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BULLETIN NO. 2006-03

December 8, 2005

TO: ALL SERVICERS AND HOLDERS

SUBJ: CLAIM ADJUSTMENT ON A MODIFIED LOAN

Purpose

The purpose of this bulletin is to provide guidance and authorization for VA field stations to adjust loan guaranty claims on modified loans when appropriate.

Background

In recent years holders have performed increasing numbers of modifications of VA-guaranteed loans, and have sometimes failed to comply with existing regulations. This bulletin describes in general the types of failures observed, and the impact of such failures on VA's liability under the loan guaranty. The normal procedure when a holder fails to comply with VA regulations is for the case to be submitted to VA Central Office (261) for review and authorization for claim adjustment. However, VBA Manual M26-4, paragraph 2.03c, presently authorizes VA field stations to perform certain claim adjustments without referral to Central Office for final determination. Central Office has determined that field stations will also be authorized to complete claim adjustments due to failures to comply with modification requirements, but M26-4 will not be revised until the redesigned Loan Administration operating environment is ready for roll-out. Therefore, this bulletin instructs and authorizes field stations to perform claim adjustments on such cases without referral to Central Office. These instructions will apply to all claims that field stations may have pending due to potential adjustments on modified loans.

Modification Requirements

VA has described the requirements for modification of guaranteed loans in title 38, Code of Federal Regulations (CFR), section 36.4314. In summary, provided a holder determines after appropriate review (including review of a current credit report) that the debtor is a reasonable credit risk, the terms of a loan may by written agreement be extended to avoid default or imminent default, or in any other case approved in advance by VA. The regulation also requires reamortization of the indebtedness, so that at least 80 percent of the amount extended is repaid within the maximum allowable term of the original loan. In addition, 38 CFR 36.4311(c) states that interest "in excess of the rate reported by a lender when requesting evidence of guaranty shall not be payable on any advance or in the event of any delinquency or default" except for late charges. This restriction applies to modified loans.

Common Failures and Impact on VA

The following are commonly noted failures of holders to comply with VA regulations, and the impact such failures have on VA's liability under the loan guaranty.

a. Reasonable Credit Risk Not Established. In some cases holders are not obtaining current credit reports to determine creditworthiness of borrowers. In other cases income is not verified to establish the ability to repay modified loans. Still other cases involve clear disregard for established patterns of loan delinquencies that should preclude a reasonable determination of creditworthiness. While sound judgment is required to make any credit decision and should not be second-guessed, egregious actions that ignore obvious information or fail to obtain required verifications can lead to erroneous decisions to modify loans that should actually be terminated. When a loan goes into default soon after modification, unless there is a documented reason that another issue caused the default, then VA may reasonably assume that the holder failed to comply with the requirement to establish creditworthiness of the borrower for the modification. The delay in loan termination caused by an erroneous decision will increase VA's liability by the additional interest and expenses accrued until eventual termination, as well as any costs of modification added to the loan indebtedness.

b. Increased Interest Rate. Some holders have increased interest rates on modifications, a practice that is not allowable under 38 CFR 36.4311(c). If a loan was otherwise properly modified and subsequently went into default for an unrelated reason, then VA's liability would have been increased by the additional interest accrued on the loan at the higher rate after modification.

c. Extended Amortization. If a loan is not set up to amortize at least 80 percent of the new balance within the maximum allowable term of the original loan, and the modified loan subsequently goes into default, then the loan balance at termination will be higher than it would have been had the loan been properly amortized. In this case, VA's liability will be greater by the amount that the higher loan balance exceeds the amount which the balance should have been.

Claim Adjustment Procedures

If the preliminary claim examination indicates that the requirements for loan modification in 38 CFR 36.4314 and/or interest rate limitation in 36.4311(c) were not followed, then a detailed analysis will be prepared for the review and concurrence of the Loan Administration Officer (LAO) or designee. The analysis should specify the failure of the holder, its impact on VA in accordance with the preceding paragraphs, and the recommended adjustment to the claim corresponding to the increased liability as a result of the holder's failure to comply with VA regulations.

a. Example 1. The reviewer finds the borrower was not a satisfactory credit risk because the reason for the default had not been corrected prior to modification, and no payments were made on the modified loan. The analysis will describe the facts and contain an estimate of the claim payable on the modified loan, as well as an estimate of the claim payable as if the loan had been terminated timely rather than modified. The difference in the two estimates is the amount by which VA's liability has been increased due to the holder's failure to establish that the borrower was a satisfactory credit risk on the modified loan. The analysis will recommend that the claim be adjusted from the amount actually claimed to the amount payable as if termination

had occurred timely in order to account for the holder's failure to comply with VA regulations. Any payments made on the modified loan will be credited in determining the claim payable.

b. Example 2. The reviewer finds that the loan was appropriate for modification, but the holder increased the interest rate when modifying the loan and default occurred later. The analysis will calculate the amount actually claimed at the higher rate and the amount payable as if the rate had not been increased and all payments on the modified loan had been applied using an amortization schedule on the modified loan with the lower interest rate. The analysis will recommend that the claim be adjusted from the amount actually claimed to the amount payable as if the rate had not been increased.

c. Example 3. The reviewer finds multiple failures to comply with VA regulations, such as failure to establish creditworthiness of the borrower for the modification, increased interest rate, and improper amortization. The analysis will calculate the amount actually claimed and the amount payable if the failures had not occurred and the loan had been terminated timely. The analysis will recommend that the claim be adjusted from the amount actually claimed to the amount payable as if the failures had not occurred.

Authority to Adjust Modified Loan Claims

An employee designated under the delegations of authority recited in 38 CFR 36.4342 is authorized to approve an analysis recommending adjustment of a claim on a modified loan without the need for Central Office approval. Such an employee will sign the letter to the holder advising of the claim review and adjustment, and will provide a copy of the analysis with the letter. Cases involving questionable modifications not covered by the guidance in this circular should be submitted with the analysis to Central Office for review and final determination, as should all other claim adjustments not specifically delegated for field station review and adjustment.

Rescission: This bulletin is rescinded October 1, 2007.

Questions and Comments

If you have questions or comments concerning this bulletin, please contact Helen Galer, Loan Administration Officer, at 713-794-3602 or Helen.Galer@vba.va.gov.

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