



# **Department of Veterans Affairs Office of Inspector General**

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## **Review of Veterans Benefits Administration Loan Guaranty Service Loan Refunding Practices**

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**Department of  
Veterans Affairs**

**Memorandum**

Date: April 25, 2003

From: Assistant Inspector General for Auditing (52)

Subj: Final Report - Review of Veterans Benefits Administration Loan Guaranty Service Loan Refunding Practices

To: Under Secretary for Benefits (20A11)

**1. Introduction**

**a. Background**

The Veterans Benefits Administration's (VBA) Loan Guaranty Service (LGS) manages the Department of Veterans Affairs (VA) home loan program. The home loan program was established to facilitate home ownership for VA beneficiaries by encouraging private lenders to extend favorable credit terms in financing the purchase of homes. In addition, the home loan program helps veterans retain ownership of their homes by providing assistance to those in default of their mortgage through its supplemental loan servicing efforts. While lenders have primary responsibility for servicing delinquent loans, VBA performs supplemental loan servicing to ensure each borrower is afforded the maximum opportunity to keep their home during periods of temporary financial difficulty. VBA's supplemental loan servicing efforts are intended to protect the interests of the veteran and the Government when the lender has not been able to arrange for the reinstatement in good standing of a delinquent loan.

VBA provides supplemental servicing through nine Regional Loan Centers (RLCs).<sup>1</sup> VBA Loan Servicing Representatives (LSRs) work with veterans and lenders to arrange alternatives to foreclosure. One alternative to foreclosure VBA uses is to purchase defaulted loans from the lender and then reamortize the loans to eliminate delinquencies. This is referred to as refunding the loan. Refunded loans become part of VA's direct loan portfolio.

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<sup>1</sup> RLCs are located at VA Regional Offices in Manchester, NH; Cleveland, OH; Roanoke, VA; Atlanta, GA; St. Petersburg, FL; St. Paul, MN; Houston, TX; Denver, CO; and Phoenix, AZ.

As of July 31, 2000, VA's direct loan portfolio included 14,881 refunded loans with unpaid principal balances totaling about \$1.14 billion. Of these refunded loans, 7,180 (48 percent) were in some stage of loan default including 3,300 (22 percent) that were "troubled loans"—meaning the loans were either seriously defaulted loans<sup>2</sup> or pending foreclosure. The unpaid principal balance for these troubled loans (2,155 seriously defaulted and 1,145 pending foreclosure) was about \$273 million and the delinquency amount (the amount required to make these loans current) was about \$54 million. Additionally, 1,058 of the 2,155 seriously defaulted loans (49 percent) were also in bankruptcy status.

## **b. Purpose**

The purpose of our review was to identify the factors that may have contributed to the default and foreclosure of refunded loans.

## **c. Scope and Methodology**

To identify opportunities to reduce the number of troubled loans and the cost of the refunding program, we reviewed a statistical sample of troubled loans to identify causes contributing to the high percentage of refunded loans that end up in troubled status. We reviewed the refunding decisions made on loans that were seriously delinquent or pending foreclosure as of July 31, 2000. Our review focused on a sample of 173 loans that were selected from the 1,549 troubled loans that were refunded subsequent to October 1, 1997. Our sample of 173 loans included 103 seriously defaulted loans and 70 loans pending foreclosure.

# **2. Results of Review**

## **a. Absence of Clear Underwriting Criteria Contributed to the Number of Troubled Refunded Loans**

LGS needed to implement clear and consistent loan refunding policies and procedures to improve the quality of loan refunding decisions, and help reduce the risk of financial loss. The absence of clear loan refunding policies and procedures contributed to the number of refunded loans that were seriously defaulted or pending foreclosure, and the significant delinquency amount associated with these troubled loans. We also found that loan refunding creditworthiness decisions were not consistently supported and the basis for loan approvals were not well documented.

Beneficiaries applying for guaranteed loans are required to meet specific underwriting criteria.<sup>3</sup> However, these underwriting criteria are not applied when

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<sup>2</sup> VA standards define seriously defaulted loans as those where the borrower is 5 or more months delinquent in making a payment.

<sup>3</sup> Lenders must calculate an applicant's residual income and debt-to-income ratio when making an underwriting decision. Residual income is the net income remaining after deducting certain

determining whether to refund a defaulted loan. As a practical matter, VA had no policy or criteria for LSRs to apply in deciding whether to refund loans for veterans who had defaulted on their original guaranteed loans. LGS officials told us they do not consider a refunded loan to be a credit extension or a new loan. Instead, they consider refunding to be a means to reduce VA's ultimate loan liability by potentially restoring the defaulted loan to a paying basis.

VBA policy provided no specific underwriting criteria that LSRs needed to consider when making refunding decisions. VBA policy only provided that LSRs give due consideration to all pertinent factors, including those developed through loan servicing conducted by the lender and/or VBA. However, VBA policy did not describe what the pertinent factors were.

LGS officials acknowledged that there were no specific underwriting criteria to be considered before refunding a loan, and stated that prudent decision making standards should be used when making refunding decisions. They said that the key factor was determining whether the veteran had the present or potential ability to resume regular payments within a reasonable time, and repay the loan. However, these officials also said that VBA policy did not require RLCs to verify income and expenses. Accordingly, VBA policy did not contain objective criteria for making refunding decisions.

We reviewed 148<sup>4</sup> loan folders, of which 91 were seriously defaulted loans and 57 were pending foreclosure. The unpaid principal balance on the loans we reviewed totaled \$13,860,942 (average \$93,655) and the delinquency amount was \$1,695,782 (average \$11,458). Additionally, 53 of the 148 loans were in bankruptcy status.

We concluded that the refunding decisions in 39 (26 percent) of the 148 loans reviewed were adequately documented and supported. However, we questioned the refunding decisions in the remaining 109 loans reviewed (74 percent), because RLC staff did not verify the refunded loan recipient's income, employment, credit history, and/or outstanding obligations to determine the recipient's ability to resume regular payments and repay the loan. In most instances where RLC staff did evaluate creditworthiness, we concluded that the evidence showed the loan recipient was not creditworthy and refunding should

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obligations and monthly living expenses. The debt-to-income ratio is the ratio of total monthly debt payments (i.e., housing expenses and debt) to gross monthly income. To qualify for a VA-guaranteed loan, residual income must be equal to or greater than a required minimum income level based on loan amount, family size, and region of the country and the debt-to-income ratio should generally be less than 41 percent.

<sup>4</sup> We selected 173 loans for review; however, we were not able to review 25 loan folders. Sixteen were not reviewed because neither LGS, the loan servicing contractor, nor the applicable regional office could locate the loan folders. In nine other cases, loan folders were provided, but they were, in reality, "dummy files" that contained minimal information. None of the information in these dummy files pertained to the refunding of the loans. See page 6 for further details.

not have been approved. The chart that follows summarizes the common underwriting deficiencies we identified.

### Common Underwriting Deficiencies

<b>Underwriting Deficiency</b>	<b>Number of Loans Identified with Deficiency<sup>5</sup></b>	<b>Percentage of Loans Reviewed</b>
Income and/or Employment not Verified	61	41 percent
Credit History and/or Outstanding Obligations not Verified	50	34 percent
Income and Credit Verified, but Ability to Resume Regular Payments was Questionable	20	14 percent

As indicated, LSRs frequently failed to verify the borrower's income and/or employment status prior to refunding the loan. In addition, LSRs did not regularly request a credit report or otherwise verify the borrower's financial obligations and expenses. We also found that even when income and expenses were verified, loans were refunded when the evidence showed the borrower did not have the ability to resume regular payments. The following are examples of improper refunding decisions we identified.

- A veteran purchased a home with a VA home loan guaranty in 1998. The veteran reported that she lost her job 2 days after closing on her original loan. Several months after finding new employment, she again lost her job. The LSR refunded the veteran's loan without verifying her employment status and income to determine her ability to resume payments. RLC officials stated that "...there is no manual requirement to obtain verification of employment or getting pay stubs to verify income when a refunding is considered. The LSR may request pay stubs if they feel that the information will aid them in making the decision to refund the loan."

The original guaranteed loan, made in June 1998, was valued at \$164,116. The loan went into default on September 1, 1998, and was refunded in June 1999 with a principal balance of \$179,270. At the time of refunding, the appraised value of the property was \$155,000. As of July 31, 2000, the borrower had made only one payment, the loan was pending foreclosure, and the unpaid principal balance was \$179,109.

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<sup>5</sup> Total is greater than 109 as some cases had multiple deficiencies.

- A non-veteran borrower assumed a veteran's guaranteed loan in 1994. The borrower defaulted on the loan in 1996, due to illness in the family and the loss of her job. VA first considered refunding this loan in January 1998, but the LSR concluded that refunding was not in the best interest of VA. No action was taken to foreclose on the loan and the borrower continued to experience financial difficulty. The loan was again considered for refunding in 1999, and the refunding was approved. The evidence of record at the time of the refunding decision revealed that the borrower had a troubled credit history, including recent liens and collections.

RLC officials stated that "...the LSR documented the loan record that the homeowner's desire to keep the property was compelling and verified all sources of income in this case. We agree that this may not have been sufficient reason to approve refunding for this non-veteran considering the borrower's credit record, broken repayment plans, and lack of equity in the property." The loan was refunded in April 1999 with a principal balance of \$101,829 and an appraised value of \$85,000. As of July 31, 2000, the borrower had made no loan payments, the unpaid principal balance remained \$101,828, and the loan was pending foreclosure.

We concluded that refunding decisions made in the absence of clear underwriting criteria resulted in increased risk of financial loss that could ultimately lead to increased loan funding fees for veterans. Among the 148 troubled loans we reviewed, the value of the refunded loans was about \$8,150 higher than the original guaranteed loans (the average beginning balance of the guaranteed loans was \$86,475 while the average beginning balance of the refunded loans was \$94,625). This occurred because delinquency amounts were rolled into refunded loan amounts.

Additionally, because the borrowers were often not creditworthy, they again fell behind in their payments and the delinquency amount increased. On average, the delinquency amount increased by \$11,500. Accordingly, the risk of financial loss increased by an average \$19,650 for the troubled refunded loans we reviewed.

The risk of financial losses among troubled refunded loans was also increased because the appraised value of properties securing refunded loans averaged \$4,000 less than the average value of the refunded loans. Refunded loans are particularly vulnerable to risks associated with holding these properties. This is especially true if the borrower files for bankruptcy protection, which can significantly increase the period of time they are allowed to remain in the property, increasing the amount the loan will be in arrears, reducing VA's ability to earn revenue from the property, and increasing the risk the property will decline in value. Additionally, if properties are left unoccupied, or are occupied by third parties (i.e., renters), the potential for loss from vandalism increases.

## **b. LGS Should Develop Performance Measures and Management Reports to Improve the Monitoring of Refunded Loans**

LGS' ability to effectively evaluate its refunded loan program was limited because there were no performance measures or management reports to monitor the performance of refunded loans. Accordingly, LGS and RLC management could not evaluate whether LSRs made appropriate refunding decisions or give LSRs feedback. LGS management should develop meaningful performance measures and useful management reports to effectively oversee and manage the refunded loan program.

A new contractor began servicing portfolio loans in January 2001 and started tracking the performance of recently refunded loans. Tracking of loans refunded during calendar year 2001 revealed that approximately 48 percent of loans refunded by RLC personnel were delinquent.<sup>6</sup> LGS should utilize this type of information to set performance goals to improve the default rate of refunded loans.

## **c. Loan Folders Could Not be Located**

We requested 173 refunded loan folders for review as part of this project. The current loan servicing contractor located 157 loan folders, but 9 were dummy or reconstructed files that contained little information; none of which was pertinent to the refunding decision. The contractor reported that they had no record of receiving the 25 missing loan files from either the prior contractor or the regional offices that processed the loans. After 2 months of searching for the missing files, LGS officials informed us that they did not believe the files could be found.

Accordingly, key documentation was not available to LGS or the loan servicing contractor to service these loans. LGS needed to conduct a nationwide search to identify the full extent of missing loan folders, take steps to locate the folders, or reconstruct the folders that cannot be found.

## **3. Actions Taken by LGS**

During the time of our review, LGS took action to improve loan refunding practices. For example, LGS initiated a Loan Administration Redesign (LARD) project. The purpose of the project is to reengineer, standardize, and document work processes and procedures involved in supplemental loan servicing

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<sup>6</sup> This figure was obtained from the loan servicing contractor's "Refunded Loan Performance Report", dated July 31, 2002. The report only measured the performance of loans refunded after they assumed responsibility for servicing VA's loan portfolio. The report illustrated the performance of refunded loans as of July 31, 2002 and showed a wide range of loan performance from month-to-month. The 48 percent delinquency figure represents an overall average for all loans refunded during 2001.



(including refunding loans) and other activities related to the primary servicing performed by mortgage companies.

LGS also issued Circular 26-02-7 (May 7, 2002), to standardize loan refunding practices. This circular requires that LSRs verify income, obtain credit reports, document the basis for decisions to refund loans in the official loan records, and obtain concurrence from the Loan Administration Officer before approving questionable refunding cases. The circular states that VBA Central Office would be interacting with RLCs to improve the underwriting of refunded loans and adjustments to the circular instructions would be made as appropriate. LGS plans to formalize these procedures in VBA policy manuals when the LARD project is completed.

#### **4. Conclusion**

LGS can reduce the number of refunded loans that end up in troubled status, reduce the risk of increased financial loss related to the refunded loan program, and manage the program more effectively by implementing clear loan refunding policies and procedures and establishing performance monitors and management reports. Additionally, LGS management should establish more effective controls over loan guaranty folders to reduce the frequency of lost records.

#### **5. Recommendations**

We recommended that the Under Secretary for Benefits improve loan refunding practices and control of loan folders by ensuring that LGS management:

- a. Monitor the implementation of Circular 26-02-7 to ensure LSRs verify borrower's income and credit history, document analysis of credit history and the ability to make future loan payments, justify decisions to refund loans, and in cases which appear questionable, obtain the concurrence of the Loan Administration Officer.
- b. Develop and utilize performance measures and management reports to effectively oversee and manage the loan refunding program and provide feedback to RLC management.
- c. Identify missing refunded loan folders and take steps to locate the folders, or reconstruct the folders.

#### **6. Under Secretary for Benefits Comments**

The Under Secretary for Benefits agreed with the findings and recommendations and provided details on corrective actions taken to address the

recommendations. (See Appendix I on pages 9-10 for the full text of the Under Secretary for Benefits comments.)

## **7. Office of Inspector General Comments**

The corrective actions taken are acceptable and we consider all issues closed. However, we may follow up on the implementation of corrective actions.

While the Under Secretary for Benefits noted in his response that “since the report found that 52% of loans refunded by VA are not in default, this reflects very favorably on VBA’s LGS’ refunding policies and procedures”, we need to clarify the performance statistic included in the report. We noted that about 48 percent of loans refunded during calendar year 2001 were delinquent as of July 31, 2002. This was based on a contractor-prepared performance report, which provided a snapshot of refunded loan performance as of July 31, 2002. The performance report did not include statistics on the performance of loans refunded prior to December 2000. The performance report did, however, reveal steady declines in the performance of refunded loans as they aged. For example, the report showed that 76 percent of loans refunded during April 2002 were current, 63 percent of loans refunded during January 2002 were current, and only 42 percent of loans refunded during January 2001 were current.

For the Assistant Inspector General for Auditing

*(original signed by:)*

*Lee R. Bailey, Director, Operational Support Division (52M)*

THOMAS L. CARGILL, Jr.

Director, Bedford Audit Operations Division (52BN)

Appendices

**Department of  
Veterans Affairs**

**Memorandum**

Date: March 21, 2003

From: Under Secretary for Benefits (20A11)

Subj: Draft Report on VBA LGS Loan Refunding Practices (No. 2000-02021-R1-0262)

To: Assistant Inspector General for Auditing (52)

1. As requested, we have reviewed the draft report dated December 13, 2002, and are providing general comments, and our responses to your recommendations.
2. The purpose of the report was stated as being to identify the factors that may have contributed to the default and foreclosure of refunded loans. VA refunds loans in danger of immediate foreclosure, so there are many factors already contributing to the potential for default. Nevertheless, VA refunds a loan because there is an opportunity to assist a veteran in retaining his or her home, and also the possibility of reducing the Government's loss under the loan guaranty. Since the report found that 52% of loans refunded by VA are not in default, this reflects very favorably on VBA's Loan Guaranty Service's (LGS) refunding policies and procedures, which give veterans a fresh start and an opportunity to overcome previous difficulties. During the course of the OIG study, we recognized that some cases could be better documented as to VA's credit review and reason(s) for refunding approval, especially in cases where the criteria used to originate new loans (VA-guaranteed loans) could indicate a questionable credit risk. Our May 2002 guidance to the field (Circular 26-02-7) therefore requires more documentation than in the past, but it also continues to reflect the position that refunding is a special consideration for a veteran experiencing financial difficulty, as well as an opportunity for VA to mitigate loss.
3. The report makes three recommendations, and VBA has already initiated actions that address these issues. We therefore concur with the recommendations, and consider them closed.
  - a. Monitor the implementation of Circular 26-02-7.

Concur. Completed - new procedures initiated and ongoing. LGS has modified its survey protocol to ensure on-site review of documentation for compliance with this circular. In addition, LGS is performing sampling of loans refunded by each Regional Loan Center on a monthly basis.

- b. Develop and utilize performance measures and management reports.

Concur. Completed. LGS began receiving management reports from Countrywide Home Loans (CHL, our portfolio loan servicer) in March 2002 on the performance of refunded loans, and has directed local use of those reports in identifying defaulted cases which should be reviewed to ensure that appropriate underwriting standards were employed. Existing VBA operating manual guidance calls for internal controls incorporating an appropriate sampling level as part of the performance management process to ensure that employees are held responsible for the quality of decisions made under delegated authority (including authority to approve refundings). We should note that the redesigned Loan Administration model projects very few (less than 100 per year) refunded loans in the future because private servicers will have greater flexibility to modify and retain those loans in their own portfolios, so there will be very few refunded decisions to quality review.

- c. Identify missing loan folders, locate or reconstruct them.

Concur. Completed. The OIG report stated 25 missing loan folders needed to be found or reconstructed so key information would be available to LGS or the loan contractor to service the loans. Although the folders might have information regarding the refunding decisions, which could be used in reviewing the appropriateness of those decisions, that information is not necessary for future loan servicing. We have determined that attempting to reconstruct missing information about refunding decisions would not be an efficient use of limited resources. The cases involved were refunded while the old Liquidation and Claims System (LCS) was in operation and data was maintained primarily in paper files. However, LGS's current system, Loan Service and Claims (LS&C), retains data electronically for an indefinite period of time. Moreover, LGS's redesign initiative will establish a totally paperless environment by the end of 2003. Our new refunding approval procedures, previously mentioned, require that documentation of data and decisions with respect to refunding be entered in the LS&C record. Newly refunded loan data is now transferred electronically to the portfolio servicing contractor, so there are no paper files to misplace. In addition, VA has focused on the importance of the loan security instruments in servicing refunded loans, no matter whether the loan was refunded in LCS or LS&C. Therefore, LGS empowered the portfolio loan servicing contractor in January 2002 to assist in locating, replacing, or reconstructing missing loan security instruments.

4. We appreciate the opportunity to have reviewed your draft report.

/s/  
Daniel L. Cooper

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