Veterans Benefits Administration
Department of Veterans Affairs
Washington, D.C. 20420

Circular 26-11-5
February 24, 2011

NEW LOAN MODIFICATION REGULATION

1. Purpose. The purpose of this circular is to announce the primary changes for modifying Department of Veterans Affairs (VA) guaranteed home loans resulting from a recent regulatory revision.

2. Background. On February 1, 2008, VA revised its regulations and promulgated a new section 36.4815 of Title 38 of the Code of Federal Regulations (CFR), which was later renamed as section 36.4315. This new regulation provided loan servicers more authority to modify loans without VA prior approval. Subsequent to that change, VA noted that some portions of the 2008 rule created burdens or obstacles to modifying VA loans. On February 7, 2011, VA published in the Federal Register (76 FR 6555) an interim final rule to address those obstacles. The rule immediately revised 38 CFR 36.4315 to make VA loan modifications more flexible and encourage loan holders to modify more loans. The new rule changes requirements related to maximum interest rates allowed on modified VA loans and the items that can be capitalized into the modified loan amount. Further, the rule expressly states that the holder of a loan may seek VA prior approval for a loan modification that does not otherwise meet any of the prescribed conditions.

3. Benefits of Loan Modifications. A loan modification typically gives a delinquent borrower a fresh start by adjusting the terms of the loan agreement so the borrower can become current on the loan and begin making sustainable, affordable payments. Modifications are achieved by making adjustments to the loan, such as: capitalizing delinquent payments, advances, or other amounts due on the loan that would otherwise need to be paid immediately in order to bring the loan current and avoid foreclosure; extending the repayment term; changing the interest rate payable; or some combination of these changes. Recent industry reports note that loan modifications that reduce payments are usually more successful than those which only provide a fresh start.

4. Maximum Modified Interest Rate

a. Loan Held by State Housing-Finance Authority. In order to allow for modification when a State housing-finance authority holds a loan, the interest rate on a modified loan may now remain the same as the original interest rate when a State housing-finance authority holds the loan and the law governing their program prohibits a change to the interest rate.

b. Maximum Interest Rate for Other Loans. The new maximum interest rate on a modified loan may be no more than 50 basis points above the Freddie Mac Weekly Mortgage Market Survey Rate for 30-year fixed-rate conforming mortgages (U.S. Average), rounded to the nearest one-eighth of one percent (0.125%). This change from the Government National Mortgage Association coupon rate (which had been the basis for the maximum rate since the 2008 revisions) to the Freddie Mac average rate should make calculation of the maximum rate easier, as the Freddie Mac rate is more widely available, both from Freddie Mac (http://www.freddiemac.com/pmms/) and in the list of Selected Interest Rates that the Federal Reserve Board updates weekly in its Statistical Release H.15 at http://www.federalreserve.gov/releases/h15/. Also, the maximum rate is now based on the executed date of the loan modification, rather than the date of approval. VA considers the execution date to be the date the modification agreement is signed by the borrower, because the servicer has made an offer to modify the loan that is accepted when the borrower signs the agreement. The date the borrower signs the agreement should be reported in the VA Loan Electronic Reporting Interface (VALERI) under the appropriate field in the Loan Modification Complete event, which must be submitted by the seventh calendar day of the month following the date the loan modification was fully executed.

c. Limited Interest Increase. While the previous regulation allowed loan modification without limit on the increase in interest rate, this new rule requires prior approval from VA of any proposed modification in which the interest rate increases by more than one percent over the existing interest rate. In most cases the benefit to the veteran of a fresh start will justify any increase in monthly payments due to the higher rate, but the requirement for prior approval provides VA an opportunity to determine if it may be appropriate in a special situation to utilize the authority under 38 U.S.C. 3732 to refund (purchase) the loan and modify it at a lower-than-market interest rate to assist the veteran.

5. Capitalization. VA encourages servicers to continue to consider modifications early in the process, which could avoid accrual of foreclosure costs that might become an issue. However, in order to allow veteran borrowers to avail themselves of the opportunity to retain homeownership by means of a loan modification, even after the foreclosure process has started, VA has amended the regulation to allow legal fees and foreclosure costs to be capitalized into the modified loan balance. This is in addition to those items previously allowed, such as unpaid principal, accrued interest, and deficits in the taxes and insurance impound accounts in the modified indebtedness, as well as advances required to preserve the lien position (e.g., homeowner association fees, special assessments, and water and sewer liens). This amendment allows borrowers to benefit from a modification, where before the up-front payment of foreclosure-related costs might have prevented the modification from working.

6. Prior Approval for Modification. The new interim final rule has been reorganized in such a manner that 38 CFR 36.4315(a) lists all of the conditions that must be satisfied in order for a servicer to modify a loan without VA's prior approval. Paragraph (b) of the section now states that if the loan fails to meet one or more of those conditions the loan holder must submit the loan to VA for prior approval before entering into any loan modification agreement. This is not a change in policy, but rather an important clarification that VA can approve deviation from the requirements when appropriate. The rule specifies that VA may approve such a modification if it is in the best interests of the veteran and the Government, after balancing the risks of non-approval versus approval, despite the absence of one or more of the conditions identified in section 36.4315(a).

7. Authorization versus Requirement. The final paragraph (38 CFR 36.4315(c)) of the new rule replicates a paragraph from the previous rule. It states that this section does not create a right of a borrower to have a loan modified, but simply authorizes the loan holder to modify a loan in certain situations without the prior approval of VA. Loan holders and servicers are encouraged to become thoroughly familiar with all of the conditions that will allow completion of a loan modification without VA prior approval, in order to utilize this tool as much as possible to mitigate potential losses and help veteran borrowers retain their homes.

8. Transition Period. The effective date of the interim final rule is February 7, 2011. That means that loan holders and their servicers should begin following the new rule and revising their procedures immediately. However, VA recognizes that lack of advance notice of the change could create some confusion for a brief time as the new features of modifying VA loans are implemented. VA field stations will exercise restraint and good judgment in reviewing modifications that might appear suspicious because they do not adhere to the new conditions, and not take any punitive actions if it is reasonable to assume that the issues were the result of the changeover to the new rule.

9. Rescission: This circular is rescinded April 1, 2014.

By Direction of the Under Secretary for Benefits

Richard P. Fyne
Acting Director, Loan Guaranty Service

Distribution: CO: RPC 2024
SS (26A1) FLD: VBAFS, 1 each (Reproduce and distribute based on RPC 2024)