US DEPARTMENT OF VETERANS AFFAIRS
OFFICE OF INSPECTOR GENERAL

Office of Audits and Evaluations

VETERANS BENEFITS ADMINISTRATION

# Additional Measures Would Better Protect Borrowers from Risks Associated with Interest Rate Reduction Refinance Loans

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# Executive Summary

The Department of Veterans Affairs (VA) assists qualified borrowers with homeownership by providing a home loan guaranty benefit for mortgages. Qualified borrowers who have obtained a VA-guaranteed mortgage can apply to refinance it under one of two options: interest rate reduction refinance loans (IRRRLs) or cash-out refinancing.[1] This report focuses on IRRRLs, which generally help holders of existing VA-backed home loans lower their interest rates and potentially reduce their monthly mortgage payments.

As a streamlined way to reduce interest rates on VA-guaranteed mortgages, IRRRLs are popular with veterans; they are especially attractive when interest rates are low. In fiscal year (FY) 2020, VA reported a 598 percent increase in the number of IRRRLs from the previous year—from 94,861 to 662,065, totaling about $199 billion.[2] The steep increase is attributable to lower interest rates starting in the last quarter of calendar year 2018, which continued through FY 2020.[3] For FY 2021, VA reported just under 832,000 IRRRLs, amounting to an overall IRRRL value of $243 billion for that fiscal year.

Although veterans can take out IRRRLs without any VA involvement, the loans must meet several VA requirements. According to VA guidance, lenders must provide loan comparison statements so that borrowers can make informed decisions about whether to refinance.[4] VA also requires that the loans allow borrowers to recoup refinancing charges (closing costs) within 36 months; provide a minimum financial benefit to the borrower from refinancing, referred to as a net tangible benefit (most notably a minimum fixed- to fixed-rate interest reduction of one-half percent and a two-discount-point ceiling); and meet seasoning requirements (a requirement that the borrower must have made at least six months of payments on the current loan to preclude unnecessary multiple refinances in a short time—that is, serial refinances).[5]

Given the considerable increase in the use of IRRRLs and the large number of borrowers involved at risk for overcharges, the VA Office of Inspector General (OIG) conducted this audit

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[1] Qualified borrowers include veterans, active service members, National Guard members, reservists, and surviving spouses who meet certain requirements, such as veterans with 24 continuous months of service and active-duty members with 90 continuous days of service. In this report, the OIG refers to borrowers as simply "veterans" in some cases.

[2] The audit team initially reviewed FY 2020 data because that was the most recent completed fiscal year when the audit began in February 2021. The team later reviewed a limited sample of FY 2021 loans.

[3] "Primary Mortgage Market Survey" (web page), Freddie Mac, accessed April 14, 2023, https://www.freddiemac.com/pmms.

[4] VA Circular 26-18-1, "Policy Guidance for VA Interest Rate Reduction Refinance Loans (IRRRL)," February 1, 2018; VA Circular 26-19-22, "Clarification and Updates to Policy Guidance for VA Interest Rate Reduction Refinance Loans (IRRRLs)," August 8, 2019.

[5] VA Circular 26-19-22, "Clarification and Updates to Policy Guidance for VA Interest Rate Reduction Refinance Loans (IRRRLs)," August 8, 2019.

to determine whether Veterans Benefits Administration (VBA) oversight of IRRRLs by its Loan Guaranty Service (LGY) ensures veterans are protected from unfavorable refinancing and unallowable or unreasonable refinance charges. In May 2018, legislation was enacted to ensure VA does not guarantee any refinances that are not in the financial interest of the borrower.[6] LGY has since implemented some policies and procedures and circular guidance (as referenced in this report) to comply with this law and published a proposed rule in the Federal Register on November 1, 2022, to align its regulations with the law.[7]

## What the Audit Found

Based on the review of a sample of VA-guaranteed IRRRLs closed during FY 2020, from October 1, 2019, through September 30, 2020, the OIG found improved oversight of IRRRLs after LGY implemented new controls from March through May 2020. Enhancements were primarily in three areas: fee recoupment, net tangible benefit, and loan seasoning. Prior to these new controls, LGY was unable to sufficiently ensure those three requirements were met. LGY carried out the changes by reprogramming the web-enabled loan guaranty system to verify compliance before the loan guaranty certificate was issued.

The OIG team determined from its examination of the sample of 171 FY 2020 borrowers that 19 loans involved errors in net tangible benefit and closing cost recoupment. The OIG estimated that at least 3,200 FY 2020 borrowers were overcharged $1.6 million because lenders did not meet those key requirements. Almost all of these overcharges occurred prior to LGY's implementation of the May 2020 controls; once the new controls were in place, LGY reduced the number of IRRRLS that were unfavorable to borrowers for these three requirements.

Despite the improvement resulting from the LGY's implementation of the May 2020 controls, some FY 2020 borrowers were still potentially overcharged for closing costs unrelated to these three requirements. In this report, these charges are described as *potential*, rather than *actual*, overcharges because the OIG and LGY did not agree on the extent to which certain closing costs should be supported and documented in the loan file or if certain costs are allowable and reasonable. A legal opinion from VA's Office of General Counsel is needed to resolve this

[6] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 § 309 (May 2018); VA Circular 26-18-13, "Policy Guidance Update: VA Refinance Loans and the Economic Growth, Regulatory Relief and Consumer Protection Act," May 25, 2018. A refinanced home loan may not be guaranteed by VA unless (1) a specified minimum time period has passed between the original loan and the refinancing and (2) the lender complies with provisions related to fee recoupment, mortgage interest rates, and net tangible benefits tests.

[7] LGY's proposed rule, AR58: Loan Guaranty: Revisions to VA-Guaranteed or Insured Interest Rate Reduction Refinancing Loans (IRRRLs), was published in the Federal Register on November 1, 2022. VA proposed to amend its rules, specifically 38 C.F.R. 36.4307, on IRRRLs to implement Pub. L. 115-174. In this rulemaking, VA also proposed to clarify requirements related to loan seasoning, recoupment, and net tangible benefit. LGY put forward changes to the existing IRRRL worksheet and the introduction of a new IRRRL comparison disclosure as well. VA accepted public comments through January 3, 2023. On June 29, 2023, the under secretary for benefits stated, "Currently, VBA is working to finalize and publish this as a final rule."

difference of interpretation. The grounds for this disagreement are described in the report narrative.

These potential overcharges—consisting of unsupported, unallowable, or unreasonable closing costs—totaled an estimated $3 million and affected approximately 18,400 borrowers in the FY 2020 audit sample. These potential overcharges stemmed from insufficient policies and procedures to ensure lenders followed requirements to document and account for these charges. The OIG maintains that borrowers deserve complete transparency of the closing costs they will be charged. VA should ensure that the closing costs charged are allowable, fully supported, and reasonable so that borrowers can be fully cognizant of the financial decisions they are making.

The OIG also found that borrowers did not always receive the loan comparison documents they needed to make informed decisions about whether to refinance. For at least 3 percent of the IRRRLs in FY 2020, as estimated, lenders did not provide the required statements at the time of application. This omission may have affected just under 2,900 borrowers during FY 2020. In addition, the OIG could not determine if lenders provided initial loan comparison statements within three business days for at least 32 percent of the IRRRLs in FY 2020 because LGY only required submittal of the final loan application.[8] Therefore, the team could not determine if those loan comparison statements were provided within the three-business-day requirement for just under 28,600 borrowers. LGY had sought to resolve this problem by reprogramming the web-enabled loan guaranty system, but it was not until December 2022 when LGY reported that it had fully updated the applicable control.

LGY also lacked controls and sufficiently detailed guidance to fully perform loan oversight and quality assurance. Once lenders issue IRRRLs, they are required to report to LGY within 60 days, at which point LGY performs oversight of these loans. However, the OIG found that LGY could strengthen its controls for this oversight process. For example, although the pamphlet requires lenders to report IRRRLs within 60 days of closing so that LGY can issue a loan guaranty certificate and perform oversight, lenders did not comply, and LGY's controls were not sufficient for obtaining compliance. As for quality assurance, the policies and procedures do not detail steps for loan specialists to take when conducting loan reviews or criteria for selecting IRRRLs for review. The policies and procedures also lack instructions for how LGY should correct overcharges identified in regional loan centers' loan reviews. Because those policies and procedures do not require reimbursing borrowers for any overcharges found during regional loan centers' reviews, borrowers may not receive their required refunds.

The audit team also reviewed a limited sample of FY 2021 IRRRLs to determine if the issues identified in FY 2020 appeared to continue. The OIG acknowledges that the last four months of FY 2020 is insufficient time to see wholesale improvements. However, it was clear that some

[8] The loan application, known as a Uniform Residential Loan Application (URLA), is a standard document used by borrowers to apply for a mortgage.

issues appeared to persist in FY 2021. Although the team could not project any estimates from this small sample, it was sufficient to make the team's limited assessment that similar issues involving loan comparisons, closing costs, and other issues observed in the FY 2020 loans were identified in the sample examined for FY 2021.

Overall, the OIG concluded that the new controls VBA's LGY implemented by May 2020 resulted in improved oversight of IRRRLs but did not fully protect borrowers from unfavorable refinances due to closing cost overcharges. Borrowers deserve full disclosure and complete transparency of the potential and final cost of their IRRRL, beginning with their loan application and the initial loan comparison. This transparency is necessary so that borrowers can make informed financial decisions about the benefit of their loan and the costs they will incur by refinancing. By strengthening these controls and its quality assurance policies and procedures, LGY can more effectively protect borrowers from unfavorable IRRRLs and also help ensure that VA is guaranteeing loans that comply with its requirements.

## What the OIG Recommended

To better protect borrowers from unfavorable IRRRLs, minimize closing cost overcharges, and improve oversight, the OIG made nine recommendations to the under secretary for benefits. These recommendations include assessing the controls to ensure that borrowers receive the loan comparison they need to make informed financial decisions; seeking legal opinions from VA's Office of General Counsel to determine if borrowers were overcharged closing costs and make borrowers whole, where appropriate; updating policies and procedures to ensure adequate documentation is obtained for all third-party closing costs; providing lenders at least annual communication about the importance of providing justifications for any loans not reported within 60 days; updating policies and procedures for full-file loan reviews to include detailed steps for loan specialists to conduct reviews; and updating policies and procedures to ensure the borrower is reimbursed for any overcharges identified during regional loan center quality reviews.

## VA Management Comments and OIG Response

The under secretary for benefits concurred with all nine recommendations. The planned corrective actions are responsive to the recommendations. The Office of General Counsel added comments to those from VBA that highlight areas of disagreement between the OIG and VA. VBA recognized these include the classification of certain closing costs and whether some audited loans passed a recoupment standard. Most notably, there is an acknowledged need for legal opinions to address the areas of disagreement highlighted within three of the recommendations.

In recognition of the differences of opinion with VBA regarding unsupported, unallowable, and unreasonable costs related to those three recommendations, the OIG classified the related costs as "potential" overcharges and further clarified its position within this final report. The OIG will monitor VBA's progress on its proposed actions for those recommendations requiring a legal opinion. In addition, the OIG addressed Office of General Counsel feedback before finalizing this report to make clear when an opinion regarding the legal interpretation of regulations reflected the OIG's perspective and to acknowledge the Office of General Counsel comments in appendix D referring to "legal ambiguities" it was concerned with in the draft report's introduction. The OIG will close each recommendation as implemented when VA provides sufficient evidence to demonstrate that adequate progress has been made.

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# Contents

# Abbreviations

| | |
|---|---|
| C.F.R. | Code of Federal Regulations |
| FY | fiscal year |
| IRRRL | interest rate reduction refinance loan |
| LGY | Loan Guaranty Service |
| OGC | Office of General Counsel |
| OIG | Office of Inspector General Uniform |
| URLA | Residential Loan Application Veterans |
| VBA | Benefits Administration web-enabled |
| WebLGY | loan guaranty system |

# Introduction

One of the benefits VA provides veterans is a home loan guaranty for mortgages for qualified borrowers.[9] A qualified borrower must apply to a lender, such as a bank or credit union, for a loan. The borrower can apply for refinancing under one of two options: the interest rate reduction refinance loan (IRRRL) or a cash-out refinance.[10] IRRRLs, the focus of this report, are popular because they are a streamlined way to save money through reduced interest rates with no up-front costs.

In fiscal year (FY) 2020, VA reported a 598 percent increase in the number of IRRRLs from the previous year—from 94,861 to 662,065. The steep increase is attributable to lower interest rates starting in the last quarter of calendar year FY 2018, which continued through 2020.[11] For FY 2020, VA reported just over 662,000 IRRRLs at an overall value of about $199 billion for that fiscal year, with individual IRRRLs averaging about $300,500.[12] For FY 2021, VA reported just under 832,000 IRRRLs, amounting to an overall value of about $243 billion, with individual IRRRLs averaging just over $292,000.[13] See figure 1 for recent trends.

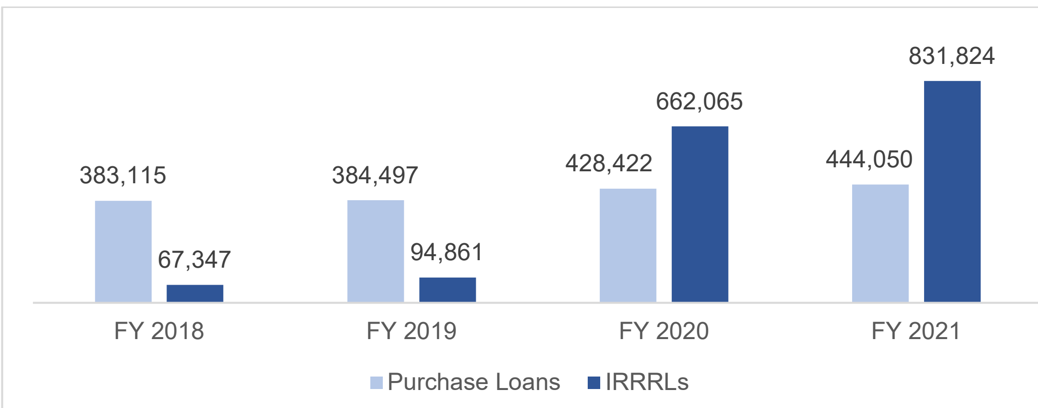


***Figure 1.*** *Increase in the number of IRRRLs from FY 2018 to FY 2021.*

*Source: Home Loan Guaranty Service Intranet, https://vbaw.vba.va.gov/HOMELOANS/fast_facts.asp.*

[9] Qualified borrowers include veterans, active service members, National Guard members, reservists, and surviving spouses who meet certain requirements, such as veterans with 24 continuous months of service and active-duty members with 90 continuous days of service. For readability, there are instances where borrowers are referred to simply as "veterans" in this report.

[10] VA Pamphlet 26-7, "Refinancing Loans," chap. 6 in *Lenders Handbook*, rev. April 10, 2009.

[11] "Primary Mortgage Market Survey" (web page), Freddie Mac, accessed April 14, 2023, https://www.freddiemac.com/pmms.

[12] "VA Home Loans Loan Volume by State," fiscal years 2018–2021 (web page), Loan Guaranty Service, accessed December 15, 2022, https://www.benefits.va.gov/HOMELOANS/lender_state_volume.asp. (This website is not publicly accessible.)

[13] "VA Home Loans Loan Volume by State," fiscal years 2018–2021 (web page), Loan Guaranty Service.

Given the considerable increase in the use of IRRLS and the large number of borrowers, the VA Office of Inspector General (OIG) conducted this audit to determine whether Veterans Benefits Administration (VBA) oversight by its Loan Guaranty Service (LGY) ensures borrowers who refinance with IRRRLs are protected from unfavorable refinancing and unallowable or unreasonable refinance charges.[14]

## VA Home Loan Program's IRRRL

An IRRRL is also known as a streamlined refinance—that is, it saves time and some fees because it generally does not require underwriting. Any lender in any geographic location can close (execute) loans directly with the borrower without any VA involvement, except for existing VA loans 30 days or more past due, which require VA approval.[15] VA requires IRRRLs to be at a lower interest rate than the existing loan unless (1) the existing loan is an adjustable-rate mortgage, (2) the term of the IRRRL is shorter than the term of the loan being refinanced, or (3) energy efficiency improvements are included in the loan. Additionally, at least 210 days must have passed since the first payment on the existing VA loan, and at least six full mortgage payments must have been made on the VA loan being refinanced. These last two requirements are generally referred to as loan seasoning and are intended to preclude unnecessary or serial refinances.[16]

VA also requires borrowers to receive a minimum financial benefit from refinancing, referred to as a net tangible benefit. An IRRRL for a fixed-rate loan to another fixed-rate loan must decrease by at least one-half percent; an IRRRL for a fixed-rate loan to an adjustable-rate loan must decrease by at least 2 percent. Further, the borrower cannot finance more than two discount points. Discount points lower the interest rate in exchange for the borrower paying an up-front fee or may be financed in the IRRRL, and each point equals 1 percent of the loan amount.

IRRRLs allow borrowers to refinance up to 100 percent of their existing VA-backed home loans with no up-front costs. The cost of refinancing—generally referred to as the closing cost—is often rolled into the loan amount and is amortized by the lender over the life of the new loan. Nevertheless, the closing costs should be "recouped" by the borrower within 36 months of the

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[14] Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 § 309 (2018). VA Circular 26-18-13. The legislation was enacted to ensure refinances are in the financial interest of the borrower. A refinanced home loan may not be guaranteed by VA unless (1) a specified minimum time period has passed between the original loan and the refinancing and (2) the lender complies with provisions related to fee recoupment, mortgage interest rates, and net tangible benefits tests.

[15] VA Pamphlet 26-7, "Refinancing Loans." VA Circular 26-20-25, "Impact of CARES Act Forbearance on VA Purchase and Refinance Transactions," June 30, 2020. Because of the COVID-19 national emergency, the 30-day requirement was waived under the Coronavirus Aid, Relief, and Economic Security (CARES) Act.

[16] VA Circular 26-19-22, "Clarification and Updates to Policy Guidance for VA Interest Rate Reduction Refinance Loans (IRRRLs)," August 8, 2019.

loan period.[17] In this context, "recoupment" is a process defined by VA, and lenders must demonstrate that the 36-month limit is not exceeded based on a calculation provided in VBA circular guidance.[18] The recoupment calculation ensures that the overall closing costs are not excessive, even though the costs are typically refinanced over the life of the loan. If LGY determines the 36-month limit is exceeded, LGY requires the lender to cure the overcharges through principal payment reduction(s). Table 1 illustrates the recoupment calculation for an IRRRL that would be within the 36-month recoupment requirement.

**Table 1. Loan Recoupment Example**

| Loan costs and recoupment | Amounts or months |
|---|---|
| Previous loan principal | $195,000 |
| Closing costs (a) | $5,000 |
| Total IRRRL | $200,000 |
| Previous loan monthly payment (b) | $650 |
| IRRRL monthly payment (c) | $500 |
| Months to recoup closing costs a/(b – c) | 33.3 months |

*Source: OIG-prepared based on hypothetical data.*

For closing costs, there are regulations as to what can be included. Specifically, lenders can charge borrowers only the following three categories of closing costs, though all three categories can be included in any given IRRRL:

- Reasonable and customary itemized closing fees and charges (examples are recording fees, credit report charges, and title examination and insurance)
- A single lender flat charge for certain loan origination costs not permissible as itemized closing fees and charges up to 1 percent of the loan amount, *or* as *both* a flat charge and additional closing costs (referred to as "alternative" charges) up to

[17] The 36-month recoupment period effectively limits the closing costs to a reasonable amount. A funding fee, as prescribed by 38 C.F.R. 36.4313(e), is a VA user fee for a VA home loan. Some borrowers, such as veterans who have service-connected disabilities, may be exempt from paying the fee. Prepaid expenses are items borrowers can pay up front such as taxes, assessments, and insurance.

[18] VBA Circular 26-19-22. Recoupment is calculated by dividing all fees, expenses, and closing costs, whether included in the loan or paid outside of closing (such as an appraisal fee), by the reduction of the monthly principal and interest payment. The VA funding fee, escrow, and prepaid expenses, such as insurance, taxes, special assessments, and homeowners' association fees, are excluded from the recoupment calculations.

1 percent of the loan amount (such as lender appraisals, attorney fees other than title work, and loan application fees)[19]

- Reasonable discount points (not to exceed 2 percent) when applicable[20]

For example, a borrower could be charged for $3,000 of itemized closing fees and charges, loan origination, and additional costs based on a flat charge of $2,500 (based on 1 percent of a $250,000 loan), and discount points of $5,000 (based on 2 percent of a $250,000 loan). Although there is no overall cap on the total closing costs, itemized closing fees and charges are subject to a reasonableness standard.

Typically, the borrower includes the entire closing costs (itemized closing fees and charges and the flat charge when applicable) as part of the total refinanced loan amount. If the lender applies loan origination and/or additional costs, it includes additional line-item costs, a singular percentage flat charge, or a combination. For example, a lender may charge four additional line-item closing costs totaling $1,250 on a $250,000 loan, and a flat charge of $1,250 (0.5 percent of a $250,000 loan). In that case, all loan origination costs of $2,500 are allowable because they do not exceed 1 percent of the loan amount. Any loan origination costs above that ceiling would be considered unallowable. If LGY subsequently determines that the 1 percent ceiling was exceeded, the borrower is refunded.

Lenders benefit by having VA partially protect them against loss in the event of foreclosure. VA guarantees at least 25 percent of the IRRRL, subject to specific maximums based on the loan amount as stipulated on the VA loan guaranty certificate.[21] If a loss ultimately occurs on the loan, VA will reimburse the lender for the guaranteed amount.

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[19] 38 C.F.R. § 36.4313 (2010). The regulation allows certain itemized fees and charges as part of a single flat charge, as alternative charges, or as both a flat charge and alternative charges with a maximum of 1 percent of the loan amount. LGY further clarifies the limit in its guidance as the existing VA loan balance (plus the cost of energy-efficient improvements) less any cash payments from the veteran. VA Pamphlet 26-7, "Borrower Fees and Charges and the VA Funding Fee," chap. 8 in *Lenders Handbook*, November 8, 2012.

[20] 38 C.F.R. § 36.4313 (2010). The regulation allows certain itemized fees and charges as part of a single flat charge, as alternative charges, or as both a flat charge and alternative charges with a maximum of 1 percent of the loan amount. LGY further clarifies the limit in its guidance as the existing VA loan balance (plus the cost of energy-efficient improvements) less any cash payments from the veteran. VA Pamphlet 26-7, "Borrower Fees and Charges and the VA Funding Fee," chap. 8 in *Lenders Handbook*, November 8, 2012.

[21] VA Pamphlet 26-7, "The VA Loan and Guaranty," chap. 3 in *Lenders Handbook*, November 8, 2012. The pamphlet states all IRRRLs must have a minimum guaranty of 25 percent of the loan amount. Loans less than $144,000 have larger guarantees for different loan ranges up to 50 percent of the loan amount. "VA home loan limits" (web page), Housing Assistance, VA-Backed Home Loans, accessed December 9, 2022, https://www.va.gov/housing-assistance/home-loans/loan-limits/.

## IRRRL Application and Guaranty Process

Figure 2 provides an overview of the IRRRL process from application through guaranty.

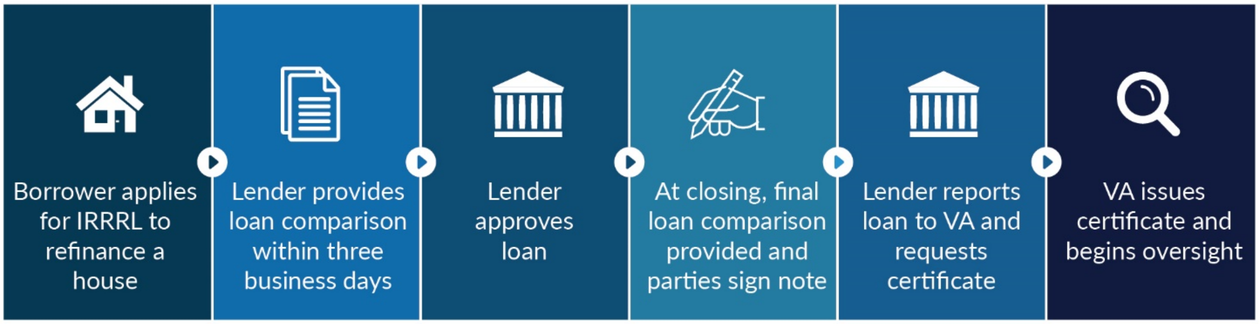


***Figure 2.*** *IRRRL application and guaranty process.*
*Source: VA OIG analysis of Lender's Handbook, VA Pamphlet 26-7.*

According to VA guidance, lenders should present a borrower with a comparison of the IRRRL to their existing loan at least twice after the application is received.[22] First, the lender should present the comparison statement within three business days from the date of the loan application.[23] The loan comparison statement provides up-front information about the overall cost and terms of the IRRRL—such as the decrease in monthly payment, the interest rate, and the time needed for the borrower to recoup closing costs—thereby helping the borrower make an informed decision about whether to refinance. After the lender approves the loan, it provides another comparison to the borrower at closing to ensure there are no changes to the loan of which the borrower is not aware. After closing the loan, lenders use VA's web-enabled loan guaranty system (WebLGY) to electronically report a loan to VA and request a loan guaranty certificate. This reporting is to be done within 60 days.[24] WebLGY captures VA baseline loan information such as the names of the property, the borrower, and the lender, as well as loan information; however, only the final loan application is required to be submitted to LGY. Finally, after the lender submits the required documentation, VA issues a loan guaranty certificate to the lender in WebLGY.[25]

[22] VA Circular 26-18-1, "Policy Guidance for VA Interest Rate Reduction Refinance Loans (IRRRL)," February 1, 2018; VA Circular 26-19-22. The loan application, known as a Uniform Residential Loan Application (URLA), is a standard document used by borrowers to apply for a mortgage.

[23] VA Circular 26-19-22.

[24] VA Pamphlet 26-7, "How to Report Loan Closing and Request Guaranty," topic 3.k, chap. 5 in *Lenders Handbook*, rev. April 1, 2019.

[25] VA Circular 26-20-25, "Transfer of TAS Functions to WebLGY," June 2, 2010.

## Loan Guaranty Service Oversight Roles

LGY's oversight department ensures regional loan centers and program participants (lenders and borrowers) comply with applicable laws, regulations, policies, procedures, and contract provisions.[26] The department consists of the quality assurance division, a monitoring unit, and a contract assurance division (which does not provide any direct oversight of IRRRLs).[27] The quality assurance division conducts special reviews and lender audits. These reviews and audits help to identify and assess risks in VA's nationwide LGY operations, including testing and evaluating internal controls. The division also oversees the eight regional loan centers and full-file loan reviews after closings to ensure lenders are achieving program goals.

LGY's monitoring unit and its regional loan centers conduct oversight of IRRRLs. Figure 3 shows the entities in LGY with their oversight roles.

| Quality Assurance Division | Monitoring Unit | Regional Loan Centers |
|---|---|---|
| • Oversees regional loan centers and lenders<br>• Examines regional loan centers' full-file loan reviews on ad hoc basis<br>• Conducts special reviews | • Conducts monthly Loan Systematic Technical Accuracy Review audits of some IRRRLs<br>• Completes lender audits | • Carries out full-file loan reviews<br>• Performs monthly quality reviews of loan specialists' performance, including on IRRRLs |

***Figure 3.*** *LGY oversight department roles.*

*Source: VA OIG analysis of VA Manual 26-9, Quality Control Procedures Loan Guaranty Operations for Regional Offices, January 25, 2016.*

The monitoring unit's oversight is limited to monthly Loan Systematic Technical Accuracy Review audits, which include a small sample of IRRRLs.[28] In addition, the monitoring unit conducts lender audits that include refinanced loans to ensure veterans are not charged unallowable fees or excess daily interest at closing.[29] These audits do not generally include

[26] VA Manual 26-9, "Oversight Department," topic 1.a, chap. 1 in Quality Control Procedures, January 25, 2016. LGY management provided the 2020 organizational chart on August 31, 2021. LGY has eight regional loan centers that administer the home loan program nationwide. The centers are in Atlanta, Georgia; Cleveland, Ohio; Denver, Colorado; Houston, Texas; Phoenix, Arizona; Roanoke, Virginia; St. Paul, Minnesota; and St. Petersburg, Florida. Regional loan center staff provide many important duties, such as overseeing lenders principally through full-file loan reviews, answering questions from potential and active borrowers, conducting prior approvals for IRRRLs that have an existing VA loan 30 days or more past due, and ensuring servicers are adequately providing loss mitigation options for defaults. Program participants are borrowers, lenders, servicers, third parties, and contractors.

[27] Based on the 2020 organizational chart LGY provided on August 31, 2021.

[28] LGY's LoanSTAR staff conduct monthly accuracy reviews of the home loan program. They randomly select 32 loans from the past month. For these loans, they examine the adequacy of servicing reviews and completed loan reviews processed by regional loan center loan technicians. VA Manual 26-9, "LoanSTAR Accuracy Reviews," chap. 2 in *Quality Control Procedures*, January 25, 2016.

[29] A daily periodic interest rate generally is calculated by multiplying the rate by the amount owed at the end of each day. This interest amount is then added to the previous day's balance, which means interest is compounding daily.

significant IRRRL coverage, as many other areas are also reviewed. Regional loan centers conduct more extensive oversight of IRRRLs as they conduct full-file loan reviews and monthly quality reviews that include IRRRLs.

After loans are executed, LGY's primary oversight activity is to test a sample of loans to ensure they were in the best financial interest of the borrowers and did not include closing cost overcharges.[30] Those reviews are referred to by LGY as full-file loan reviews. Regional LGY loan specialists conduct loan reviews for IRRRLs, as well as cash-out and purchase loans. If necessary, the lead loan specialist and the assistant loan production officer evaluate the completed reviews. The reviews are used to identify deficiencies and advise lenders and servicers of needed corrective actions.

For these full-file loan reviews, the central office provides the loans, which are randomly selected based on risk criteria not included in LGY's policies and procedures.[31] According to the LGY quality assurance and risk management program analyst (the LGY program analyst), who reports to the chief of quality assurance, eight risk criteria pertain specifically to IRRRLs. These criteria include monthly payments increasing by more than 20 percent, recoupment periods greater than 36 months, and more than two discount points. LGY also usesWebLGY to select a random sample of loans to review. Regional loan center staff are also required to review a sample of loans made by lenders during their one-year probationary period.[32] In addition, regional loan centers conduct monthly quality reviews of completed full-file loan reviews to assess loan specialists' performance. Lastly, LGY's quality assurance division assesses full-file and monthly quality loan reviews conducted by regional loan centers to ensure compliance.[33]

For FY 2020, LGY personnel completed 24,890 full-file loan reviews, which amounted to roughly 2 percent of LGY's total loan volume of about 1.2 million. For FY 2021, 19,057 loan reviews were performed, which amounted to roughly 1 percent of LGY's total loan volume of about 1.4 million.

[30] VA Manual 26-1, "Review Findings," topic 2, chap. 4 in *Guaranteed Loan Processing Manual*, rev. May 23, 2017.

[31] VA Manual 26-1, "Conduct a Review After Guaranty is Issued," topic 1, chap. 4 in *Guaranteed Loan Processing Manual*, rev. May 23, 2017.

[32] VA Manual 26-1, "Conduct a Review After Guaranty is Issued." Probationary lenders are those completing one year of supervision before being granted authority to close loans automatically. VA Pamphlet 26-7, "Withdrawal of Automatic Authority," topic 17.03 chap. 17 in *VA Sanctions Against Program Participants*, rev. May 23, 2017. Lenders can be put on probation for recurring deficiencies after the 1-year probationary period.

[33] According to the LGY program analyst, monthly quality reviews are part of loan specialists' performance assessments and are conducted by loan specialists (team leaders) on randomly selected loans.

Loan review information is used to improve lender and servicer compliance.[34] Reviews that find the borrower is due a refund—such as for closing cost overcharges or principal reduction—are to be addressed by the regional loan centers within 30 days of the finding.

LGY is authorized to take additional disciplinary actions for significant noncompliance, such as serial refinances.[35] It can require VA approval before closing loans and can decide not to guarantee loans if lenders (or servicers) demonstrate significant noncompliance.[36] Egregious activities, including predatory actions, can result in sanctions such as monetary penalties and full or partial exclusion or suspension from participation in the VA loan guaranty program for a specified period.[37] The chief of quality assurance said LGY is also expanding its enforcement options to include requesting that Department of Housing and Urban Development administrative law judges consider administrative sanctions, such as fining lenders for noncompliance.

## Two Notable Special Loan Reviews in 2019 and 2020

LGY's quality assurance division conducted a special review of any IRRRLs with loan application dates from May 25, 2018, to August 8, 2019.[38] The loan review focused on IRRRLs that did not comply with requirements for recoupment period, tangible benefits, and seasoning. The review identified 22,132 of the 56,809 loans (39 percent) issued by 480 lenders that were noncompliant:

- Ninety-eight percent (21,584) of noncompliant loans had recoupment periods exceeding the required 36 months for closing costs.
- Two percent (544) of noncompliant loans failed the net tangible benefit requirement (at least a one-half percent reduction for fixed- to fixed-rate loans or at least a 2 percent reduction for fixed- to adjustable-rate loans).
- Four loans were inappropriately refinanced within six months of the last original loan or prior refinance (a seasoning violation).

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[34] VA Manual 26-9, "Objective," topic 2, chap. 1 in *Quality Control Procedures*, January 25, 2016; "Servicers of VA Loans" (web page), VA Home Loans, accessed December 15, 2022, https://www.benefits.va.gov/homeloans/servicers.asp. Servicers are responsible for processing loan payments, following up on defaults, and other administrative activities.

[35] VA Manual 26-1, "Basic Rules Governing Debarment, Suspension, and Limited Denial Participation Actions," topic 1, chap. 5 in *Guaranteed Loan Processing Manual*, May 23, 2017.

[36] VA Manual 26-1, "Basic Rules Governing Debarment, Suspension, and Limited Denial Participation Actions."

[37] VA Manual 26-1, "Basic Rules Governing Debarment, Suspension, and Limited Denial Participation Actions."

[38] On November 3, 2020, LGY officials provided the audit team with the results of the special review, letter templates, and enclosures.

The quality assurance chief said that he was not aware of any lenders suspended in the last 10 years.

According to the LGY program analyst, the quality assurance division conducted a second special review from September 1, 2019, through December 15, 2020, to identify any additional loans that did not meet the 36-month recoupment requirement for closing costs. That division reviewed the top 10 noncompliant lenders that had not already been subject to a loan review. Those lenders accounted for 85 percent of all loans that did not meet the requirement.

Those lenders closed 31,524 loans during that second special review period. LGY focused only on recoupment because net tangible benefit and seasoning noncompliance were much less prevalent. LGY found 74 loans (1.25 percent) had recoupment periods over 36 months from a statistical sample of 2,954 loans. This is significantly less than the 38 percent recoupment error rate in the first review. The LGY program analyst attributed the improvement to guidance issued in August 2019.[39]

## FY 2020 Control Enhancements

LGY implemented new proactive controls in FY 2020 to ensure better compliance with the May 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act, and with VA's August 2019 preliminary guidance to protect borrowers from predatory lending.[40] In essence, the law seeks to protect borrowers from unfavorable IRRRLs—for example, those with unallowable and unfavorable refinance charges (closing costs)—and to prevent VA from guaranteeing IRRRLs that are at a higher risk of default.[41] To receive and retain the full amount of VA's guaranty, the lender making the IRRRL must meet the requirements of the act for fee recoupment, net tangible benefit, and loan seasoning.[42]

LGY updated its controls from March through May 2020 to comply with the act. Enhancements were primarily in three areas previously discussed: fee recoupment (to ensure borrowers recoup closing costs within 36 months of the loan through reduced loan payments), net tangible benefit (most notably a minimum fixed- to fixed-rate interest reduction of one-half percent and a two-discount-point ceiling), and loan seasoning (a requirement that the borrower must have made at least six months of payments on the current loan to preclude unnecessary serial refinances).[43] According to the chief of quality assurance, if WebLGY determines a loan does

[39] VA Circular 26-19-22.

[40] Economic Growth, Regulatory Relief, and Consumer Protection Act; VA Circular 26-19-22.

[41] Economic Growth, Regulatory Relief, and Consumer Protection Act; VA Circular 26-19-22.

[42] Economic Growth, Regulatory Relief, and Consumer Protection Act.

[43] The extended period of low rates available in the United States in FY 2020 and FY 2021 created opportunities for lenders to aggressively market and originate IRRRLs. Consequently, there was a significant increase in IRRRLs, from 94,861 in FY 2019 to 831,824 in FY 2021. Some lenders used the low rates to lure borrowers into serial refinancing, which hurts the borrower when there is little or no long-term economic benefit.

not meet those parameters, it blocks the loan guaranty certificate from being issued and requires a manual review by LGY staff.

As of January 2022, the LGY program analyst explained to the OIG audit team that the program's policies and procedures had not been completely updated based on LGY's preliminary guidance because a draft IRRRL regulation was still pending final review by VA and the Office of Management and Budget. On November 1, 2022, LGY published a proposed rule in the Federal Register to align its regulations with the law.[44]

The VA OIG considered the results of the special loan reviews in 2019 and 2020, as well as the control enhancements explained in this section, when determining whether LGY's oversight of IRRRLs protected borrowers from unfavorable refinancing or charges.

[44] LGY's proposed rule, AR58: Loan Guaranty: Revisions to VA-Guaranteed or Insured Interest Rate Reduction Refinancing Loans (IRRRLs), was published in the Federal Register November 1, 2022. VA proposed to amend its rules, specifically 38 C.F.R. 36.4307, on IRRRLs to implement Pub. L. 115-174. In this rulemaking, VA proposed to clarify requirements related to loan seasoning, recoupment, and net tangible benefit. LGY also proposed changes to the existing IRRRL worksheet and the introduction of a new IRRRL comparison disclosure. VA accepted public comments through January 3, 2023. On June 29, 2023, the under secretary for benefits stated, "Currently, VBA is working to finalize and publish this as a final rule."

# Results and Recommendations

## Finding: LGY's Oversight of IRRRLs Generally Improved but Borrowers Need Additional Protection

Despite improvements resulting from LGY's implementation of the May 2020 controls, LGY still processed IRRRLs in a way that was unfavorable to a significant number of borrowers. Lenders overcharged some borrowers for closing costs and did not always provide borrowers the information they needed to determine if their prospective loans were in their best interest.

Before implementing the May 2020 controls, LGY was unable to sufficiently ensure loans met requirements for net tangible benefit (interest rate reduction and discount points), closing cost recoupment, and loan seasoning.[45] Based on a review of 171 FY 2020 borrowers, the team determined that 19 loans involved errors in net tangible benefit and closing cost recoupment. Given the results of the review, the OIG estimated that at least 3,200 FY 2020 borrowers were overcharged $1.6 million because lenders did not meet those key requirements. Almost all of these overcharges occurred prior to LGY's implementation of the May 2020 controls; once the new controls were in place, LGY reduced the number of IRRRLS that were unfavorable to borrowers for these three requirements.[46]

However, some FY 2020 borrowers were still potentially overcharged for costs independent of these three requirements. These potential overcharges—consisting of unsupported, unallowable, or unreasonable closing costs—totaled $3 million and affected approximately 18,400 borrowers. These potential overcharges stemmed from insufficient policies and procedures to ensure lenders followed requirements to document and account for these charges.[47]

LGY requires lenders to provide borrowers with loan comparison statements immediately after the borrower applies and then again at closing; these comparisons are intended to help borrowers determine if they are making financial decisions that serve their best interest.[48] However, the OIG estimated that lenders did not provide borrowers with the required comparison statements within three business days of loan application for at least 3 percent of the IRRRLs in FY 2020, which may have affected just under 2,900 borrowers. Also, for at least 32 percent of the IRRRLs in FY 2020, the audit team could not determine if the initial loan comparison was provided within the required three business days because the loan file did not include an initial loan application (as LGY was only requiring submittal of the final loan application). The OIG asserts

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[45] This report refers to the improvements LGY made from March through May 2020 to comply with the Economic Growth, Regulatory Relief, and Consumer Protection Act as the May 2020 controls.

[46] Economic Growth, Regulatory Relief, and Consumer Protection Act; VA Circular 26-19-22.

[47] 38 C.F.R. § 36.4313, "Charges and fees," (d)(1)(ix)(2) and (d)(1)(ix)(5).

[48] VA Circular 26-18-1; VA Circular 26-19-22.

that LGY should assess whether the loan comparison controls implemented through December of FY 2022 operate as planned to ensure borrowers can make informed decisions about refinancing.

LGY could also benefit from stronger policies and procedures to improve its oversight of lenders and enhance its quality assurance for the loans VA is guaranteeing. LGY did not have adequate controls to ensure that lenders reported IRRRLs within the required 60 days for LGY to begin oversight. Written policies and procedures do not cover how to resolve issues identified during regional loan center monthly quality reviews, such as closing cost overcharges, which should be reimbursed to the borrower by the lender.[49] LGY also needs improved criteria for selecting percentage of loans to review.ying risk categories to trigger reviews, and targeting the number or

The OIG's finding is supported by the following determinations:

- LGY implemented controls in FY 2020 that generally improved borrower protection from unfavorable IRRRLs, specifically for net tangible benefit (interest rate reduction and discount points), closing cost recoupment, and loan seasoning.
- VA lacks assurance that borrowers received loan comparison statements they needed to make informed decisions due to missing and late loan comparison statements.
- Some lenders still potentially overcharged FY 2020 borrowers by including unsupported, unallowable, or unreasonable items as closing costs, which are independent of requirements addressing net tangible benefit, closing cost recoupment, and loan seasoning.
- LGY lacked sufficient controls for oversight, as well as detailed quality assurance policies and procedures to protect borrowers and ensure that the loans VA is guaranteeing are fully compliant with all applicable regulations.

## What the OIG Did

This audit finding is based on a statistically selected sample of 171 IRRRLs closed during FY 2020 (from October 1, 2019, through September 30, 2020). Those 171 IRRRLs were distributed equally across three strata—one stratum involved loans that had undergone a full-file loan review; the other two strata included loans at higher risk. This sample comprised 75 lenders, 16 of which had two or more loans in the sample. The lender with the largest number of loans in the sample had 17 (10 percent).

[49] Loan Guaranty Service, "Conducting a Full File Loan Review" chap. 4 in *WebLGY Full File Loan Review User Instructions*, ver. 1.4, April 2016.

In FY 2020, LGY was in the process of implementing new controls for IRRRLs, with the last significant new control in place on May 21, 2020. Therefore, the team used June 1, 2020, as a cutoff date for determining whether a loan should be following the new controls. Of the 171 sampled loans, 153 loans closed before June 1, 2020, and 18 loans closed after that date. The team's sample had a higher proportion of loans before June 1, 2020, mainly because some lenders erroneously reported that loans had not met a requirement for one of the key sample selection criteria. Specifically, lenders reported they had exceeded the 36-month recoupment requirement when in fact they had met it in most cases. The OIG team confirmed the requirements were met for those loans during the audit.

To check if the errors observed in FY 2020 appeared to continue in FY 2021, the audit team also selected a limited sample of 30 IRRRLs from FY 2021 (from October 1, 2020, through September 30, 2021). Although this sample is too small to permit statistical projections, it was sufficient for the team to determine whether loan comparison documents were missing and closing costs were overcharged. The team found from its limited assessment that the issues similar to those identified in the FY 2020 sample were also detected in the FY 2021 sample. The OIG acknowledges that a review of the last four months of FY 2020 (June 1 through September 30, 2020,) provided insufficient time to demonstrate wholesale improvements. However, it confirmed that some issues appeared to have persisted in FY 2021.

The team also conducted virtual site visits to two of LGY's eight regional loan centers: Phoenix, Arizona, and St. Petersburg, Florida. See appendixes A and B for additional information about the scope, methodology, and sampling.

## Controls LGY Implemented in FY 2020 Generally Improved Borrower Protection from Unfavorable IRRRLs

As previously mentioned, LGY implemented new controls in WebLGY from March through May 2020 that reduced loan deficiencies by helping to ensure borrowers recouped closing costs within 36 months, refinanced interest rates and discount points met the net tangible benefit requirements, and IRRRLs were properly seasoned. LGY programmed WebLGY to determine when a loan did not comply with the controls. If the system found noncompliance, it blocked the loan guaranty certificate from being issued and required a manual review by LGY staff.

The OIG found that the controls LGY implemented from March to May 2020 better protected borrowers from unfavorable terms. Of the 171 FY 2020 IRRRLs reviewed, the team identified a total of 19 loans that were not compliant with the net tangible benefit or closing cost recoupment requirements—18 before June 1, 2020, and just one after the new controls were in place.[50] The audit team did not identify recoupment issues based on its limited review of 30 IRRRLs from FY 2021. However, two loans by the same lender failed the net tangible benefits requirement

[50] The audit team did not identify any improperly seasoned loans.

because they were financed with discount points in excess of 2 percent, and the borrowers will need to be made whole through principal reductions. In addition, one loan did not meet the loan seasoning requirement as it was closed just under three weeks earlier than the 210-day requirement.

Table 2 provides an overview of the loan deficiencies found in the sample of 171 loans for FY 2020 related to the new controls—closing cost recoupment and net tangible benefit requirements—and demonstrates the improvements gained from the control enhancements since June 1, 2020.

**Table 2. Recoupment and Net Tangible Benefit Loan Deficiencies**

| Deficiency | Total loans with deficiency | Loans not meeting requirement before May 2020 controls | Loans not meeting requirement after May 2020 controls |
|---|---|---|---|
| Closing costs and fees not recouped within 36 months | 11 | 10 | 1 |
| Net tangible benefit | | | |
| • Rate decreases less than 0.5 percent | 7 | 7 | 0 |
| • Discount points not less than or equal to 2 percent | 1 | 1 | 0 |
| **Total** | **19** | **18** | **1** |

*Source: VA OIG analysis of statistically sampled loans from October 1, 2019, through September 30, 2020.*

Based on these 19 loans, the OIG estimated that at least 3,200 borrowers were affected and overcharged at least $1.6 million during FY 2020.

## Recoupment of Closing Costs within 36 Months

VA's "recoupment" limit helps borrowers avoid excessive closing costs, as those costs must be recouped by the borrower within 36 months based on a VA-required calculation. In practice, the borrower is actually paying back the closing costs refinanced as part of monthly mortgage payments, as those costs are typically part of the refinanced loan and amortized and paid over the life of that loan.[51] The repayment of the closing costs is similar to repayment of the loan principal, both incurring interest over the life of the loan. Lenders calculate the recoupment period to ensure the 36-month limit is not exceeded based on a calculation provided in VBA's guidance. The recoupment calculation ensures that the overall closing costs are not excessive even though the costs are typically refinanced over the life of the loan. LGY's updated controls

[51] VBA Circular 26-19-22. Recoupment is calculated by dividing all fees, expenses, and closing costs, whether included in the loan or paid outside of closing (such as an appraisal fee), by the reduction of the monthly principal and interest payment. The VA funding fee, escrow, and prepaid expenses, such as insurance, taxes, special assessments, and homeowners' association fees, are excluded from the recoupment calculations.

identify those loans exceeding 36 months, and LGY conducts loan reviews if the lender reports recoupment greater than 36 months. If LGY determines the 36-month limit is exceeded, LGY requires the lender to cure the overcharges through principal payment reduction(s).

The OIG found closing cost recoupment overcharges totaling about $10,100 for 11 loans, 10 of them before control enhancements (June 1, 2020). They ranged from about $27 to $5,600 and spanned 37 to 169 months (14 years).[52]

LGY officials agreed with the questioned costs for three of the 11 loans, totaling about $7,827 of the $10,100. LGY officials provided calculations to the audit team for the remaining eight loans based on their assumption that all lenders used the “complex” recoupment method instead of the “simple” method.[53] However, that assumption was incorrect, as the recoupment data on the lender-prepared loan comparison statements showed the “simple” method was used. The audit team used the simple method because it matched the information on the loan comparison statements provided to the borrowers. The LGY officials could not provide a sufficient explanation as to why they used the more complex method for all eight loans or why they considered lender-reported loan comparison data inaccurate. Moreover, officials had ultimately decided the simple method was the more logical way to calculate recoupment and directed lenders to use only that method starting on July 24, 2020. All 11 loans with closing cost recoupment overcharges closed prior to this date.

The OIG concluded that 11 borrowers need to be refunded a total of about $10,100 for these recoupment overcharges.

## Rate Reduction of at Least One-Half Percent

One of the requirements of the net tangible benefit is for the IRRRLs interest rate to decrease by at least one-half percent (50 basis points) compared with the existing loan for fixed- to fixed-rate loans. One of the controls LGY implemented in May 2020 was to identify loans not meeting that rate reduction. If that occurs, lenders must adjust the interest rate to meet the minimum one-half percent reduction. The audit team identified seven loans made before control enhancements that did not meet the rate reduction requirement. Therefore, those seven borrowers were overcharged more than $10,000 in excess interest in total, with overcharges ranging from over $400 to

[52] The overcharges are a result of the excess amount between the charged closing costs and the maximum closing costs that the borrower should have been charged based on the required 36-month recoupment calculation.

[53] Based on LGY guidance, the lender had the option to use one of two recoupment calculation methods from August 8, 2019, through July 23, 2020: a complex or simple method. Both methods required the lender to exclude certain costs (VA funding fee, escrow, and prepaid expenses such as insurance, taxes, special assessments, and homeowner’s association fees) from the closing cost numerator. However, the complex method also excludes these costs from the estimated new payment used to calculate the monthly payment reduction in the denominator, resulting in a shorter recoupment period and a smaller refund due to the borrower if 36 months is exceeded. For the simple method, the denominator does not exclude those costs, resulting in a longer recoupment period and a larger refund due the borrower if 36 months is exceeded.

$4,500. LGY officials agreed that six of the seven loans exceeded one-half percent and would take corrective actions, most likely through principal reductions for the excess interest paid.

For the seventh loan, the interest rate reduction was only 0.375—from 3.875 percent to 3.5 percent. The LGY program analyst stated the existing loan with an interest rate of 3.875 percent had been increased to 4.625 percent based on a disaster loan modification and therefore the rate reduction was 1.125 percent.[54] The only support for the 4.625 percent disaster loan modification was a loan servicer note in WebLGY. The audit team disagreed with LGY because neither WebLGY nor VA Loan Electronic Reporting Interface had loan updates in those systems of records or any supporting loan documentation indicating that a loan modification occurred. The audit team concluded the interest rate reduction was only 0.375 percent because LGY lacked sufficient documentation to support the purported loan modification.

The OIG concluded that the seven borrowers should be refunded a total of $10,022 in excessive interest.

### Discount Points No More Than 2 Percent

The net tangible benefit also includes a requirement that no more than two discount points may be financed by the borrower for an IRRRL.[55] If the discount points exceed 2 percent, VA requests the lender to issue a refund to the borrower in that amount as a principal reduction and provide evidence this was done. The audit team determined that a lender overcharged a veteran $353 by charging discount points of 2.195 percent, which exceeded the 2 percent net tangible benefit requirement. This loan was executed before the control enhancements. After the audit team identified the discrepancy, LGY officials agreed, conducted a full-file loan review, and required the lender to issue a refund to the borrower as a loan principal reduction.

In FY 2021, two of the 30 limited-sample IRRRLs financed by the same lender failed the net tangible benefits requirement because they were financed with discount points in excess of 2 percent (2.375 and 3.25 percent). These borrowers will need to be made whole through principal reductions.

Overall, the OIG concluded the new controls reduced the number of noncompliant loans. Only one of the 18 loans sampled after controls were implemented had a related loan deficiency (exceeding the 36-month recoupment requirement). These results show the effectiveness of the control enhancements from FY 2020 for net tangible benefit and recoupment.

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54 VA Manual 26-4, "VA Disaster Modification," chap. 5.06.e in *VA Servicer Handbook*, February 26, 2019. VA disaster modifications allow "servicers to offer a permanent modification of loan terms to provide payment relief to impacted delinquent borrowers when the borrower has not submitted a complete loss mitigation application." The interest rate cannot increase by more than 1 percent and cannot exceed the weekly Freddie Mac Primary Mortgage Market Survey Rate.

55 VA Circular 26-19-22.

## LGY Did Not Always Ensure Borrowers Could Make Informed Decisions, Due to Late or Missing Loan Comparison Statements

As previously stated, the lender is required to present a loan comparison statement to the borrower within three business days from the date of the loan application and again at closing.[56] However, for the FY 2020 loan sample, the OIG found lenders did not provide the borrowers initial loan comparison statements for 16 of the 171 loans. In addition, the initial loan comparison was not given within three business days of the loan application for another two of the 171 loans. Based on this result, the OIG estimated that lenders did not provide just under 2,900 borrowers with the required statement within three business days of the loan application for the IRRRLs in FY 2020.

In addition to those 18 loans for which lenders did not issue comparison statements at all or within three business days, lenders may not have presented initial loan comparison statements within the three days for a wider set of loans. For 66 of the 171 sampled loans, LGY provided the first comparison statements, but the initial loan application was missing from the loan file. The fact that the initial loan application was not in the file is not an error under VA requirements, as VA only requires the final loan application be submitted. Nevertheless, because the initial loan application was not in the file, the OIG could not determine if the required initial cost comparison was provided within three business days of that initial application. The OIG estimates that just under 28,600 borrowers in FY 2020 could have been affected.

The OIG also found that lenders did not provide borrowers with the required second comparison statements at closing for 10 of 171 FY 2020 IRRRLs in the team's sample. Based on this result, the OIG estimates that at least 520 borrowers could have been affected. For the limited sample of FY 2021 loans, the audit team also identified missing first or closing loan comparison statements for six of 30 loans, which indicates that this issue may persist.

After enactment of the May 2018 public law to protect borrowers from unfavorable IRRRLs, VA established disclosure standards in the related guidance that include a comparison of the borrower's existing loan and the IRRRL.[57] When both loan comparisons are not provided at the prescribed times, borrowers may not be fully aware of the differences between their existing loans and the subsequent IRRRLs, such as the new monthly payment, interest rate, and closing costs. In addition, if the lender does not provide the initial loan application, loan specialists cannot determine if lenders are providing initial loan comparisons within three business days. It is important to note that the team did not identify any materially negative outcomes from not receiving a loan comparison statement. However, lack of documentation and missing or delayed

[56] VA Circular 26-18-1; VA Circular 26-19-22.

[57] Economic Growth, Regulatory Relief, and Consumer Protection Act, § 309.

loan comparison statements undermine LGY's efforts to help borrowers make decisions that will improve their future financial positions.

Since February 2018, LGY has required lenders to provide an initial loan comparison statement within three business days of the loan application.[58] In August 2019, LGY issued guidance that further required lenders to provide a loan comparison statement at closing.[59] However, LGY did not implement sufficient controls to meet that requirement until December 2022 and only started implementing controls to partially meet that requirement in December 2021. LGY initially told the audit team that loan comparison statement controls were not implemented earlier because it was a "large project" that took an "extended amount of time to ensure proper operation into VA systems and lender systems."

According to the LGY chief of quality assurance, WebLGY required as of December 2021 that lenders upload only one loan comparison statement (either the initial comparison statement or the one at closing) in the system before requesting and receiving a loan guaranty certificate. Without the certificate, the lender will not receive the loan guaranty from VA and gain its protection if the loan goes into foreclosure.

In August 2022, the LGY chief of quality assurance acknowledged LGY's requirement for lenders to provide both statements but said he considered one loan comparison at closing sufficient for the borrower to make an informed decision and to guaranty the loan. This signed final loan comparison provided at closing outlines the terms of the loan. However, in September 2022, LGY did update its loan review guidance to require lenders to submit the initial loan comparison within three business days and the final loan comparison at closing, starting December 1, 2022.[60] LGY also highlighted that borrowers have three business days after closing to cancel the loan if it is not in their financial interest.[61]

Because LGY stated the new controls were initially implemented in December 2021 (FY 2022) and additional controls were implemented in December 2022 (FY 2023), the audit team previously requested that LGY provide evidence the controls implemented in December 2021 are working as planned. To date, LGY has been unable to provide any such evidence. Accordingly, recommendation 1 is to assess whether the loan comparison controls implemented in December 2021 and December 2022 operate as planned to confirm veterans received these statements as required.

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[58] VA Circular 26-18-1.

[59] VA Circular 26-19-22.

[60] VA Circular 26-22-16, "Full File Loan Review (FFLR) Stacking Order Update," September 15, 2022; VA Circular 26-22-16, "Stacking Order for IRRRLs, Exhibit B," September 15, 2022.

[61] 12 C.F.R. § 10.26.23 allows the borrower to exercise the right to rescind the loan until midnight of the third business day following the closing of the loan.

## Some Borrowers Were Still Potentially Overcharged Closing Costs

Although LGY's implementation of the May 2020 controls improved IRRRLs' compliance for net tangible benefit and closing cost recoupment, these new controls did not prevent FY 2020 borrowers being potentially overcharged due to the inclusion of unsupported, unallowable, or unreasonable closing costs. The OIG maintains that borrowers deserve full disclosure and complete transparency of the potential and final cost of the IRRRL from the loan application and initial loan comparison through closure so that they can make informed financial decisions about the benefit of their loan and the costs they will incur by refinancing. The closing costs should be allowable, fully supported, and reasonable so that borrowers can be completely cognizant of the costs they will be charged by refinancing their loans.

The OIG notes that overcharged closing costs described in this report are described as *potential* overcharges because the OIG and LGY differ on how some closing costs should be supported and documented in the loan file, as discussed later in the report. Accordingly, a legal opinion from VA's Office of General Counsel is needed to address this difference and conclude if these charges are actual overcharges. The OIG estimates that approximately 18,400 of the FY 2020 borrowers (21 percent) were potentially overcharged a total of $3 million for unsupported, unallowable, or unreasonable closing costs. The OIG contends that LGY should improve its policies and procedures to ensure that borrowers do not incur unallowable, unsupported, and unreasonable closing costs for certain charges and that all costs are fully transparent.

Federal regulations and LGY's policies and procedures identify what charges are allowable and unallowable, whether they are considered an itemized charge or as part of the flat charge, and what types of support are required.[62] They also provide reasonable and customary guidelines for some of these costs.

Based on the closing costs charged to the 171 loans in FY 2020, the audit team found that 49 of 171 loans included potentially overcharged closing costs totaling about $9,828. Ten of these 49 loans had more than one potential closing cost overcharge. Based on these results, the OIG estimates that approximately 18,400 borrowers were potentially overcharged closing costs of approximately $3 million.

[62] 38 C.F.R. § 36.4313(d)(2) states: "A lender may charge, and the veteran may pay a flat charge not exceeding 1 percent of the amount of the loan, provided that such flat charge shall be in lieu of all other charges relating to costs of origination not expressly specified and allowed in this schedule." C.F.R. § 36.4313(d)(5) states: "The fees and charges permitted under this paragraph are maximums and are not intended to preclude a lender from making alternative charges against the veteran which are not specifically authorized in the schedule provided the imposition of such alternative charges would not result in an aggregate charge or payment in excess of the prescribed maximum." VA Pamphlet 26-7, "Fees and Charges the Veteran Borrower Can Pay," topic 2, chap. 8 in *Lenders Handbook*, rev. November 8, 2012.

Table 3 illustrates the number of occurrences and loans for each of the five unallowable, unsupported, or unreasonable closing cost categories identified during the team's review of the FY 2020 loan sample.

**Table 3. Unallowable, Unsupported, or Unreasonable Closing Costs in FY 2020 Sample**

| Cost category | Amount ($) | Occurrences | Unique loans* |
|---|---|---|---|
| (1) Unsupported third-party charges | 2,815 | 20 | 19 |
| (2) Unsupported government and other fees | 477 | 14 | 14 |
| (3) Unsupported state deviation fees | 3,185 | 15 | 11 |
| (4) Unallowable origination fees in excess of 1 percent | 114 | 4 | 4 |
| (5) Unreasonable mortgage brokerage fee | 3,237 | 1 | 1 |
| **Total** | **9,828** | **54** | **49** |

*Source: VA OIG analysis of statistically sampled loans from October 1, 2019, through September 30, 2020.*

* *Ten loans had multiple unsupported closing cost charges.*

Based on a limited review of 30 FY 2021 loans, the audit team identified similar potential closing cost issues for seven IRRRLs, including potential overcharges as a result of missing third-party invoices, unsupported government fees, and an unreasonable mortgage brokerage fee.

Overall, the OIG takes the position that all the closing costs charged to the borrower should be fully disclosed so that borrowers can make informed financial decisions in their own best interest and the loan file should include sufficient support for those charges. Lenders should not be able to charge borrowers unallowable, unsupported, or unreasonable closing costs, as borrowers deserve full disclosure and complete transparency as they consider refinancing their loans.

In the subsections that follow, the report details these charges as well as areas where the OIG and LGY disagree.

## (1) Third-Party Charges Not Supported by Invoices

The OIG identified 19 loans in its sample that had a total of 20 missing invoices in the related files for private third-party charges. The missing invoices were for charges for 16 credit reports, three processing fees, and one undisclosed debt report. The C.F.R. permits credit report fees as part of the itemized closing fees and charges if reasonable and customary.[63] The C.F.R. permits loan-processing fees and debt reports along with other costs and charges as part of loan origination costs not to exceed 1 percent of the loan amount. Federal internal control standards

[63] 38 C.F.R. § 36.4313.

state that transactions should be recorded at the correct amount and represent "economic events that occurred."[64] The VA pamphlet, which provides lenders with the guidelines and requirements for the VA Home Loan Program, likewise requires third-party charges to be limited to the actual charges.[65] Specifically, the VA pamphlet states, "Whenever the charge relates to services performed by a third party, the amount paid by the borrower must be limited to the actual charge of that third party."[66] However, the pamphlet does not explicitly require lenders to obtain and maintain those third-party invoices. Although such a requirement is not explicitly stated, invoices are the documents that provide the information needed to ensure that transactions are in the correct amount and represent economic events that occurred. Without invoices, neither the audit team nor any party could ensure the closing cost charges were valid or accurate. Further, borrowers would not have the transparency they need to fully understand their closing costs.

LGY officials agreed that seven of 20 missing invoices were overcharges but disagreed with the remaining 13 deficiencies. They cited policy unrelated to IRRRLs that states no invoice is required for third-party charges for credit reports.[67] However, the cited policy only relates to underwriting, and is not analogous to potential overcharges for IRRRLs. Specifically, underwriting is a mortgage lender's process of assessing the risk of lending money to a borrower. In fact, because underwriting is not required for IRRRLs unless the existing loan is delinquent, the policy concerning underwriting is not applicable. Moreover, the chief of quality assurance explained that the credit report is categorized as a reimbursable expense, which means invoice support is required if lenders claim reimbursement as part of the mortgage transaction. Those lenders did claim reimbursement for the credit report charges as part of the closing costs, so the OIG stands by its position that the lenders should have included the invoices.

In discussions with the audit team, the chief of quality assurance attempted to justify the lack of support for any non-credit report costs such as processing fees by explaining that these unsupported costs should be allowed to be charged retroactively as part of the 1 percent flat charge, even though the costs were, in fact, charged as itemized costs.[68] For closing costs, lenders can charge borrowers for (1) reasonable and customary itemized closing fees and charges (costs), (2) a flat charge for loan origination costs which are not allowed as itemized closing fees up to 1 percent of the loan amount *or* a flat charge and additional closing costs (referred to as "alternative" charges) up to 1 percent of the loan amount, and (3) reasonable discount points

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[64] Government Accountability Office, *Standards for Internal Control in the Federal Government*, principle 11.05, GAO-14-704G, September 2014.

[65] VA Pamphlet 26-7, "Itemized Fees and Charges," topic 2.c., chap.8 in *Lenders Handbook*, November 8, 2012.

[66] VA Pamphlet 26-7, "Itemized Fees and Charges."

[67] VA Pamphlet 26-7, "Credit Report Standards," topic 7.a, chap. 4 in *Lenders Handbook*, rev. February 22, 2019.

[68] C.F.R. § 36.4313(d)(2) allows a lender to charge, and the borrower to pay, a flat charge for loan origination fees not exceeding 1 percent of the amount of the loan, in lieu of all other origination charges that are not reimbursable as itemized fees and charges. C.F.R. § 36.4313(d)(5) allows other fees and charges, referred to as alternative charges, if the total charges do not exceed 1 percent of the loan amount.

when applicable.[69] The OIG contends that borrowers should not have been charged for the credit report and non-credit report closing costs because the costs were unsupported, whether they were counted as itemized charges or as part of the flat charge. Further, the C.F.R. describes the costs that can be charged as itemized costs, which include the cost of credit reports. In contrast, the regulation does not state itemized costs can be charged retroactively as part of the 1 percent flat charge. In short, lenders should only be requiring borrowers to pay for fully supported costs; they should not pass along unsupported closing costs to borrowers.

The chief of quality assurance also asserted that borrowers were not paying the unsupported non-credit report charges in most cases, as lenders already reduced their compensation to offset those charges. The chief of quality assurance added that, if the lender is reducing compensation, it is effectively refunding the fees that are unallowable prior to closing, which is the only method to make a loan compliant. In addition, he explained the Consumer Financial Protection Bureau no longer allows lenders to show any credits in addendums, and therefore doing so would make the loan noncompliant. The OIG audit team disagrees with this assertion as those costs were charged as itemized costs and not as part of the flat charge. The OIG audit team checked in the loan files, however, and could not confirm that lenders included any credits for the unsupported charges. If this practice occurred, it was undocumented in the file and therefore not transparent to the borrower, LGY, or the OIG.

Overall, the OIG questions these explanations. LGY is effectively allowing lenders to treat the flat charge partly as compensation, while the OIG's perspective is that the regulation's intent is to allow lenders to be reimbursed for origination fees as part of total closing costs. Lenders may profit from the interest charged on loans, discount points, and from other financial transactions, but they should only be reimbursed for closing costs incurred either as itemized costs or as part of the flat charge. Finally, the lender should include only fully supported closing costs on the closing statement, as this practice would eliminate the need for any credits and potential loan noncompliance risks.

The OIG concludes that borrowers should not have been charged for these closing costs—either as an itemized charge or as part of the flat charge—unless the costs were supported by invoices or other evidence. If LGY believes that lenders should be able to charge borrowers unsupported, undocumented closing costs as part of the 1 percent flat charge, LGY should seek a legal opinion justifying this position, as the OIG has proposed in recommendation 2.

### (2) Unsupported Government and Other Fees

The C.F.R. permits government fees as part of itemized closing fees and charges if reasonable and customary, such as recording fees and homeowner's association fees. The OIG found 14 of

[69] 38 C.F.R. § 36.4313. The regulation allows certain itemized fees and charges as part of a single flat charge, as alternative charges, or as both a flat charge and alternative charges with a maximum of 1 percent of the loan amount.

171 FY 2020 loans contained government or other fees that could not be supported by government bills and receipts or third-party invoices. Without supporting documentation, the OIG could not ensure that all the government or other fees were valid. Twelve of the 14 loans had insufficient support for recording and mortgage fees, one loan had a partially unsupported homeowner's association insurance fee, and another had a partially unsupported credit report fee. For example, as detailed in table 4, a borrower was billed $80 for recording fees when only a mortgage fee of $40 could be determined. The nature of the remaining $40 was unclear.

**Table 4. Example of Unsupported Recording Fee**

| **Closing cost details** | | | |
|---|---|---|---|
| **Other costs** | **Paid by borrower** | | **Paid by others** |
| | At closing | Before closing | |
| **E. Taxes and Other Government Fees** | $80 | | |
| 01. Recording Fees: Deed: **Mortgage: $40** | **$80** | | |
| 02. | | | |

*Source: VA OIG analysis of statistically sampled loans from October 1, 2019, through September 30, 2020.*

The VA pamphlet does not include a requirement to itemize all government fees and obtain related bills and receipts. Also, LGY has not required a complete itemization of all government and other fees or required any additional support for those fees, accepting any unknown fees as part of "other government fees." As stated in the previous section, the VA pamphlet does not explicitly require lenders to obtain and maintain third-party invoices, but it does require third-party charges to be limited to the actual charges.[70] Although a requirement is not explicitly stated, bills and receipts for government fees and invoices for third-party charges are necessary to ensure that transactions are in the correct amount and represent economic events that occurred.

Federal internal control standards indicate that transactions should be recorded at the correct amount and represent economic events that occurred. In addition, the Consumer Financial Protection Bureau requires lenders to disclose the "total fees expected to be paid to the state or local government for recording deeds after the word 'Deed' and, separately, to disclose the total fees expected to be paid to state or local government for recording security instruments after the word 'Mortgage.'" These fees should be shown on line 01 in table 4.[71] This recording is necessary because if all government fees are not described on line 01 of the closing statement, the borrower cannot be fully aware of the nature of all the charges. Given the need to record the correct amounts reflecting actual events, it is fundamental that without supporting documents,

[70] VA Pamphlet 26-7, "Itemized Fees and Charges."

[71] Consumer Financial Protection Bureau, *TILA-RESPA Integrated Disclosure: Guide to the Loan Estimate and Closing Disclosure*, December 2017.

neither the audit team nor any other party could ensure the closing cost charges were valid or accurate.

LGY officials did not agree with the audit team's assessment of the 14 fee discrepancies and the need for support regarding those charges. For 12 of the 14 fee discrepancies, the LGY program analyst stated

> Closing disclosure line E 01 Recording fees are made up of government fees consisting of Recording fees for Deeds, Mortgage and other Government fees. The dollar amount in question falls under Other Government fees and as such will not have a line item on the [closing disclosure] but is rolled up into the total fee.

As indicated in table 4, there is available space next to the "Recording Fees" or on line 02 for the lender to clearly label where the additional dollar amount came from, to ensure transparency in closing costs for the borrower.

The OIG maintains that LGY should require lenders to provide support for fees included in the closing costs in order to protect the borrowers' best interests as well as to ensure the transparency of loan costs to LGY, the lender, and the OIG. In recommendation 3, the OIG proposes that LGY obtains third-party documentation and lenders report itemized closing costs at the lowest level of detail.

### (3) Unsupported State Deviation Fees

Thirty-one of the 50 states and two territories—Puerto Rico and the US Virgin Islands—have one or more state deviation charges that establish the amounts borrowers should pay for certain services. Examples include $100 for attorney fees for refinances in Texas, $175 for residential mortgage fees in Illinois, and $90 on refinances for the title insurance premium under the Iowa Title Guaranty Program. The C.F.R. permits state deviation costs as part of itemized closing fees and charges if reasonable and customary.[72] The VA pamphlet states

> Additional fees attributable to local variances [state deviations] may be charged to the veteran [borrower] only if specifically authorized by VA. The lender may submit a written request to the regional loan center for approval if the fee is normally paid by the borrower in a particular jurisdiction and considered reasonable and customary in the jurisdiction.[73]

[72] 38 C.F.R. § 36.4313.

[73] VA Pamphlet 26-7, "Itemized Fees and Charges."

### *Inadequate State Deviation Fees Documentation*

For 11 of the 171 FY 2020 loans, the OIG found 15 state deviation charges totaling about $3,180 that did not have adequate supporting documentation. LGY could not provide VA's authorizations for those 15 state deviation fees, as required to determine if reasonable and customary by the C.F.R. and VA policy.[74]

The LGY program analyst stated LGY lost the authorizations during consolidation of regional offices and turnover in the Loan Policy Division. LGY relies on a schedule of state deviation fees dated August 13, 2020, which lacks a document title and an official's approval.[75] LGY does not have a policy or procedure requiring retention of past approvals and the names of the approving official(s), which are necessary for keeping the schedule up-to-date. As a result, borrowers were charged and continue to be charged for state deviation fees that lack sufficient support. In addition, loan specialists cannot fully rely on the state deviation charges when conducting loan reviews.

LGY agreed with the OIG that these state deviation fees were unsupported. Recommendation 4 calls on LGY to develop updated policies and procedures for the state deviation process so that these charges can be better supported.

### *Allowability of State Deviation Overages*

In addition to questioning state deviation costs in their entirety for 11 loans in the sample due to lack of support, the audit team questioned LGY's practice of including any cost over the state deviation fee amounts included in the published schedule as part of the 1 percent flat charge. The team considers these to be limits or maximums, and exceeding them results in overcharges to the borrower, which contradict what the OIG perceives as the intent of the published state fees.

LGY considers the amount over the state fee limit to be chargeable as part of the 1 percent flat charge. The LGY program analyst wrote

> Unless otherwise stated in the VA state deviation or VA regulations, the fees listed on the state deviation schedule are allowable fees not maximum fees. If the lender exceeds the fee listed, then the dollar amount over the normal fee is added to the 1 percent fee the lender can charge.

However, the practice of including the excess costs as part of a flat charge is not supported in LGY's written policies and procedures. Further, the C.F.R. describes the costs that can be charged as itemized costs, which includes state deviation charges. The regulation does not state itemized costs can be charged as part of the 1 percent flat charge. The fact that the state deviation

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[74] 38 C.F.R. § 36.4313; VA Pamphlet 26-7, "Itemized Fees and Charges."

[75] "State Fees and Charges Deviations Change Sheet" (web page), VA Home Loans, accessed November 16, 2020, https://www.benefits.va.gov/homeloans/documents/docs/state_deviations.pdf.

schedule identifies specific amounts supports the audit team's contention that the intent is to establish limits, and any excess charges should be unallowable. For example, the only support provided by LGY for a $400 settlement fee for one of the 11 loans identified was documentation for an escrow fee that indicated the fee "may not exceed" $175. The team initially intended to question the $225 overage but questioned the entire $400 due to inadequate support for the settlement fee, as described above. The fact that LGY specifically identifies the excess to be included in the 1 percent flat charge when applicable indicates LGY acknowledges the existence of some states' application of limits on certain state deviations.

The OIG concluded that LGY should obtain a legal opinion on the allowability of state deviation charges in excess of the state-published amounts as part of responding to recommendation 4.

## (4) Unallowable Origination Fees in Excess of 1 Percent

The C.F.R. allows a lender to charge, and the borrower to pay, a flat charge for loan origination fees not exceeding 1 percent of the amount of the loan, in lieu of all other origination charges that are not reimbursable as itemized fees and charges.[76] The C.F.R. goes on to explain that other fees and charges, referred to as alternative charges, are permitted as long as the total charges do not exceed 1 percent of the loan amount.[77] In summary, lenders can charge borrowers only the following three categories of costs, though all three categories can be included in any given IRRRL:

- Reasonable and customary itemized closing fees and charges (such as recording fees, credit report charges, and title examination and insurance)
- A single lender flat charge for loan origination costs not allowed as itemized closing fees, and charges up to 1 percent of the loan amount or a flat charge and additional closing costs (referred to as "alternative" charges) up to 1 percent of the loan amount (such as lender appraisals, attorney fees other than title work, and loan application fees)
- Reasonable discount points when applicable[78]

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[76] 38 C.F.R. § 36.4313(d)(2). "A lender may charge, and the veteran may pay a flat charge not exceeding 1 percent of the amount of the loan, provided that such flat charge shall be in lieu of all other charges relating to costs of origination not expressly specified and allowed in this schedule."

[77] 38 C.F.R. § 36.4313(d)(5). "The fees and charges permitted under this paragraph are maximums and are not intended to preclude a lender from making alternative charges against the veteran which are not specifically authorized in the schedule provided the imposition of such alternative charges would not result in an aggregate charge or payment in excess of the prescribed maximum."

[78] 38 C.F.R. § 36.4313. The regulation allows certain itemized fees and charges as part of a single flat charge, as alternative charges, or as both a flat charge and alternative charges with a maximum of 1 percent of the loan amount.

VA's policies and procedures provide examples of costs that cannot be charged to the borrower as itemized fees and charges, and others that should be covered by the flat charge.[79] Examples of costs covered only by the flat charge are loan closing or settlement fees, attorney fees other than for title work, lender appraisals, loan application or processing fees, and postage and other mailing charges. During loan reviews, loan specialists enter the closing costs into WebLGY, which recalculates the total closing costs to ensure that, as part of the flat charge, they do not exceed the 1 percent regulatory limit.

The OIG determined that four of the 171 FY 2020 loans in its sample had closing costs over the allowable 1 percent regulatory limit. The costs ranged from $0.25 to about $99. While the OIG recognizes these amounts are trivial, the principle of not exceeding the cap is essential. The fixed cap makes any deviation a violation, which eliminates any judgment when exceeded.

These unallowable costs occurred because lenders did not limit the origination fees to 1 percent and failed to issue credits to ensure the regulatory limit was not exceeded.[80] As a result, four borrowers were overcharged closing costs. For example, one loan had an origination fee of about $2,106, but the allowable 1 percent limit was about $2,007 (loan payoff amount of $200,723 multiplied by 1 percent), leaving an overcharge to the borrower of about $99. The audit team asked LGY to review this charge, and LGY concurred that it was an overcharge that should be refunded to the borrower.

Central to loan specialists' determination of costs eligible under the flat charge is a provision in the VA pamphlet that differs from the C.F.R. The regulation allows certain itemized fees and charges as part of a single flat charge, as alternative charges, or as both a flat charge and alternative charges with a maximum of 1 percent of the loan amount.[81] In contrast, the pamphlet explicitly states that certain itemized fees and charges should be allowed only as part of a single flat charge not exceeding 1 percent of the loan. It does not mention that those certain itemized fees and charges can also be applied as alternative charges.[82] If a loan specialist were to apply the procedures in the VA pamphlet, lenders potentially would not be reimbursed for any alternative charges.

While the audit team did not identify any instances in which the situation described above occurred, it could cause confusion for less experienced loan specialists and could result in disallowing valid and allowable costs. For example, if a lender does not apply a percentage flat charge and instead claims a $500 lender appraisal and a $300 loan-processing fee as alternative

[79] VA Pamphlet 26-7, "Fees and Charges the Veteran-Borrower Can Pay."

[80] Lender credits are money from the lender that may be used to offset allowable fees and charges.

[81] 38 C.F.R. § 36.4313.

[82] VA Pamphlet 26-7, chap. 8, sec. 2.d. "Lender's One Percent Flat Charge," topic 2.d, chap. 8 in *Lenders Handbook*, November 8, 2012. VA Form 26-8923 is used for IRRRLs to calculate the 1 percent of the loan less any cash payments to the veteran and is referenced in this pamphlet.

charges, a loan specialist could make the mistake of disallowing those charges during a full-file loan review. The difference between the pamphlet and the C.F.R. could also cause confusion for lenders new to the VA Home Loan Program.

According to the LGY program analyst, the reason the practice matched the C.F.R. but not the policy was to allow “the VA and the lenders to be more flexible in documenting fees and charges for individual state and local jurisdictions. This also allows the Veteran borrower to easily understand what they are paying for.” The audit team asserts that practice should align with policy, which in turn should align with the C.F.R., so that staff can more efficiently identify and resolve closing cost overcharges. LGY’s chief of quality assurance subsequently acknowledged the need to update the policy to align with the C.F.R. and LGY’s practice.

The OIG recommends that LGY update its policy to follow the C.F.R. (see recommendation 5).

### (5) Unreasonable Mortgage Brokerage Fee

The audit team identified one loan in which a significant mortgage broker’s compensation fee of $3,237 for finding a lender (finder’s fee) was included in the 1 percent flat charge. This charge was an outlier, as there were no other similar charges by any of the other 74 lenders among the 171 loans reviewed. The audit team concluded the necessity of another financial firm to direct borrowers to mainstream lenders normally is unnecessary. The audit team reviewed 17 loans for this lender and found only one loan in which this type of charge was listed as part of the lender’s 1 percent flat charge.

The VA pamphlet states that finder’s fees can be charged as part of the 1 percent flat charge.[83] The audit team asked LGY about the fee for the mortgage broker and its relationship to the C.F.R., which states, “Except as provided in this subpart, no brokerage or service charge or their equivalent may be charged against the debtor or the proceeds of the loan either initially, periodically, or otherwise.” The LGY program analyst stated that at the time the regulation was created, the reference applied to real estate brokers, not mortgage brokers, and is therefore an allowable cost as part of the 1 percent flat charge.

Nonetheless, the C.F.R. outlines the permissible fees and charges that can be itemized and states, “The veteran [borrower] may pay reasonable and customary amounts” for those fees and charges.[84] It describes costs in the flat charge as “in lieu of all other charges relating to costs of origination not expressly specified and allowed in this schedule.” Therefore, costs in the flat charge should also be reasonable and customary.[85] Moreover, this exorbitant charge is

[83] VA Pamphlet 26-7, “Lender’s One Percent Flat Charge.”

[84] 38 C.F.R. § 36.4313(d)(1).

[85] 38 C.F.R. § 36.4313(d)(2).

contradictory to what the OIG perceives as the intent of the law, which is to protect veterans and consumers.[86] Based on these two reasons, the OIG considers this charge unreasonable.

Although the C.F.R. expressly disallows brokerage fees, LGY's position and VA pamphlet make assumptions that are not explicit in the regulation—specifically, that loan finder's fees are allowable while real estate brokerage fees are unallowable. However, the OIG acknowledges that the regulation does effectively provide for an exception for this and any type of loan origination charge since a lender may make alternative "charges against the veteran [borrower] which are not specifically authorized in the schedule" provided 1 percent is not exceeded.[87] Even given any exception(s), the OIG still considers this cost subject to a reasonableness standard and again contradictory to the intent of the law, which is to protect borrowers from unnecessary charges and to prevent lenders from weakening the financial benefit of refinancing. The OIG proposes that LGY obtains a legal opinion from the VA's Office of General Counsel on the allowability of mortgage brokerage fees charged under the 1 percent flat charge as described in recommendation 6.

Overall, the OIG contends that LGY needs to improve its policies and procedures and obtain legal opinions to better protect borrowers from overcharges and ensure closing costs are adequately supported and comply with federal regulations. LGY needs to approach this issue with the goal of providing borrowers with the full disclosure they deserve. VA can ensure that veterans are paying only for necessary costs by making these costs more transparent to borrowers, lenders, LGY, and the OIG.

All the overcharges—ranging from unsupported third-party fees to an unreasonable mortgage brokerage fee—could be remedied if LGY improved its policies and procedures related to documenting support for these closing costs. First, LGY needs to seek legal opinions from VA's Office of General Counsel to determine if fees initially charged as itemized fees are allowed to be retroactively accepted as part of the 1 percent flat charge if unsupported. Second, LGY needs to seek an opinion to determine if state deviation charges in excess of the state-published amounts and mortgage brokerage fees are allowable as part of the 1 percent flat charge. Based on these opinions, LGY should review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole. (See recommendations 2, 4, and 6.)

[86] Economic Growth, Regulatory Relief, and Consumer Protection Act, § 309.

[87] 38 C.F.R. § 36.4313(d)(5).

## LGY Should Improve Its Oversight of IRRRLs

Once lenders issue IRRRLs, they are required to report to LGY within 60 days, at which point LGY performs oversight of these loans. However, the OIG found that LGY needs to strengthen its controls for this oversight process, as the audit team identified several LGY weaknesses:

- Controls do not ensure IRRRLs are reported within 60 days.
- Quality control processes do not include detailed and complete steps that loan specialists should follow for full-file loan reviews.
- How loans should be selected for full-file loan review has not been fully documented.
- Quality assurance policies and procedures do not cover resolution of issues identified during regional loan center monthly quality reviews.

By strengthening these controls and its quality assurance policies and procedures, LGY can more effectively protect borrowers from unfavorable IRRRLs and also ensure that VA is guaranteeing loans that are compliant with all requirements.

### Controls Do Not Ensure Lenders Reported IRRRLs on Time for Oversight

According to the VA pamphlet, a loan must be reported to VA, along with all documentation, within 60 days of closing.[88] On-time reporting is required so LGY can issue a loan guaranty certificate and conduct timely and effective oversight, such as full-file loan reviews. A lender that fails to meet this deadline must provide a written explanation signed by a corporate officer of the lender.

Of 171 sampled FY 2020 IRRRLs, the audit team identified 19 that were not reported within the 60-day requirement and were therefore subject to delayed oversight. These 19 loans took an average of 90 days to report, ranging from 64 to 288 days. For the 19 occurrences, LGY could not provide the audit team with a signed statement from the lender justifying late reporting or satisfactorily explaining why signed statements were not obtained. LGY stated, “The delay in reporting a loan is due to the large volume of loans and post-closing backlog combined with the available work force.” Five of the 19 loans received a full-file loan review, and during only one of those reviews was a request made to provide a reason for failing to meet the 60-day deadline.

LGY could not conduct effective oversight during the period those loans went unreported and could not issue loan guaranty certificates within the required time frame. According to the LGY

[88] VA Pamphlet 26-7, “How to Report Loan Closing and Request Guaranty,” topic 3.k, chap. 5 in *Lenders Handbook*, rev. April 1, 2019.

program analyst, in November 2021, LGY added new risk criteria to identify loans not meeting the 60-day requirement; those loans would then be randomly selected for full-file loan review.

Of the 30 FY 2021 IRRRLs reviewed, the audit team determined that two were not reported to LGY within 60 days. The team concluded that this issue appears to continue.

Recommendation 7 calls on LGY to provide lenders at least annual communication about the importance of providing justifications for any loans not reported within 60 days.

## Quality Control Processes for Conducting Full-File Loan Reviews Are Not Detailed or Complete

Full-file loan reviews are LGY's primary quality assurance activity to ensure loans are in the borrower's best financial interest and do not include closing cost overcharges. If loan specialists identify deficiencies, LGY advises lenders and servicers what corrective actions they should take. Loan specialists must review the closing cost disclosure, which contains the detailed closing costs.[89] Appendix C shows a typical closing cost statement as part of the disclosure.

Of the audit team's sample of 171 loans from FY 2020, LGY performed full-file loan reviews on 57. The team found 10 of the 57 IRRRLs in the sample that underwent a loan review contained at least one unallowable or unsupported closing cost, totaling 11 deficiencies. The deficiencies identified were three missing invoices, four unsupported state deviation fees, three recording fee discrepancies, and one flat fee charge exceeding the 1 percent limit. Five of those deficiencies were not identified during the loan review.

LGY's policies and procedures do not include the detailed and complete procedures that loan specialists need to conduct loan reviews that reveal these types of deficiencies.[90] The main tool used by loan specialists is included in the WebLGY loan review module. Specifically, the WebLGY loan review module for IRRRLs incorporates checks to see that the net tangible benefit is met and that loans exclude unallowable or excessive costs, correctly apply the funding fee, and include disclosures. The module also indicates whether the loan specialist has notified the lender to provide any refunds to the borrowers.

However, the loan review module in WebLGY does not incorporate checks to ensure the recoupment period is within 36 months, the lender provides both loan comparison statements, the loan meets seasoning requirements and clearly identifies any government fees, and state deviation fees have the required approval documentation. Even though most loan specialists interviewed indicated they conduct these key steps, some expressed a need for more detailed and

[89] Loan Guaranty Service, "Conducting a Full File Loan Review," chap. 4 in *WebLGY Full File Loan Review User Instructions*, ver. 1.4, April 2016.

[90] Loan Guaranty Service, "Conducting a Full File Loan Review."

complete procedures. For example, two specialists stated that they used personal checklists because of incomplete steps in the module.

LGY's policies and procedures have not been updated since 2016.[91] The chief of quality assurance agreed the policies and procedures needed to be updated after discussions with the audit team.

Recommendation 8 addresses updating policies and procedures for full-file loan reviews to include detailed steps for loan specialists to conduct reviews.

## Selection Criteria Have Not Been Fully Documented for Conducting Full-File Loan Reviews

LGY's policies and procedures do not provide all the criteria for selecting loans for full-file review, including IRRRLs.[92] In addition, the policies and procedures do not (1) include a list of criteria for selecting which loans to review, (2) identify the risk categories that always trigger reviews, and (3) establish overall targets for the number or percentage of loans to review. When asked why LGY did not document selection criteria and consider a more methodical approach to loan review selection, the program analyst stated

> LGY's written policies and procedures are public access and allowing a lender to see all VA audit selection criteria might allow a lender to bypass VA safeguards. VA has documented the selection criteria for loan reviews including those for IRRRLs in the system of record selection criteria coding. The VA risk-based selection criteria are methodical. A loan is only pulled for FFLR [full-file loan review] if they meet a methodical selection measure. The selection risk triggers enable the VA to focus resources and take actions in situations where the risks are higher.

Not including this information in its policies and procedures deviates from federal internal controls standards, which state that operating units "document policies in the appropriate level of detail to allow management to effectively monitor the control activity."[93] In addition, LGY can limit public access to certain policies and procedures it deems confidential.

The audit team concluded that these deficiencies occurred because LGY's quality assurance division considered its policies and procedures and controls sufficient for loan review oversight. However, the chief of quality assurance subsequently agreed the policies and procedures needed

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[91] Loan Guaranty Service, "Conducting a Full File Loan Review."

[92] VA Pamphlet 26-1, "Regional Loan Center Procedures Regarding VA Lenders," chap. 1, and "Selection Criteria," topic 1.c., chap. 4, in *Guaranteed Loan Processing Manual*, rev. May 23, 2017; Loan Guaranty Service, "Conducting a Full File Loan Review."

[93] Government Accountability Office, *Standards for Internal Control in the Federal Government*, principles 12.02, 12.03, "Documentation of Responsibilities through Policies."

to be updated. Documentation of these risk factors in written policies and procedures would make them available to all relevant LGY managers and staff to improve oversight.

Recommendation 8 states that LGY should update its policies and procedures for full-file loan reviews to include the risk factors to be assessed and methodology for loan review selection.

### Procedures Do Not Fully Ensure Resolution of Issues Identified during Regional Loan Center Monthly Quality Reviews

Written policies and procedures do not cover how to resolve issues identified during regional loan center monthly quality reviews, such as closing cost overcharges for which the lender should reimburse the borrower. Monthly quality reviews are part of LGY's assessment of loan specialists' performance. The reviews are conducted by lead loan specialists at the regional centers on loans chosen at random. These reviews are performed in addition to the loan reviews conducted by regional loan center loan specialists and Loan Systematic Technical Accuracy Reviews by LGY's monitoring unit. According to two lead loan specialists, if during the monthly quality review they discover an overcharge is due to the borrower, they notify managers, who then inform the lender of the overcharge. However, there are no additional written procedures to ensure the veteran is refunded when applicable. Because there are no written procedures to ensure borrowers are reimbursed for any overcharges, borrowers may not receive required refunds.

According to the LGY program analyst, "When this rare event occurs, the VA LGY team relies on employee [loan specialist or lead loan specialist] compliance to the VA mission statement as well as VA core values to ensure the veteran is made whole." In contrast, loan reviews and Loan Systematic Technical Accuracy Review policies and procedures do include steps to ensure borrowers are refunded for any needed monetary adjustments. The audit team's sample included IRRRLs with full-file loan reviews since those reviews are LGY's principal oversight function; therefore, the team did not have the opportunity to identify any instances of unprocessed regional loan center quality review refunds.

Recommendation 9 addresses updating policies and procedures to ensure the borrower is reimbursed if any overcharges are identified during regional loan center quality reviews.

## Conclusion

Overall, the controls LGY implemented in FY 2020 strengthened its administration of IRRRLs, thereby reducing loan deficiencies and generally ensuring that borrowers recouped closing costs within 36 months, received a net tangible benefit, and signed loans that were properly seasoned. The OIG maintains that LGY should build on this success by making certain that borrowers receive closing cost comparisons and strengthening its controls over closing costs. Based on a review of 171 loans from FY 2020, the OIG estimates that 21,600 borrowers were overcharged about $4.6 million, with potential overcharged closing costs totaling approximately $3 million. The team's limited review of FY 2021 IRRRLs suggests that these issues continue.

LGY can begin this process by seeking a legal opinion on issues where it disagrees with the OIG audit findings, namely the allowability of charges that the OIG considers unsupported or unallowable, and also the extent to which these charges should have been fully supported and documented in the loan file. The OIG maintains that the loan file and all the closing costs charged to the borrower should be transparent so that veteran borrowers can make informed financial decisions in their own best interest. If the potential overcharges described in this report are determined to be actual, LGY needs to take steps to make the borrowers whole.

Finally, LGY can continue its efforts to improve its administration of IRRRLs by strengthening how it oversees and guarantees these loans, a critical step for protecting borrowers and also for VA guaranteeing only loans that are fully compliant. LGY can take action to confirm that lenders report IRRRLs within 60 days, that loan specialists have detailed and complete steps for full-file loan reviews, that appropriate staff document how loans should be selected for this review, and remediate issues identified during the review. Together, these improvements will continue the positive change that began with the May 2020 improvement in LGY's controls and help ensure that loans are in the borrower's financial interest, and not subject to overcharges. The OIG maintains that LGY should focus on the goal of full disclosure and complete transparency to borrowers so that they can make informed and beneficial financial decisions.

## Recommendations 1–9

The OIG recommended the under secretary for benefits take the following steps:

1. Assess the loan comparison statement controls implemented in December 2021 and 2022 to ensure they operate as planned and confirm borrowers receive these statements as required.
2. Seek a legal opinion from the VA's Office of General Counsel on the allowability of fees initially charged as itemized fees to be retroactively accepted as part of the 1 percent flat charge if unsupported, and then review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole.
3. Develop and update policies and procedures to ensure invoices or bills are obtained for all third-party charges and lenders report itemized closing costs at the lowest level of detail.
4. Develop and update policies and procedures for the state deviation process and requirements, assess the extent of missing VA authorizations on the schedule of state deviations and obtain the necessary documentation, and obtain a legal opinion from the VA's Office of General Counsel on the allowability of state deviation

charges in excess of the state-published amounts, and then review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole.

5. Revise policies and procedures to comply with federal regulations on the itemization of costs charged under the 1 percent flat charge to ensure closing costs are properly charged.
6. Obtain a legal opinion from the VA's Office of General Counsel on the allowability of mortgage brokerage fees charged under the 1 percent flat charge, and then review the potential overcharge identified in the audit sample to determine if action is needed to make the borrower whole.
7. Provide lenders at least annual communication about the importance of providing justifications for any loans not reported within 60 days.
8. Modify policies and procedures for full-file loan reviews to include detailed steps for loan specialists to conduct reviews, as well as the risk factors and methodology for loan selection.
9. Update policies and procedures to ensure the borrower is reimbursed for any overcharges identified during regional loan center quality reviews.

## VA Management Comments

The under secretary for benefits concurred with all nine recommendations and acknowledged the report highlights recommendations for improvements. The general comments provided highlight the measures VBA has taken to enhance oversight of the IRRRL program. For example, VBA implemented controls in FY 2020 to enhance its oversight of IRRRLs and emphasized that VBA is working to finalize and publish the November 1, 2020, proposed rule as a final rule, which will update existing regulations to align with the requirements prescribed in Public Laws 115-174 and 116-33.

VBA noted its opinions differ on some of the conclusions outlined in the report: "Specifically, there is disagreement on the classification of certain closing costs as "unsupported, unallowable, or unreasonable" and "whether certain audited loans passed the recoupment standard." VBA stated it is in the process of requesting review by VA's Office of the General Counsel (OGC).

In addition, OGC provided comments regarding areas of disagreement and other concerns, most notably relating to areas in need of legal opinions included in three of the recommendations. Appendix D includes the full text of the under secretary's comments.

## VBA Comments

To address recommendation 1, "VBA will assess the loan comparison statement controls implemented in December 2021 and 2022 to ensure they operate as planned and confirm borrowers receive these statements as required," the planned completion date is the end of December 2023.

For recommendation 2, VBA will request a legal opinion from OGC on "the allowability of fees initially charged as itemized fees to be retroactively accepted as part of the one percent flat charge if unsupported." VBA will then review the potential overcharges identified by the OIG based on that legal opinion.

In response to recommendation 3, VBA plans to review and update applicable policies and procedures regarding third-party charges and lenders' itemized fees by December 31, 2023.

To address recommendation 4, OGC will be asked to also provide VBA with an opinion on "the allowability of state deviation charges in excess of the state-published amounts." VBA will then be positioned to update policies and procedures as well as review the potential overcharges identified in the audit sample to determine if remedial action is needed.

For recommendation 5, OGC will respond to VBA's request for "interpretation of federal regulations on the itemization of costs charged under the one percent flat charge to ensure closing costs are properly charged." VBA will revise policies and procedures accordingly to ensure compliance.

To implement recommendation 6, VBA will seek another OGC opinion on "the allowability of mortgage brokerage fees charged under the 1 percent flat charge," and then will examine the identified potential overcharge based on that legal opinion to determine if action is needed to make the borrower whole.

To address recommendations 7, 8, and 9, VBA plans to modify by the end of the 2023 calendar year "policies and procedures to provide lenders at least annual communication about the importance of providing justifications for any loans not reported within 60 days;" develop detailed steps for loan specialists to conduct full-file loan reviews, including risk factors and methodology for loan selection; and "ensure the borrower is reimbursed for any overcharges identified during regional loan center quality reviews."

## OGC Comments

VA's OGC stated its role in resolving the unsettled legal questions in this report. It also provided comments and noted several legal concerns. OGC stated that the report references the intent behind legal conclusions and authorities, noting, "It is unclear if the report is referring to Congress's intent in enacting a statute, VA's intent in promulgating a regulation, or OIG's opinion about such intent. It is also unclear what information was relied upon when drawing the conclusions."

The OGC provided specific comments on what it termed "legal ambiguities" in the introduction of this report related to "conflating loan guaranty benefit eligibility with credit-qualification, implying that VA-guaranteed loans are not subject to geographical limits, giving [the] impression that the 1 percent flat fee is assessed against 'existing' guaranteed loans, and conflating one-year automatic authority probationary period with VA's withdrawal of such authority."

In addition, it could not determine if the estimated overcharges of $4.6 million include or exclude the amounts that lenders repaid to borrowers to cover deficiencies. OGC stated it "is concerned there is a high risk the report will be taken out of context and that the figure estimated as potential overcharges will be misunderstood as a matter of certainty." Lastly, OGC requested the OIG wait to publish this report for six to eight weeks until OGC provides its legal opinion because of the unsupported legal assertions, the legal ambiguities, and the unsettled legal questions.

## OIG Response

The under secretary of benefits provided acceptable action plans for all recommendations. The OIG will monitor implementation of all planned actions and will close the remaining recommendations when VBA provides sufficient evidence demonstrating progress addressing the intent of the recommendations and the issues identified.

In response to VBA's general comments, the OIG again acknowledges the improvements made as a result of implementation of the FY 2020 controls and the future publication of a final rule and regulation updates. The OIG also recognizes its difference of opinions with VBA regarding certain unsupported, unallowable, and unreasonable costs and for that reason, recommendations 2, 4, and 6 include seeking a legal opinion from OGC. (VBA has also indicated a legal opinion from OGC will be requested in implementing recommendation 5.) Regarding the different conclusions by VBA and the OIG for audited loans not meeting the recoupment standards, the OIG stands by its position that the lender-prepared loan comparison statements provided to borrowers confirm the simple method was used, and therefore those eight borrowers were overcharged closing costs.

In response to OGC comments, the OIG clarified in this final report that opinions about legal intent were its own based on the provisions from the source information cited on unsupported itemized costs retroactively charged as part of the 1 percent flat charge, state deviation fees, and mortgage brokerage fees.

In preparing this final report, the OIG also made adjustments as needed to address OGC's concern about the "legal ambiguities" it referred to within the review draft's introduction. Additional responses to OGC's comments on legal ambiguities follow:

- Conflating loan guaranty benefit eligibility with credit-qualification on page 1: The OIG cannot determine OGC's concern, as the report states that qualified borrowers must apply to a lender, such as a bank or credit union, for a loan. Qualified borrowers include veterans, active service members, National Guard members, reservists, and surviving spouses who meet certain requirements, such as veterans with 24 continuous months of service and active-duty members with 90 continuous days of service.
- Implying VA-guaranteed loans are not subject to geographical limits on page 2: VA's Pamphlet states, which is included in this report, "Any lender in any geographic location can close (execute) loans directly with the borrower without any VA involvement, except for existing VA loans 30 days or more past due that require VA approval."
- Giving the impression that the 1 percent flat fee is assessed against an "existing" guaranteed loan being refinanced instead of the IRRRL on page 3: The OIG removed "existing" from the statement and similar ones throughout this report to clarify.
- Conflating the one-year automatic authority probationary period with VA's withdrawal of such authority: The OIG clarified the statement that regional loan center staff are required to review a sample of loans made by probationary lenders during the one-year probationary period. OIG also noted that probationary lenders are those completing one year of supervision before being granted authority to close loans automatically, and lenders can be put on probation for recurring deficiencies after the one-year probationary period.

In response to OGC's comment related to the estimated overcharges, the OIG had classified the estimated overcharged costs as "potential," given the need for legal opinions regarding unsupported costs retroactively charged as part of the 1 percent flat charge, the allowability of state deviation charges in excess of the state-published amounts, and the allowability of mortgage brokerage fees charged under the 1 percent flat charge. In addition, the potential overcharges include any amounts LGY has asked lenders to repay the borrowers. LGY indicated it would have lenders make principal reductions as noted in the report above in some cases.

In response to the request that the release of this report be delayed for the six to eight weeks needed for a thoroughly researched OGC legal opinion, the OIG determined that delay is not warranted. The OIG has adjusted the language of the report to provide transparency concerning the issues pending legal opinion and has also provided additional support for the OIG's findings.

# Appendix A: Scope and Methodology

## Scope

The VA Office of Inspector General (OIG) audit team conducted its work from February 2021 through May 2023. The principal review period included all VA-guaranteed interest rate reduction refinance loans (IRRRLs) closed from October 1, 2019, through September 30, 2020 (FY 2020). The review period was expanded from October 1, 2020, through September 30, 2021, (FY 2021) for a smaller limited sample to determine if deficiencies similar to those identified persisted. The scope of the audit was limited to the IRRRLs within those review periods.

## Methodology

The methodology to achieve the audit objective included the following:

- Review of applicable laws, regulations, policies, procedures, and guidelines
- Determination of the sufficiency of the evidence collected and its relevance to the Audit objectives
- Evaluation of the significant internal control deficiencies within the context of the audit objective, especially Loan Guaranty Service (LGY) control activities and monitoring
- Assessment of the design, implementation, or operating effectiveness of the internal controls to the extent necessary to address the audit objectives, including quality assurance controls such as lender audits and results, full-file loan reviews, and data processing controls such as hard-stop controls and flagging loans that do not meet the requirements for certification of a VA loan guaranty
- Interviews with LGY quality assurance division managers and staff, as well as with the monitoring unit's personnel, to better understand controls and oversight
- Interviews with leaders, lead loan specialists, and loan specialists at the Phoenix, Arizona, and St. Petersburg, Florida, regional loan centers and review of additional documentation to better understand controls and processes
- Examination of a statistically valid, randomized sample of 171 electronic records of IRRRLs closed during the review period to assess
    - whether IRRRLs in the sample did not result in a net tangible benefit to the borrower as required by federal regulation, or had unallowable, unsupported, or unreasonable refinancing costs or fees; and

- if there were any instances of questionable or improper payments, fraud indicators, noncompliance with federal laws and regulations, or indicators of waste or abuse in the loan sample.

## Internal Controls

The OIG team determined that internal controls were significant to the audit objective. The team assessed LGY's internal controls relevant to the audit objective. This included an assessment of the five internal control components: control environment, risk assessment, control activities, information and communication, and monitoring.[94] In addition, the team reviewed the principles of internal controls related to the audit objective. The team identified the following two components and their associated principles as significant to the audit objective, identified internal control weaknesses, and proposed recommendations to address the causes of the findings.[95]

- **Component 3: Control Activities.** The oversight body and management should demonstrate a commitment to integrity and ethical values, and the oversight body should oversee the entity's internal control system.
  - Management should also (1) establish an organizational structure, assign responsibility, and delegate authority to achieve the entity's objectives; (2) demonstrate a commitment to recruit, develop, and retain competent individuals; and (3) evaluate performance and hold individuals accountable for their internal control responsibilities.
  - Management should (1) design control activities to achieve objectives and respond to risks, (2) design the entity's information system and related control activities to achieve objectives and respond to risks, and (3) implement control activities through policies.
- **Component 5: Monitoring Activities.** Management should establish and operate activities to monitor the internal control system, evaluate the results, and remediate internal control deficiencies in a timely manner.

## Fraud Assessment

The audit team assessed the risk that fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements significant within the context of the audit objectives

[94] Government Accountability Office, *Standards for Internal Control in the Federal Government*.

[95] Since this audit was limited to the internal control components and underlying principles identified, it may not have disclosed all internal control deficiencies that may have existed at the time of the audit.

could occur during this audit. The team exercised due diligence in staying alert to any fraud indicators by

- soliciting the OIG's Office of Investigations for indicators,
- being aware of any predatory lender practices such as unjustified significant interest rate increases at closing and serial refinances, and
- being aware of any unreported material lender deficiencies during full-file loan reviews because of collusion between loan specialists and lenders.

The OIG did not identify any instances of fraud or potential fraud during this audit.

## Data Reliability

The team used computer-processed data from WebLGY, VA Loan Electronic Reporting Interface, and lenders when applicable. To test for reliability, the team determined whether any data were missing from key data fields in the sample, such as the property address. The team compared data from both electronic systems and lenders' supporting documentation, such as closing disclosure statements that included closing costs and refinanced interest rates. Testing of the data disclosed that they were sufficiently reliable for the audit objective.

## Government Standards

The OIG conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that the OIG plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for the findings and conclusions based on audit objectives. The OIG believes the evidence obtained provides a reasonable basis for the findings and conclusions based on the audit objectives.

# Appendix B: FY 2020 Statistical Sampling Methodology

## Approach

To accomplish the objective, the audit team reviewed a statistical sample of all VA-guaranteed IRRRLs closed from October 1, 2019, through September 30, 2020, (FY 2020) and identified a sampling universe of loans based on the three strata described below. The FY 2021 sample was selected using the same sampling design, but the sample size was selected judgmentally to determine if significant issues in FY 2020 continued to persist. Therefore, the statistical sampling methodology is presented solely for FY 2020, which could provide reliable and projectable results.

## Sampling Universe and Population

The sampling universe included 88,491 loans for the review period that met the stratification factors. That population was selected from the 662,065 VA-guaranteed IRRRLs closed during FY 2020.

## Sampling Design

The audit team selected a statistical sample of 171 IRRRLs distributed equally for three strata from the sampling universe. The sampling universe was stratified by full-file loan reviews and two higher-risk, non-loan review strata as detailed below.

- Stratum 1 includes all IRRRLs that underwent a full-file loan review.
- Stratum 2 includes these high-risk criteria:
  - closing costs to loan value of 3 percent and higher
  - closing costs recouped over 36 months
  - monthly payment reduction of 3 percent or less
  - discount points greater than 2 percent
- Stratum 3 includes these high-risk criteria:
  - IRRRL closed within 240 days of prior loan
  - interest rate reduction of less than one-half percent for fixed- to fixed-rate loans
  - interest rate reduction of less than 2 percent for fixed to adjustable-rate mortgage loans
  - loans terminated or foreclosed within 3 months of IRRRL closure

Table B.1 includes the sample selected by strata, sampling universe, and sample size.

**Table B.1. Sample Selected**

| Stratum | Sampling universe | Sample size |
|---|---|---|
| 1. Loan review* | 9,450 | 57 |
| 2. Non-loan review—high-risk 1 | 78,283 | 57 |
| 3. Non-loan review—high-risk 2 | 758 | 57 |
| **Total** | **88,491** | **171** |

*Source: VA OIG statistician's stratified population. Data were obtained from WebLGY.*

**Loan review is a full-file loan review.*

## Sampling Factors

The sample size was determined after reviewing the expected precision of the projections based on the sample size, potential error rate, and logistical concerns of the sample review. While precision improves with larger samples, the rate of improvement decreases significantly as more records are added to the sample review.

## Projections and Margins of Error

The projection is an estimate of the population value based on the sample. The associated margin of error and confidence interval show the precision of the estimate. If the OIG repeated this audit with multiple sets of samples, the confidence intervals would differ for each sample but would include the true population value 90 percent of the time.

Figure B.1 shows the effect of progressively larger sample sizes on the margin of error.

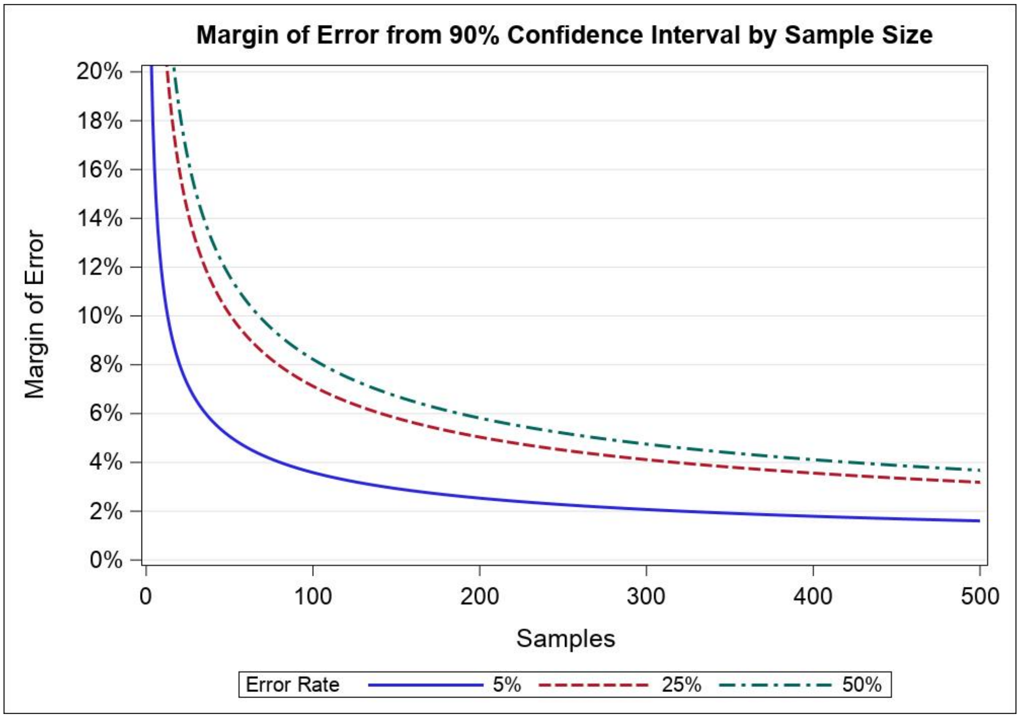


***Figure B.1.*** *Effect of sample size on margin of error.*

*Source: VA OIG statistician's analysis.*

## Projections

Table B.2 presents the projection summary for the unsupported, unallowable, and unreasonable costs, including the population estimate, margin of error, lower limit, and upper limit.

### Table B.2. Statistical Projections Summary for Unsupported, Unallowable, and Unreasonable Costs

| Estimate name | Estimate number | 90 percent confidence interval | | | Sample size |
|---|---|---|---|---|---|
| | | Margin of error | Lower limit | Upper limit | |
| Unsupported, unallowable, and unreasonable costs—borrowers | 26,565 (30%) | 8,082 (9%) | 18,483 (21%) | 34,647 (39%) | 171 |
| Unsupported, unallowable, and unreasonable costs—dollars | $9,114,180 | $6,082,227 | $3,031,952* | n/a | 171 |

*Source: VA OIG statistician's analysis.*

**Lower limit of one-sided 90 percent confidence interval used. A one-sided confidence interval can be calculated with either a lower or upper limit. A lower limit was selected because of the low projection precision.*

Table B.3 presents the projection summary for the net tangible benefit and recoupment costs, including the population estimate, margin of error, lower limit, and upper limit.

### Table B.3. Statistical Projections Summary for Net Tangible Benefit and Recoupment Costs

| Estimate name | Estimate number | 90 percent confidence interval | | | Sample size |
|---|---|---|---|---|---|
| | | Margin of error | Lower limit | Upper limit | |
| Net tangible benefit & recoupment—borrowers | 6,760 (8%) | 3,479 (4%) | 3,281* (4%) | n/a | 171 |
| Net tangible benefit & recoupment dollars | $3,582,693 | $1,961,278 | $1,621,415* | n/a | 171 |

*Source: VA OIG statistician's analysis.*

** One-sided 90 percent confidence interval.*

Table B.4 presents the projection summary for the initial and closing loan comparisons, including the population estimate, margin of error, lower limit, and upper limit.

### Table B.4. Statistical Projections Summary for Loan Comparisons

| Estimate name | Estimate number (percent) | 90 percent confidence interval | | | Sample size |
|---|---|---|---|---|---|
| | | Margin of error | Lower limit | Upper limit | |
| Initial loan comparison missing or not provided within three business days | 7,802 (9%) | 4,930 (6%) | 2,872 (3%) | 12,733 (14%) | 171 |
| Initial loan comparison received, but missing the initial loan application* | 37,180 (42%) | 8,605 (10%) | 28,575 (32%) | 45,785 (52%) | 171 |
| Closing loan comparison—borrowers | 3,006 (3%) | 2,486 (3%) | 520** (1%) | n/a | 171 |

*Source: VA OIG statistician's analysis.*

** Loan application is referred to as the Uniform Residential Loan Application (URLA).*

*** One-sided 90 percent confidence interval.*

# Appendix C: Sample Closing Disclosure

The closing disclosure provides the borrower with the final details regarding the mortgage loan. It includes the loan terms, projected monthly payments, and how much the borrower will pay in fees and closing costs. Figure C.1 is a section of the closing disclosure that illustrates the closing cost fees associated with the loan. The loan amount for the closing disclosure was $159,128.

## Closing Cost Details

| Loan Costs | Borrower-Paid | | Paid by Others |
|---|---|---|---|
| | At closing | Before Closing | |
| A. Origination Charges | $3,625.42 | | |
| 01. 1.293% of Loan Amount (Points) | $2,057.53 | | |
| 02. Origination Fee | $1,567.89 | | |
| B. Services Borrower Did Not Shop For | $4,093.69 | | |
| 01. Credit Report to Universal Credit Services-Corporate | $95.00 | | |
| 02. Flood Certification to ServiceLink National Flood | $8.00 | | |
| 03. Title - Closing Coordination Fee | $750.00 | | |
| 04. Title - Closing Protection Letter | $50.00 | | |
| 05. Title - Courier Delivery | $80.00 | | |
| 06. Title - Escrow Processing Fee | $75.00 | | |
| 07. Title - Lender's Title Insurance | $724.00 | | |
| 08. Title - Settlement Fee | $75.00 | | |
| 09. Title - Standard Endorsements | $50.00 | | |
| 10. Title - Title Examination | $350.00 | | |
| 11. Title - Title Review Fee to Puelo Delisle PLLC | $350.00 | | |
| 12. Title - Title Search | $450.00 | | |
| 13. Title - Update, Recording Handing Fee | $225.00 | | |
| 14. VA Funding Fee to Dept. of VA | $791.69 | | |
| 15. Verification Fee to Universal Credit Services | $20.00 | | |
| C. Services Borrower Did Shop For | | | |
| 01. | | | |
| D. TOTAL LOAN COSTS (Borrower-Paid) | $7,719.11 | | |
| Loan Costs Subtotals (A+B+C) | $7,719.11 | | |
| Other Costs | | | |
| E. Taxes and Other Government Fees | $160.00 | | |
| 01. Recording Fees Deed: Mortgage:$160.00 | $160.00 | | |
| 02. | | | |
| F. Prepaids | $277.95 | | |
| 01. Homeowner's Insurance Premium (mo.) | | | |
| 02. Mortgage Insurance Premium (mo.) | | | |
| 03. Prepaid Interest ($16.35 per day from 2/13/20 to 3/1/20) | $277.95 | | |
| 04.Property Taxes (mo.) | | | |
| 05. | | | |

| | | | |
|---|---|---|---|
| **G. Initial Escrow Payment at Closing** | **$832.10** | | |
| 01. Homeowner's Insurance $52.42 per month for 5 mo. | $262.10 | | |
| 02. Mortgage Insurance Premium per month for mo. | | | |
| 03. Property Taxes $114.00 per month for 6 mo. | $684.00 | | |
| 04. | | | |
| 05. | | | |
| 06. | | | |
| 07. | | | |
| 08. Aggregate Adjustment | -$114.00 | | |
| **H. Other** | | | |
| 01. | | | |
| **I. TOTAL OTHER COSTS (Borrower-Paid)** | **$1,270.05** | | |
| Other Costs Subtotals (E+F+G+H) | $1,270.05 | | |
| **J. TOTAL CLOSING COSTS (Borrower-Paid)** | **$8,989.16** | | |
| Closing Costs (Subtotals D+I) | $8,989.16 | | |
| Lender Costs | | | |

CLOSING DISCLOSURE Page 2 of 5 LOAN ID #

***Figures C.1.*** *Closing disclosure example.*

*Source: VA OIG analysis of statistically sampled loans from October 1, 2019, through September 30, 2020.*

# Appendix D: VA Management Comments

**Department of Veterans Affairs Memorandum**

Date: June 29, 2023

From: Under Secretary for Benefits (20)

Subj: OIG Draft Report –Additional Measures Would Better Protect Borrowers from Risks Associated with Interest Rate Reduction Refinance Loans (IRRRLs) [Project No. 2021-01295-AE-0055] (VIEWS 10236648)

To: Assistant Inspector General for Audits and Evaluations (52)

1. Attached is VBA's response to the OIG Draft Report: Additional Measures Would Better Protect Borrowers from Risks Associated with Interest Rate Reduction Refinance Loans. VA's Office of General Counsel has also provided comments which are included in the attached.

*The OIG removed point of contact information prior to publication.*

(Original signed by)

Joshua Jacobs

Attachment

Attachment

**Veterans Benefits Administration (VBA)**
**Comments on OIG Draft Report**
**Additional Measures Would Better Protect Borrowers from Risks Associated with Interest Rate Reduction Refinance Loans (IRRRLs)**

The Veterans Benefits Administration (VBA) concurs with the Office of Inspector General's (OIG) draft report findings and provides the following general comments:

VBA appreciates the OIG's review of Loan Guaranty Service (LGY) Oversight of Interest Rate Reduction Refinancing Loans (IRRRLs). We acknowledge that this report highlights some recommendations for improvement, and we concur with all nine OIG recommendations regarding Public Law 115-174's and Public Law 116-33's provisions on fee recoupment, net tangible benefit, and loan seasoning. However, VBA would like to provide the following general comments to some of the findings and conclusions of OIG.

In Fiscal Year (FY) 2020, VBA introduced new measures to enhance oversight of the IRRRL program. These measures focus on improving compliance with fee recoupment, net tangible benefit, and loan seasoning standards, which are statutory elements that affect VA's guaranty of IRRRLs. VBA has also created oversight mechanisms to track lender compliance and has compelled lenders to make Veterans whole in cases of noncompliance. Additionally, on November 1, 2022, VBA published in the Federal Register a proposed rule, "Loan Guaranty: Revisions to VA-Guaranteed or Insured Interest Rate Reduction Refinancing Loans". Currently, VBA is working to finalize and publish this as a final rule, which will update existing regulations to align with the requirements prescribed in Public Laws 115-174 and 116-33.

While acknowledging all policy and process improvements implemented by VBA to enhance oversight of its IRRRL program requirements, VBA and OIG hold different opinions on some of the conclusions outlined in the report. Specifically, there is disagreement on the classification of certain closing costs as "unsupported, unallowable, or unreasonable". Furthermore, VBA and OIG hold differing perspectives regarding whether certain audited loans passed the recoupment standard. VBA is in the process of requesting review by VA's Office of the General Counsel (OGC); the results of the legal opinions in accordance with recommendations 2, 4, 5 and 6 will determine if further action should be taken.

The following comments are submitted in response to the recommendations in the OIG draft report:

<u>Recommendation 1</u>: Assess the loan comparison statement controls implemented in December 2021 and 2022 to ensure they operate as planned and confirm borrowers receive these statements as required.

<u>VBA Response</u>: Concur. VBA will assess the loan comparison statement controls implemented in December 2021 and 2022 to ensure they operate as planned and confirm borrowers receive these statements as required.

Target Completion Date: December 31, 2023

<u>Recommendation 2</u>: Seek a legal opinion from the VA's Office of General Counsel on the allowability of fees initially charged as itemized fees to be retroactively accepted as part of the 1 percent flat charge if unsupported, and then review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole.

VBA Response: Concur. VBA will seek a legal opinion from OGC on the allowability of fees initially charged as itemized fees to be retroactively accepted as part of the one percent flat charge if unsupported. Based on the opinion, VBA will review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole. Due to the requirement to obtain an OGC opinion and subsequent actions being dependent upon the opinion, a definitive time frame cannot accurately be provided.

Target Completion Date: TBD

Recommendation 3: Develop and update policies and procedures to ensure invoices or bills are obtained for all third-party charges and lenders report itemized closing costs at the lowest level of detail.

VBA Response: Concur. VBA will review and update policies and procedures, where applicable, as they pertain to third-party charges and lenders itemized fees.

Target Completion Date: December 31, 2023

Recommendation 4. Develop and update policies and procedures for the state deviation process and requirements, assess the extent of missing VA authorizations on the schedule of state deviations and obtain the necessary documentation, and obtain a legal opinion from the VA's Office of General Counsel on the allowability of state deviation charges in excess of the state-published amounts, and then review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole.

VBA Response: Concur. VBA will request an OGC opinion on the allowability of state deviation charges in excess of the state-published amounts. Based on the OGC opinion provided, VBA will update policies and procedures as well as review the potential overcharges identified in the audit sample to determine if action is needed to make the borrowers whole. Due to the requirement to obtain an OGC opinion and subsequent actions being dependent upon the opinion, a definitive time frame cannot accurately be provided.

Target Completion Date: TBD

Recommendation 5: Revise policies and procedures to comply with federal regulations on the itemization of costs charged under the 1 percent flat charge to ensure closing costs are properly charged.

VBA Response: Concur. VBA will request a legal opinion from OGC on the interpretation of federal regulations on the itemization of costs charged under the one percent flat charge to ensure closing costs are properly charged. Based on the opinion received, VBA will revise policies and procedures to comply with federal regulations on the itemization of costs charged under the one percent flat charge to ensure closing costs are properly charged. Due to the requirement to obtain an OGC opinion and subsequent actions being dependent upon the opinion, a definitive time frame cannot accurately be provided.

Target Completion Date: TBD

Recommendation 6: Obtain a legal opinion from the VA's Office of General Counsel on the allowability of mortgage brokerage fees charged under the 1 percent flat charge, and then review the potential overcharge identified in the audit sample to determine if action is needed to make the borrower whole.

VBA Response: Concur. VBA will obtain a legal opinion from OGC on the allowability of mortgage brokerage fees charged under the one percent flat charge, and then based on the opinion, will review the potential overcharge identified in the audit sample to determine if action is needed to make the borrower whole. Due to the requirement to obtain an OGC opinion and subsequent actions being dependent upon the opinion, a definitive time frame cannot accurately be provided.

Target Completion Date: TBD

Recommendation 7: Provide lenders at least annual communication about the importance of providing justifications for any loans not reported within 60 days.

VBA Response: Concur. VBA will review policies and procedures to provide lenders at least annual communication about the importance of providing justifications for any loans not reported within 60 days.

Target Completion Date: December 31, 2023

Recommendation 8: Modify policies and procedures for full-file loan reviews to include detailed steps for loan specialists to conduct reviews, as well as the risk factors and methodology for loan selection.

VBA Response: Concur. VBA will modify policies and procedures for full-file loan reviews to include detailed steps for loan specialists to conduct reviews, as well as the risk factors and methodology for loan selection.

Target Completion Date: December 31, 2023

Recommendation 9: Update policies and procedures to ensure the borrower is reimbursed for any overcharges identified during regional loan center quality reviews.

VBA Response: Concur. VBA will update policies and procedures to ensure the borrower is reimbursed for any overcharges identified during regional loan center quality reviews.

Target Completion Date: December 31, 2023

Comments from VA's Office of the General Counsel—

1. OGC concurs with OIG and VBA that OGC is the appropriate office to resolve the unsettled legal questions the report raises. The General Counsel is the chief legal officer of the Department, as defined by statute. 38 U.S.C. § 311.
2. OGC has some legal concerns, however, about the report more generally:
    a. The report asserts a number of legal conclusions about legal authorities, and the intent behind them, without providing background support. See, e.g., pgs. 22, 25, 29. In these contexts, it is unclear if the report is referring to Congress's intent in enacting a statute, VA's intent in promulgating a regulation, or OIG's opinion about such intent. It is also unclear what information was relied upon when drawing the conclusions.
    b. The report is subject to a number of legal ambiguities. See, e.g., pg. 1 (conflating loan guaranty benefit eligibility with credit-qualification); pg. 2 (implying that VA-guaranteed loans are not subject to geographical limits); pg. 3 (giving impression that 1 percent flat fee is assessed against "existing" guaranteed loan being refinanced instead of the IRRRL); pg. 7 (conflating 1-year automatic authority probationary period with VA's withdrawal of such authority).
    c. The report acknowledges that a number of legal issues must be resolved by OGC before an accurate finding of improper overcharges can be determined. See Recommendations 2, 4, 5, and 6. Yet the report concludes a number of charges were unsupported, unallowable, or unreasonable, and estimates they totaled $4.6 million. (Notably, OGC could not determine if this estimate includes or excludes the amounts that lenders repaid to Veterans to remediate deficiencies.) OGC is concerned there is a high risk the report will be taken out of context and that the figure estimated as potential overcharges will be misunderstood as a matter of certainty.

3. Given the unsupported legal assertions, the legal ambiguities, and the unsettled legal questions, OGC believes it would be premature to issue this report into the public record. OGC should first have the opportunity for the chief legal officer to fulfill the statutorily appointed role and provide a thoroughly researched and legally reasoned opinion (generally a 6-to-8-week process).

*For accessibility, the original format of this appendix has been modified to comply with Section 508 of the Rehabilitation Act of 1973, as amended.*

# OIG Contact and Staff Acknowledgments

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