www.warren.senate.gov/files/documents/2017_09_14_Ginnie_Mae_Response.pdf.

[14] Pub.L. 115-174 (May 24, 2018), 132 Stat. 1296, codified at 38 U.S.C. § 3709.

[15] 83 Fed. Reg. 64459 (Dec. 17, 2018).

[16] Protecting Affordable Mortgages for Veterans Act of 2019, Pub.L. 116-33, § 2, 133 Stat. 1038 (July 25, 2019).

of a repayment plan."[17] Under the seasoning requirement, a loan may only be guaranteed if the borrower has made at least six consecutive monthly payments on the loan that is being refinanced.[18] VA asks for feedback on the impact of including repayment plan amounts in the definition of "monthly payment."[19]

We believe including repayment plan amounts in the monthly payment definition will be harmful to veterans because it will limit their options for resolving a delinquency. VA believes, as we do, that IRRRLs can be useful as a home retention option.[20] But if repayment plan amounts are included in the definition of "monthly payment," as proposed, veterans who can afford the regular monthly payment of principal, interest, taxes, and insurance, but not the repayment portion will be ineligible for an IRRRL. While some will be eligible for a loan modification, those who are not will face foreclosure.

Alternatively, if repayment plan amounts are excluded from the "monthly payment" definition, a veteran who is delinquent on a repayment plan but is still able to make the regular monthly payment will still be able to use an IRRRL to make their payments more affordable and, thereby, save the home.

For this reason, amounts owed as part of a repayment plan should not be included in the "monthly payment" definition for loan seasoning.

4. VA should ensure that IRRRLs are not pushed on distressed borrowers when a loss mitigation option would be better.

The proposed rule will allow loans to be refinanced into IRRRLs even when they are in default, so long as they have previously met the 6-month payment seasoning requirement.[21] After this and all other requirements have been met, the loan will remain eligible even if the borrower subsequently defaults. This will enable lenders to use "an IRRRL as a de facto home retention option."[22] We support this concept but urge VA to adopt an additional requirement to protect veterans: If a borrower is in default, the borrower must be evaluated for a loss mitigation option before proceeding with an IRRRL.

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[17] Proposed 38 C.F.R. 36.4307(a)(9)(i)(A).
[18] *Id.*
[19] 87 Fed. Reg. at 65706.
[20] *See id.*
[21] 87 Fed. Reg. at 65706 ("VA believes that, rather than barring such veterans from receiving an IRRRL, the text of section 3709(c) allows for the requisite six consecutive monthly payments to be made at any point during the repayment term of the loan being refinanced. Regardless of whether a loan is in default, if the loan was seasoned before the default, the loan can satisfy the first element of the seasoning standard.").
[22] 87 Fed. Reg. at 65706.

A loss mitigation option such as a loan modification may be less expensive for the borrower and create a lower monthly payment than an IRRRL. An IRRRL may include thousands of dollars of closing costs. In contrast, VA's loss mitigation options carry very limited, if any, costs for the borrower. Furthermore, the interest rate on an IRRRL is determined by the lender, whereas the interest rate on a loan modification is capped at a level determined by VA. Therefore, a modification may result in a lower monthly payment than an IRRRL.

During the foreclosure crisis a decade ago, many distressed borrowers tried to refinance their way out of unaffordable loans prior to default, only to quickly find themselves back in foreclosure—with a bigger loan. For a distressed borrower facing a long-term hardship, refinancing may be a matter of "kicking the can down the road" rather than a permanent solution that creates an affordable payment. For this reason, VA should not permit lenders to process IRRRL applications from defaulting borrowers without first determining whether a loss mitigation option would be a better solution for the borrower.

A defaulting borrower who applies for an IRRRL should be required to provide the potential lender with documentation from the current loan servicer showing the results of an evaluation for loss mitigation. If the request for loss mitigation has been denied or would create a monthly payment greater than the payment achievable with an IRRRL, the lender should be allowed to approve the IRRRL application despite the borrower being in default. Otherwise, the IRRRL application should be paused, and the borrower should be encouraged to pursue a loss mitigation option by working with the incumbent servicer.

5. VA should update the Lender's Handbook to prevent lenders from using escrow account balance refunds to evade the prohibition on receiving cash out in IRRRLs.

Currently the VA Lender's Handbook (VA Pamphlet 26-7) says "In a limited number of situations, the borrower may receive cash at closing." One of the examples is a "refund of the escrow balance on the old loan. This often occurs when a party other than the present holder originates the loan."[23]

The Handbook encourages lenders to consult VA about the acceptability of a borrower receiving more than $500 cash at an IRRRL closing.[24] This shows that VA is aware that larger amounts may be contrary to the program limitations and, instead, be a "back-door" equity withdrawal.

[23] VA Lender's Handbook at page 6-5.

[24] *Id.*

An escrow balance refund may be thousands of dollars. We are concerned that disreputable loan originators may use this loophole to make a cash-out refinancing using an IRRRL without the proper underwriting requirements.[25]

We therefore encourage VA to eliminate this example and require that any refund of an escrow balance be used to fund the escrow account on the new loan. If that is not feasible, the refund should be applied to reduce the principal balance of the old loan.

6. Some aspects of the rule raise concerns and should be monitored.

6.1 VA should ask Congress to add the VA funding fee to the recoupment test.

Proposed paragraph 38 C.F.R. § 36.4307(a)(8) will exclude the VA funding fee from the numerator of the recoupment test. According to the Federal Register notice, VA interprets 38 U.S.C. § 3709(a)(1) as "explicitly requir[ing]" this exclusion. We believe this is a significant flaw in the statute and the rule and encourage VA to ask Congress to amend the statute.

The funding fee pays for the VA guarantee and is required of most veterans. While the .5% fee for IRRRLs is less than the maximum for cash-out refinancing, it can still be a significant expense.[26] For that reason, we believe amending the rule to include the funding fee in the recoupment calculation will demonstrate that the full cost of the refinancing can be recouped within the prescribed 36-month recoupment period.

6.2 The IRRRL program should not allow fixed-to-ARM refinancing.

Under the current and proposed rules, lenders will be allowed to make IRRRLs that refinance an existing fixed-rate loan into a new adjustable rate loan—without conducting any underwriting for ability to repay. We believe this is dangerous for veterans and should not be permitted.

When making an IRRRL, the lender is allowed to rely on the borrower's past payment history as an indicator of their ability to afford the new loan payment. But that reliance is misplaced when the new loan has an adjustable rate that may later exceed the rate on the old loan. When refinancing from a fixed-rate loan to an ARM, the veteran may obtain a lower payment initially, but may owe a higher

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[25] *See* Michael R. Bright, Testimony before House Comm. on Veterans Affairs Subcomm. on Economic Opportunity at 6 (Jan. 10, 2018), available at https://docs.house.gov/meetings/VR/VR10/20180110/106744/HHRG-115-VR10-Wstate-BrightM-20180110.pdf.

[26] VA Circular 26-11-19 (Nov. 22, 2011).

payment in the future. And without proper underwriting, there is no reason to believe the veteran can afford the higher payment.

While there may be a valid reason to refinance into an ARM, VA should require lenders to fully underwrite the borrower's application, including full documentation and evaluation of the veteran's ability to repay under VA's origination guidelines.

If VA believes it lacks this authority, we encourage the Department to ask Congress for authority to adopt a rule that would only allow the origination of fixed-rate loans under the IRRRL program.

6.3 Study the use (or misuse) of discount points.

Under the proposed rule, when: a) the loan being refinanced has a fixed rate; b) the new loan will have an adjustable rate; and c) the required interest rate reduction (of not less than 200 basis points) is achieved solely by using discount points, those discount points may be included in the loan amount only if the following conditions are met:

- No more than one discount point is added to the loan and the resulting new loan balance has a loan-to-value ratio of 100% or less; or
- If more than one discount point is added to the loan, and the resulting loan-to-value ratio is 90% or less.[27]

But if both the new loan and the old loan will have a fixed rate, the above discount point restrictions do not apply.[28]

We recognize that VA is merely implementing the statute as directed by Congress, and that VA previously adopted an identical rule for cash-out refinancings.[29] But we are concerned that the statute and rule's treatment of discount points exposes veterans to the risk of financial harm. The trade-off between paying discount points or a higher interest rate is complex. Some researchers believe that consumers rarely benefit from paying discount points in any loan. After reviewing thousands of loans originated between 1996 and 2003, one study found that borrowers typically paid too much for discount points (prepaying their loans sooner than expected).[30] Other borrowers who paid points

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[27] Proposed § 36.4307(a)(10)(ii)(B) and (C).
[28] Proposed § 36.4307(a)(10)(i).
[29] 83 Fed. Reg. 64459, 64460 (Dec. 17, 2018).
[30] Yan Chang & Abdullah Yavas, Do Borrowers Make Rational Choices on Points and Refinancing (undated), available at https://library.nclc.org/companion-material/do-borrowers-make-rational-choices-points-and-refinancing-chang-yavas; Amy Hoak, McClatchy-Tribune, MarketWatch,

kept their loans too long, perhaps in the hope that they might hold the original loan long enough to compensate for the points paid, and consequently missed out on the savings they would have gained by refinancing their loans earlier than they ultimately did. We also believe that loan originators may use discount points in an abusive way to qualify loans for the IRRRL program in order to evade VA's traditional underwriting guidelines.

To address that risk, we encourage VA to study the use of discount points in all VA-guaranteed loans, to answer questions such as—

- how often are discount points used;
- how often are points included in the loan amount;
- do some lenders use points more than others;
- are points used in particular types of loans more than others; and
- how often do veterans benefit from the use of points over the long term (or do they exhibit the same flawed behavior found in the study cited above)?

VA should collect and make public data on these questions so other researchers may analyze it and recommend appropriate changes.

Nevertheless, given that discount points will be permitted, we strongly support VA's decision to "add a new paragraph (a)(10)(iii) [to 38 C.F.R. § 36.4307] to remind lenders that, under existing paragraph (a)(4)(i), no more than two discount points may be added to the loan amount."[31]

7. Conclusion

We thank VA for the opportunity to comment on this proposed rulemaking. Overall, we support the proposed rule and believe it will help protect veterans from churning. But the rule has some flaws. Some of the flaws may only be cured by new legislation, and we encourage VA to work with Congress to improve the statute. Other problems may be cured by VA without legislation—particularly the escrow loophole and the risk that distressed veterans will be pushed into IRRRLs when modifications would be better. We encourage VA to make the changes recommended above to improve the IRRRL program.

"Paying points seldom wise when choosing a mortgage" (Dec. 30, 2006) (describing study), available at https://www.mercurynews.com/2006/12/30/paying-points-seldom-wisewhen-choosing-a-mortgage-2/.

[31] 87 Fed. Reg. at 65707.

Appendix of Signatories

Since 1969, the nonprofit National Consumer Law Center® (NCLC®) has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people in the United States. NCLC's expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitative practices, help financially stressed families build and retain wealth, and advance economic fairness. These comments were written by NCLC attorney Andrew Pizor, apizor@nclc.org.

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