



Office of Inspector General

UNDERWRITING PRACTICES CAROLINA MORTGAGE COMPANY OF FAYETTEVILLE, NC

*This lender for VA home loans
followed VA underwriting guidelines
in most cases.*

Report No. 9R5-B10-099
Date: May 6, 1999

**Department of
Veterans Affairs**

Memorandum

Date: May 6, 1999

From: Director, Operations Division (52KC)
VA Office of Inspector General

Subj: Report of Audit of Underwriting Practices,
Carolina Mortgage Company of Fayetteville, NC (Report No. 9R5-B10-099)

To: Director, VARO Atlanta, GA (316/00)

Summary

The Office of Inspector General (OIG) conducted an audit of loan underwriting practices of Carolina Mortgage Company of Fayetteville (Carolina Mortgage) for VA home loans on properties in the Carolina Hills Subdivision, near Sanford, NC, between October 1, 1995, and March 4, 1998. The purpose of the review was to determine if the lender, which has automatic approval authority, complied with VA regulations and requirements when underwriting loans that subsequently defaulted. When originated, the loans were within the jurisdiction of VA Regional Office (VARO) Winston-Salem, NC. This jurisdiction has since been moved to VARO Atlanta, GA.

We found that Carolina Mortgage generally originated VA-guaranteed loans in accordance with VA underwriting guidelines. However, we found that they inappropriately approved 2 of the 27 loans we reviewed. This occurred because they did not follow guidelines which require that they adequately consider the impact significant debts might have on the loan applicants' ability to meet the mortgage payments. VA guidelines require that lenders deduct significant debts and obligations from the applicants' total effective income if they severely restrict the applicants' resources and other factors do not compensate for the identified weakness in the loan. In both cases, the applicants would not have met minimum VA criteria if the guidelines had been accurately applied.

As a result, the interests of VA and the veteran were not protected and VA was exposed to unnecessary losses for these two loans. A claim of \$17,652.56 was paid on one loan, while the other loan, with a guarantee amount of \$26,456, is scheduled for a foreclosure sale in April 1999. Although we found these loans to be inappropriately underwritten, the discrepancies were not flagrant enough to warrant indemnification, since there was not any evidence that either of the loans involved possible fraud or misrepresentation.

Recommendation

Loan Guaranty Service staff should discuss these discrepancies with Carolina Mortgage officials to ensure that VA guidelines for significant debts are appropriately followed in all future VA-guaranteed loans they underwrite.

Regional Office Director's Comment

The Director concurred with the findings and recommendation. He planned to discuss the discrepancies with Carolina Mortgage officials by phone and schedule a meeting with them when in their area. He also planned to advise us of the face-to-face meeting.

Office of Inspector General Comment

We consider the recommendation resolved, and we will follow up on its implementation.

For the Assistant Inspector General for Auditing

(Original signed by)

WILLIAM D. MILLER
Director, Kansas City Audit Operations Division

Background

The purpose of the VA Home Loan Guaranty Program is to assist veterans in obtaining housing. Title 38, United States Code, authorizes VA to grant automatic lending authority to lenders who meet VA standards. These standards include funding stability and sufficient experience in originating and servicing VA mortgages. These lenders have the authority to process and approve loans and to commit the VA to the loan guaranty, although some loans are processed and submitted for approval by VA underwriters.

Automatic lenders use VA guidelines to underwrite the loans. VA guidelines require an appraisal to determine each property's value and a loan application to obtain the veteran's financial status. VA Pamphlet 26-7, Lender's Handbook, contains VA credit standards, which require that lenders analyze each applicant's income and credit worthiness for a VA loan. Lenders must ensure that applicants meet VA guidelines for employment stability, income reliability, debt repayment history, and residual income by:

- verifying employment history and income,
- verifying bank deposits,
- obtaining credit reports and confirming credit, and
- computing the income remaining after paying home costs, debts and obligations, and taxes.

The handbook prescribes that lenders are responsible for verifying information in the loan application before they underwrite the loan. A lender originating a loan on an automatic basis must certify that (i) the veteran is a satisfactory credit risk and (ii) the payment terms bear a proper relationship to the veteran's income and expenses.

When the information supporting loan approval is not accurate, the lender may be liable, at a minimum, to indemnify VA and could be subject to other administrative sanctions. VA Regulation 4325(c) states that if fraud, misrepresentation, or failure to comply with the regulations concerning guaranty is discovered, the lender is liable to VA for the amount of the loss caused by such misrepresentation or failure.

During the audit of Attributes of Defaulted VA Home Loans,¹ we identified a housing subdivision in the Sanford, NC, area, where lenders experienced default rates that were significantly higher than the national average. We determined that Carolina Mortgage originated some of the defaulted loans between October 1, 1995, and March 4, 1998. Therefore, we reviewed the origination of VA guaranteed loans by Carolina Mortgage in this housing subdivision during this period.

¹ OIG Report No. 9R5-B10-047.

Objective, Scope, and Methodology

The Office of Inspector General conducted the audit to determine compliance with VA regulations by this lender for loans that had defaulted. The audit was performed in accordance with generally accepted government auditing standards and included tests of records, reviews of pertinent documentation, and interviews with responsible Veterans Benefits Administration (VBA) personnel, lender officials and veteran-borrowers. As part of our audit, we examined pertinent records from the lender's office and VBA's regional office in Winston-Salem, NC. We confirmed the validity of information and documents used to approve the loans, including employment, income, bank deposits, credit status, and dependency status. The audit focused on 27 defaulted loans (guaranteed for \$755,727) underwritten by Carolina Mortgage for properties in the Carolina Hills Subdivision, near Sanford, NC, between October 1, 1995, and March 4, 1998.

Results of Review

Carolina Mortgage generally originated VA guaranteed loans in accordance with VA underwriting guidelines. However, Carolina Mortgage inappropriately approved 2 of the 27 loans included in our audit because they misinterpreted or misapplied the guidelines regarding the inclusion of significant debts in the loan analysis. In both cases, the applicants would not have met minimum VA criteria if the guidelines had been accurately applied. The loans and discrepancies are presented in Exhibits A and B.

Paragraph 5.15 of VA Pamphlet 26-7 instructs lenders to deduct significant debts and obligations from total effective income when determining the loan applicant's ability to meet the mortgage payments. Significant debts include debts and obligations with a remaining term of 10 months or more and debts with a term less than 10 months that require payments so large as to cause a severe impact on the family's resources for any period of time.

- In one case, the lender did not include two short-term debts with less than 7 months left to pay in the loan analysis. The total monthly payments on these two debts totaled \$223, which would cause a severe impact on the family's resources. The applicant would have been \$17 under the residual income guidelines if the two short-term debts had been included. This is an indication that the applicant may have difficulty meeting monthly payments.
- In the other case, the lender did not include an obligation with a remaining term of 10 months and a monthly payment of \$151 in the loan analysis. If the debt had been included in the loan analysis, the applicant would still have met residual

income guidelines, but the debt-to-income ratio² would have been 51 percent, which is 10 percent higher than the guideline.

When underwriting both loans, the lender excluded significant debts by using the loans' buydown arrangements³ as compensating factors—favorable characteristics that offset weaknesses in marginal loans. VA guidelines allow the lender to consider a buydown as a compensating factor if it logically is able to compensate for the identified weakness in the loan. Although both loans were underwritten on the applicants' ability to pay the full payment amount following the buydown period, the excluded debts exceeded the amount saved from the buydowns. Therefore, these buydown arrangements did not adequately compensate for the exclusion of the debts.

The two loans were guaranteed for a total of \$52,119. A claim of \$17,652.56 has been paid on one loan, while the other loan is scheduled for a foreclosure sale in April 1999.

Conclusion

Although both loans were inappropriately underwritten, the discrepancies are not flagrant enough to warrant indemnification on the two loans, since there was not any evidence that either of the loans involved possible fraud or misrepresentation. However, Loan Guaranty Service staff should discuss these discrepancies with Carolina Mortgage officials to ensure that VA guidelines for significant debts are appropriately followed in all future VA-guaranteed loans they underwrite.

² Ratio of total monthly debt payments (housing expense, installment debts, etc.) to gross monthly income.

³ To improve sales in sluggish real estate markets, builders/sellers occasionally establish payment schedules that temporarily "buy down," or reduce, the interest rate, which lowers loan payments during the initial years of the mortgage.

VA LOAN NUMBER: 18-18-6-0609366
LOAN AMOUNT: \$66,141
GUARANTY AMOUNT \$26,456
LOAN STATUS: Foreclosed sale set for 4/2/99
LOAN TYPE: Automatic (Loan closed 11/30/95)

Summary

The lender did not follow VA criteria and inflated the veteran's residual income in the loan analysis by not including two significant debts with monthly payments totaling \$223.

Pertinent Details

The lender's credit report listed two significant debts that the lender did not deduct from the applicant's total effective income. A debt with a finance company had a balance of \$746 with a monthly payment of \$122 and seven payments remaining. A debt with an appliance store had a balance of \$686 with a monthly payment of \$101 and seven payments remaining. The lender excluded both short-term debts by using the loan's buydown arrangement as a compensating factor to offset the weakness in the loan. The loan was underwritten at the full payment amount, which would follow the buydown period.

Paragraph 5.15 of VA Pamphlet 26-7 instructs lenders to deduct significant debts and obligations from total effective income when determining ability to meet the mortgage payments. Significant debts include debts and obligations with a remaining term of 10 months or more and debts with a term less than 10 months that require payments so large as to cause a severe impact on the family's resources for any period of time.

The applicant was over the residual income guideline by \$206, but would have been \$17 under the guideline if the two debts (monthly payments totaling \$223) had been included. According to Paragraph 5.10b, a buydown arrangement may be considered to offset a short-term obligation. The underwriter may have been justified in underwriting the buydown at the full payment amount as a compensating factor for one of the short-term debts, but not for both.

If the \$101 debt had not been included in the loan analysis, the applicant would still have met the residual income guideline, but the applicant's debt-to-income ratio would have been 53 percent. According to Paragraph 5.16o, a high ratio is not necessarily reason enough to reject a loan, but must be considered with all other factors. If the ratio is greater than 41 percent, the lender is required to justify the reason for the approval unless the residual income exceeds the residual income guideline by at least 20 percent.

EXHIBIT A

Although the lender did attempt to justify the approval, we believe that the combined factors in this case indicate that this loan should have been rejected.

VA LOAN NUMBER: 18-18-6-0617627
LOAN AMOUNT: \$64,158
GUARANTY AMOUNT \$25,663
LOAN STATUS: Foreclosed (Claim paid \$17,652.56)
LOAN TYPE: Automatic (Loan closed 10/18/96)

Summary

The lender did not follow VA criteria and inflated the veteran's residual income in the loan analysis by not including a debt with over six payments remaining.

Pertinent Details

The lender did not consider a debt with a finance company, that had a balance of \$1,803 with a monthly payment of \$151 and 10 payments remaining. Paragraph 5.15 of VA Pamphlet 26-7 instructs lenders to deduct significant debts and obligations from total effective income when determining the applicant's ability to meet the mortgage payments. Significant debts include debts and obligations with a remaining term of 10 months or more and debts with a term less than 10 months that require payments so large as to cause a severe impact on the family's resources for any period of time.

The applicant was over the residual income guideline by \$198 without including the finance company debt. The lender used the fact that the loan had a buydown arrangement to compensate for this debt. According to Paragraph 5.10b, a buydown arrangement may be considered to offset a short-term obligation. However, this was not a short-term obligation, because debts of 10 months or more are considered long-term. In addition, the buydown arrangement did not fully offset the debt payment. The first year's mortgage payment was reduced by only \$88 per month, while the obligation payment was \$151, a difference of \$63.

If the debt had been included in the loan analysis, the applicant would still have met the residual income guideline, but the debt-to-income ratio would have been 51 percent. According to Paragraph 5.16o, a high ratio is not necessarily reason enough to reject a loan, but must be considered with all other factors. If the ratio is greater than 41 percent, the lender is required to justify the reason for the approval unless the residual income exceeds the residual guideline by at least 20 percent. Although the lender did attempt to justify the approval, we believe that the combined factors in this case indicate that this loan should have been rejected.

MEMORANDUM FROM THE DIRECTOR, VARO ATLANTA, GA



DEPARTMENT OF VETERANS AFFAIRS
Regional Office
720 Peachtree Street, NE
Atlanta, GA 30365

April 26, 1999

Mr. William D. Miller
Director, Kansas City Operations Division
VA-OIG Regional Office of Audit, Suite 1330
1100 Main Street
Kansas City, MO 64105

Subj: Audit of Underwriting Practices
Carolina Mortgage Company of Fayetteville, NC (Project No. 8R5-214)

1. We concur with your findings and recommendation.
2. We will discuss these discrepancies with Carolina Mortgage officials by phone and will schedule a meeting with them when we are in their area. We will advise you of our face-to-face meeting but the discussion by phone will take place immediately.

Sincerely yours,

(Original signed by:)
J. Gary Hickman
Director

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