United States General Accounting Office

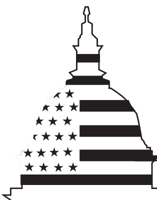
GAO

Report to the Honorable Bob Stump
House of Representatives

May 2001

DEPARTMENT OF VETERANS AFFAIRS

Improved Measures Needed to Assess Supplemental Loan Servicing Program



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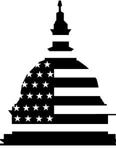
Abbreviations

ARM	Adjustable rate mortgage
FATS	Foreclosure Avoidance Through Servicing
FHA	Federal Housing Administration
FTE	Full time employee
HUD	Department of Housing and Urban Development
LCS	Liquidation and Claims System
LS&C	Loan Service and Claims
LTV	Loan to value
MBA	Mortgage Bankers Association
MBS	Mortgage-backed securities
NOD	Notice of Default
SLMP	Servicer Loss Mitigation Program
SQC	Statistical Quality Control
VA	Department of Veterans Affairs
VHBPF	Veterans Housing Benefit Program Fund



United States General Accounting Office
Washington, DC 20548

May 4, 2001

The Honorable Bob Stump
House of Representatives

Dear Mr. Stump:

Every year, thousands of veterans default on mortgage loans guaranteed by the Department of Veterans Affairs (VA). When veterans default on these loans, lenders may foreclose on the loans and file claims against the VA loan guaranty program. In fiscal year 2000, VA paid claims on over 24,000 foreclosed loans. To help veterans retain their homes and minimize their financial losses, VA has a policy of providing additional assistance through its supplemental loan servicing program.

This report responds to your request that we review VA's supplemental loan servicing program. Our objectives were to

- describe VA's policies and procedures for servicing troubled loans,
- assess VA's implementation of its policies and procedures for servicing troubled loans, and
- analyze VA's measures for assessing the effectiveness of its supplemental servicing program and ability to generate meaningful data for overseeing and improving loan servicing.

To help us describe VA's policies for servicing troubled home loans, we reviewed VA manuals and other related documents. To assess VA's implementation of its policies for servicing troubled loans, we visited three of the nine VA regional loan centers. We obtained information on their supplemental servicing activities and interviewed VA officials, including loan servicing representatives responsible for providing supplemental servicing. We also reviewed VA's quality-control procedures. To analyze VA's measures for assessing the effectiveness of its supplemental loan servicing program and ability to generate meaningful data for overseeing and improving its loan servicing performance, we reviewed VA's performance measures and VA data on loan status for the nine VA regional loan centers. Although we identified inconsistencies in data provided by VA, we did not assess the accuracy of the data. We also compared VA's performance measures to those employed by the Department of Housing and Urban Development (HUD) for its Federal Housing Administration

(FHA) insured loan program. We conducted our work in Washington, D.C.; Cleveland, OH; St. Petersburg, FL; and Phoenix, AZ, between July 2000 and March 2001, in accordance with generally accepted government auditing standards. Written comments from the Secretary of Veterans Affairs on a draft of this report are presented in appendix VI. A detailed description of our scope and methodology is presented in appendix I.

Results in Brief

VA performs its own supplemental servicing of defaulted loans to ensure that each veteran-borrower[1] is afforded the maximum opportunity to continue as a home owner during periods of temporary financial distress. Lenders have the primary responsibility for servicing delinquent loans, including notifying borrowers of past due payments and making efforts to resolve delinquencies. VA's supplemental servicing is intended to protect the interests of the veteran and the government when these efforts fail and a loan goes into default. VA's loan servicing representatives are to work with veterans and sometimes lenders to arrange or assist in arranging a number of possible alternatives to foreclosure. For example, VA loan servicing representatives might encourage a lender to extend reasonable forbearance, which enables a veteran to suspend mortgage payments for up to 12 months, followed by a lump-sum payment or higher monthly payments. In another example, VA might purchase a defaulted loan from a lender and modify the terms of the loan to make it easier for a veteran to continue to make payments. VA loan servicing representatives make these and four other types of alternatives to foreclosure available to veterans with defaulted loans.

The practices of the three regional loan centers we visited generally conformed with VA policies and procedures. The management and staff of VA's nine regional loan centers implement VA policies related to supplemental loan servicing. The loan servicing representatives follow standard VA procedural manuals for supplemental loan servicing and conduct work using VA's Loan Servicing and Claims (LS&C) computer system, which is standard across the regional offices. The regional loan centers we visited also had procedures in place to ensure that VA's loan servicing representatives comply with VA policies and procedures. However, the operations of VA's regional loan centers were temporarily affected by consolidations in certain regions.

[1]In this report, we refer to all those eligible for VA-guaranteed loans as veteran-borrowers.

A lack of meaningful performance measures and useful and timely management reports hinders VA's ability to effectively manage its supplemental servicing program. VA's key performance measure for its supplemental servicing program is the Foreclosure Avoidance Through Servicing (FATS) ratio.[2] The FATS ratio has not been a meaningful measure of VA's supplemental servicing performance for a variety of reasons. For example, the measure is not very sensitive to changes in the quality of servicing. During the temporary interruption in service caused by the regional loan center consolidation, the FATS ratio was only minimally impacted. In addition, VA does not have a meaningful performance measure for the cost savings associated with supplemental servicing. Moreover, VA's computer system has not been able to generate useful and timely management reports that regional loan center managers and VA's headquarters staff can use in managing their supplemental servicing program. During our review, we also found that VA could not efficiently generate reliable aggregate data on its supplemental servicing program.

This report contains two recommendations to the Secretary of Veterans Affairs to improve VA's loan servicing performance measures and its computer system. VA agreed with our recommendation to improve its computer system, but disagreed with our recommendation to improve its performance measures.

Background

The VA loan program is an entitlement program for eligible veterans, service members, reservists, and surviving spouses. The program provides single-family, residential mortgage loan guarantees for purchasing, constructing, repairing, or refinancing homes. The loan guaranty provides private-sector mortgage lenders, such as banks, thrifts, or mortgage companies, with a partial guaranty on mortgage loans when these loans go into foreclosure. In exchange for the guaranty, VA encourages lenders to offer loans to veterans on terms more favorable than those available with conventional financing—for instance, requiring a small down payment, or none at all.

The VA loan guaranty program was initially established in 1944 as an adjustment benefit for veterans who had served in the Armed Forces

[2] The FATS ratio is VA's measure of the percentage by which foreclosures would have been greater if VA had not pursued alternatives to foreclosure.

during World War II. Its objectives have evolved over time. The main objective of the current program is to provide a long-range housing benefit to veterans that will help them finance the purchase of homes on favorable loan terms and retain ownership of their homes. Over the years, the VA loan guaranty program has been amended in an effort to increase home ownership among veterans. These amendments have extended eligibility to all parties on active duty or honorably discharged from military service, increased the maximum loan term and guaranty amount, and allowed borrowers and lenders to negotiate loan interest rates.

The basic features of the VA loan guaranty program are set by law. Currently, the maximum amount of a guaranty or entitlement is $50,750. VA places no limits on the size of loans, but lenders generally limit the loan amount to $203,000, owing to secondary mortgage market requirements.[3] In exchange for protection against financial losses when VA-guaranteed loans end in foreclosure, lenders are encouraged to provide eligible borrowers with loans that do not require a down payment. Lenders originating VA guaranteed mortgages are subject to VA's underwriting standards. The standards are meant to ensure that borrowers have the ability to pay and are creditworthy. The interest rate on VA-guaranteed loans can be negotiated based on prevailing mortgage rates. Borrowers also have obligations to VA. They must meet VA's eligibility requirements and pay VA funding fees of 1.25 to 2.75 percent of the loan amount, depending on the size of down payment and the type of military service completed. Veterans disabled while in service are exempt from payment of the funding fee. Appendix II provides more detailed background information on VA's loan guaranty program.

In addition to helping borrowers finance the purchase of homes, the VA loan program helps them retain ownership of their homes by providing assistance to those in default through its supplemental servicing program. The supplemental servicing performed by VA's loan servicing

[3]The secondary mortgage market is the market in which mortgage loans and mortgage-backed securities (MBS) are bought and sold. The secondary mortgage market agents, such as the Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) or private mortgage companies, purchase mortgage loans as an investment or issue MBS backed by cash flows from the mortgage loans. In addition to Fannie Mae and Freddie Mac, the secondary mortgage market is served by the Government National Mortgage Association (Ginnie Mae), which is a government corporation within HUD. Ginnie Mae guarantees the timely payment of interest and principal on MBS backed by cash flows from pools of federally guaranteed mortgage loans, such as VA-guaranteed and FHA-insured loans.

representatives is a unique feature of VA's loan guaranty program. Other federally insured loan programs do not provide such servicing. For example, HUD delegates all servicing responsibilities to the lenders in its program for FHA insured loans.[4] FHA lenders are required by law to engage in loss mitigation action to provide alternatives to foreclosure. See appendix III for a comparison of the VA and HUD servicing programs.

The VA provides supplemental loan servicing through its nine regional loan centers in Atlanta, Cleveland, Denver, Houston, Manchester, Roanoke, Phoenix, St. Paul, and St. Petersburg.[5] Prior to 1996, the VA's 45 regional offices administered loans, provided full-scale loan servicing, processed claims, and handled property management. However, according to VA officials, the agency decided to consolidate loan processing, servicing, and claims functions into the nine regional loan centers after a comprehensive review of its loan guaranty program. The consolidation, which began in 1997 and was completed in June 2000, was intended to improve services to veterans and reduce costs by increasing efficiency and economies of scale. The 45 regional offices provide services related to property appraisal and foreclosed properties, as well as services related to other veterans' programs.

VA's loan servicing representatives conduct work using the LS&C computer system. The LS&C system was implemented throughout the regional loan centers during August and September 1999. The LS&C system is an on-line, production-oriented system, which was intended to help the loan servicing representatives to provide better supplemental servicing capabilities. The LS&C system also was intended to help VA reduce costs by allowing servicing personnel to service loans rather than spend time entering basic data and status updates into their old batch-oriented system.

[4]FHA is a government corporation within HUD. FHA provides federal mortgage insurance on residential mortgages. FHA's single-family mortgage program shares some characteristics with VA's guarantee program, most notably in requiring a small or no down payment from the borrower. Generally, conventional mortgages, which are mortgages without federal insurance or guarantees, require larger down payments.

[5]Hawaii and Puerto Rico also have their own regional offices that perform supplemental servicing.

VA Performs Its Own Supplemental Servicing of Defaulted Loans

While lenders have primary responsibility for servicing delinquent loans, VA performs its own supplemental servicing of defaulted loans to ensure that each veteran-borrower is afforded the maximum opportunity to continue as a home owner during periods of temporary financial distress. VA's supplemental servicing is intended to protect the interests of the veteran and the government when the lender has not been able to arrange for the reinstatement of a delinquent loan. VA's loan servicing representatives are to work with veterans and sometimes lenders to arrange or assist in arranging a number of possible alternatives to foreclosure. These alternatives include

- encouraging lenders to extend reasonable forbearance,
- encouraging lenders to modify the terms of the original loan agreement,
- purchasing the defaulted loan from the lender and then reamortizing the loan to eliminate a delinquency,
- encouraging the private sale of a property,
- arranging a compromise claim payment to the lender if an offer to purchase the property is received but the proceeds will not be enough to pay off the loan, and
- accepting a deed in lieu of foreclosure.

Lenders' Loan Servicing Responsibilities

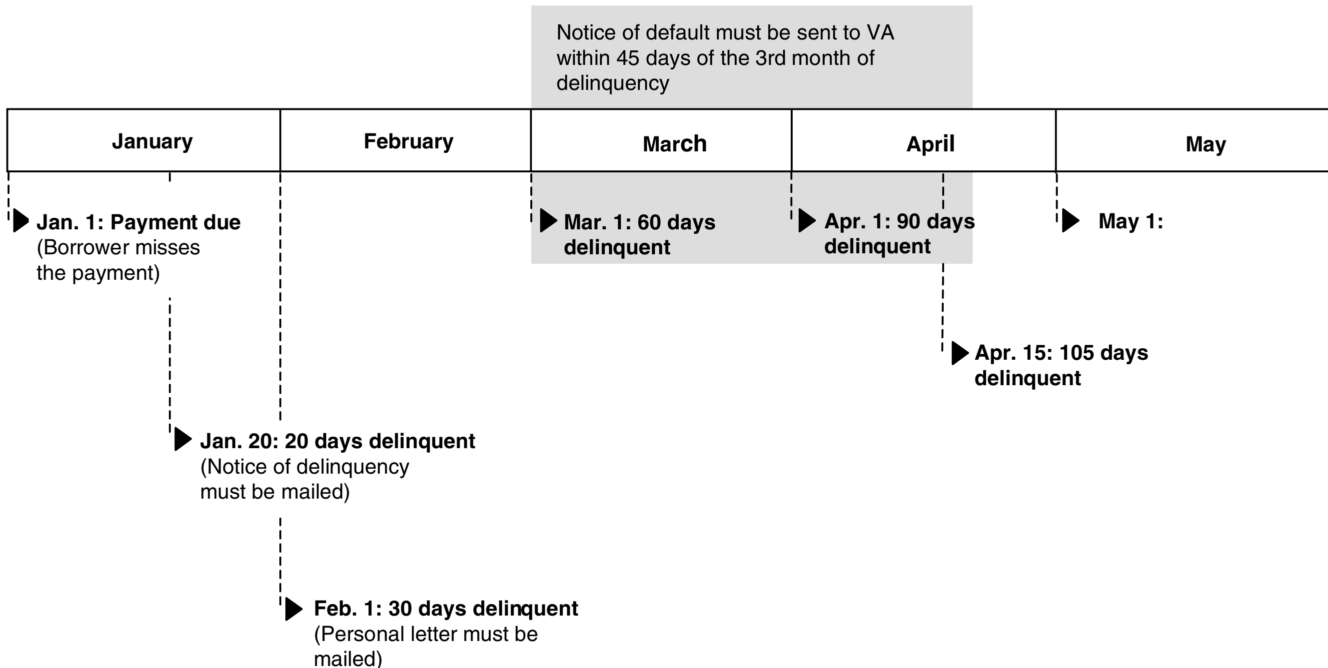
Private lenders that hold loans guaranteed by VA are responsible for servicing them. Their loan servicing responsibilities generally include collecting monthly mortgage payments, maintaining loan records, and making collection efforts for delinquent loans. According to VA's Servicing Guide, a lender's delinquent loan servicing system must include (1) an accounting system that promptly alerts servicing personnel when a loan becomes delinquent, (2) staff trained in servicing loans and counseling delinquent borrowers, (3) procedural guidelines for analyzing each delinquency, and (4) a quality-control system for managing and reporting collection efforts.

When a borrower's loan payments are delinquent, the lender is responsible for contacting the borrower, determining the reason for the delinquency, and making arrangements for repayment of the delinquency, if possible. VA requires lenders to take several steps to resolve the problem. First, a lender must provide written notice to borrowers requesting immediate payment if a loan installment has not been received within 17 days of the due date. This notice must be mailed within 3 days and must include the amount of any late charges due. Second, the lender must try to contact the borrower by telephone to determine why the borrower has not made the payment and to make arrangements for resolving the delinquency. Third, if the borrower has not made a payment within 30 days after the payment

was due and cannot be contacted by telephone, VA requires the lender to send a personal letter to the borrower. Fourth, if the lender cannot work out arrangements for repayment by the time that three installments are due, the default is to be reported to VA. The lender must send a Notice of Default (NOD) to VA within 45 days of the third missed payment. This notice must explain why the loan has gone into default and provide a summary of the lender's servicing efforts. If the lender does not notify VA within 45 days of the borrower's third missed payment, VA may adjust any claim under the guaranty.

Figure 1 provides an example of a time line showing a lender's servicing responsibilities for a delinquent loan. For example, if a borrower misses a payment on January 1, the lender must send a delinquency notice to the borrower by January 20. If the lender has not received a payment by March 1—the third missed loan payment—the lender must send an NOD to VA by April 15.

Figure 1: Example of a Time Line for a Delinquent VA Loan



Source: GAO analysis.

VA's Supplemental Servicing Policies

VA's policies require that its loan servicing representatives begin supplemental servicing immediately after receiving a NOD from the lender. VA loan servicing representatives are to closely review the lender's servicing of the account and follow up by contacting the borrower. Based on the information provided by the borrower, regarding present and future income, employment status, and other relevant case-specific facts, the VA loan servicing representatives may attempt to arrange or assist in arranging one of the following alternatives for borrowers:

- **Forbearance**: VA's policy is to encourage lenders to extend reasonable forbearance when a borrower is unable to begin making payments immediately. VA loan servicing representatives may intercede with the lender on behalf of the veteran to work out a plan for forbearance and repayment that is acceptable to both parties. Payments are allowed to remain delinquent for a reasonable amount of time—usually not more than 12 months.[6] After that time, the borrower reinstates the loan either by making a lump-sum payment or by increasing monthly payments.
- **Modification**: In some cases, VA also encourages lenders to modify the terms of the original loan agreement—e.g., by extending the loan period. Modifications can succeed when the borrower cannot maintain the original monthly payments or pay off delinquencies, but can keep the loan current on less stringent terms. VA loan servicing representatives may also intercede with the lender on behalf of the borrower to help arrange modification agreements.[7]
- **Refunding**: When a lender is not willing to extend further forbearance or modify the terms of the loan, but the borrower has the ability—or will have the ability in the near future—to make payments, VA may refund the loan.[8] In these cases, VA purchases the defaulted loan from the lender.

[6] According to VA officials, it is unlikely that VA will propose a forbearance period of 12 months with no payments, and it is even less likely that a lender will agree to such a proposal. Much more common is a 2 or 3 month forbearance period or a 6 or 12 month period with payments of one regular installment plus a portion of another installment.

[7] VA refers to both loan modifications and the extension of forbearance as "successful interventions if the loan reinstates."

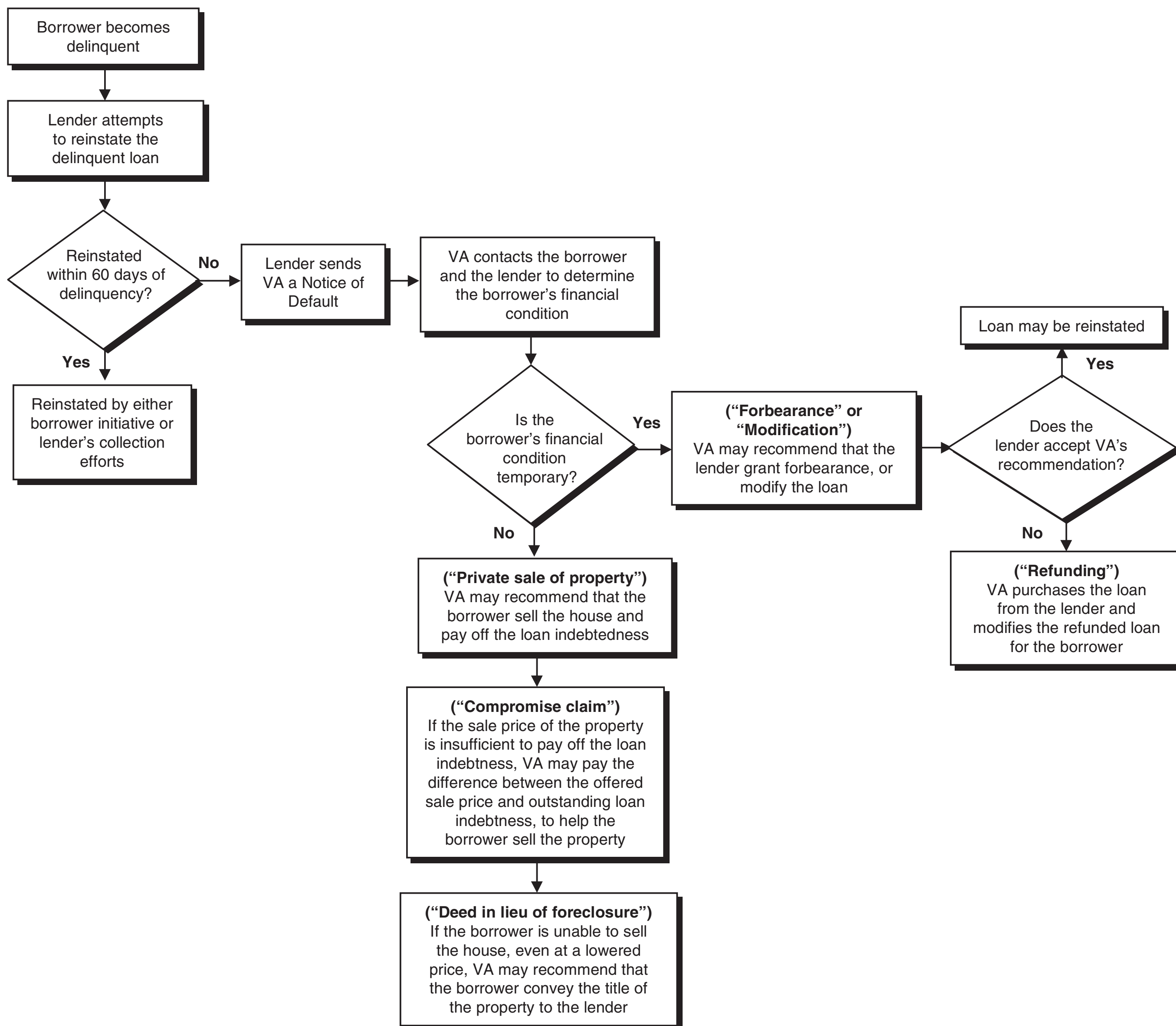
[8] More specifically, VA considers a loan eligible for refunding when it is determined that (1) the lender is unwilling to grant further forbearance, (2) the veteran desires to retain and occupy the property, (3) the veteran has shown an ability to care for and maintain the property, (4) the veteran has a present or potential ability to satisfactorily resume regular payments within a reasonable time and to repay the loan, (5) the estimated net value of the property exceeds the unguaranteed portion of the loan, and (6) the veteran is willing to accept modifications to the loan that make it nontransferable without prior approval of the Secretary of VA.

When VA refunds a loan, the loan becomes a part of VA's direct portfolio and is serviced by VA's loan portfolio service contractor. VA may reamortize the loan to eliminate a delinquency and reduce the interest rate. The law giving VA this authority does not vest borrowers with any right to have their loans refunded or to apply for refunding. Nevertheless, VA's policy is to consider in every case before foreclosure whether refunding is in the best interests of the veteran and the government.

- **Private sale of property**: When a borrower has no realistic prospects for maintaining even reduced mortgage payments, VA encourages the private sale of property to avoid foreclosure. Counseling by VA loan service representatives about the benefits of a private sale may allow a borrower to salvage any equity in the home and reduce or eliminate losses to all interested parties. When the borrower has equity in the home, VA's policy is to encourage lenders to grant the borrower reasonable forbearance to permit a sale.
- **Compromise claim**: In some cases, a borrower in default may not be able to arrange a private sale because the value of the property is less than the total amount owed on the loan. This might be the case, for example, in areas with depressed housing markets. In such a situation, VA may consider providing a "compromise claim" payment to the lender if an offer to purchase the property is received, but the proceeds will not be sufficient to pay off the loan. For example, if a veteran finds a buyer who will purchase the property for its fair market value and the proceeds of the sale are applied to the existing indebtedness, a compromise agreement would enable VA to pay a claim to the lender to cover the difference between the sale price and the amount remaining on the loan. VA is to consider this if the difference between the loan payoff amount and the purchase price is less than the amount of VA's maximum guaranty.
- **Deed in lieu of foreclosure**: When a borrower is unable to resolve a default, refunding is not appropriate, and a private sale cannot be arranged, VA may consider accepting a deed in lieu of foreclosure. VA will accept a deed if it is in the best interests of both the borrower and VA. Accepting a voluntary deed saves on foreclosure costs, cuts down on possible decreases in the value of the security, avoids having a foreclosure on the borrower's credit record, and reduces or eliminates the amount of the borrower's indebtedness. However, obtaining a deed must be legally feasible, and the borrower must be willing to cooperate. A deed in lieu will usually not be accepted if there are any junior liens on the property or if the claim amount under the deed in lieu is more than under foreclosure.

Figure 2 provides a simplified example of the decisionmaking process VA loan servicing representatives use when considering alternatives to foreclosure.

Figure 2: Simplified Illustration of VA's Consideration of Alternatives to Foreclosure



Source: GAO analysis of VA procedures.

VA or the lender may implement any of the alternatives to foreclosure discussed above, except only VA may implement refunding. Additionally, VA must approve in advance lender initiated compromise claims and deeds in lieu of foreclosure, unless a lender participates in VA's Servicer Loss Mitigation Program (SLMP). Participation in SLMP allows lenders to not only initiate, but also perform most of the analyses involved in approving compromise claims or deeds in lieu of foreclosure.[9] VA pays lenders a fee for processing such alternatives to foreclosure.[10] The purpose of VA's SLMP program is to (1) reduce the cost of the loan guaranty program to the taxpayer by decreasing the length of time required to implement these alternatives, (2) reduce the workload of VA's regional offices by paying authorized servicers to perform the analysis and approval functions usually completed by VA, and (3) increase the number of these alternatives used by providing servicers with an incentive to consider a compromise sale or deed in lieu of foreclosure at earlier stages of default, when these alternatives are more often feasible. Lenders must apply to VA to obtain approval to participate in this program. VA officials told us that approximately 130 lending institutions are currently participating in VA's SLMP program and that these institutions process most of the compromise claims and deeds in lieu of foreclosure.

If it is not feasible for VA or the lender to process any of the alternatives to foreclosure discussed above, the lender will generally proceed with foreclosure.

[9]Lenders must obtain a "determination of insolubility" from VA before proceeding with a compromise claim or deed in lieu of foreclosure. A determination of insolubility means that the borrower's circumstances indicate that he or she does not have the ability to prevent foreclosure of the loan while continuing to provide for the family's basic needs.

[10]VA pays a lender that participates in the SLMP a flat $200 processing fee for every compromise sale or deed in lieu of foreclosure completed. The lender also receives money for completing the compromise process ahead of schedule—$200 per month of time saved from the scheduled completion date.

VA's Supplemental Servicing Practices Generally Conform to its Policies and Procedures

The practices of the three regional loan centers we visited generally conform to VA policies and procedures. VA's 351 loan servicing representatives worked with veterans and lenders to complete more than 10,500 alternatives to foreclosure in fiscal year 2000. However, the operations of VA's regional loan centers were temporarily affected by consolidations in certain regions.

Supplemental Servicing Practices

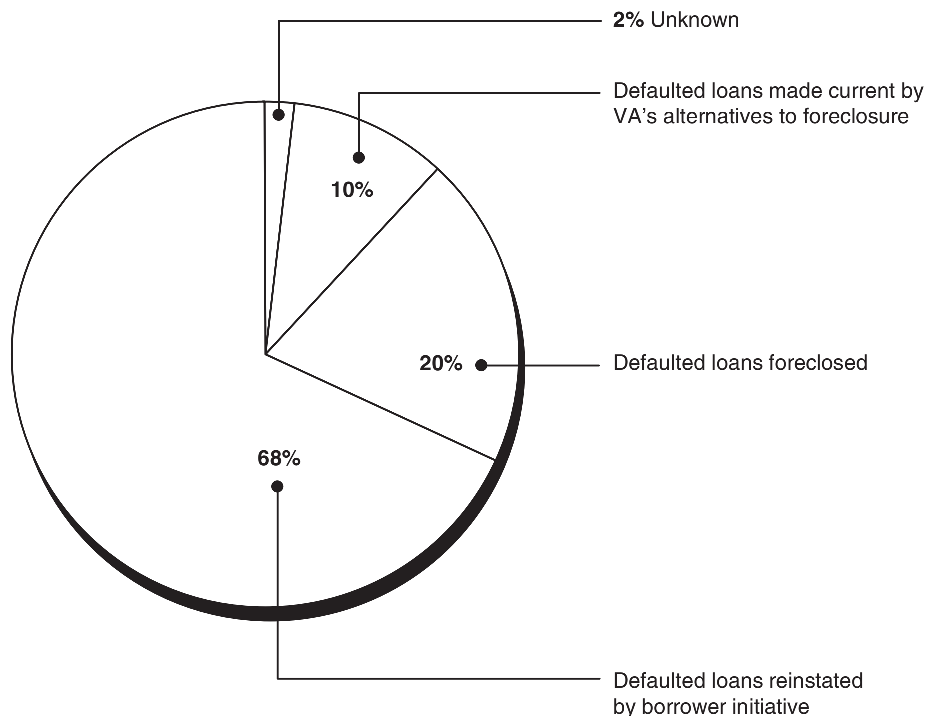
The practices of the three regional loan centers we visited generally conform to VA policies and procedures. The loan servicing representatives follow standard VA policies and procedural manuals for supplemental loan servicing and conduct work using VA's LS&C computer system, which is also standard across the regional offices. These standard policies, manuals, and computer system serve to create uniformity among the nine regional loan centers.

The regional loan centers we visited also had procedures in place to ensure that loan servicing representatives comply with VA's policies and procedures. These quality control procedures are also standard across all of VA's regional loan centers. The primary objective of VA's quality control is to promote and maintain a high level of quality and consistency in services and end products. VA's Statistical Quality Control (SQC) reviews are to be conducted on a monthly basis. Cases are to be selected randomly and reviewed for compliance with VA's quality criteria. VA's procedures contain specific guidance and criteria for reviewing each case. VA uses the SQC index to measure the number of appropriate actions found during SQC reviews, calculated as a percentage of total actions reviewed. This index is provided in VA's performance report and is intended to reflect the accuracy of VA processing, which can affect both customer satisfaction and VA's efficiency.

Supplemental Servicing Activity

Over the past 5 years, VA has received an average of nearly 122,000 NODs per year. A large majority—on average, nearly 70 percent—of defaulted loans are reinstated without the VA intervention. VA's loan servicing representatives have been able to implement VA's alternatives to foreclosure in an average of about 10 percent of the cases in which loans default annually. On average, another 20 percent of defaulted VA loans have gone to foreclosure each year. (See fig. 3.)

Figure 3: What Happened to Defaulted VA Loans (1996 – 2000)



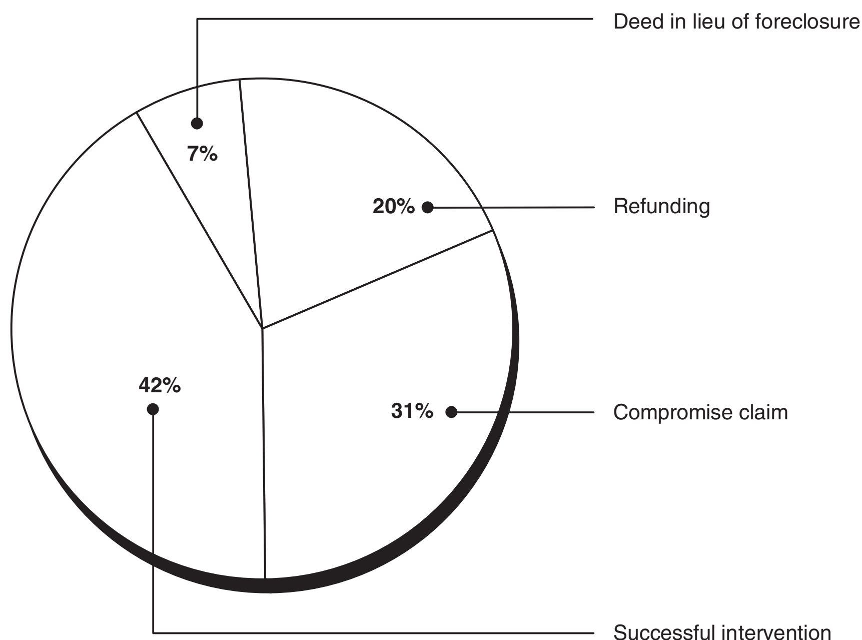
Note: Some defaulted loans have unknown status because they were neither cured nor foreclosed in the year they defaulted.

Source: GAO analysis of VA data.

Over the past 5 years, VA has completed an average of about 12,400 alternatives to foreclosure each year. The most common alternative VA's loan servicing representatives implement is what VA calls a successful intervention, which includes VA involvement in lenders granting either forbearance or modifying the delinquent loan. These successful interventions account for an average of 42 percent of all alternatives to foreclosure implemented by VA over the past 5 years. The next most

frequent alternative implemented was the compromise claim, followed by refunding, and then deed in lieu of foreclosure. (See fig. 4.) Appendix V provides additional data on supplemental loan servicing by regional loan centers.

Figure 4: Alternatives to Foreclosure Completed by VA (1996 – 2000)

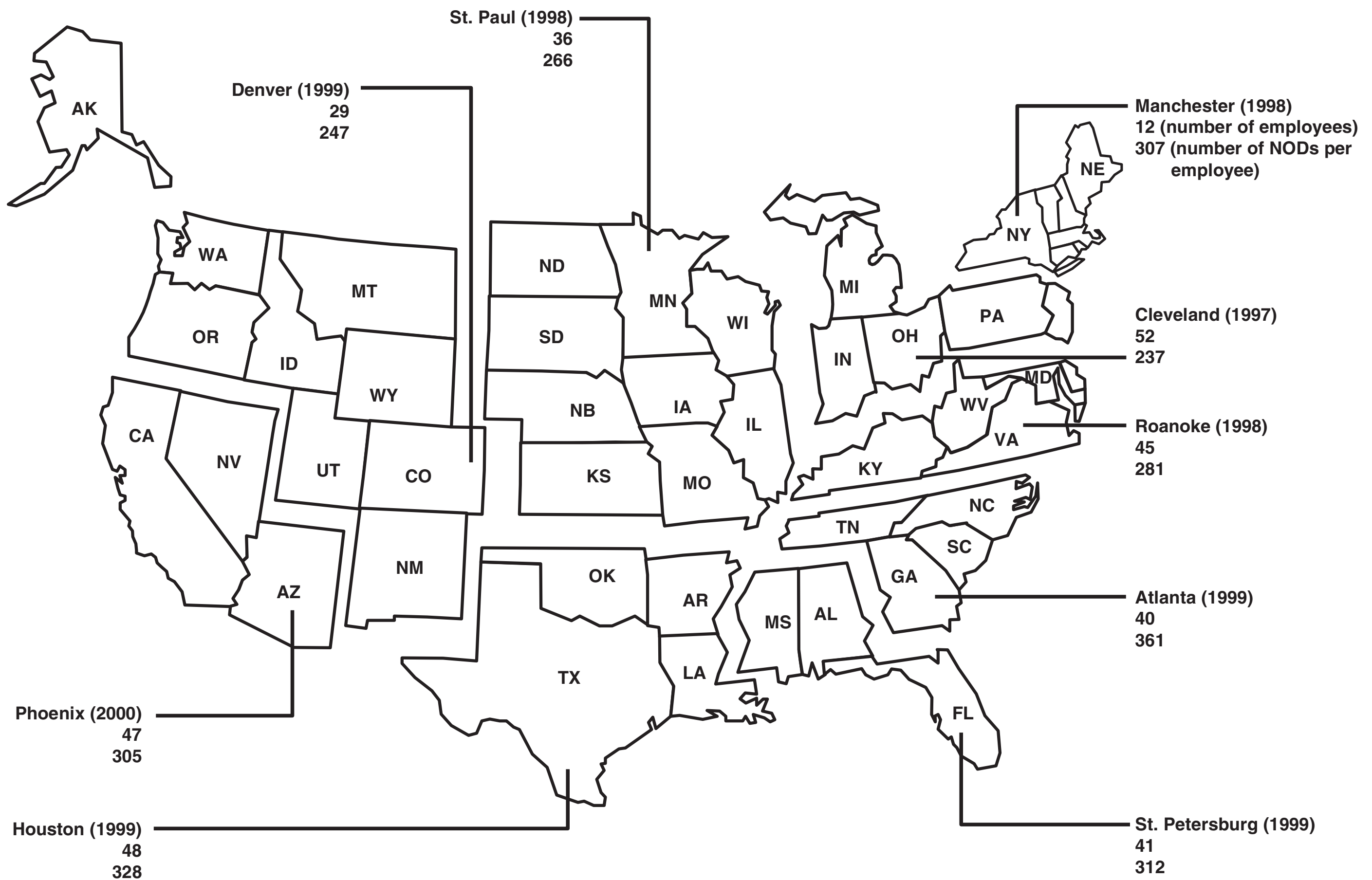


Source: GAO analysis of VA data.

Regional Loan Center Consolidations Temporarily Affected Service

At the end of fiscal year 2000, VA's nine regional loan centers had a total of 351 full-time employees working specifically on the loan service and claims functions. The Cleveland Regional Loan Center was the largest, with a total of 52 employees; and the Manchester center was the smallest, with 12 employees. Employees at the nine regional loan centers handled an average of 294 NODs each, during fiscal year 2000. The Atlanta Regional Loan Center had the highest number—361 NODs per employee. The Cleveland center had the lowest number—237 NODs per employee. Figure 5 shows the number of loan servicing employees and the number of NODs per employee in fiscal year 2000 at each regional loan center. It also shows the state jurisdictions serviced by each regional loan center, as well as the year of each center's consolidation.

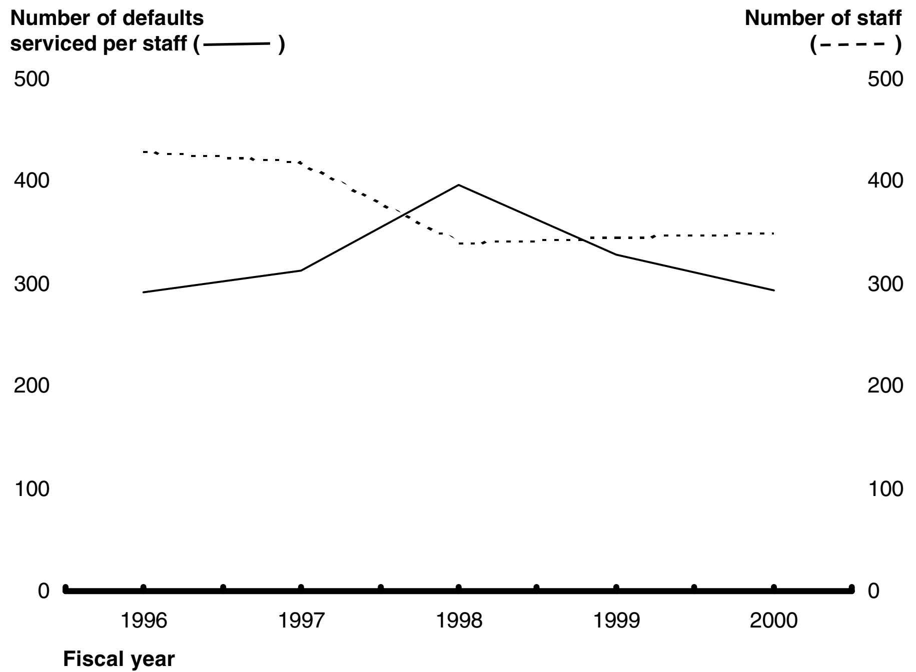
Figure 5: Loan Servicing Employees and Defaults Serviced Per Employee at VA Regional Loan Centers (Fiscal Year 2000)



Source: GAO analysis of VA data.

Both the number of employees and average number of NODs they handle have varied over the years, mostly because of the consolidation of the regional loan centers. In fiscal year 1996, before the consolidation of the regional loan centers, VA had a total of 430 employees performing loan service and claims functions. In fiscal 2000, after the consolidation was completed, that number fell to 351 — a decrease of approximately 18 percent from 1996. The average number of NODs per employee rose from 292 in fiscal year 1996 to 397 in fiscal year 1998. However, in fiscal year 2000, the number of NODs per employee dropped to 294, the level prior to consolidation in 1996. (See fig. 6.)

Figure 6: Changes in VA Staff Dedicated to Supplemental Loan Servicing (1996-2000)



Source: GAO analysis of VA data.

As figure 6 indicates, consolidation ultimately reduced the number of employees handling loan servicing and claims; although the average number of NODs per employee remained about the same. However, the consolidation left some offices short staffed for a period of time, and this temporarily affected service. For example, officials at the St. Petersburg Regional Loan Center told us that it took their center nearly a year to catch up with the backlog of loan cases, some of which were transferred from other regional loan offices. VA's officials in St. Petersburg also told us that they expected their office to be permanently closed; and they completely stopped servicing loans for a period of time, as they prepared for the move. In addition, officials at the Phoenix Regional Loan Center told us that at one point during consolidation, two of its loan service representatives were responsible for servicing approximately 2,300 defaulted loans—six times the workload that is considered reasonable because few employees of the closed offices were willing to relocate to Phoenix after the consolidation. However, we have since learned that the Phoenix Regional Loan Center, which was the last to complete its consolidation in July 2000, is now almost fully staffed and has achieved a

reasonable number of NODs per employee. The Phoenix center, however, continues to have a large number of relatively new loan servicing representatives, and it will take time for them to be fully trained.

While the consolidation helped to centralize the loan servicing function, each regional loan center we visited still had a high degree of administrative autonomy from the VA headquarters in Washington, D.C. As a result, administrative practices vary somewhat among centers. For example, the St. Petersburg center management told us that they follow a "case management" approach to supplemental loan servicing. This center has teams that are responsible for all aspects of loan administration—from servicing to processing foreclosures. Teams at the Phoenix center, however, are organized more along the lines of a functional structure where each team is responsible for a particular loan administration function. Additionally, teams in various regional loan centers may have different internal management structures. For example, managers in the St. Petersburg center told us that their five loan servicing teams operate autonomously. Each team has "empowered" loan servicing representatives that rotate within the team and serve as the team leader. These team leaders serve as a focal point for the team and review the work of other team members. They are also empowered to approve all alternatives to foreclosure without further supervisory approval. This was not the case, for example, at the Cleveland center. Additionally, the management of the St. Petersburg center told us that the teams, rather than individuals, are responsible for meeting internal performance goals. They said the teams have become competitive among themselves and that this has improved performance. VA headquarters managers told us that they plan to complete a comprehensive review of their loan servicing program in the near future that will include a review of such administrative practices at the regional loan centers.

VA Does Not Have Meaningful Performance Measures Nor Useful and Timely Management Reports for Its Supplemental Servicing Program

VA's ability to effectively manage its supplemental servicing program is hindered by a lack of meaningful performance measures and useful and timely management reports. VA's FATS ratio[11] has not been a meaningful measure of VA's supplemental servicing performance. The shortcomings of this measure include its (1) insensitivity to the quality of loan servicing, (2) inability to account for regional differences in economic conditions, and (3) inability to reflect the ultimate disposition of a particular loan. In addition, VA does not have a meaningful performance measure to account for the costs associated with alternatives to foreclosure compared with foreclosure.

Moreover, VA's computer system has not been able to generate useful and timely management reports that regional loan center managers and VA's headquarters staff can use in managing their supplemental servicing program. During our review, we also found that VA could not efficiently generate reliable aggregate data on its supplemental servicing program.

VA Does Not Have Meaningful Performance Measures

The FATS ratio is equal to the number of cases resolved through direct VA intervention, divided by this number plus foreclosures. The total number of cases resolved through direct VA intervention is the sum of all cases involving any of the alternatives to foreclosure.

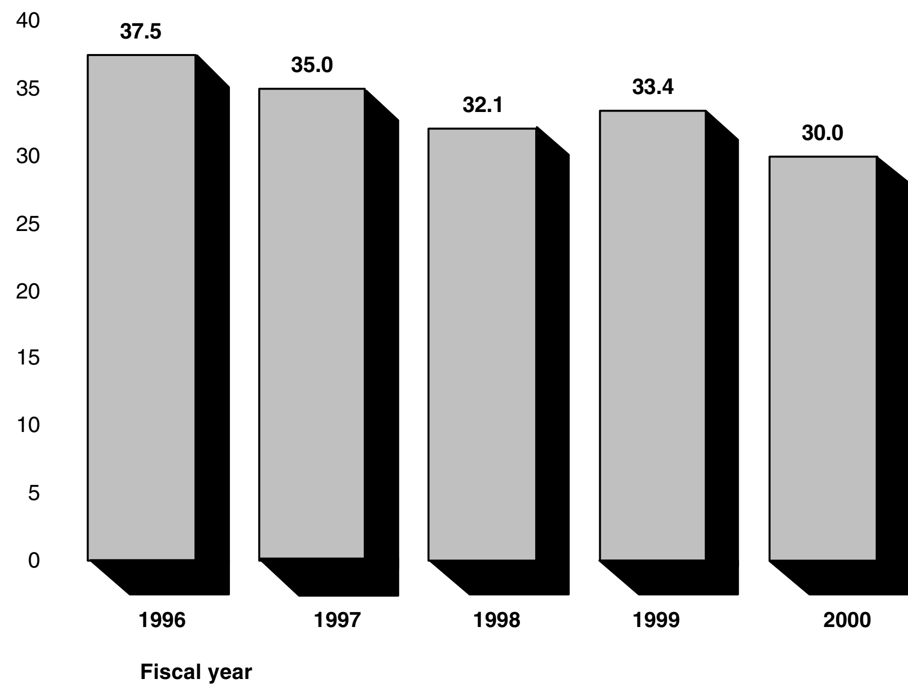
According to VA's fiscal year 2001 Performance Plan, VA has set a goal of raising the FATS ratio to 40 percent. This would mean that VA's interventions helped 40 percent of veterans facing foreclosure resolve their defaulted loans using one of VA's alternatives to foreclosure. In fiscal year 2000, the FATS ratio was 30 percent.

Before fiscal year 1999, VA calculated the FATS ratio by a different method, weighting the various alternatives to account for the difficulty of implementing them and the benefits they offered. After a review of the FATS ratio in September of 1999, VA officials said they decided to drop the weighting system because it encouraged the use of alternatives that may not have been the best choice and distorted the number of actual interventions taken. To present comparable data over time, we calculated the unweighted FATS ratio—the measure VA currently uses—based on the

[11]The FATS ratio is VA's measure of the percentage by which foreclosures would have been greater if VA had not pursued alternatives to foreclosure.

aggregate data VA provided to us.[12] Figure 7 shows the nationwide FATS ratio for fiscal years 1996 through 2000. Figure 8 shows the FATS ratio at each of VA's regional loan centers in fiscal year 2000.

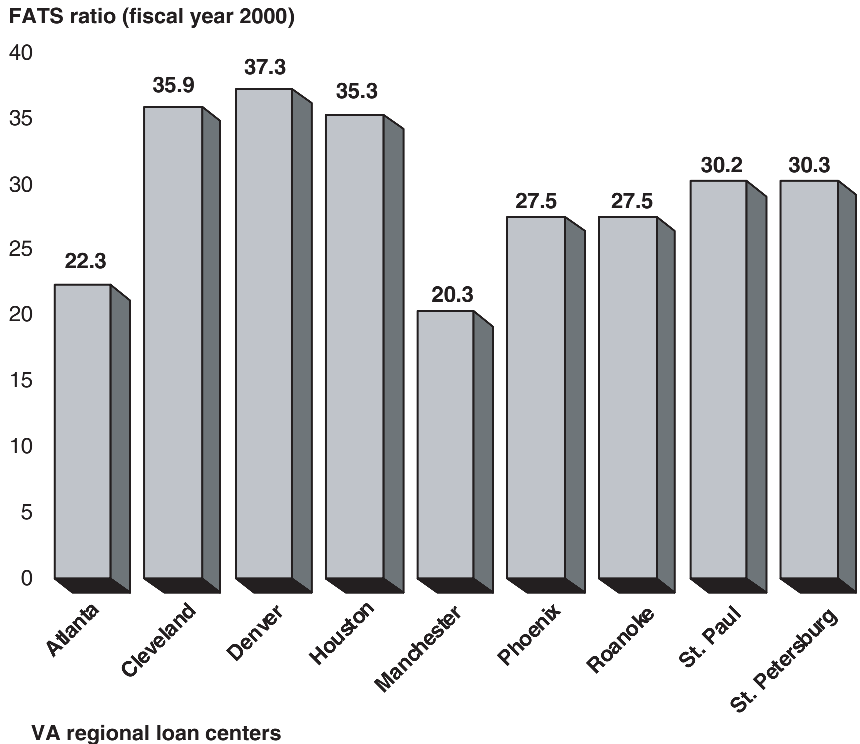
Figure 7: Nationwide FATS Ratio for Fiscal Years 1996 - 2000



Source: GAO analysis of VA data.

[12]VA provided data for the areas that were eventually consolidated into each regional loan center, even though the loan center consolidation occurred gradually over the past few years.

Figure 8: FATS Ratio at VA Regional Loan Centers (Fiscal Year 2000)



Source: GAO analysis of VA data.

While the FATS ratio is intended to reflect the level of activity performed by VA on behalf of veterans, it presents a number of problems. First, it is not sufficiently sensitive to changes in servicing levels, and thus it has not varied much over time. It has not been possible, in some cases, to observe changes in the FATS ratio due to loan servicing difficulties associated with the regional office consolidation at the time the servicing was affected. For example, when the St. Petersburg Regional Loan Center stopped servicing loans, the impact on the FATS ratio appeared to be minimal. However, the ratio is actually lower for fiscal year 2000 than for the period that includes the consolidation. Representatives from the Phoenix center told us that they had similar problems during the regional office consolidation. (Appendix V provides specific information on the FATS ratio at each regional loan center over the past 5 years.) A VA headquarters official said that processing alternatives to foreclosures requires a long time; and such a time lag could allow VA to take credit for loan servicing provided much earlier, evening out the FATS ratio over time. Additionally, other factors

that are unrelated to the actual performance of VA loan servicing representatives may also affect the FATS ratio. For example, when lenders participate in the SLMP program, VA loan servicing representatives must provide the lenders with a determination of insolubility; and, because of this involvement, these alternatives are still counted in the FATS ratio.

Second, the FATS ratio does not account for regional differences in economic conditions, although regional economic conditions may affect the ability of loan servicing representatives to implement various alternatives to foreclosure. For example, according to VA regional loan center officials, recent economic conditions in southern California resulted in lower home prices, making it nearly impossible for loan servicing representatives to arrange compromise claims. This occurs because decreases in home prices increase the amount needed to pay a claim, and VA will not offer a compromise claim if the amount of the payout under the compromise claim is greater than the claim under a foreclosure. According to VA documents, during VA's September 1999 review of the FATS ratio, two regional loan center directors expressed concern about using the FATS ratio as a performance measure, primarily because they believed that economic factors could severely affect it. For instance, if there is a substantial increase in the number of foreclosures, the directors maintained that even a loan center with experienced, productive loan servicing representatives might not be able to significantly raise the number of alternatives to foreclosure counted in the FATS numerator. In this case, the FATS ratio would decline.

VA officials said that when VA managers look at the FATS ratio for individual regional loan centers, local teams, or individual loan servicing representatives, they must take into account the local economic conditions, which impact that performance, as well as other factors such as staffing and training levels. We note, however, that VA does not have a systematic method to account for the impact of regional economic conditions or other such factors.

Third, the FATS ratio does not take into account the ultimate disposition of a particular loan. It only accounts for individual servicing events, so a loan, which had a successful intervention at one point, could ultimately default. VA provided data on previous interventions on loans that eventually ended in foreclosure, and the percentage appeared to be small—an average of 1.6 percent over the past 5 years. Nevertheless, if this number were to increase in the future for any reason, this consideration may be important when reviewing the performance of regional loan centers. In other words, the benefit to the veteran from the intervention

depends on the duration over which the veteran remains in the home due to the intervention.

In addition, the FATS ratio is intended to measure the benefits of VA's loan servicing program but omits another important component: cost reduction. In fact, VA officials told us that they have not tracked the costs associated with the various alternatives to foreclosure. To provide a very broad estimate of the cost-effectiveness of VA's supplemental servicing, VA officials told us that they multiply the average claim paid by the number of cases in which VA intervention prevents foreclosure. In the last few fiscal years, VA officials said they have made claim payments averaging around $19,000 and arranged some 6,000 successful interventions. They concluded, based on these rough calculations, that the government had saved more than $100 million by avoiding the payment of claims in these cases, even after personnel and overhead costs were factored in.

VA officials said that their previous computer system did not have reports designed for tracking average claims paid on deeds in lieu of foreclosure, and the amount paid for compromise claims was not captured within the system. Officials said that the LS&C computer system tracks these amounts, but it is still undergoing development; and reports are still being developed.

VA's FATS ratio reflects the level of activity performed by VA on behalf of veterans. However, VA does not have an effective way to measure the cost savings its supplemental servicing program generates. Other agencies, such as FHA, do have such a measure. FHA, for example, calculates a lender performance score based, in part, on the lender's success in holding down costs to FHA while reinstating or terminating defaulted mortgages. FHA effectively creates a benchmark by comparing the performance of each FHA lender with the performance of other lenders in the same jurisdiction. Although VA cannot use FHA's benchmark, because the unit of observation for VA is the regional loan center, VA could create benchmarks that account for variations in economic conditions; legal requirements, such as different state foreclosure laws; and other factors that vary among its nine regions.

Once it is fully implemented, the LS&C system appears to provide the potential for VA to significantly improve its ability to assess the costs and benefits and improve the management of its supplemental servicing program. Over time, as VA's LS&C computer system obtained extensive data on defaulted loans, the system could be used to create measures for

data items such as the average cost of the various alternatives to foreclosure. The system could also be used to create benchmarks. For example, VA could use its database to analyze how trends in alternatives to foreclosure and foreclosures over time and across regions are related to economic conditions in those regions.[13] Economic conditions in a region at each point in time can be measured by variables such as an unemployment rate. In addition, we have identified another potentially useful variable to establish benchmarks. The Office of Federal Housing Enterprise Oversight, the safety and soundness regulator of the two government-sponsored housing enterprises, Fannie Mae and Freddie Mac, has created a quarterly housing price index for regions, states, and metropolitan areas. With such resources, VA could take into account, for example, how a decline in regional housing prices contributes to higher VA costs, rather than necessarily attributing higher costs strictly to the performance of the regional loan center's supplemental servicing activity.

VA's Computer System Does Not Generate Useful, Timely Management Reports

To date, regional loan center managers and headquarters staff have not had useful and timely reports that would help in managing the supplemental servicing program. Managers at each of the three regional loan centers we visited told us that since VA implemented the LS&C system, such management reports were not available. They said that VA headquarters staff had been working with the regions to reach a consensus on the types of management reports that would be most useful, however. Regional loan center managers also described problems with the quality of the data generated by the LS&C system. They said that the LS&C had been undercounting the number of alternatives to foreclosures completed. For example, a Phoenix manager said that the regional loan center was not credited for about 30 compromise claims processed by one service representative. VA headquarters asked regional office managers to collect information on loan servicing manually from November 2000 through February 2001 for comparison with data generated from the LS&C system.

We also found that VA's computer system could not efficiently generate timely and reliable aggregate data. During this engagement, we requested that VA provide us with basic data on its supplemental servicing program.

[13]Statisticians and economists often use a statistical technique called regression to explain variation in a dependent variable based on variation in independent variables. Regression techniques could also be used to explain variation in qualitative choice dependent variables involving discrete categorization (i.e., in contrast to variables with continuous measurement), such as alternatives to foreclosure and foreclosure.

VA took more than 4 months to provide the data, and some data could not be provided within our time frame. We identified numerous inconsistencies in the data VA initially provided to us and had to request revisions even to basic data on the numbers of alternatives to foreclosures processed and the FATS ratio.

VA headquarters management said that the lack of a reporting capability has been the largest single issue that it has had to address in the LS&C system. VA headquarters management told us that the decision to implement the system in September of 1999 was made with assurances from VA's Office of Information Technology that a reporting mechanism would be in place within 3 months of implementation. This deadline passed with no reporting system. Six months after implementation, a short-term reporting mechanism was developed that extracted data from the production database, reformatted it as a legacy Liquidation and Claims System[14] master record, and then used legacy report programs to generate reports. VA officials said that this effort resulted in some inaccurate reports, which caused regional loan center managers to be skeptical about the results of all of the reports.

By the fall of 2000, about 1 year after implementing the LS&C system, VA officials told us the LS&C reporting mechanism became available. However, VA officials said they are still in the process of feeding data into the data warehouse. Officials said they are also working on getting business language data definitions and calculations defined, written, published, and concurred upon. These data definitions and calculations, once agreed upon and implemented, would help ensure consistency in the way regional loan centers account for their work. VA officials told us they expect to have some reports in place by the end of April 2001.

Conclusions

VA's supplemental servicing program seeks to help veterans when they cannot pay their mortgages. The program offers a range of alternatives to foreclosure that are intended to protect the interests of the veteran and the government. VA recently completed the consolidation of 45 regional offices into 9 regional loan centers that provide supplemental servicing.

[14]VA used the Liquidation and Claims System before the implementing the LS&C system in September 1999. According to VA officials, Liquidation and Claims System was a batch-oriented statistical data collection and reporting application with limited operation support.

This consolidation resulted in some temporary disruptions in service, but the centers are now fully operational.

VA's ability to effectively manage its supplemental servicing program has been affected by two issues. First, VA does not have meaningful performance measures that allow it to accurately assess the effectiveness of its program. The full implementation of the LS&C computer system appears to provide the potential for VA to significantly improve its ability to assess both the benefits and costs of its supplemental servicing program. This system could be used to create benchmarks that would help mitigate some of the shortcomings of the FATS ratio. It could also be used to create a measure of cost savings. While not the primary goal of the program, costs savings should be a consideration in the program's management. Other agencies, such as HUD's FHA loan program, have such a measure.

Second, VA's computer system has not been able to generate useful and timely management reports that regional loan center managers and headquarters staff can use in managing their supplemental loan servicing program. VA managers have acknowledged that this has been the largest, single issue that they have had to address with the LS&C system and said they are working to correct this problem. However, there have been numerous delays in the development of management reports that have affected their ability to effectively manage their supplemental servicing program.

Recommendations

We recommend that the Secretary of the Veterans Affairs direct VA's Under Secretary for Benefits to develop meaningful performance measures for the nine regional loan centers. The overall framework could include creating performance benchmarks that take into account the impact of economic conditions and legal requirements on VA's ability to reduce the number of foreclosures while holding down costs. The overall framework could also take into account the benefits of alternatives to foreclosure for veteran-borrowers, perhaps using a FATS ratio in conjunction with performance benchmarks.

We also recommend that the Secretary of the Veterans Affairs direct VA's Under Secretary for Benefits to take action to ensure that improvements are made in a timely fashion to its computer system so that it can generate accurate and useful management reports. These actions would include current initiatives to provide consistent business definitions of the alternatives to foreclosure. In addition, to implement the first

recommendation, the actions would include compilation of data—such as average costs of alternatives to foreclosure and house price movements in the region—that could be used to assess benefits from supplemental servicing and to create benchmarks for regional loan center performance.

Agency Comments

The Secretary of Veterans Affairs (the VA Secretary) provided written comments on a draft of this report, and these comments are reprinted in appendix VI. VA and HUD also provided technical comments, which we incorporated into this report where appropriate. In particular, we clarified the report and our recommendation to reflect that VA's LS&C system itself does not produce management reports, but that data from the LS&C system are entered into a data warehouse from which reports are produced.

The VA Secretary agreed with our recommendation that VA improve its computer system so that it can generate accurate and useful management reports. He stated that VA is strongly committed to this effort and discussed a number of steps VA is taking to improve the system that should lead to improved management reports.

The VA Secretary disagreed with our recommendation that VA develop meaningful performance measures, including considerations of cost savings, for the nine regional loan centers. He said that the FATS ratio is a meaningful national measure of supplemental servicing performance and that VA did a recent study confirming this. He also said VA has concluded that it is not wise to include cost savings in a performance measure that is intended to reflect assistance to veterans.

As demonstrated in our report, while the FATS ratio is intended to reflect the level of activity performed by VA on behalf of veterans, it has a number of shortcomings. The full implementation of the LS&C computer system, however, appears to provide the potential for VA to improve upon this measure of benefits. An improved performance measure with appropriate benchmarks could provide a systematic way for regional managers to assess and improve the outcome of their work in providing benefits to veterans.

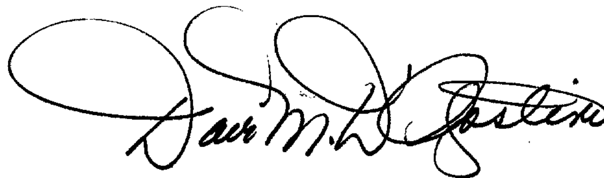
Additionally, VA's policy states that supplemental servicing is intended to protect the interests of the veteran and the government. While not the primary goal of the program, costs and cost savings—or protecting the interests of the government—should be a consideration in the program management. We have clarified the language in the report to reflect that

the FATS ratio should not necessarily be adjusted to account for costs or cost savings, but rather that some more accurate measure of costs and cost savings should be developed and considered. The full implementation of the LS&C system also appears to provide the potential for VA to develop such a measure.

We will send copies of this report to the Chairmen and Ranking Minority Members, House Committee on Veterans' Affairs and Subcommittee on Benefits, House Committee on Veterans' Affairs; Chairman and Ranking Member, Senate Veterans' Affairs Committee; Secretary, Department of Veterans Affairs; and other interested parties. We will also make copies available to others upon request.

Please contact me or William B. Shear at (202) 512-8678 if you or your staff have any questions. Major contributors to this report are listed in appendix VII.

Sincerely yours,



Davi M. D'Agostino
Director, Financial Markets and
Community Investment

Appendix I: Objectives, Scope, and Methodology

The objectives of this report are to (1) describe the Department of Veterans Affair's (VA) policies and procedures for servicing troubled home loans, (2) assess VA's implementation of its policies and procedures for servicing troubled home loans, and (3) analyze VA's measures for assessing the effectiveness of its program for servicing troubled loans and ability to generate meaningful data for overseeing and improving loan servicing.

To describe VA's policies for servicing troubled home loans, we reviewed VA manuals and documents and interviewed officials from the VA, the Mortgage Bankers Association, three veteran's service organizations, and the Reni Mae Corporation. We reviewed materials provided to us by the Reni Mae Corporation related to a proposal to assist VA in helping veterans who faced possible foreclosure. For purposes of comparison, we interviewed officials from the Department of Housing and Urban Development (HUD) about the agency's policies for servicing Federal Housing Administration (FHA) insured, single-family residential mortgage loans. We did not assess these policies.

To assess VA's implementation of policies for servicing troubled home loans, we visited regional loan centers in Cleveland, OH; St. Petersburg, FL; and Phoenix, AZ. We obtained information on their supplemental servicing activities and interviewed VA officials, including loan servicing representatives. We also reviewed VA's quality-control procedures.

To analyze both VA's measures for assessing the effectiveness of its supplemental servicing program and the agency's ability to generate meaningful data that can be used in its overseeing and improving its loan servicing program, we reviewed VA's performance measures and requested data on defaults, foreclosures, and alternatives to foreclosure for the nine VA regional loan centers. In addition to analyzing this data, we interviewed VA regional loan center and Washington headquarters officials about data collection and performance measures for the supplemental servicing program. While we identified inconsistencies in VA data during our review, we did not assess the accuracy of the data. For the purposes of comparison, we reviewed the performance measures HUD uses to assess the effectiveness of its FHA program for servicing troubled loans. We did not analyze HUD's performance measures.

We conducted our work in Washington, D.C.; Cleveland, OH; St. Petersburg, FL; and Phoenix, AZ between July 2000 and March 2001, in accordance with generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of

Veterans Affairs. His written comments are presented in appendix VI. We also obtained technical comments from VA, which we incorporated in this report as appropriate. In addition, we obtained technical comments from HUD officials on our description of HUD policies for servicing FHA-insured single-family residential mortgage loans. We incorporated HUD's technical comments in this report where appropriate.

Appendix II: Background Information on the VA Single-Family Mortgage Guaranty Program

The first section of this appendix provides general background information on the VA single-family mortgage guaranty program. The second section provides information on the number and average amount of loans VA has guaranteed since 1996.

General Description of VA's Single-Family Mortgage Guaranty Program

The VA loan program is an entitlement program that provides single-family, residential mortgage loan guarantees for eligible veterans, service members, reservists, and surviving spouses. VA loans cover the purchase, construction, repair, and refinancing of homes. The loan guaranty provides private sector mortgage lenders, such as banks, thrifts, and mortgage companies with a partial guarantee on mortgage loans when loans go into foreclosure. In exchange for the protection that the VA guaranty provides lenders, VA encourages lenders to provide small or no-down-payment loans to veterans. Currently, the maximum guaranty on a VA loan is $50,750. While VA places no limits on the maximum loan amount that a veteran may obtain, lenders generally limit the amount to $203,000 because of secondary market requirements. To obtain the loan, veterans must meet VA's eligibility and underwriting requirements. To help support the program, VA requires that veterans pay a funding fee to VA. The subsidy cost of VA loan guarantees and direct loans are financed by credit subsidy appropriations to the Veterans Housing Benefit Program Fund. The details of the basic features of the VA loan program are described below.

Terms and Conditions

Although VA generally encourages lenders to provide no-down-payment loans to veterans, in certain cases a down payment is still required. According to the *VA Lender's Handbook*, lenders usually require that a veteran make a down payment when the purchase price of the property exceeds a "reasonable value" or the loan is a graduated payment mortgage in which the monthly mortgage payments gradually increase. In addition, lenders usually require a down payment if the amount of the guaranty is less than 25 percent of the loan amount. In such cases, the down payment will equal the difference between the amount of the guarantee and 25 percent of the loan—a requirement imposed by the secondary mortgage market, in which VA loans and other types of mortgage loans and mortgage-backed securities (MBS) are bought and sold.

Most VA-guaranteed loans are pooled to support MBS guaranteed by the Government National Mortgage Association (Ginnie Mae), a government corporation within HUD. Ginnie Mae guarantees the timely payment of interest and principal on MBS backed by cash flows from pools of

federally guaranteed mortgage loans, such as VA-guaranteed and FHA-insured loans. The MBS are sold to private investors, including pension funds, life insurance companies, and individuals.

VA currently allows veterans and lenders to negotiate the interest rate on VA-guaranteed loans based on prevailing mortgage rates. The maximum loan term is 30 years and 32 days.

Guaranty Rates and Loan Amount

The amount of the guaranty depends on the original loan amount and whether the veteran has previously used the entitlement to housing loan benefits. (See table 1.) Currently, the maximum guaranty is $50,750. In addition, the law allows a veteran who has previously obtained a VA-guaranteed loan, but has not used the maximum entitlement, to obtain another loan using the amount remaining under the entitlement.

Table 1: VA Loan Guaranty Rate (as of March 2001)

VA loan amount	VA loan guarantee rate
Up to $45,000	50% of the loan amount
Between $45,001-$56,250	$22,500
Between $56,251-$144,000	Lesser of $36,000 or 40% of the loan amount
Greater than $144,000	Lesser of $50,750 or 25% of the loan amount

Source: VA.

While VA places no limits on the size of loans veterans obtain, lenders generally limit VA-guaranteed loans to $203,000, or four times the VA guaranty, the limit used by the secondary mortgage market.

Eligibility

Eligibility for a VA-guaranteed loan is based on active duty service after September 15, 1940. At least 90 days of active duty service is required for wartime veterans; 181 days for peacetime veterans; and 2 years for veterans who enlisted after September 7, 1980, or entered as an officer after October 16, 1981. Members of the Reserves and National Guard are also eligible if they have completed at least 6 years of service. In addition, the unmarried surviving spouse of a veteran who has died or is missing owing to service-connected causes is considered eligible. However, because there are numerous exceptions to the service requirements, VA requires that veterans apply to VA to determine their eligibility. Veterans are also responsible for selecting a lender that will honor the certificate of eligibility.

Underwriting Requirements

Lenders of VA-guaranteed loans are required to follow VA's general underwriting guidelines for evaluating and verifying an applicant's financial status. Lenders must calculate an applicant's residual income and debt-to-income ratio when making a loan decision. According to the VA Lender's Handbook, the residual income is the amount of net income remaining after deducting debts, obligations, and monthly living expenses such as food, health care, and clothing. The debt-to-income ratio is the ratio of total monthly debt payments (i.e., housing expenses and debts) to gross monthly income. To qualify for a VA-guaranteed loan, VA requires that an applicant's residual income be equal to or greater than a required minimum for the applicant's loan size, family size, and region of the country, and that the applicant's debt-to-income ratio be generally less than 41 percent. According to the *VA Lender's Handbook*, VA advises that lenders exercise flexibility and sound judgment in making loan decisions.

Funding Fee

To help support the program, veterans are required to pay a funding fee to obtain a VA-guaranteed loan. Currently, veterans who have served on active duty are required to pay 2 percent of the loan amount, while those who have served in the Reserves or National Guard pay 2.75 percent of the loan amount. (See table 2.) Congress periodically changes the funding fee rates to reflect changes in the cost of administering the program or to assist a certain class of veterans. The funding fee rates also vary by loan type and down payment amount. In addition, veterans who have previously used the entitlement pay higher funding rates than those using it for the first time. Veterans with service-connected disabilities or their surviving spouses are exempt from paying funding fees.

Table 2: VA-Guaranteed Loan Funding Fee (as of July 2000)

Type of loan	Type of veteran	Down payment	Funding fee for first-time use	Funding fee for subsequent use
Purchase and construction loans	Regular military	None	2.00%	3.00%
		5% or more	1.50	1.50
		10% or more	1.25	1.25
	Reserves/National Guard	None	2.75	3.00
		5% or more	2.25	2.25
		10% or more	2.00	2.00
Cash-out refinancing loans	Regular military	Not applicable	2.00	3.00
	Reserves/National Guard	Not applicable	2.75	3.00
Interest rate reduction refinancing loans	Not applicable	Not applicable	0.50	0.50
Manufactured home loans	Not applicable	Not applicable	1.00	1.00
Loan assumptions	Not applicable	Not applicable	0.50	0.50

Source: VA.

Program Fund

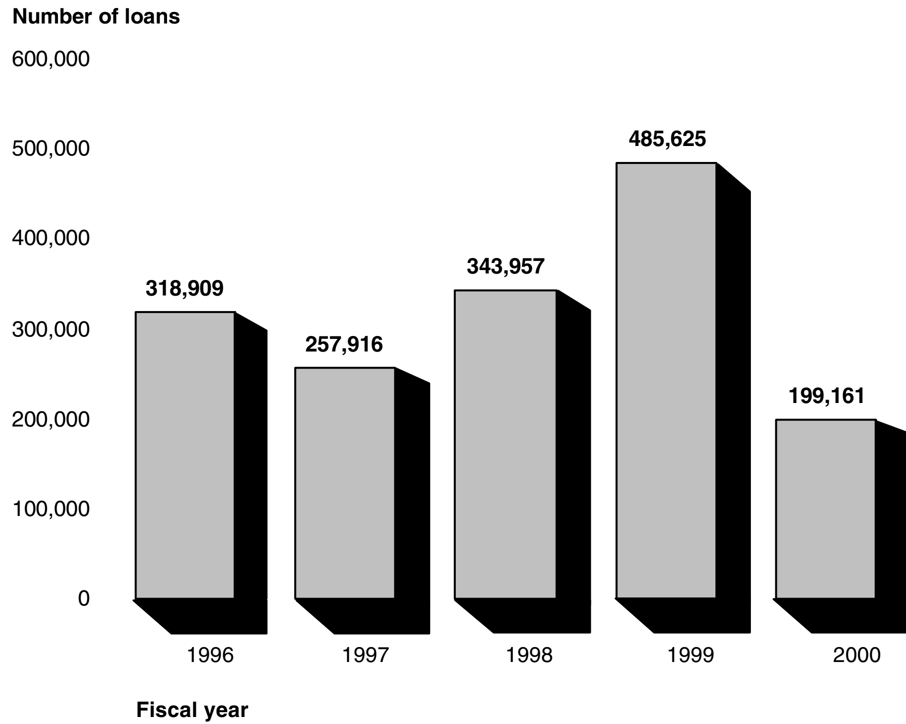
Under the Federal Credit Reform Act of 1990, loans guaranteed after September 30, 1991 are financed by credit subsidy appropriations to the Veterans Housing Benefit Program Fund (VHBPF) Program Account.[1] This account also receives an appropriation for administrative expenses. Funding fees paid by veteran borrowers are deposited in the VHBPF Guaranteed Loan Financing Account, a nonbudget account that records all nonsubsidized cash flows of credit transactions.

Number and Average Amount of VA-Guaranteed Loans

In fiscal year 2000, VA guaranteed approximately 199,000 loans, a significant drop from the previous year's figure of approximately 486,000 loans. (See fig. 9.) Meanwhile, the average amount of a VA-guaranteed loan has steadily increased from approximately $102,000 in 1996 to $117,000 in 2000. (See fig. 10.)

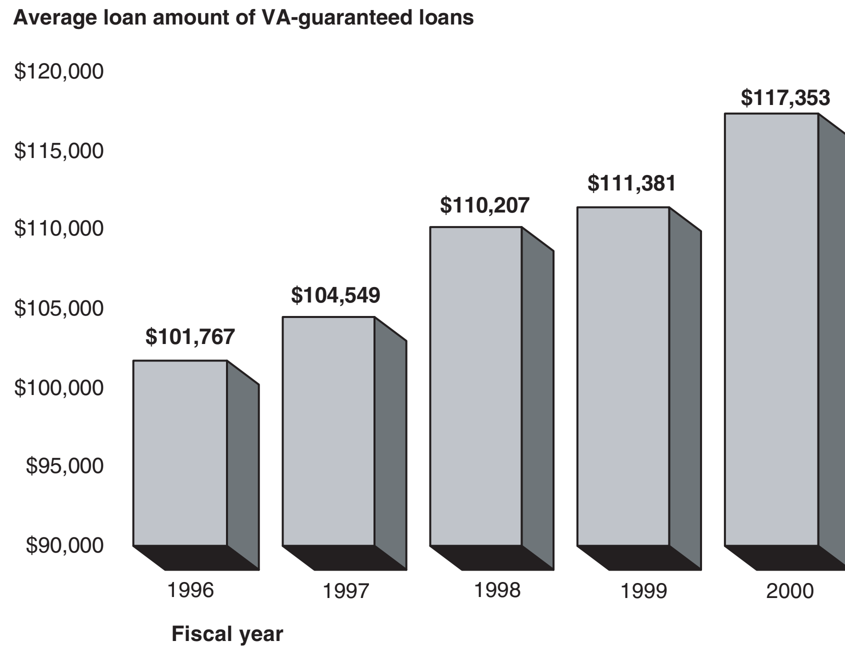
[1]The Federal Credit Reform Act of 1990 changed the budgetary treatment of federal credit programs to make the system consistent with and comparable to noncredit transactions. The intent of credit reform was to separate the subsidy costs (costs to the government) from the nonsubsidized cash flows of credit transactions and to focus on the former for budgeting and analysis.

Figure 9: Number of Loans Guaranteed by VA



Source: VA.

Figure 10: Average Loan Amount of VA-Guaranteed Loans



Source: VA.

Appendix III: Information on the FHA Single-Family Mortgage Insurance Program and the Performance of VA and FHA Mortgage Loans

The first section of this appendix provides general background information on the FHA mortgage insurance program. The FHA mortgage insurance program, administered by HUD, shares some characteristics with VA's loan guarantee program. Appendix IV provides a comparison of VA and FHA policies for servicing troubled loans. The second section compares the loan performance of VA-guaranteed loans with that of FHA-insured loans. This comparison is intended to provide further perspective on VA and FHA loan programs, and not to define any linkages. The second section also briefly discusses a number of factors that affect the probability that a borrower will default on a mortgage.

General Description of the FHA Single-Family Mortgage Insurance Program

Established by the National Housing Act of 1934, FHA insures mortgages made by qualified lenders for the purchase or refinancing of homes. A primary goal of the FHA mortgage insurance program is to assist households that may be underserved by the private market, many of them low-income and first-time homebuyers. Like the VA guarantee, FHA mortgage insurance helps reduce financing costs for borrowers by protecting lenders against the risk of loan default. FHA-insured loans generally sell on the secondary mortgage market in the form of MBS guaranteed by Ginnie Mae. FHA loans are protected by FHA's Mutual Mortgage Insurance Fund, which is funded by borrower premiums.

Terms and Conditions

As with a VA mortgage guaranty, the main advantage of FHA mortgage insurance is that the criteria for qualifying for credit are not as strict as they are for conventional financing. FHA generally allows potential home owners to finance approximately 97 percent of the value of their home purchase through their mortgage. Thus, borrowers can make a minimum down payment of 3 percent of the value of their home. FHA insurance also allows borrowers to finance many closing costs, so that actual loan amounts can exceed 97 percent of home value.

Like the VA program, FHA insurance also limits some of the fees lenders may charge borrowers for making loans. The origination fee, charged by the lender for the administrative cost of processing the loan, may not exceed 1 percent of the mortgage amount. FHA sets limits on the dollar value of the mortgage loan. Borrowers seeking mortgages that exceed FHA loan limits can increase their down payment or obtain financing under a conventional mortgage. Borrowers pay an up-front insurance premium at the time of purchase that is generally added to the mortgage and regular mortgage payment.

While the VA program guarantees fixed-rate residential mortgage loans, up to 30 percent of the mortgages FHA insures annually can be adjustable-rate mortgages (ARM). ARMs insured by FHA have had higher delinquency and foreclosure rates than fixed-rate mortgages.

Fees

To cover the costs of FHA loans, HUD imposes up-front and annual mortgage insurance premiums on home buyers. The up-front premium, which is charged when borrowers close on the loan and can be included in the mortgage payment, is 1.5 percent. The annual mortgage insurance premium, which is 0.25 to 0.50 percent, depending on the loan term, is automatically canceled when the loan amount is reduced to 78 percent of the sales price or appraised value at time of loan origination, whichever is less.[1]

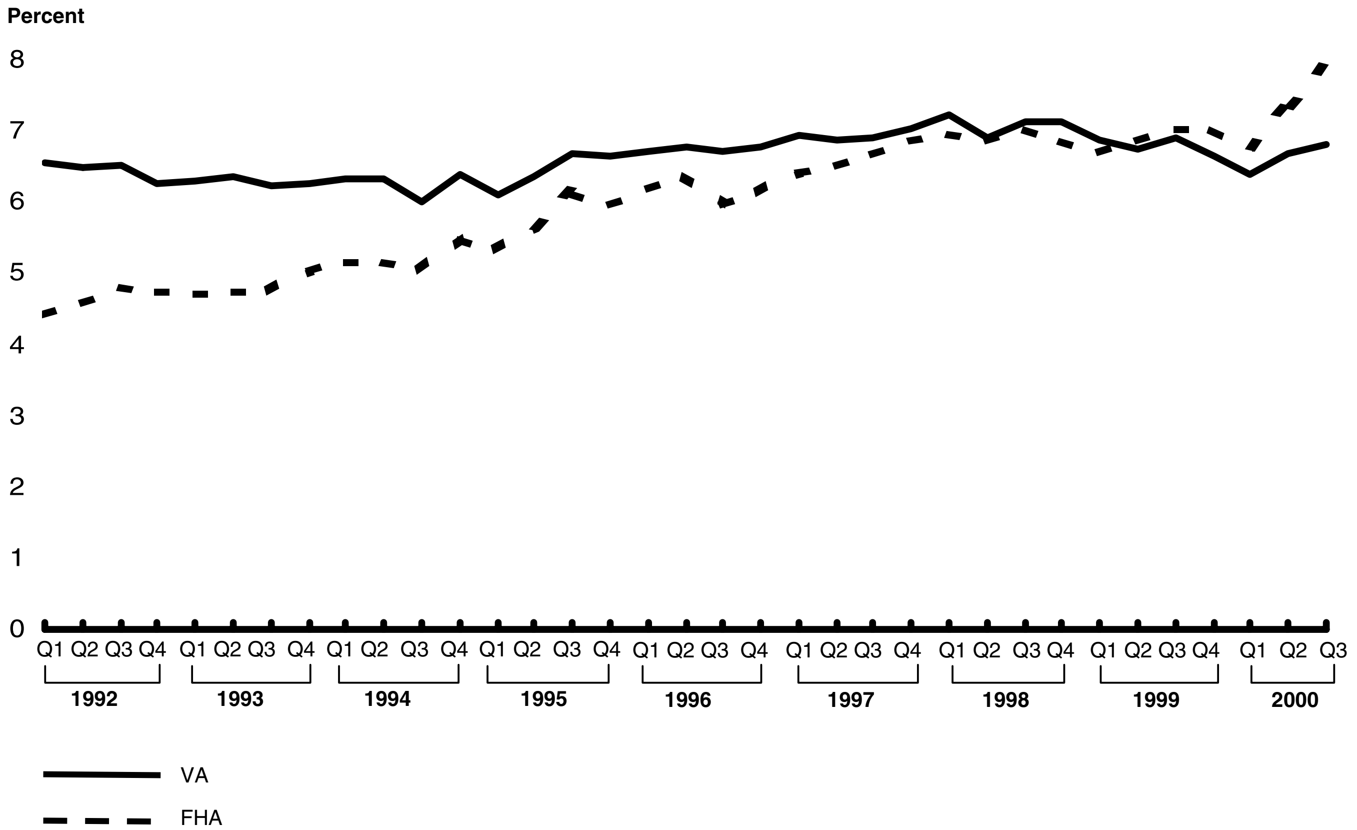
The Loan Performance of Fixed-Rate Mortgages is Similar for VA and FHA Borrowers

The VA-guaranteed loans and FHA insured loans tend to perform similarly. (See figs. 11 and 12.) We did not compare VA-guaranteed loans with conventional private loans because VA-guaranteed loans generally require no down payment. Our comparisons of VA and FHA loan performance are based on data we collected from the Mortgage Bankers Association (MBA).[2] The MBA reports the percentage of loans outstanding during each quarter of a calendar year. We used data for VA and fixed-rate FHA residential mortgage loans, because VA currently guarantees only fixed-rate mortgages. According to VA officials, VA had authorization to guarantee ARMs during fiscal years 1993, 1994, and 1995. However, MBA does not report separate data for VA ARMs. VA officials told us that in fiscal year 1993 about 2 percent of their guaranteed loans were ARMS. This number increased to 11 percent in 1994 and 20 percent in 1995.

[1]FHA has recently revised its insurance premium structure for loans originated on or after January 1, 2001, that are insured under the Mutual Mortgage Insurance Fund. The revisions include reduction in the up-front premium, from 2.25 percent to 1.5 percent, and automatic cancellation of annual mortgage insurance premium when the loan reaches a certain loan-to-value ratio. In the past, some FHA borrowers were required to pay annual mortgage insurance premiums throughout the mortgage life.

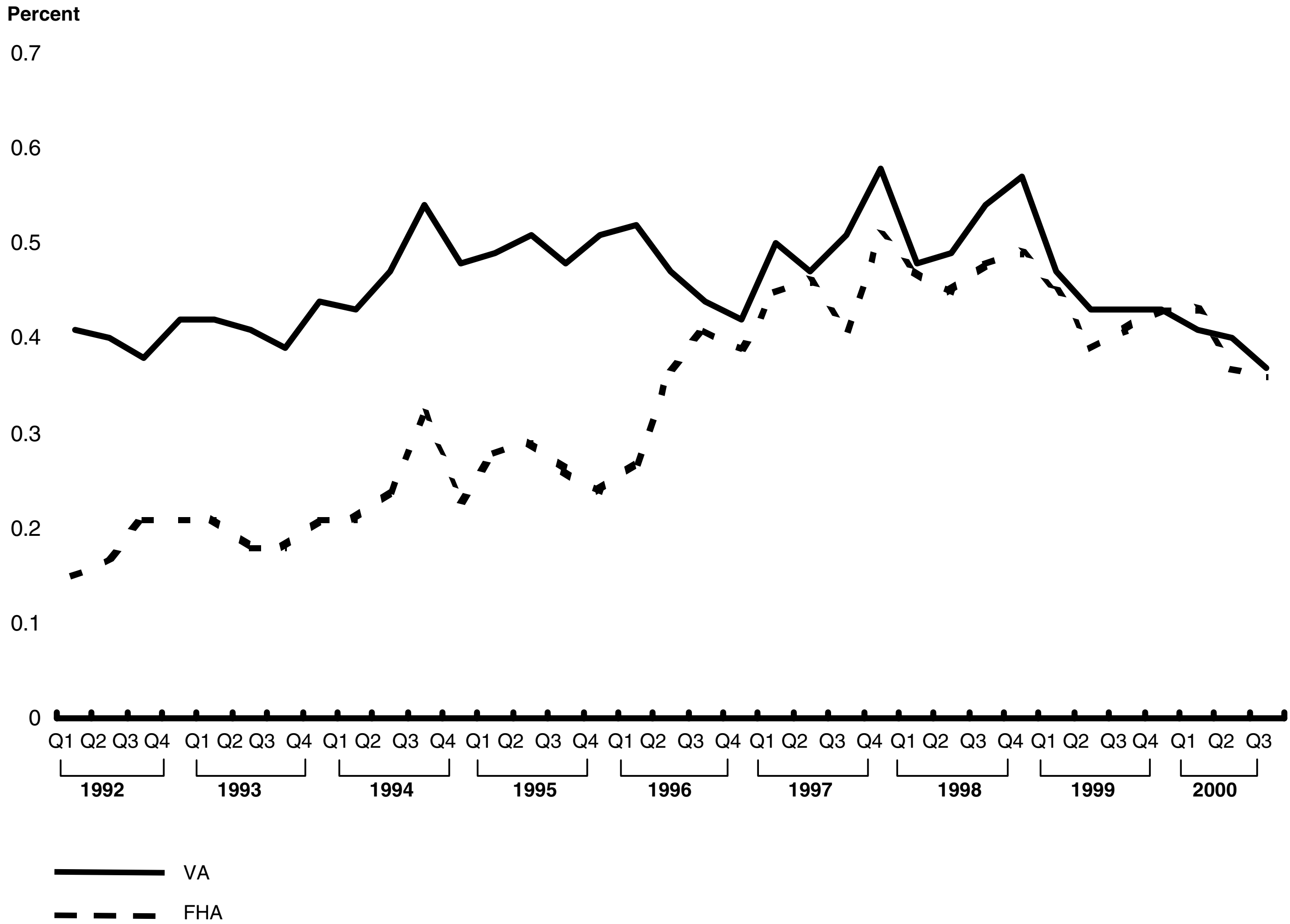
[2]MBA conducts the quarterly *National Delinquency Survey*. The MBA Survey collects data from over 180 lenders, including mortgage bankers, commercial banks, saving banks, saving and loan associations, and life insurance companies. The MBA Survey includes about 25 million mortgage loans on single-family residential properties. Data on fixed-rate FHA loans are reported by a smaller sample of lenders.

Figure 11: Percentage of Outstanding VA and Fixed-Rate FHA Loans Delinquent 30 Days or More



Source: MBA.

Figure 12: Percentage of Outstanding VA and Fixed-Rate FHA Loans for Which Foreclosures Were Started During the Quarter



Source: MBA.

Several factors affect both the probability that a borrower will default on a mortgage and the severity of the loss when foreclosure occurs. These factors include the following:

- **Negative borrower equity**—a condition that occurs when the current loan balance is greater than the current value of the mortgaged property. Negative borrower equity can occur if home prices decline in a particular geographic area.
- **The age of the mortgage**—the age of the mortgage affects the current loan balance, due to amortization of outstanding loan principal. Mortgage defaults and foreclosures tend to peak between the fourth and seventh years after mortgage origination.
- **Original loan to value (LTV)—**loans with a higher LTV at origination are more likely to experience negative equity when house values decline.
- **Adverse conditions that affect a borrower's ability to repay**—the loss of a job, divorce, or the death of spouse can trigger borrower's failure to make scheduled mortgage payments. These conditions, combined with severe negative borrower equity, increase the likelihood of foreclosure and large loss severity.

Appendix IV: Comparisons of VA and HUD Policies for Servicing Troubled Loans

To provide a general perspective on VA policies for servicing troubled loans, we compared VA policies with HUD's. This appendix highlights major differences and similarities between VA and HUD policies for servicing troubled loans. HUD administers the Loss Mitigation Program for servicing FHA-insured loans. A general description of the FHA single-family mortgage insurance program may be found in appendix III.

Overview

The loan servicing programs of VA and HUD have similar objectives: (1) to help their borrowers avoid foreclosure and (2) to minimize financial losses. However, the agencies use different means to achieve these objectives. They differ in the level of servicing responsibilities that are placed on their lenders and in the types of alternatives to foreclosure they offer.

Lenders' Responsibilities for Servicing Troubled Loans

While VA performs its own supplemental servicing, FHA lenders are required to engage in loss mitigation for the purpose of providing alternatives to foreclosure.[1] FHA lenders have full authority to offer any of HUD's alternatives to foreclosure without prior HUD approval. In contrast, VA lenders are free to discuss all alternatives with borrowers, but they must obtain prior VA approval before processing some of VA's alternatives to foreclosure.

The VA's Servicer Loss Mitigation Program (SLMP), introduced in 1993, gave participating lenders authority to offer both the deed in lieu of foreclosure option and compromise claims. SLMP thus provides lenders with much the same level of authority HUD lenders enjoy. However, participation in the SLMP is optional, but participation in HUD's Loss Mitigation Program is mandatory. Additionally, VA must provide a "determination of insolubility" before SLMP lenders can proceed with either a deed in lieu of foreclosure or compromise claim.

Alternatives to Foreclosure

Both VA and HUD encourage their lenders to utilize alternatives to foreclosure, which are less costly and time consuming than foreclosure proceedings. These alternatives include forbearance, loan modification,

[1]In 1998, the National Housing Act was amended to add a triple penalty for failure to engage in loss mitigation. (12 U.S.C. § 1715u) The penalty is to be three times the amount of any insurance benefits claimed by the lender on the mortgage. (12 U.S.C. § 1730f. 14(a)(2))

and private sale of property. In addition, each agency offers alternatives to foreclosure that the other does not.

One alternative that HUD offers for its loans that VA does not is called the partial claim. (See table 3.) Using this alternative, HUD essentially provides the borrower with an interest-free second loan on the property in the amount necessary to reinstate the delinquent loan. The borrower is not required to repay this loan until the first mortgage is paid in full or the property is sold.

Refunding is one VA alternatives to foreclosure that HUD does not use. Under this alternative, VA may purchase a defaulted loan from a lender and then reamortize the loan to eliminate a delinquency.

Reflecting the different roles lenders play in servicing troubled loans, cash incentives lenders receive from VA and HUD for offering alternatives to foreclosure also differ. (See table 3.) VA pays cash incentives only to SLMP lenders that process compromise claims and deeds in lieu of foreclosure. HUD pays lenders cash incentives for offering any of its alternatives to foreclosure.

Table 3: Alternatives to Foreclosure Offered by VA and HUD Loan Servicing Programs and Cash Incentives Paid to Lenders (as of March 2001)

	Offered by:		Cash incentives paid to lenders:	
Type of alternative to foreclosure	VA	HUD	VA	HUD
Forbearance	√	√	None	$100[c]
Loan modification	√	√	None	$500
Private sale of property	√	√	None	$1,000
Deed-in-lieu of foreclosure	√	√	$200	$250
Refunding	√	Not offered	None	Not applicable
Compromise claim[a]	√	√	$200[b]	$1,000
Partial claim	Not offered	√	Not applicable	$250

[a] VA uses the term “compromise claim” while HUD uses “preforeclosure sale” when referring to this type of alternative.

[b] VA pays an additional $200 for each month a compromise claim is completed prior to a deadline.

[c] HUD pays additional $200 to lenders in the top 25th percentile performance.

Source: GAO analysis of VA and HUD documents.

Appendix V: Data on VA’s Supplemental Servicing

This appendix provides details of the data we presented in the report. Table 4 provides details of VA’s supplemental servicing activities from fiscal years 1996 to 2000; table 5 lists such details by each regional loan center. Table 6 provides details of changes in loan servicing staff and the Notice of Defaults (NOD) per employee at each regional loan center, from fiscal years 1996 to 2000. Finally, table 7 provides details of the Foreclosure Avoidance Through Servicing (FATS) ratio at each regional loan center, from fiscal years 1996 to 2000.

Table 4: VA’s Supplemental Servicing Activities

Type of loan activity	1996	1997	1998	1999	2000	Average (1996-2000)
Number of loans guaranteed	318,909	257,916	343,957	485,625	199,161	321,114
Average loan amount	$101,767	$104,549	$110,207	$111,381	$117,353	$109,051
Number of NODs received by VA	125,695	131,740	135,445	113,758	103,050	121,938
Percentage of NODs made current by borrower initiative and VA's alternatives to foreclosure	73.2%	70.2%	71.2%	87.5%	91.8%	77.9%
By borrower initiative	63.3	60.2	61.4	76.4	81.6	67.7
By VA's alternatives to foreclosure:	9.9	10.0	9.9	11.1	10.2	10.2
Successful intervention	4.5	4.6	4.1	5.4	2.8	4.3
Compromise claim	2.9	3.0	3.7	3.2	2.8	3.1
Refunding	1.5	1.5	1.5	2.0	4.0	2.0
Deed-in-lieu of foreclosure	1.0	0.8	0.7	0.5	0.6	0.7
Percentage of NODs foreclosed	16.5	18.5	20.9	22.1	23.9	20.2
Percentage of NODs with unknown status[a]	10.4	11.3	7.9	-9.6	-15.6	1.9

[a]Some defaulted loans have unknown status because they were neither cured nor foreclosed in the year they defaulted.

Source: GAO analysis of VA data.

Table 5: VA's Supplemental Servicing Activities at Each Regional Loan Center (Average: Fiscal Years 1996-2000)

Type of Loan Activity	Atlanta	Cleveland	Denver	Houston	Manchester	Phoenix	Roanoke	St. Paul	St. Petersburg	Average
Number of loans guaranteed	39,747	34,153	38,681	39,712	13,040	49,386	40,846	32,250	33,298	35,679
Average loan amount	$99,881	$99,932	$122,734	$89,884	$109,588	$133,997	$122,796	$96,535	$95,286	109,051
Number of NODs received by VA	16,367	13,777	7,797	19,862	4,351	19,074	14,279	11,337	15,093	13,549
Percentage of NODs made current by borrower initiative and VA's altnernatives to foreclosure	76.8%	84.3%	74.6%	80.4%	72.3%	73.9%	69.9%	83.4%	81.7%	77.9%
By borrower initiative	69.9	74.9	63.7	69.9	61.8	58.8	61.3	75.3	71.6	67.7%
By VA's alternatives to foreclosure:	7.0	9.5	11.0	10.5	10.5	15.1	8.7	8.1	10.1	10.2%
Successful Intervention	3.8	6.1	4.0	5.0	3.2	2.9	2.8	4.6	5.7	4.3%
Compromise Claim	0.9	1.5	3.1	2.0	4.8	9.8	3.1	1.5	1.1	3.1%
Refunding	2.0	1.0	2.9	2.9	0.9	1.7	2.1	1.2	2.6	2.0%
Deed-in-lieu of foreclosure	0.3	0.9	0.9	0.5	1.6	0.8	0.7	0.8	0.7	0.7%
Percentage of NODs foreclosed	19.7	15.2	16.9	16.1	22.8	29.5	25.5	15.9	17.9	20.2%
Percentage of NODs with sunknown status[a]	3.5	0.4	8.4	3.4	5.0	-3.4	4.6	0.7	0.3	1.9%

[a]Some defaulted loans have unknown status because they were neither cured nor foreclosed in the year they defaulted.

Source: GAO analysis of VA data.

Table 6: Percentage Change in Full Time Employees (FTEs) Dedicated to Loan Servicing and Percentage Change in NODs Per FTE at Each Regional Loan Center

VA Regional Loan Center		1996-1997	1997-1998	1998-1999	1999-2000	1996-2000
Atlanta	Change in FTEs (%)	-1.6%	-25.0%	6.9%	5.4%	-16.7%
	Change in NODs per FTE (%)	6.2	43.7	-19.0	-12.4	8.3
Cleveland		-12.8	-12.4	-6.8	12.6	-19.8
		15.2	14.6	0.9	-18.4	8.7
Denver		-20.8	-15.1	17.2	9.0	-14.1
		32.8	37.5	-27.7	-12.7	15.2
Houston		-3.0	3.1	-25.8	-10.6	-33.7
		7.9	0.4	9.0	-2.8	14.8
Manchester		17.4	-13.9	5.3	2.4	8.9
		-7.7	24.9	-15.3	-21.3	-23.1
Phoenix		42.5	-34.4	26.3	-29.6	-16.8
		-25.8	40.9	-36.9	22.6	-19.1
Phoenix		42.5	-34.4	26.3	-29.6	-16.8
		-25.8	40.9	-36.9	22.6	-19.1
Roanoke		0.7	-5.4	4.2	21.8	20.8
		7.5	15.1	-20.9	-22.3	-23.8
St. Paul		-16.7	-13.2	-13.0	17.7	-26.0
		23.7	16.2	-11.5	-17.5	4.9
St. Petersburg		-17.3	-46.0	35.1	19.7	-27.7
		27.3	86.8	-35.7	-25.2	14.4
Change in total number of employees		-2.4	-18.8	1.3	1.6	-18.5
Change in average number of defaults per employee		7.4	26.7	-17.1	-10.8	0.5

Source: GAO analysis of VA data.

Table 7: Foreclosure Avoidance Through Servicing (FATS) Ratio at Each Regional Loan Center

VA Regional Loan Center	1996	1997	1998	1999	2000	Average (1996-2000)
Atlanta	30.8%	28.3%	25.1%	25.4%	22.3%	26.2%
Cleveland	38.3	40.3	35.0	42.3	35.9	38.4
Denver	47.7	38.8	37.5	39.6	37.3	39.3
Houston	38.9	40.7	42.4	39.4	35.3	39.5
Manchester	39.3	36.7	31.9	31.2	20.3	31.6
Phoenix	38.3	33.5	34.7	32.9	27.5	33.9
Roanoke	27.9	26.2	19.6	26.8	27.5	25.4
St. Paul	41.9	39.0	26.0	30.4	30.2	33.6
St. Petersburg	42.3	39.4	33.2	34.5	30.3	36.0
Average	37.5	35.0	32.1	33.4	30.0	33.5

Source: GAO analysis of VA data.

Appendix VI: Comments From the Department of Veterans Affairs

Note: GAO comments supplementing those in the report text appear at the end of this appendix.

THE SECRETARY OF VETERANS AFFAIRS
WASHINGTON

April 13, 2001

Ms. Davi M. D'Agostino, Director
Financial Markets and Community Investment
U. S. General Accounting Office
441 G Street, NW
Washington, DC 20548

Dear Ms. D'Agostino:

This responds to your draft report, ***DEPARTMENT OF VETERANS AFFAIRS: Improved Measures Needed to Assess Supplemental Loan Servicing Program*** (GAO-01-xxx). I am pleased that GAO reports the Department of Veterans Affairs (VA) is in conformance with its policies and procedures in servicing home loans to veterans.

Regarding GAO's specific recommendations, I disagree with GAO's view that VA develop meaningful performance measures for the nine regional loan centers. The Veterans Benefits Administration (VBA) is already using such performance measures with the Foreclosure Avoidance Through Servicing (FATS) ratio. VBA is beginning a redesign study of its servicing operation. This will include a review of the FATS ratio. We do not intend, however, to use cost to the Government as a performance measure. Although VA decisions on foreclosure alternatives will continue to be made primarily on the basis of what is in the veteran's best interest, the cost to the government of an alternative will always be a consideration. I agree with GAO's recommendation that VBA improve the Loan Servicing and Claims (LS&C) system to generate accurate and useful management reports and am pleased to report considerable progress to that end.

Enclosure (1) details VA's disagreement with GAO's recommendation on performance measures and VA's planned and completed actions to improve the LS&C system. Enclosure (2) provides some technical corrections and some language suggestions to improve the accuracy and understanding of GAO's discussion of VA's supplemental servicing of its veteran home loans.

Sincerely yours,

Anthony J. Principi

Enclosures

Enclosure (1)

DEPARTMENT OF VETERANS AFFAIRS COMMENTS
TO GAO DRAFT REPORT,
DEPARTMENT OF VETERANS AFFAIRS: Improved Measures Needed to Assess Supplemental Loan Servicing Program
(GAO-01-xxx)

GAO recommends that I direct VA's Assistant (sic) **Secretary for the Veterans Benefits Administration to develop meaningful performance measures for the nine regional loan centers. The overall framework could include creating performance benchmarks that take into account the impact of economic conditions and legal requirements on VA's ability to reduce the number of foreclosures while holding down costs. The overall framework could also take into account the benefits of alternatives to foreclosure for veteran-borrowers, perhaps using a FATS ratio in conjunction with performance benchmarks.**

Do Not Concur - VA already has a meaningful national measure of supplemental servicing performance in its Foreclosure Avoidance Through Servicing (FATS) ratio. The recommendation suggests a framework for a measure that includes "creating performance benchmarks that take into account the impact of economic conditions and legal requirements on VA's ability to reduce the number of foreclosures while holding down costs." In 1999 and 2000, VA studied the results of its supplemental servicing actions for the previous 12 years. This study carefully considered how economic conditions impacted the availability of alternatives to foreclosure, and how local legal requirements may have increased the attractiveness of alternatives or made them less beneficial. The study concluded that a revised national FATS ratio was the best measure of VA's supplemental servicing activities, and that such a measure accounted for local economic conditions and legal requirements. VA is about to begin a redesign study of its servicing operations to examine the impact of the recent consolidation of servicing into nine regional loan centers (RLCs), and if operating policies and procedures need revision. This new study will also look at measuring the performance of each RLC and will assist RLC managers in developing local performance measures so they can properly manage their workloads.

The previous FATS study also concluded that, while it is certainly appropriate to compare the cost to the Government of an alternative to foreclosure in an individual case, it is not wise to include cost savings in a performance measure that is intended to reflect assistance to veterans. The assistance to veterans is a basic benefit of the VA home loan program that should not be reduced to a price tag to compare alternatives.

1

Enclosure (1)

DEPARTMENT OF VETERANS AFFAIRS COMMENTS
TO GAO DRAFT REPORT,
DEPARTMENT OF VETERANS AFFAIRS: Improved Measures Needed to Assess Supplemental Loan Servicing Program
(GAO-01-xxx)
(Continued)

GAO also recommends that I direct VA's Assistant (sic) **Secretary for the Veterans Benefits Administration to take action to ensure that improvements are made in a timely fashion to the LS&C system so that it can generate accurate and useful management reports. These actions would include current initiatives to provide consistent business definitions of the alternatives to foreclosure. In addition, to implement the first recommendation, the actions would include compilation of data – such as average costs of alternatives to foreclosure and house price movements in the region – that could be used to assess benefits from supplemental servicing and to create benchmarks for regional loan center performance.**

Concur – VA is strongly committed to this effort, and it is well underway. We have assigned an additional Loan Guaranty staff person to assist in developing business definitions and technical specifications used in preparing reports. We have added funds to the maintenance and development contract of LS&C to acquire additional programmer support for this reporting effort. During the redesign study of servicing operations, additional report formats may be developed to ensure that local managers obtain the data to adequately measure performance and properly use resources.

2

GAO Comment

The VA Secretary said VA conducted a study in 1999 and 2000 (VA's 1999 study) that concluded that the national FATS ratio was the best measure of VA's supplemental servicing activities and that such a measure accounted for local economic conditions and legal requirements. In reaching our conclusions and making our recommendation, we reviewed and considered information VA supplied on its 1999 study. According to the information provided, in September 1999 the Loan Guaranty Service convened a group of headquarters and regional VA personnel to review FATS and various alternatives. In all, six alternatives were considered based on eight criteria. The unweighted FATS ratio met all criteria. In contrast, a measure similar to FATS, but adjusted in some manner to account for local economic factors beyond VA control, did not meet three criteria:

- proposal must be supportable, reliable and easily validated,
- proposal must have a clear and simple approach, and
- the group must reach a consensus on the recommendations.

Based on the information provided, it did not appear that the group then considered the future potential of the LS&C computer system to provide improved performance measures for benefits to veterans or cost savings to the government. With full implementation of the LS&C computer system, we reached the conclusion that VA should develop new performance measures for benefits to veterans and cost savings to the government that can be compared across the nine regional loan centers.

Appendix VII: GAO Contacts and Staff Acknowledgments

GAO Contacts

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William B. Shear, (202) 512-4325

Acknowledgments

In addition to those named above, Kyong Lee and Kristi Peterson made key contributions to this report.

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