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VETERANS BENEFITS ADMINISTRATION

Oversight and Resolution of Home Loan Defaults

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Executive Summary

The VA Office of Inspector General (OIG) conducted this audit to determine whether the Veteran Benefits Administration's (VBA) Loan Guaranty Service (LGY) provided required oversight of the home loan default resolution process to ensure home loan defaults were appropriately resolved and minimized. Defaults are resolved by servicers using five potential loss mitigation options. The impact to the borrower can be minimized by timely resolution and selection of the loss mitigation option that is in the borrower's best financial interest. The loss mitigation options include three home retention options: repayment plans, special forbearances, and loan modifications. In addition, two loss mitigation options avoid foreclosure, which are deeds-in-lieu of foreclosure and compromise sales. VA's reported default resolution rate has steadily increased each year for the last four fiscal years from nearly 83.4 to just over 86.5 percent for fiscal years 2015 and 2018, respectively. In fiscal year (FY) 2018, VA reported over 14,800 veterans, active duty service members, or their families (borrowers) lost their homes due to foreclosure, which was down from about 18,000 who lost their homes in FY 2015. In FY 2018, VA reported seriously delinquent and foreclosure inventory rates of 2.03 percent and 0.87 percent, respectively. This was comparable to the conventional loan rates and lower than the Federal Housing Administration (FHA) rates.

To receive a VA-guaranteed home loan, a borrower must apply to a lender such as a bank or credit union. VA guarantees up to 25 percent of the original loan amount. Once the home loan is approved, lenders often transfer the loan to companies that act as private loan servicers, or in some instances the lenders service the loan themselves. If a borrower misses one payment, the home loan becomes delinquent. The loan is considered in default after 61 days without payment. The loan servicers are responsible for using the available loss mitigation options, such as repayment plans, to work with the borrowers to reach an agreement that will resolve defaulted loans and avoid foreclosure and loss of the home.

LGY monitors loan servicer activities and intervenes as needed to ensure that the borrower is properly afforded all opportunities available to either help the borrower keep the home or is provided an alternative to foreclosure. Loan technicians at regional loan centers conduct adequacy of servicing (AOS) reviews after 120 consecutive days without a reported loan payment. Regional loan center (RLC) technicians determine whether the servicer is complying with VA regulations by giving borrowers every opportunity to pursue all possible loss mitigation options to avoid foreclosure. VA pays the loan servicers monetary incentive awards upon successful completion of any of the loss mitigation options, and issues infractions when a servicer does not comply with VA regulatory requirements.

What the Audit Found

VBA's LGY did not always provide sufficient oversight to ensure all borrowers with defaulted VA home loans received the necessary loan servicing to appropriately resolve and minimize the impact of the default. The audit team estimated, based on a sample review of 200 loans, that approximately 14 percent had at least one LGY oversight deficiency. Specifically, the audit team found that in some instances LGY was unaware servicers were not reporting loan status, while in other instances it did not ensure loan servicers sent the borrowers the required loss mitigation letters. The audit team also found that LGY did not conduct quarterly monitoring of loan servicing and did not implement a mandatory tier-ranking system for loan servicers. The LGY director previously stated the upgraded VA Loan Electronic Reporting Interface (VALERI) system expected to be implemented by May 2019 (subsequently implemented on May 28, 2019) would provide these capabilities. The audit team and LGY also identified potential loan servicing risks to borrowers in disaster areas.

Loan Status Updates

LGY was unaware whether some loans were in default or current for varying periods of time, even though all servicers must report the loan statuses monthly. The audit team estimated that LGY may not have been aware of the status of approximately 6 percent, or 187,000 loans, with an estimated outstanding loan amount of just under $40 billion for varying periods of time during FY 2018. This equates to approximately 3,800 defaulted loans of about $811 million based on VA's reported default rate of 2.03 percent in FY 2018. RLC management and staff use the web-based application VALERI to view loan information, monitor loan servicing, report loan events, generate loss mitigation recommendations, conduct AOS reviews, and manage workloads. Current and prior LGY managers did not establish controls in VALERI to ensure servicers report loan status monthly because they were unaware of the extent of this issue, including the number and duration of loans that went unreported and were satisfied with VALERI's oversight capabilities. The LGY director indicated that the majority of loans that went unreported were due to servicers transferring loans, and VBA indicated there was little risk since most loans were current. LGY's data quality team does identify some unreported loans if VA and servicer data does not match, but the audit team estimates that this team identifies only a maximum of about 600 loans with errors per year. In addition, the data quality team's oversight does not include unreported loans that do not have any data matching issues. Given the audit team analysis of the length of time that some loans went unreported, delayed oversight could potentially increase the risk of borrowers choosing less advantageous loss mitigation options or losing their homes.

Loss Mitigation Letters

The audit team found a number of deficiencies with respect to loss mitigation letters. First, loan servicers did not report that the required loss mitigation letters were sent to borrowers. Second, that some loss mitigation letters were sent late. Third, that some loss mitigation letters were not sent. The audit team estimated that at least one of these problems was present in approximately 4,500 of 55,900 loans (8 percent). Loss mitigation letters include the potential loss mitigation options and how to contact the servicer and VA. The servicers must send the letter by the 75th day of the delinquency or the 45th day if the default occurs within six months from the beginning of the loan. The Code of Federal Regulations requires servicers to send loss mitigation letters and electronically report that the letters were sent. Borrowers may have realized a more advantageous outcome if they had been made aware of their options through the loss mitigation letters. Loan technicians are required to impose regulatory infractions based on the applicable VA Manual if the letter was not sent.[1]

However, in 2011, LGY removed the requirement to monitor and enforce loss mitigation letter reporting, and servicers were not penalized with infractions. LGY removed the business rule from VALERI because of past evidence that servicers were sending the letters and it was advantageous for servicers to send the letters. LGY should have deemed servicing inadequate at the completion of the AOS review if there was no evidence that the letter was sent because sending a letter is a requirement in the Code of Federal Regulations.[2] Servicers receiving continuous regulatory infractions could be identified through quarterly performance analysis and result in a reduced tier ranking for payment of incentives.

Quarterly Monitoring of Loan Servicer Performance

The Code of Federal Regulations has had a requirement for quarterly evaluations of loan servicer performance to assign tier rankings since 2010.[3] Both the current and prior LGY directors were aware of this requirement. However, LGY did not conduct quarterly monitoring from 2010 through the present as required because VALERI has been unable to compile and generate the necessary quarterly analysis for individual servicers. In FY 2017, nine years after VALERI's implementation, LGY's Monitoring Unit identified the inability of VALERI to compile the necessary information as a weakness. The audit team concluded that LGY did not make quarterly

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[1] VA Manual 26-3, revised, chap. 18, sec. 18.01, "Regulatory Infractions," b. and 18.02 "Regulatory Infractions Descriptions," a.2. "Technician-Added Infractions," (a) "Late Loss Mitigation Letter Sent," September 29, 2017. A regulatory infraction occurs when a servicer does not comply with VA regulatory requirement(s). Regulatory infractions are system-generated or manually added by a VA technician anytime throughout the life of the loan, after termination, and when conducting a post audit.

[2] 38 Code of Federal Regulations (C.F.R.) § 36.4350.

[3] 38 C.F.R. § 36.4318 effective June 15, 2010, with the same requirements still present in the most recent July 15, 2015, edition of the Code of Federal Regulations.

monitoring of loan servicers a high priority because the prior LGY director from 2012 through 2016 considered the overall performance of servicers to be adequate and did not consider this a high-risk area.

Because LGY did not conduct quarterly reviews of loan servicers, it could not identify underperforming servicers. Underperforming servicers are more likely to fail their obligations to send loss mitigation letters and properly undertake loss mitigation efforts, which could have delayed AOS reviews and caused borrowers to select less advantageous loss mitigation options, or potentially lose their homes. Also, without quarterly monitoring of performance, LGY could not identify the need for additional oversight, such as increased monthly post-audits or on-site audits, as required by the VA Servicer Handbook if there were loan servicer performance issues.[4]

Tier-Ranking System for Loan Servicers

The Code of Federal Regulations required VA to implement a system of annual tier rankings based on servicer performance in June 2010, and LGY should have implemented tier rankings in February 2011.[5] The ranking system is supposed to have four tiers, with Tier 1 being the highest and Tier 4 being the lowest.[6] Tier rankings allow an agency to strategically rank the performance of loan servicers and pay incentives commensurate with their performance. LGY has not yet implemented this ranking system and, if implemented, incentive payments would have varied based on performance by tier. Instead, LGY has paid all servicers based on a Tier 2 ranking since 2011 regardless of their servicing performance, and regulatory infractions had no effect on tier rankings. For example, based on a Tier 2 ranking all servicers received $500 for a defaulted loan resolved with a loan modification. If tier rankings were implemented, those incentive payments would have varied between $0 to $700 for a successful loan modification for Tiers 4 and 1, respectively. As a result, borrowers may have received inferior default loan servicing from lower-performing servicers, which increased the risk of a less advantageous outcome. The audit team found 19 of the 51 servicers (37 percent) servicing the loans in the sample underperformed, which would be considered negatively for tier-ranking purposes.

This occurred because VALERI is not capable of compiling and generating quarterly monitoring of servicers' performance statistics, which is necessary to implement the tier-ranking system. Both the current and prior LGY directors were aware of the tier-ranking regulatory requirement, and the need for quarterly evaluations of servicers' performance to assign tier rankings. The prior LGY director, with the longest tenure of four years, explained that tier rankings were not implemented because LGY did not establish a framework for measuring servicers. The current

[4] VA Servicer Handbook M26-4, chap. 15, sec. 15.05, "Quarterly Post-Audit Reports," May 9, 2017; and VA Manual M26-9, chap. 5, sec. 3.b, "Servicer Selection," January 25, 2016.

[5] 38 C.F.R. § 36.4318 effective June 15, 2010, with the same requirements still present in the most recent July 15, 2015, edition of the C.F.R.

[6] 38 C.F.R. § 36.4318.

LGY director explained LGY needs to determine what data elements will be part of tier rankings and noted there will be upcoming system changes to accommodate that data and that it may take up to two years to implement based on the long regulatory process.

Disaster Area Loans

As part of this audit, the audit team and LGY management identified potential loan servicing risks to borrowers in disaster areas. Borrowers possibly faced unnecessary forbearances and higher interest rate loan modifications which increased the risk of future defaults and foreclosures. A forbearance is a short-term waiver of payment intended to financially assist the borrower and is normally resolved by payment in full, a repayment plan or a loan modification.

LGY issued guidance to home loan servicers in 2017 and 2018 encouraging these companies to assist borrowers in financial distress who were affected by major natural disasters. In this context, disaster areas are those affected by a Federal Emergency Management Agency-declared disaster, such as floods, tornadoes, and storms. VA encourages servicers to provide all available options including forbearances and loan modifications to borrowers in distress and delinquent as a result of a disaster. The audit team and LGY identified risks in June 2018 based on limited analysis from an RLC that showed attempts by a nationwide servicer to obtain significantly higher interest rates for loan modifications after forbearances. This servicer was potentially going beyond the intent of the guidance by soliciting borrowers to default and resolving those defaults that were only in the servicers' best financial interest. Due to the OIG's limited review in this area and LGY conducting a preliminary risk analysis for borrowers with home loans in disaster areas in July 2019 which did not justify a formal risk assessment, the OIG made no recommendations.

What the OIG Recommended

The OIG recommended that the under secretary for benefits conduct the following:

- Implement controls to identify and address unreported monthly loan status in the upgraded VALERI systems and implement compensating controls in the interim.
- Ensure that loan servicers report when loss mitigation letters are sent and impose necessary regulatory infractions when required.
- Ensure the post-audit and adequacy of servicing reviews are compiled and trended and generate key loan servicer performance statistics.
- Develop a plan to implement a formal tier-ranking system following the implementation of the upgraded VALERI system.

Management Comments

The under secretary for benefits concurred with all four recommendations and provided acceptable action plans for the recommendations. The under secretary also requested closure of Recommendation 2 and 4 based on actions that VBA has taken. The OIG will follow up to verify that all actions stated in the under secretary's response have been completed prior to closing those recommendations. VBA also provided technical comments, which the OIG incorporated in the report where appropriate. VBA was concerned that the OIG did not portray LGY as the industry leader for loan servicing and resolution of defaulted loans and did not agree with some of the OIG's conclusions as detailed below.

VBA stated LGY's foreclosure and delinquency rates outperformed FHA and were on par with conventional loans and thus veterans experienced better home retention outcomes. The OIG included those relevant foreclosure and seriously delinquency rates in Table 2 of this report and agrees in general that VA loans outperformed FHA loans for those factors. An explicit statement on that topic is also in the Executive Summary.

VBA took exception to the report's statement that LGY was unaware of the status of approximately 6 percent, or 187,000 loans totaling approximately $40 billion for varying periods of time during FY 2018. VBA also stated that LGY was aware of temporary gaps in reporting loan status due to the industry practice of the sale and transfer of loans, and there is little risk since most loans are current. The OIG believes that 187,000 loans is substantial and reporting the total estimated loans going unreported shows the extent of the issue. Additional OIG analysis conducted after VBA's response did reveal that 80 percent of the 20 loans unreported were transferred by servicers. However, as stated in this report, 9 of the 20 loans unreported were unreported for three months or more, including seven current loans going unreported for six months or more. One loan went unreported for 11 months. The length of time these went unreported is indicative of the extent of the lack of oversight. Those statistics also show that LGY did not conduct appropriate follow-up because LGY did not timely obtain the current loan status or issue infractions.

VBA did not agree with the OIG conclusions regarding loss mitigation letters and indicated that there are redundancies built into the process to ensure borrowers are presented with loss mitigation options, such as letters sent by VA to the borrower at day 120. The OIG recognizes the importance of those subsequent processes, but these processes do not change the legal requirements. In particular, the Code of Federal Regulations requires loan servicers to report to VA that loss mitigation letters have been sent by the 75th day of the delinquency or the 45th day when applicable. Those letters include important information for the borrower such as the potential loss mitigation options and how to contact the servicer and VA. Notwithstanding the legal requirement, borrowers who are provided those options two and a half months after delinquency are more likely to timelier resolve their defaults.

VBA disagreed that LGY should have deemed servicing inadequate at the completion of the AOS review if there was no evidence that a loss mitigation letter was sent. VBA indicated the requirement by the VALERI Technician User Guide relates to a 30-day delinquency letter and is unrelated to the aforementioned 75-day letter. Regardless, sending both of these letters is part of the minimum collection actions to be taken by loan servicers to contact the borrower based on the Code of Federal Regulations. These essential communications between the servicer and the borrower ensure they are informed of how to timely resolve the defaults. Therefore, the OIG considers servicers to have not adequately serviced the loan without meeting this important and simple regulatory requirement.

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Abbreviations

AOS	adequacy of servicing
FHA	Federal Housing Administration
FY	fiscal year
LGY	Loan Guaranty Service
LoanSTAR	Loan Systematic Technical Accuracy Review
OIG	Office of Inspector General
RLC	regional loan center
VALERI	VA Loan Electronic Reporting Interface
VBA	Veterans Benefits Administration

Introduction

The VA Office of Inspector General (OIG) conducted this audit to determine whether the Veterans Benefits Administration's (VBA) Loan Guaranty Service (LGY) provided required oversight of the default resolution process that ensured home loan defaults were appropriately resolved and minimized.

Why the OIG Did This Audit

Defaults and foreclosures on homes can emotionally and financially harm veterans and their families. Defaults that are not resolved can ultimately result in a foreclosure and loss of the home for veterans, servicemembers, or family members (borrowers). For fiscal year (FY) 2018, VA reported about 106,400 new defaults with a default resolution rate of 86.5 percent.[7] However, over 14,800 borrowers lost their homes due to a foreclosure. Since February 2008, VA has placed greater reliance on loan servicers to resolve defaults timely and implement loss mitigation options that are in the best financial interest of borrowers. VBA monitors servicer activities and intervenes as needed during loan delinquency.

Home Loan Guaranty Program

VA's Home Loan Guaranty Program (home loan program) was established in 1944 to decrease "economic and sociological problems" faced by post-war service members. A borrower must apply to a lender, such as a bank or credit union. If a lender approves a loan, VA may guaranty a portion of the loan, protecting the lender against loss up to the amount guaranteed, which is generally 25 percent of the original loan amount. VA had over 3.1 million outstanding loans guaranteed at the end of FY 2018, which includes about 740,000 new and refinanced home loans issued in FY 2017 and about 611,000 new and refinanced home loans issued in FY 2018.

VBA Oversight

VBA's LGY oversees the home loan program by assessing and monitoring the program's risks and reviewing the lender and servicer compliance with relevant laws, regulations, and policies. Risks to borrowers range from continued or recurring defaults to foreclosures that create financial and emotional burdens on borrowers. Risks to VA range from the administrative costs

[7] The default resolution rate is calculated by taking the sum total of successful repayment plans, special forbearances, loan modifications, cured defaults without intervention, compromise sales, deeds in lieu of foreclosure, refunds, and defaults loans that have paid in full, divided by the sum total of successful repayment plans, special forbearances, loan modifications, cured defaults without intervention, compromise sales, deeds in lieu of foreclosure, refunds, defaults loans that have paid in full, and foreclosures (less any reported invalid foreclosure sales).

of overseeing defaulted loans to the potential acquisition costs of foreclosed properties conveyed by lenders and the costs of managing and selling foreclosed properties.

LGY's Loan Administration is responsible for all activities involving VA-guaranteed home loans from origination until the loan is paid in full or terminated, including oversight of loan servicers and defaulted loans. LGY administers the home loan program nationwide through eight regional loan centers (RLCs). The following are key aspects of LGY's oversight process for the home loan program.

- LGY's Monitoring Unit conducts quality assurance audits of high-risk lenders and servicers by reviewing defaulted, resolved, and foreclosed loans. In FY 2018, the Monitoring Unit reported 46 lender and eight servicer audits. According to the Monitoring Unit's management, the unit also conducts full-file loan reviews that may include a small percentage of defaulted and foreclosed loans.
- LGY's Loan Systematic Technical Accuracy Review (LoanSTAR) staff conduct monthly accuracy reviews of the home loan program. These staff randomly select 32 loans for review each month from VA Loan Electronic Reporting Interface (VALERI) reports based on adequacy of servicing (AOS) reviews and post-audits completed by RLC loan technicians the previous month. In FY 2018, LoanSTAR staff was scheduled to conduct 384 accuracy reviews within Loan Administration.
- RLC loan technicians conduct monthly reviews on loans where servicers use loss mitigation options or in other circumstances such as when foreclosures or partial releases of security occur. These reviews are called post-audits and verify the appropriateness of payments, account for regulatory infractions, and make any necessary adjustments. In FY 2018, 2,963 post-audits were conducted according to LGY's chief of the Quality Assurance Monitoring Unit.

Default Resolution Process

Lenders often send VA loans to private loan servicers, such as banks, for servicing. In the mortgage industry, servicing means conducting general loan-related tasks such as collecting mortgage payments and paying taxes, and delinquent loan-related tasks such as providing loss mitigation options to the borrower to bring the loan current. Important to the context of this report, if a borrower misses one mortgage payment, the VA-guaranteed loan becomes delinquent.[8] The loan is considered in default after 61 days without payment. Loan servicers are required to report a default on a home loan electronically by entering the default notification date in VALERI.[9] VALERI was implemented in 2008 and is a web-based application that RLC

[8] VA Manual 26-3, revised, chap. 4, "Delinquent Loan Servicing," 4.01 a., September 29, 2017.

[9] VA Manual 26-3, revised, chap. 2, "Introduction to VALERI," 2.04, "Servicer Event Reporting," September 29, 2017.

management and staff use to view loan information, monitor loan servicing, generate loss mitigation recommendations, conduct the AOS reviews, issue incentives to servicers, conduct post-audits, and manage workloads. Loan servicers are responsible for reporting loan events, including receipt of monthly payments from borrowers in VALERI and working with borrowers to reach an agreement that will bring the loan current and avoid foreclosure.[10]

After 120 consecutive days without a reported payment on the loan, RLC loan technicians conduct an AOS review of the servicer for the defaulted loan. The loan technicians determine whether the servicer is complying with VA regulations by giving the borrower every opportunity to pursue all possible loss mitigation options to avoid foreclosure. This includes determining why any prior loss mitigation options were not completed and identifying any disadvantageous options such as suspicious loan modifications. If the loan remains in default after the first 120-day AOS review, the technicians conduct additional AOS reviews at 90 days, again at another 90 days, then at 180 days thereafter. These additional AOS reviews ensure the servicer continues to provide adequate servicing until the delinquency is resolved or the home goes into foreclosure. Loan technicians become involved with the loan servicing directly if the borrower requires VA's assistance or the servicer is unable to help the borrower. Figure 1 provides a timeline and overview of the AOS process after the borrower misses a payment through additional AOS reviews if the borrower remains in default.

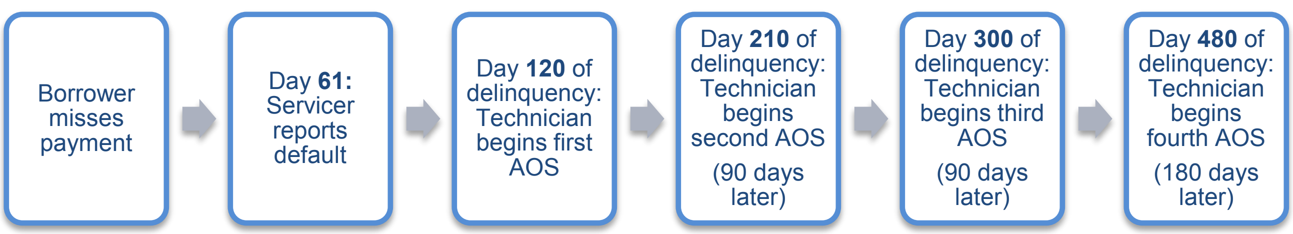

***Figure 1**. Timeline and overview of AOS process*
Source: VALERI Technician User Guide

VA reported that 95 percent of borrowers who received default assistance resolved their defaults and retained their homes in FY 2017. Although the number of new VA home loan defaults reported has steadily increased since FY 2015, the default resolution rate has also increased. VA reported its default rate, the percentage of VA home loans that defaulted, has remained around 2 to 3 percent for the last four calendar years. VA's default rate was similar to the default rates for conventional loans over the last four calendar years and lower than the Federal Housing Administration (FHA) default rates of between 3 and 5 percent. Further, VA reported that

[10] VA Manual 26-3, revised, chap. 2, "Introduction to VALERI," 2.04, "Servicer Event Reporting," September 29, 2017; and VA Manual 26-3, revised, chap. 4, "Delinquent Loan Servicing," 4.02, "Servicer Reporting Requirements," September 29, 2017.

approximately 104,800 borrowers avoided foreclosure in FY 2018 and foreclosures have decreased from about 18,000 in FY 2015 to about 14,800 in FY 2018. VA's foreclosure inventory rate, the percentage of loans in foreclosure, of 0.87 percent during 2018 is lower than the foreclose inventory rate for conventional loans and FHA, whose foreclosure inventory rates were 0.94 and 1.66 percent in 2018, respectively. A low foreclosure inventory is desirable to minimize the cost of acquisition, maintenance, and selling costs when foreclosed properties are conveyed by the lender to VA. Table 1 illustrates the number of new home loan defaults and the default resolution rates. Table 2 illustrates the VA, conventional, and FHA default and foreclosure rates.

Table 1. Home Loan Defaults and Foreclosures

Event	FY 2018	FY 2017	FY 2016	FY 2015
New VA defaults reported	106,394	97,948	89,598	85,263
VA default resolution rate	86.51%	85.31%	84.02%	83.39%

Source: VBA Fast Facts

Table 2. VA Compared to Industry from April 1 through June 30

Event	2018	2017	2016	2015
VA seriously delinquent rate	2.03%	2.03%	2.46%	2.92%
Conventional seriously delinquent rate (1)	2.00%	2.25%	1.78%*	2.24%
FHA seriously delinquent rate	3.86%	3.78%	4.43%	5.50%
VA foreclosure inventory rate	0.87%	0.99%	1.19%	1.37%
Conventional foreclosure rate (1)	0.94%	1.19%	0.95%	1.19%
FHA foreclosure rate	1.66%	1.86%	2.15%	2.68%

Source: Mortgage Bankers Association's Third Quarter National Delinquency Survey data (as of the second quarter) of each calendar year. The survey includes about 38 million mortgage loans and 100 entities such as mortgage and savings banks reporting performance for VA, conventional and FHA rates. The seriously delinquent rates are for loans that are delinquent for 90 days or more or in the process of foreclosure.
(1) The conventional rate data for 2015 and 2016 are for prime rate loans and the data for 2017 and 2018 include all nongovernmental conventional loans which would include prime rate loans.

Loss Mitigation Options

VA has five loss mitigation options available to help borrowers resolve defaults and avoid foreclosure including repayment plans, special forbearances, loan modifications, compromise sales, and deed-in-lieu-of foreclosure. VA delegates the primary responsibility for loss mitigation to loan servicers to help the borrower resolve the default in a timely manner using the best option available.[11] The Code of Federal Regulations lists the preferred order of the five options to consider starting with the repayment plan through the last option, deed-in-lieu of foreclosure, while recognizing that circumstances for borrowers may vary.[12] To encourage loss mitigation, VA pays incentive awards to the loan servicer when any of the five options are successfully completed. This encourages servicers to provide every opportunity for borrowers to retain their homes or avoid foreclosure.[13] Home retention incentive payment amounts for Tier 2 range from $160 monthly for a successful repayment plan or special forbearance to $500 for a loan modification. Foreclosure alternative incentives for Tier 2 can range from $250 for a deed-in-lieu of foreclosure to $800 for a compromise sale.[14] VA does not charge any portion of an incentive payment to the borrower, and the payment does not affect the loan. Table 3 describes the home retention options. Table 4 describes the alternatives to foreclosure.

Table 3. Home Retention Options

Options	Description
Repayment plan	The borrower makes the regular monthly mortgage payment plus part of the missed payments.
Special forbearance	The servicer agrees not to initiate foreclosure and collect reduced or no payments for a set time to allow the borrower to repay the delinquency when the forbearance period ends.
Loan modification	The servicer adds the borrower’s delinquency to the loan balance and, as part of a written agreement, establishes a new payment schedule, including a potentially different interest rate.

Source: VA Manual 26-3*, revised, chap. 5, “Loss Mitigation”*

Table 4. Alternatives to Foreclosure

Alternatives	Description
Compromise sale	The servicer agrees to allow a borrower to sell the home for a lesser amount than what is currently required to pay off the loan.
Deed-in-lieu-of foreclosure	The borrower voluntarily agrees to deed the property to the servicer instead of going through the foreclosure process. The servicer agrees to release all obligations under the mortgage.

Source: VA Manual 26-3*, revised, chap. 5, “Loss Mitigation”*

[11] VA Manual 26-3, revised, chap. 5, “Loss Mitigation,” 5.01, “Loss Mitigation Options,” September 29, 2017.

[12] 38 C.F.R. § 36.4319(b) lists the options in their preferred order of consideration which are: 1) repayment plan, 2) special forbearance, 3) loan modification, 4) compromise sale, and 5) deed in lieu of foreclosure.

[13] VA Manual 26-3, revised, chap. 5, “Loss Mitigation,” 5.01, “Loss Mitigation Options,” September 29, 2017; and VA Manual 26-3, revised, chap. 7, “Incentive Payment,” 7.01, “Incentive Payment,” September 29, 2017.

[14] 38 C.F.R. § 36.4319.

Results and Recommendations

Finding 1: LGY Did Not Always Provide Sufficient Oversight of Loan Servicers for Resolving Home Loan Defaults

VA has steadily increased the home loan program's default resolution rates over the last four fiscal years. However, additional controls are needed to ensure all borrowers receive the necessary assistance from servicers and LGY oversight. The audit team estimated that approximately 7,900 of 55,900 loans (14 percent) had at least one LGY Service oversight deficiency from August 1, 2017, through June 14, 2018. Specifically, the team found that LGY was not aware of the extent of loans going unreported by loan servicers, including the number and duration of the loans going unreported, and did not ensure loan servicers sent the borrowers the required loss mitigation letters. Inadequate loan servicing can be detrimental to the borrower and potentially result in a longer default, the selection of a less advantageous loss mitigation option, or an increased risk of home loss and foreclosure.

LGY also did not conduct required quarterly monitoring of loan servicing and did not implement a mandatory tier-ranking system for loan servicers. This resulted in limited oversight of servicer performance and equal rankings regardless of servicer performance history and equal incentive payments for successful loss mitigation options. Lastly, the audit team and LGY management identified potential loan servicing risks to borrowers in disaster areas such as possible unnecessary forbearances and higher interest rate loan modifications. Disaster areas are those affected by Federal Emergency Management Agency-declared disasters such as floods, tornadoes, or storms and include ecological or other human-made disasters.

The audit team determined that multiple causes contributed to insufficient oversight of loan servicers. These causes included LGY lacking internal controls to ensure servicers reported monthly loan status and servicer loss mitigation letters, LGY not ensuring loan servicers' performance was critically evaluated and ranked, and the VALERI system not meeting the needs and reporting requirements of the home loan program. The LGY director previously stated the upgraded VALERI system expected to be implemented by May 2019 (subsequently implemented May 28, 2019) would provide these capabilities.

What the OIG Did

The audit team selected a statistical sample of 200 from about 55,900 loans from August 1, 2017, through June 14, 2018, that were without a reported payment for 120 days or more and required an AOS review, loans that resulted in foreclosures, or loans resolved after default. The sample consisted of 50 loans from each of the following categories: unresolved defaulted loans, unresolved defaulted loans in disaster areas, foreclosed loans previously in default, and cured/resolved loans previously in default.[15] The audit team reviewed the loans to determine whether loan technicians conducted AOS reviews to provide effective oversight of loan servicers and whether they paid incentives or issued infractions where appropriate. The audit team also obtained additional information regarding loans in disaster area counties that included examples of servicer disaster forbearance letters and a disaster loan modification analysis. The audit team discussed loan risks regarding disasters such as unnecessary forbearances and loan modifications at higher rates with the LGY Quality Assurance Monitoring Unit. Appendixes A and B contain the scope and methodology and statistical sampling methodology, respectively.

This finding discusses LGY's need to

1. Provide adequate oversight to servicers and defaulted loans, which included loan servicers reporting monthly loan status, adequately servicing defaulted loans, and reporting or sending loss mitigation letters,
2. Conduct quarterly monitoring of loan servicer performance, and
3. Implement required tier ranking for loan servicers.

The finding also addresses the audit team and LGY's identification of potential loan servicing risks to borrowers in disaster areas.

LGY Did Not Provide Adequate Oversight of Servicers and Defaulted Loans

The audit team identified 45 oversight deficiencies for 43 of the 200 sampled loans, mainly due to servicers not reporting the monthly loan status or not reporting if loss mitigation letters were sent for defaulted loans. Based on these results, the audit team projected that approximately 7,900 of 55,900 loans (14 percent) had oversight deficiencies before or during the AOS reviews that occurred during the review period. The oversight deficiencies involved 19 of the 51 total servicers (37 percent) in the sample. Based on the deficiencies, the audit team concluded the performance of the 19 servicers could negatively affect future tier rankings if that performance continued because the servicers did not provide borrowers the best service possible and were not meeting VA requirements.[16] From the sample review, the audit team determined:

- LGY did not identify that loans servicers did not report the monthly loan statuses for 20 loans and LGY did not apply infractions. Based on the sampled loans, the audit team projected 3,300 defaulted loans nationwide were unreported.

[15] The unresolved defaulted loans in disaster areas category consisted of 37 disaster counties based on nine Federal Emergency Management Agency disaster declarations during the scope period. Nationwide there were 788 disaster counties based on 66 Federal Emergency Management Agency disaster declarations during the scope period.

[16] VA Servicer Handbook M26-4, chap. 20, "Servicer Performance," 20.01, September 9, 2015.

- LGY did not ensure loan servicers sent loss mitigation letters within 75 days or 45 days of delinquency as appropriate and did not apply infractions on the servicers for 23 defaulted loans. Based on the sampled loans, the audit team projected 4,500 defaulted loans nationwide had loss mitigation letters unreported, sent late or not sent.
- A loan servicer did not make a good faith effort to contact a borrower and a loan technician did not follow up regarding the servicer's contact efforts for one of the defaulted loans. In addition, a loan technician did not make required phone contacts during the pre-foreclosure process for another defaulted loan. The audit team did not report projections for these two loan deficiencies because of the high margin of error.

LGY Unaware of Extent of Loan Servicers Not Reporting Loan Statuses

VA requires loan servicers to report data and events in VALERI so that RLC loan technicians can oversee loan servicing activities such as the AOS reviews conducted for loans in default.[17] The Code of Federal Regulations requires loan servicers to submit monthly electronic updates to VA that include whether the loan is current or in default by the seventh day of each month for all loans.[18] For example, a servicer is required to report a default on a home loan in VALERI electronically.[19] If VALERI does not have a default notification date, the system will not trigger a notification to a loan technician that an AOS review is needed for a defaulted loan. The VA Manual requires an infraction when a loan servicer does not report required events to VA during the life of the loan.[20] Therefore, unreported loans would be considered improperly serviced if the loan status is not reported monthly.

From a sample of 200 loans, the audit team determined that monthly updates for 20 of the loans were not submitted as required including:

- Nine loans that LGY identified as unresolved defaulted loans that were actually current and in good standing. These monthly status update lapses ranged from three to 11 months with seven of those loans going unreported for six months or more.

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[17] VA Manual 26-3, revised, chap. 2, "Introduction to VALERI," 2.03, "Technician Roles and Responsibilities," and 2.04, "Servicer Event Reporting," September 29, 2017.

[18] 38 C.F.R. 36.4317.

[19] VA Manual 26-3, revised, chap. 2, "Introduction to VALERI," 2.03, "Technician Roles and Responsibilities," September 29, 2017.

[20] VA Manual 26-3, revised, chap. 18, "Regulatory Infractions," 18.01, "Regulatory Infractions," September 29, 2017.

- Eleven defaulted loans where servicers failed to report the monthly loan status. These lapses ranged from one to three months with eight of those loans going unreported for one month.

Based on sample results, the audit team estimated that loan statuses of approximately 3,300 of 55,900 loans (6 percent) from August 1, 2017, through June 14, 2018, went unreported through November 1, 2018. In addition, although the focus of the audit was defaulted loans, the audit team determined this same condition existed for current loans. Using the 6 percent error rate and applying it to the more than 3.1 million loans outstanding as of September 30, 2018, the LGY Service may not have been aware of the status of approximately 187,000 loans totaling nearly $40 billion.[21] This equates to approximately 3,800 defaulted loans of about $811 million, based on VA's reported default rate of 2.03 percent in FY 2018. Although the majority of loans that went unreported were current loans, LGY needs to ensure servicers are reporting loan statuses monthly to minimize the risks to borrowers in default. The LGY director indicated that the majority of loans that went unreported were due to servicers transferring loans, which was an industry-wide problem, and VBA indicated there was little risk since most loans were current.

Delayed oversight of defaulted loans could potentially increase the risk of borrowers choosing less advantageous loss mitigation options or losing their homes. The audit team confirmed two defaulted loans had delayed servicing because these loans' statuses were not reported. These loans were outside of the sample the audit team reviewed but were provided to the audit team by the loan servicing officers at the St. Paul, Minnesota, and Houston, Texas, RLCs. Example 1 provides details on the loan that resulted in the borrower going through a foreclosure.

Example 1

A servicer did not report the monthly status of a loan for almost two years until the loan went into default and LGY subsequently delayed an AOS review for four months. Specifically, a borrower's VA-guaranteed home loan began in August 2014. The servicer did not report the loan status in VALERI for 20 months, beginning in January 2016 and ending in September 2017. The loan went into default in August 2017 after being delinquent for June and July. The servicer reported the default in September to LGY that should have initiated an AOS review in October 2017, 120 days following the first delinquent payment. However, the AOS review was delayed by four months and did not occur until February 2018. The loan ultimately resulted in foreclosure in July 2018. An earlier AOS review may have helped the borrower avoid the loss of the home through foreclosure. The loan servicer confirmed with RLC management that the

[21] The team's estimation was determined by multiplying the current number of loans reported by LGY on September 30, 2018—3,116,926 loans—by the OIG-projected nonreporting error rate of 6 percent. See Appendix C for additional details on these estimates.

> *gap in reporting was a mistake on the servicer's part, as this company only serviced a few VA-guaranteed home loans and had some employee turnover during the nonreporting period.*

The audit team determined that VALERI was implemented in 2008 without the capability to identify unreported monthly loan statuses. In addition, the system was not upgraded with this capability since its implementation. LGY established a data quality team to conduct periodic analysis of nonmatching data, such as loan numbers between VALERI and servicers' systems in 2009. The prior LGY director from 2012 through 2016 was involved with the implementation of VALERI and was not aware that a significant number of loan servicers—19.6 percent of servicers from sampled loans—were not reporting loan statuses as required. Late reporting is a regulatory infraction that could affect a loan servicer's performance rating if a tier-ranking system is in place. Also, the prior LGY director generally thought VALERI was meeting the needs of the home loan program.

The LGY director is responsible for ensuring VA is aware of the loan status for all VA-guaranteed home loans.[22] Both the current and prior LGY directors were unaware of the extent of this issue, including the number and duration of loans going unreported. The audit team concluded both directors were satisfied with VALERI's oversight capabilities. The current director explained VALERI's oversight included evaluations of servicer scorecard reports. These scorecard reports include limited servicer default resolution and oversight performance data, such as resolution by loss mitigation option and regulatory infractions. However, the scorecards are incomplete because the reports do not include all AOS review results or account for all infractions such as those issued for nonreporting of loan status and loss mitigation letters.

The LGY director stated the LGY planned upgrade of the VALERI system would include the capability to monitor a servicer's performance and indicate whether a loan status was not reported.[23] Both the St. Paul and Houston RLC loan guaranty and servicing officers, including the data quality team in St. Paul, were aware that loan statuses went unreported periodically, but not the extent of the issue identified from the audit team's work. The data quality team informed the OIG that it reviews loans with data problems on a case-by-case basis, including addressing servicer reporting problems. The review includes reports of mismatched data between VALERI and the servicers' systems. LGY provided an example of this report with loans originating from 2010 through 2018 that showed 70 loans with matching issues. The data quality team stated it only corrects 30 to 50 loans per month, which would be about 360 to 600 loans per year. However, the data quality team's analysis did not include unreported loans without data matching issues. LGY has not taken significant actions to address this issue because it was unaware of the extent of this issue.

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[22] 38 C.F.R. 36.4345.

[23] Upgraded VALERI system implemented on May 28, 2019.

LGY Did Not Always Ensure Loan Servicers Adequately Serviced Defaulted Loans

After a loan servicer reports a loan status as a default, loan technicians conduct AOS reviews to ensure the servicer is complying with VA regulations. The loan technicians ensure the servicer is working with the borrower to attempt to resolve the loan default with a loss mitigation option and avoid foreclosure until the loan becomes current, is terminated, or paid in full. The loan technicians perform several loss mitigation oversight activities throughout the default process to ensure the servicer is working with the borrower to resolve the debt. For example, reviewing any "suspicious loan modifications," such as loan modifications with an increased interest rate greater than one percent.[24] Loan technicians review uploaded documents in VALERI, such as detailed contact logs and the servicer case notes during the AOS process. Loan technicians also ask loan servicers the following five questions and assess the adequacy of the loan servicing based on the responses:

1. Have you talked to the borrower? If so, what was the date of last contact?
2. What was the reason for the default?
3. Are you currently considering a loss mitigation option?
4. Why were any prior loss mitigation options that you considered not completed?
5. Do you have any indication that the veteran is protected under the Servicemember Civil Relief Act? If so, what Servicemember Civil Relief Act protections are being offered?

Generally, the servicers answer these questions with brief responses in an email or upload notes to VALERI.

In accordance with the VA Manual, the first evaluation of the servicer's AOS should occur 120 days from the delinquency date.[25] The technicians have just under a month to complete the AOS review.[26] If the loan remains in default after the first 120-day AOS review, the technicians conduct additional AOS reviews to ensure the servicer continues to provide adequate servicing until the delinquency is resolved or the home goes into foreclosure.[27]

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[24] VA Manual 26-3, revised, chap. 5, sec. 5.06.b.10, "Loan Modification,"; and sec. 5.13.b, "Loan Modification Oversight," September 29, 2017.

[25] VA Manual 26-3, revised, chap. 4, sec. 4.03.a, "Adequacy of Servicing (AOS)," September 29, 2017.

[26] VALERI Technician User Guide, chap. 2, sec. 2.09.b, "Complete VALERI Process," April 1, 2016.

[27] VALERI Technician User Guide, chap. 4, "Delinquent Loan Servicing," 4.03, "Assigned Technician Oversees Delinquent Loan Events,"4.03a.8., "Default Cured Loan Reinstated," 4.03a.3.q., "Did the servicer consider a loss mitigation option?," November 23, 2016.

The audit team estimated that approximately 4,700 of 55,900 loans (8 percent) did not receive adequate servicing during the AOS review based on 24 sampled loans with AOS deficiencies that resulted in inadequate servicing. An important aspect of servicing after attempting contact with the borrower is sending a loss mitigation letter. The OIG expected a servicing error rate significantly less than 8 percent since it is a requirement in the Code of Federal Regulations for servicers to electronically report if the letters were sent, but the AOS deficiencies consisted of 23 loans with no reported loss mitigation letters and one loan with a servicer not making a good faith effort to contact a borrower.[28] In addition, LGY should have imposed infractions on the servicers for 24 of those loans based on the relevant VA manuals. The remaining 19 of 43 loans that were not classified as AOS deficiencies included 18 loans not reported by the servicer for at least one month, as AOS reviews were not required, and one loan for LGY not completing its required follow-up.

LGY Did Not Ensure Loan Servicers Sent Borrowers Loss Mitigation Letters

The most frequent AOS oversight deficiency area found in the sample was that loan servicers did not report that required loss mitigation letters were sent to borrowers. The audit team also confirmed that the loan servicers did not send the letters or sent the letters late in some cases. Loss mitigation letters include important information for the borrower such as how to contact the servicer and VA, as well as potential loss mitigation options. The audit team found that 23 of the 200 sampled loans had 19 letters that were unreported but might have been sent, two confirmed unsent letters, and two late letters sent 15 and 160 days after the deadline. LGY did not issue infractions for these deficiencies and should have deemed servicing inadequate at the completion of the AOS review. Based on the sample results, the audit team estimated that 4,500 of 55,900 defaulted loans (8 percent) did not have evidence of a loss mitigation letter, reported that letters were sent late, or were not sent. Borrowers may have realized a more advantageous outcome if they had been made aware of their options through the loss mitigation letters.

The Code of Federal Regulations requires loan servicers to report to VA that loss mitigation letters have been sent and allows use of various collection techniques to resolve the default.[29] According to the regulation, the servicers must also send the letters by the 75th day of the delinquency, or the 45th day if the default occurs within six months from the beginning of the

[28] 38 C.F.R. 36.4317.

[29] 38 C.F.R. 36.4317, 36.4350 require servicers to use various collection techniques to resolve the default. Chronologically the techniques first include telephone contact after the initial late payment notice followed by a letter if no payment has been made within 30 days after the due date. Next, an attempt for an in-person interview is required if contact has not occurred, a reason for default has not been established or a repayment plan has not been executed.

loan if payment was not received.[30] However, the VA Manual does not identify this as a mandatory reporting requirement. Specifically, the manual states, "The servicer may notify VA when a loss mitigation letter has been mailed to the borrower regarding their delinquent loan status."[31] VA does require loan servicers to send the loss mitigation letter. Based on the VALERI Technician User Guide, loan technicians are also required to conclude the servicing is inadequate if the servicer did not send a delinquency letter to a borrower.[32] This guide does not discuss the loss mitigation letter requirement as a basis for determining if servicing is inadequate. However, sending both letters is part of the minimum collections actions to be taken by servicers to contact the borrower based on the Code of Federal Regulations. The VA Manual requires loan technicians to manually impose a regulatory infraction if the loss mitigation letter was not sent.[33] A regulatory infraction is imposed whenever a servicer does not comply with VA regulatory requirements. Infractions are system-generated or can be manually added by RLC loan technicians. Servicers receiving continuous regulatory infractions could be identified through quarterly performance analysis and result in a reduced tier ranking for payment of incentives.

In May 2011, LGY issued guidance that VALERI would no longer initiate these processes for loan technicians to enforce the requirement, but loan servicers were still required to send letters to borrowers. LGY also removed the business rules and regulatory infractions associated with loss mitigation letter reporting even though those requirements remained in the VA Manual. As a result, loan technicians were not verifying whether the letter was sent and did not apply any regulatory infractions.

The assistant director for loan and property management explained VALERI was incorrectly issuing infractions due to a system configuration deficiency even though letters were reported as sent. He stated LGY subsequently decided to remove the business rule from VALERI because of past evidence that servicers were sending the letters and that it was advantageous for servicers to send the letters. He mentioned other oversight aspects, such as servicer audits, would identify missing servicer loss mitigation letters. He added that LGY plans to monitor this requirement during future LoanSTAR reviews of post-audits. LoanSTAR staff conduct monthly reviews of the home loan program, but the audit team estimates that only less than one half of 1 percent of all defaulted loans are randomly selected for these reviews annually. The chief supervisory loan

[30] 38 C.F.R. 36.4350.

[31] VA Manual 26-3, revised, chap. 4, "Delinquent Loan Servicing," 4.01, "Delinquent Loan Servicing," and sec. 4.02 "Servicer Reporting Requirements," c.1, September 29, 2017.

[32] VALERI Technician User Guide, chap. 4, sec. 4.04 a.3.o, "Make Adequacy of Service Recommendation," November 23, 2016.

[33] VA Manual 26-3, revised, chap. 18, sec. 18.02.a.2 (a), "Late Loss Mitigation Letter Sent," September 29, 2017. A regulatory infraction occurs when a servicer does not comply with VA regulatory requirement(s). Regulatory infractions are system-generated or manually added by a VA technician anytime throughout the life of the loan, after termination, and when conducting a post audit.

specialist explained that LoanSTAR does not evaluate loss mitigation letters but intends to have questions focused on loss mitigation in the future.

LGY's guidance and actions conflicted with the existing reporting and monitoring requirements. The Government Accountability Office's *Standards for Internal Control in the Federal Government* states management is responsible for "design[ing] control activities so that all transactions are completely and accurately recorded." Transactions are to be promptly recorded to maintain their relevance and value to managers in controlling operations and making decisions. Transactions would include the date of sending a loss mitigation letter. The audit team concluded that ensuring loss mitigation letters are sent may result in borrowers avoiding a less advantageous outcome by knowing what their options are earlier. The audit team found confusion among RLC management and staff at two RLCs regarding oversight of servicer loss mitigation letters compliance during AOS reviews. Specifically, one RLC imposed manual infractions for missing letters while another deferred to the May 2011 guidance. However, overall, RLC management and technicians conducted adequate oversight during the AOS reviews since most of them were following the guidance to not enforce the loss mitigation requirement provide by LGY management.

The LGY director informed the audit team that LGY plans to reassess the need for these servicer loss mitigation letters given the compensating controls, such as earlier servicer letters required by the Consumer Financial Protection Bureau at day 36 of delinquency and VA letters sent to borrowers at day 120 of delinquency. But until the Code of Federal Regulations requirement is changed, VA is required to ensure servicers send loss mitigation letters to borrowers and electronically report them being sent.[34]

LGY Did Not Conduct Quarterly Monitoring of Loan Servicer Performance

The Code of Federal Regulations has required quarterly evaluations of loan servicer performance to assign tier rankings since 2010.[35] LGY's VA Manual requires quarterly reviews consisting of analysis of post-audit results and LGY also requires AOS reviews as the basis for these servicer evaluations to identify negative servicing trends, such as not contacting borrowers or not reporting defaults in a timely manner or attempting suspicious loan modifications.[36] However, LGY informed the audit team that it was not doing quarterly reviews, and its Quality Assurance's Risk Management Corrective Action Plan documented that it did not conduct quarterly monitoring as required because VALERI was not able to compile and generate the

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[34] 38 C.F.R. 36.4317 and 38 C.F.R. 36.4350

[35] 38 C.F.R. 36.4318 effective June 15, 2010, with the same requirements still present in the most recent July 1, 2015, edition of the C.F.R.

[36] VA Manual 26-3, revised, chap. 15, "Post Audit," 15.06, "Quarterly Post Audit Reports," September 29, 2017.

necessary quarterly analysis of post-audit and AOS review results for individual servicers. The LGY director acknowledged this requirement and stated the upgraded VALERI system would have this capability. The prior LGY director acknowledged he was aware of the requirement but did not initiate any system changes to VALERI because he considered the overall performance of servicers to be adequate based on LGY's periodic reviews through daily operations. The audit team concluded that LGY did not make quarterly monitoring of loan servicers a high priority because the LGY director from 2012 through 2016 considered the overall performance of servicers to be adequate and did not consider this a high-risk area.

LGY's Quality Assurance team identified VALERI's inability to compile the necessary information as a weakness in FY 2017. The team recommended that LGY loan management policy staff work with the assigned contracting officer representative to ensure the upgraded VALERI system incorporated full reporting capability on all workload aspects, with emphasis on actions associated with key oversight measures. LGY began planning for an upgraded system in FY 2017 and development began in October 2017.

Limited Ability to Identify Underperforming Loan Servicers

The audit team estimated that approximately 7,900 of 55,900 loans (14 percent) had at least one LGY oversight deficiency. LGY's Quality Assurance team reported that for FY 2017, no trending of the post-audit and AOS review results was being performed. LGY also cannot conduct additional oversight, such as increased monthly post-audits or on-site audits as required by the VA manuals, if loan servicer performance issues are not identified.[37] By not conducting quarterly reviews of loan servicers, LGY reduces its opportunity to identify underperforming servicers. Underperforming servicers are more likely to fail their obligations to send loss mitigation letters and properly undertake loss mitigation efforts, which may affect borrowers by delaying the AOS review, selecting a less advantageous loss mitigation option, or losing their homes.

The VA Servicer Handbook requires LGY Central Office to analyze system-generated reports to identify patterns, trends, or common mistakes every quarter to determine if there are servicer-specific issues.[38] If the error trend continues, LGY Central Office may require RLCs to increase the number of cases selected for monthly post-audits of loans that required an adequacy of servicing review and resolved through loss mitigation or were foreclosed. Continued negative post-audit findings can include mandatory training, onsite audit, or referral to the OIG. In addition, the VA Servicer Handbook requires that VA monitor servicer performance to ensure

[37] VA Servicer Handbook M26-4, chap. 15, sec. 15.05.a, "Quarterly Post-Audit Report", May 9, 2017; and VA Manual M26-9, revised, chap. 5, sec. 3.b, "Servicer Selection," January 25, 2016.

[38] VA Servicer Handbook M26-4, chap. 15, sec. 15.05.a, "Quarterly Post-Audit Report," May 9, 2017.

compliance with VA requirements, assess training needs, and assess trends within the servicing community.[39]

The LGY director acknowledged the VALERI system's inability to generate quarterly AOS review and post-audit data for loan servicer oversight. He emphasized LGY use of servicer scorecards when needed and monitoring of each loan through post-audits for current oversight. The director recognized that quarterly monitoring was important and had explained LGY planned to have the ability to generate quarterly trending in the upgraded VALERI system. The upgraded VALERI system was implemented on May 28, 2019. The prior LGY director told the audit team that LGY ran reports for loan servicers on an as-needed basis.

LGY Did Not Implement Tier-Ranking System for Loan Servicers

In February 2005, VA proposed a four tier-ranking system for loan servicers be included as part of the Code of Federal Regulations.[40] In June 2010, the Code of Federal Regulations was updated to require VA to implement a system of annual tier rankings based on servicer performance.[41] However, LGY has not yet implemented this ranking system because the existing VALERI system cannot provide the servicer performance measures, including monitoring needed for a tier-ranking system.

Tier rankings allow an agency to strategically rank the performance of loan servicers and pay incentives commensurate with servicers' performance. The regulations require VA to evaluate servicers' performance quarterly starting with the quarter that ended September 30, 2010, and assign annual tier rankings by the 45th day after calendar year end (February 15, 2011).[42] The ranking system is supposed to have four tiers, with Tier 1 being the highest and Tier 4 being the lowest. The 2010 regulations also directed VA to rank servicers in Tier 2 until annual tier-rankings are established. LGY has ranked and paid all servicers in Tier 2 since 2011.[43]

LGY has not yet implemented this ranking system, and incentive payments would have varied based on performance if the tier-ranking system was implemented. LGY has paid all servicers based on a Tier 2 ranking since 2011 regardless of their servicing performance, and regulatory infractions had no effect on tier rankings. Until a tier-ranking system is in place, underperforming servicers will continue to receive the same incentive payments as higher-performing servicers. If all servicers are incentivized equally, it could lead to less

[39] VA Servicer Handbook M26-4, chap. 20, sec. 20.01, "Servicer Performance," September 9, 2015.

[40] Loan Guaranty: Loan Servicing and Claims Procedures Modifications, Proposed Rule 70 Fed. Reg. 8472, February 18, 2005.

[41] 38 C.F.R. 36.4318 effective June 15, 2010, with the same requirements still present as of July 11, 2019.

[42] 38 C.F.R. 36.4318.

[43] VA Servicer Handbook M26-4, chap. 20, "Servicer Performance," September 9, 2015.

motivation for improved servicer performance and negatively impact the borrower's ability to resolve a home loan default in the best possible manner.

The LGY director had informed the audit team that the upgrade to the VALERI system would have the capability to measure servicer performance. The LGY director further explained LGY needs to determine what data elements will be part of tier ranking and noted there will be upcoming system changes to accommodate that data. He stated the tier-ranking system will take one to two years to implement based on the long regulatory process, including approval by the VA Secretary, the Office of Management and Budget, and a public comment period. The prior LGY director explained that tier rankings were not implemented because LGY did not establish a framework for measuring servicers.

Borrowers in Disaster Areas Potentially Subject to Higher Loan Risks

The OIG and LGY managers identified potential loan servicing risks to borrowers in disaster areas, with borrowers possibly facing unnecessary forbearances and higher interest rate loan modifications that could increase the risk of future defaults and foreclosures. A forbearance is a short-term waiver of payment intended to financially assist the borrower and is normally resolved by payment in full, a repayment plan, or a loan modification.

Disaster areas are those affected by Federal Emergency Management Agency-declared disasters such as floods, tornadoes, or storms, and include ecological or other human-made disasters. As part of VA circulars, LGY issued guidance to home loan servicers in 2017 and 2018 encouraging these companies to assist borrowers in financial distress who were affected by major natural disasters. VA encourages servicers to provide all available options to borrowers in distress and delinquent due to disaster, including forbearances and loan modifications. Oversight includes reviewing any "suspicious loan modifications," such as disaster loan modifications with an increased interest rate greater than one percent.[44] There were approximately 3,500 unresolved defaulted loans in disaster areas, which included Hurricanes Irma and Maria, for the 10.5-month period that ended in June 2018. In addition, those areas have large populations and relatively more borrowers with current VA loans subject to increased risks.

The audit team and LGY identified risks in June 2018 based on a Phoenix, Arizona, RLC loan administration officer analysis of 11 loans. The analysis showed a nationwide servicer attempted to modify borrowers' loans at higher interest rates than allowed by VA policy for five of the 11 loans after forbearance. Example 2 was included in this analysis.

[44] VA Manual 26-3, revised, chap. 5, "Loss Mitigation", 5.13, "Loan Modification Oversight," September 29, 2017; 38 C.F.R. 36.4315 and VA Manual 26-3, revised, chap. 19, "Disasters," 19.06, "Eligibility for VA Disaster Loan Modification," March 9, 2018.

Example 2

> *A nationwide servicer offered a forbearance and then a loan modification with an interest rate 1.75 percent higher than the rate on the original loan. The servicer attempted to raise the fixed interest rate from 3.25 to 5 percent. The servicer's attempt to significantly increase the interest rate shows the risks to borrower and increases the likelihood that servicers may not always be providing the borrower with the best loss mitigation options and terms. LGY's controls worked as planned, as the loan technician denied the modification because it was greater than one percent over the existing loan interest rate and not in the best interest of the borrower.[45] This same servicer handled four additional loans in a similar manner.*

Based on the analysis of defaulted loans in disasters areas, the audit team concluded that this loan servicer could potentially be going beyond the intent of the guidance by soliciting borrowers to default and resolving those defaults that were only in the servicers' best financial interest. Some servicers received incentive payments for resolving these short-term defaults. The team's review was limited since servicers do not report forbearance solicitations or agreements between servicers and borrowers in VALERI. Therefore, the team could not determine if the defaults in sampled loans were the result of forbearances and made no recommendation. However, after the audit team inquired about defaulted loans in disaster areas, LGY informed the team that its Monitoring Unit planned to conduct a risk assessment for borrowers with home loans in disaster areas in FY 2019. In July 2019, the quality assurance chief informed the audit team a preliminary risk analysis had been conducted and that analysis did not necessitate a formal risk assessment of the disaster loans area. In addition, he highlighted existing controls of suspicious loan modification reviews and new controls of evaluations of disaster loan modifications and suspicious activities during servicer audits and RLC site surveys.

Conclusion

LGY did not implement sufficient internal controls to ensure borrowers whose loans are in default receive the necessary loan servicing to appropriately resolve and minimize the impact of the default. Effective servicing helps borrowers retain their homes or obtain other alternatives to foreclosure. LGY should take advantage of the opportunity afforded by the planned FY 2019 implementation of an upgraded VALERI system to establish needed trends of AOS and post-audit reviews.

By implementing internal controls to identify and address unreported monthly loan statuses, LGY can ensure borrowers whose loans are in default receive the necessary assistance within the appropriate timelines. Generating quarterly servicer performance statistics and establishing a

[45] 38 C.F.R. 36.4315; VA Manual 26-3, revised, chap. 5, sec. 5.06, "Loan Modification," September 29, 2017.

formal tier-ranking system will result in sufficient servicer oversight and ensure proper payment of incentives based on performance. Finally, borrowers in disaster areas deserve the highest service and risks should be assessed to ensure these borrowers are fully protected.

Recommendations 1–4

The OIG recommended the following:

1. The under secretary for benefits implements controls to identify and address unreported monthly loan status in the upgraded VA Loan Electronic Reporting Interface system and implement compensating controls in the interim.
2. The under secretary for benefits ensures that loan servicers report when loss mitigation letters are sent and impose necessary regulatory infractions when required.
3. The under secretary for benefits ensures post-audit and adequacy of servicing reviews are compiled and trended and generate key loan servicer performance statistics.
4. The under secretary for benefits develops a plan to implement a formal tier-ranking system following the implementation of the upgraded VA Loan Electronic Reporting Interface system.

Management Comments and OIG Response

The under secretary for benefits concurred with all four recommendations and provided acceptable action plans for the recommendations. VBA also provided technical comments, which the OIG incorporated in the report where appropriate. VBA was concerned that OIG did not portray LGY as the industry leader for loan servicing and resolution of defaulted loans and did not agree with some of the OIG's conclusions as detailed after the discussion of the recommendations.

To address Recommendation 1, the under secretary stated VBA will implement controls to identify and address unreported monthly loan status in the upgraded VALERI system and implement compensating controls in the interim, with a target implementation date of December 31, 2019.

To address Recommendation 2, the under secretary stated VBA released a circular on August 20, 2019, which implemented new procedures and established the requirement that loan servicers report all loss mitigation letters and provide a copy in the VALERI system when loans are selected for AOS and post-audit review. In addition, VBA required loan technicians to issue regulatory infractions if evidence is not provided. The under secretary requested closure of this recommendation; however, the OIG will follow up to verify that all actions stated in the under secretary's response have been completed prior to closing the recommendation.

To address Recommendation 3, VBA stated LGY has been working with the contractor to develop requirements for enhanced reporting capabilities and is on track to implement quality trending capabilities by the target implementation date. In addition, VBA stated LGY had already self-identified the limited reporting capabilities in the legacy VALERI system and developed a corrective action plan through its risk management process, including limited trending analysis based on current reporting capabilities and enhanced reporting requirements in the new VALERI system. VBA provided a target implementation date of December 31, 2019.

To address Recommendation 4, the under secretary stated VBA is on track to implement servicer tier ranking in the fourth quarter of FY 2022. VBA stated that this risk was previously identified but did provide a corrective action plan which noted a June 17, 2019, deficiency based on this OIG report. VBA stated the legacy VALERI system lacked the data necessary to implement tier rankings and LGY decided to implement tier rankings in coordination with the new VALERI system (VALERI-R). VBA provided a corrective action plan that provided high level milestones, such as internal concurrence by VBA and the Office of General Counsel on the related proposed rule by the fourth quarter of FY 2020. The under secretary requested closure of this recommendation; however, the OIG will follow up to verify that VBA is on track to implement tier rankings prior to closing the recommendation.

VBA stated LGY's foreclosure and delinquency rates outperformed FHA and were on par with conventional loans, and thus veterans experienced better home retention outcomes. OIG provided those relevant foreclosure and seriously delinquent rates in Table 2 of this report and agree the rates show VA loans outperformed FHA loans for those factors. An explicit statement on that topic is also in the Executive Summary.

VBA took exception to the report's statement that LGY was unaware of the status of approximately 6 percent—or 187,000—of loans, totaling approximately $40 billion for varying periods of time during FY 2018. In addition, VBA criticized only highlighting the loan value of all loans of $40 billion in the Executive Summary and not the value of approximate 3,800 defaulted loans of about $800 million. VBA also stated that LGY was aware of temporary gaps in reporting loan status due to the industry practice of the sale and transfer of loans, and there is little risk since the overwhelming majority of the loans are current and have no effect on VBA's oversight and resolution of defaulted loans.

OIG believes that 6 percent is substantial and reporting the total estimated loans going unreported shows the true extent of the issue, especially given the duration that many of those loans went unreported. In addition, the loan status, current or default, cannot be determined when the servicer does not report the status of the loan and puts a defaulted borrower at greater risk due to delayed LGY oversight. Additional OIG analysis conducted after VBA's response did reveal that 80 percent of the 20 loans unreported were transferred by servicers. However, as stated in this report, nine of the 20 loans unreported were unreported for three months or more, including seven current loans going unreported for six months or more. One loan went unreported for 11 months. These periods of time show the extent of the lack of oversight. Those statistics also show that LGY did not conduct appropriate follow-up because LGY did not obtain the current loan status or issue infractions in a timely manner. Those infractions would have probably motivated the servicers to report the loan status. In addition, both the current and prior LGY directors and the data quality team were unaware of the extent of this issue, including the number and duration of loans going unreported.

VBA did not agree with the conclusions regarding loss mitigation letters and indicated that there are redundancies built into the process to ensure borrowers are presented with loss mitigation options. VBA considers LGY's loss mitigation letter to the borrower at day 120 and the beginning of the adequacy of servicing process at day 120 of delinquency to be compensating controls. The OIG recognizes the importance of those subsequent processes, but the Code of Federal Regulations requires loan servicers to report to VA that loss mitigation letters have been sent by the 75th day of the delinquency, or the 45th day if the default occurs within six months from the beginning of the loan if payment was not received. Those letters include important information for the borrower such as the potential loss mitigation options and how to contact the servicer and the VA. Notwithstanding the legal requirement, borrowers who are provided those options after two and a half months delinquency are more likely to resolve their defaults in a timely manner.

VBA disagreed that LGY should have deemed servicing inadequate at the completion of the AOS review if there was no evidence that a loss mitigation letter was sent. VBA indicated the VALERI Technician User Guide requirement relates to a 30-day delinquency letter and is unrelated to the aforementioned 75-day letter. Regardless, sending both letters is part of the minimum collection actions to be taken by loan servicers to contact the borrower based on the Code of Federal Regulations. These essential communications between the servicer and the borrower ensure they are informed of how to resolve the defaults in a timely manner. Therefore, without meeting this important and simple regulatory requirement the OIG considers servicers to have not adequately serviced the loan.

Appendix C provides the full text of the under secretary for benefits' comments.

Appendix A: Scope and Methodology

Scope

The audit team conducted its work from April 2018 through July 2019. The team evaluated loans that were currently in default and required an AOS review, resulted in foreclosures, or had a default that was resolved from August 1, 2017, through June 14, 2018. The audit team obtained the data from LGY Service on June 14, 2018, to ensure the audit sample was obtained in July.

Methodology

To accomplish the audit objective, the audit team identified and reviewed applicable laws, regulations, policies, procedures, and guidelines related to home loan defaults and foreclosures. The audit team obtained testimonial information related to work processes associated with home loan defaults and foreclosures from interviews with the following management and staff:

- VBA's Central Office: executive director, LGY; assistant director for loan and property management; and supervisor of loan management,
- LGY's Quality Monitoring Unit and LoanSTAR offices: assistant director, oversight; LGY Service's monitoring unit supervisor; chief of Nashville Monitoring Unit; and assistant chief of Nashville Monitoring Unit, and
- RLC Loan Guaranty officers, loan administration officers, loan servicing officers, loan production officer, assistant loan production officers, senior loan technicians, and loan technicians.

The audit team performed site visits at the Phoenix, Arizona; Houston, Texas; and St. Paul, Minnesota, RLCs in June and October 2018. At the Phoenix RLC, the team interviewed managers and staff regarding the resolution of defaulted loans and foreclosures, reviewed communications with servicers and borrowers, and obtained background information including an overview of the AOS process. At the Houston and St. Paul RLCs, the team interviewed managers and staff and obtained additional information about the loans included in the sample that underwent an AOS. In addition, the audit team performed site visits at the LGY's Monitoring Unit, responsible for LoanSTAR reviews, and Quality Assurance offices in June 2018 and VBA's Central Office in October 2018. The team interviewed managers and staff regarding their oversight of the program and obtained recent oversight reports such as loan servicer audits.

In coordination with VA OIG statisticians, the audit team used the universe of loans to select and review a random sample of 200 loans from four strata. Those four strata consisted of unresolved loans without a reported payment for 120 days; unresolved loans in disaster areas without a reported payment for 120 days; loans that resulted in foreclosures; or loans resolved from

August 1, 2017, through June 14, 2018. Appendix C provides more details on the statistical sampling methodology.

The audit team reviewed sampled loans to determine whether loan technicians appropriately conducted AOS reviews to ensure effective oversight of loan servicers. This included a review of the incentives paid and determining if infractions were issued when required. The audit team used VBA's WebLGY and VALERI electronic loan processing systems to review the sampled loans and relevant documentation. The audit team discussed the findings with VBA officials and included their comments where appropriate.

Fraud Assessment

The audit team assessed the risk that fraud, violations of legal and regulatory requirements, and abuse could occur during this audit. The audit team exercised due diligence in staying alert to any fraud indicators by taking actions or being aware of any indicators such as the following:

- Soliciting the OIG's Office of Investigations for indicators
- Reviewing OIG hotline complaints and concerns for indicators
- Conducting fraud assessments to identify fraud risks significant to the objective
- Soliciting the LGY director and RLC managers for indicators
- Reviewing incentive payments to ensure they were accurate and not overpaid for sampled loans
- Reviewing loss mitigation options to ensure valid options for sampled loans
- Reviewing any suspicious loan modifications in non-disaster counties for sampled loans
- Reviewing any unnecessary solicitations, short-term special forbearances, and suspicious loan modifications in disaster counties for sampled loans and those LGY provided
- Reviewing the history of sampled loans to identify any unusual patterns
- Reviewing servicer case notes and VALERI loan records for sampled loans to identify any unusual entries, including any related party transactions between loan technician and servicer

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

Data Reliability

The audit team used computer-processed data provided by LGY. To test for reliability, the team determined whether any data were missing from key fields, included any calculation errors, or were outside the time frame requested. The team also assessed whether the data contained obvious duplication of records, alphabetic or numeric characters in incorrect fields, or illogical relationships among data elements. Furthermore, the team compared data provided by LGY, such as default loan status, loan number, property zip code, current loan status, payment due date, servicer name, property address, and loss mitigation action, against information contained in the 200 loans reviewed electronically in WebLGY and VALERI.

Testing of the data disclosed that they were sufficiently reliable for the audit objective. Comparison of the data with information contained in the electronic loan files did not disclose any problems with data reliability.

Government Standards

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

Appendix B: Statistical Sampling Methodology

Approach

To accomplish the audit objective, the audit team reviewed a statistical sample of unresolved defaulted loans, unresolved defaulted loans in disaster areas, foreclosed loans previously in default, and cured/resolved loans previously in default. The audit team used statistical sampling to quantify the extent of loans where LGY Service did not effectively ensure that loan servicers were adequately servicing defaulted loans.

Population

The review population initially included 58,605 loans without a reported payment for 120 days or more and required an AOS review or were no longer in default due to successful default resolution or foreclosure. This amount was reduced to 55,906 because 828 defaulted loans in stratum 1 were outside the scope period and 1,871 defaulted loans in stratum 4 were duplicates.

Sampling Design

The audit team divided the universe into four strata as shown in Table B.1. The team sampled 50 loans from each stratum, totaling 200, to ensure samples would include all time periods a reduction might occur. Table B.1 describes the four strata of the types of defaulted loans reviewed.

Table B.1. Strata of Loans

Stratum	Definition	Loans
1	Unresolved defaulted loans outstanding on or between August 1, 2017, and February 14, 2018, that had not had a mortgage payment as of June 14, 2018. This was intended to identify loans delinquent for 120 days that needed adequacy of servicing.[46]	10,354
2	Unresolved defaulted loans in disaster counties outstanding on or between August 1, 2017, and February 14, 2018, that had not had a mortgage payment as of June 14, 2018.[47]	3,483
3	Foreclosed loans (previously in default) on or between August 1, 2017, and June 14, 2018.	16,428

[46] Nine current loans, six from stratum 1 and three from stratum 2, were unintentionally included in the sample. Specifically, during initial review of the sample, the team identified loans that were not in default but went unreported for over 120 days. These loans were current and went unreported by the servicer for over 120 days.

[47] Stratum 2 consists of 37 disaster counties based on nine Federal Emergency Management Agency disaster declarations during the scope period. Nationwide there were 788 disaster counties based on 66 Federal Emergency Management Agency disaster declarations during the scope period.

Stratum	Definition	Loans
4	Cured or resolved loans (previously in default) on or between August 1, 2017, and June 14, 2018.	25,641
Total		**55,906**

Source: Data were obtained from VALERI LGY database.

Weights

The OIG calculated estimates in this report using weighted sample data. Sampling weights are computed by taking the product of the inverse of the probabilities of selection at each stage of sampling.

Projections and Margins of Error

The OIG used Statistical Analysis System (SAS) software to calculate the weighted universe estimates and associated sampling errors. SAS employs replication methodology to calculate margins of error and confidence intervals that correctly account for the complexity of the sample design. The margins of error and confidence intervals are indicators of the precision of the estimates. If the OIG repeated this review with multiple samples, the confidence intervals would differ for each sample but would include the true population value 90 percent of the time. Table B.2 illustrates the number of loans with oversight deficiencies and loans inadequately serviced and the related projections.

Table B.2. LGY Oversight Errors and Inadequate Servicing and Projections

Type	Sample errors	Count or percent	Projection	Margin of error	Lower limit 90% confidence interval	Upper limit 90% confidence interval
Loans with at least one LGY oversight deficiency	43	Count	7,881	2,257	5,624	10,138
		Percent	14.1%	4.0%	10.1%	18.1%
Loans with inadequate servicing	24	Count	4,740	1,938	2,801	6,678
		Percent	8.5%	3.5%	5.0%	11.9%

Source: VA OIG projection of estimated loans with errors. Data were obtained from VALERI LGY database.

Table B.3 illustrates the types of deficiencies, the number of loans with those oversight deficiencies, and the related projections.

Table B.3. Types of Adequacy of Servicing Errors and Projections

Type	Sample errors	Count or percent	Projection	Margin of error	Lower limit 90% confidence interval	Upper limit 90% confidence interval
Loan servicer did not report monthly loan status and LGY did not identify it or issue infractions (1)	20	Count	3,348	1,362	1,986	4,710
		Percent	6.0%	2.4%	3.6%	8.4%
Loan Servicer did not send loss mitigation letter within 75 days of delinquency, or within 45 days of delinquency for original loans or letter sent late and no infraction issued	23	Count	4,533	1,915	2,618	6,448
		Percent	8.0%	3.0%	5.0%	12.0%
Other Oversight Errors (2)	2	n/a	n/a	n/a	n/a	n/a

Source: VA OIG projection of estimated loans with errors. Data were obtained from VALERI LGY database.
(1) The audit team initially identified nine loans in the sample that LGY considered in default and in need of an AOS because there had not been a payment for 120 days. During testing the team learned that these loans in fact had gone unreported and the audit team determined those loans were not in default. Those nine loans combined with an additional 11 defaulted loans were found to go unreported by the loan servicer for at least one month from August 1, 2017, through November 1, 2018. (2) Loan servicer did not make a good faith effort to contact borrower and loan technician did not follow up; loan technician did not make required phone contacts during pre-foreclosure process. No estimate because margin of error exceeds projected point estimate.

Additional Estimations Calculated

The audit team estimated that servicers did not report and LGY was unaware of the loan status of approximately 187,016 VA-guaranteed home loans. The estimation was determined by multiplying the current number of loans reported by LGY on September 30, 2018—3,116,926 loans—by the OIG-projected nonreporting error rate of 6 percent. In addition, the audit team estimated that these loans have a total outstanding loan amount of approximately $40 billion. This was calculated by multiplying the estimated number of unreported loans—187,016—by the average outstanding loan amount of $213,454 that LGY reported as of October 31, 2018. This equates to approximately 3,800 defaulted loans (187,016 unreported loans multiplied default rate of 2.03 percent) of about $811 million (3,800 defaulted loans multiplied by $213,454 average outstanding loan amount reported by LGY on October 31, 2018).

For the scope period from August 1, 2017, through June 14, 2018, the team estimated that 3,348 defaulted loans with an outstanding loan value of over $714 million (3,348 defaulted loans multiplied by $213,454 average outstanding loan amount reported by LGY on October 31, 2018) went unreported and received delayed or no oversight by VBA to ensure adequacy of service during the default resolution process. Therefore, VBA did not ensure that loan servicers provided all the required assistance to veteran borrowers to avoid foreclosure.

Appendix C: Management Comments

Department of Veterans Affairs Memorandum

Date: August 23, 2019

From: Under Secretary for Benefits (20)

Subj: OIG Draft Report – Audit of VBA's Oversight and Resolution of Home Loan Defaults [Project No. 2018-03979-R4-0045]]

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

1. Attached is VBA's response to the OIG Draft Report: Audit of VBA's Oversight and Resolution of Home Loan Defaults.
2. Questions may be referred to Marie Gregory, Program Analyst, at (202) 632-8847.

(Original signed by)

Paul R. Lawrence, Ph.D.

Attachments

Attachment

Veterans Benefits Administration (VBA)
Comments on OIG Draft Report
Audit of VBA's Oversight and Resolution of Home Loan Defaults
Project Number 2018-03979-R4-0045

VBA provides the following comments:

VBA appreciates the Office of the Inspector General's (OIG) review of VBA's Oversight and Resolution of Home Loan Defaults. VBA acknowledges this report highlights areas for improvement and generally agrees with the OIG recommendations. However, VBA has significant concerns with the draft report as OIG does not adequately delineate Loan Guaranty Service's (LGY) industry leading performance in the area of loan servicing and resolution of defaulted loans. Since the inception of LGY's VA Loan Electronic Reporting Interface (VALERI) system, the program experienced unprecedented growth. LGY recorded record loan volume from 2012 through 2018. For example, the Department of Veterans Affairs (VA) guaranteed almost 540,000 loans in fiscal year (FY) 2012 (a record at the time), only to be followed by subsequent years of record loan volumes of approximately 629,000, 631,000, 705,000, and 740,000 in FY 2013, 2015, 2016, and 2017, respectively. Additionally, VA guaranteed another 610,000 loans in FY 2018. During this time, LGY was an industry leader in loan servicing, recording foreclosure and delinquency rates that outperformed FHA and were on par with conventional loans. This is despite the fact that over 85 percent of VA home loans are closed with no money down (100% financing), whereas conventional loans require a down payment between 5-20 percent. Because of the oversight processes and system controls in place, Veterans have better outcomes regarding home retention than comparable borrowers in other programs.

Additionally, LGY does not agree with some of the conclusions reached by the OIG. For instance, VBA takes exception to the OIG's conclusion that LGY was unaware of the status of approximately 6 percent, or 187,000 loans for varying periods of time during FY 2018. In multiple conversations with the OIG, VBA explained that in the course of routine industry practice, servicers sell and transfer loans to other servicers and investors. This industry practice causes an unavoidable temporary gap in reporting until the new servicer is able to board the loan and start reporting monthly status to VA in the VALERI system. There is little risk to the program since an overwhelming majority of the loans are current and have no impact on VBA's oversight and resolution of defaulted loans. Furthermore, VA is very aware of the temporary gaps in reporting caused by servicing transfers, which is an unavoidable business process in the servicing industry.

VBA also takes exception to the OIG's practice of overstating the financial impact of their findings. In the Executive Summary, the OIG estimates that LGY may not be aware of the status of approximately 6 percent, or 187,000 loans, then attaches an estimated monetary total of approximately $40 billion for varying periods of time in FY 2018. However, in the text of the report, the OIG states that the purpose of servicers reporting loan data includes overseeing loans in default, which the OIG approximates at 3,800 loans. The estimated monetary total of the 3,800 default loans is approximately $800 million. VBA takes exception to the practice of highlighting larger numbers in the Executive Summary then including more refined numbers and associated dollar amounts in the text of the report as this is misleading to the reader.

In addition, VBA does not agree with the OIG's conclusions regarding Loss Mitigation Letters and VBA's oversight of seriously delinquent loans to determine adequacy of servicing (AOS). While servicers are required to send a loss mitigation letter early in the loan default, VBA has redundancies built into this process to ensure borrowers are presented with loss mitigation options. VBA's VALERI system automatically sends a Loss Mitigation letter to the borrower after 120-days delinquent and initiates an AOS oversight work bucket requiring a loan technician to manually review the case. LGY conducts an AOS review at 120-days delinquent to determine whether servicers are in contact with borrowers to present loss mitigation options to provide alternatives to foreclosure. The purpose of this review is to ensure borrowers are being contacted and to determine the extent of VBA's involvement in the loss mitigation process.

VBA disagrees with the OIG's conclusion that LGY should have deemed servicing inadequate at the completion of the AOS review if there was no evidence that a loss mitigation letter was sent. To support this conclusion, the OIG cites LGY's VALERI Technician User Guide (Chapter 4: Delinquent Loan Servicing, 4.04 a. 3. o.), which requires servicers to send a delinquency letter and make a good faith effort to contact the borrower. However, the delinquency letter is not the same requirement as a Loss Mitigation letter. The delinquency letter requirement stems from 38 CFR § 36.4350 (Servicing procedures for holders), which requires servicers to send a letter to the borrower after 30-days delinquent emphasizing the seriousness of the delinquency and the importance of taking prompt action to resolve the default if telephone contact could not be made. The emphasis is on the servicer's good faith effort to contact the borrower, not the Loss Mitigation letter requirement earlier in the default process. While VBA agrees that a regulatory infraction should be imposed upon the servicer if there is no evidence that the Loss Mitigation letter was sent, this requirement does not impact the AOS decision when it is determined that borrowers have been contacted and presented with loss mitigation options as alternatives to foreclosure.

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

Recommendation 1: The Under Secretary for Benefits implements controls to identify and address unreported monthly loan status in the upgraded VA Loan Electronic Reporting Interface system and implements compensating controls in the interim.

VBA Response: Concur. VBA will implement controls to identify and address unreported monthly loan status in the upgraded VA Loan Electronic Reporting Interface system and implement compensating controls in the interim.

Target Completion Date: December 31, 2019

Recommendation 2: The Under Secretary for Benefits ensures that loan servicers report when loss mitigation letters are sent and imposes necessary regulatory infractions when required.

VBA Response: Concur: VBA developed a Circular implementing new procedures establishing the requirement that loan servicers report all Loss Mitigation letters and provide a copy in the VALERI system when loans are selected for AOS and Post Audit (PA) review. On August 20, 2019, VBA released Circular 26-19-24 establishing policy requiring servicers to upload all Loss-Mitigation letters in the VALERI system and requiring Loan Technicians to cite for a regulatory infraction if evidence is not provided.

The Circular is posted on the following sites:

https://www.benefits.va.gov/homeloans/resources_circulars.asp (Internet)

https://vbaw.vba.va.gov/homeloans/hot_topics.asp (VA Intranet)

VBA requests closure of this recommendation.

Recommendation 3: The Under Secretary for Benefits ensures post-audit and adequacy of servicing reviews are compiled and trended and generates key loan servicer performance statistics.

VBA Response: Concur: At the time of the OIG's engagement, LGY had already self-identified the limited reporting capabilities in the legacy VALERI system and developed a corrective action plan (CAP) through its risk management (RM) process. LGY's CAP to implement trending of AOS and PA finding was previously provided to OIG and included some limited trending analysis based on current reporting capabilities and enhanced reporting requirements in the new VALERI environment. LGY has been working with the contractor to develop requirements for enhance reporting capabilities and is on track to implement quality trending capabilities by December 31, 2019.

Target Completion Date: December 31, 2019

Recommendation 4: The Under Secretary for Benefits develops a plan to implement a formal tier ranking system following the implementation of the upgraded VA Loan Electronic Reporting Interface system.

VBA Response: Concur. At the time of the OIG's engagement, LGY had already self-identified the need to implement a formal tier ranking system through its risk management (RM) process. Because of the lack of data available in the legacy VALERI system, LGY decided to implement tier ranking regulations concurrent with the implementation of VALERI-R enhanced reporting functionality. LGY created the attached CAP to implement tier ranking by publishing applicable regulations. LGY is on track to implement servicer tier ranking in the fourth quarter of FY 2022. VBA requests closure of this recommendation.

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

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