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Legal Update
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VA Guaranty for Non-Cash-Out Refinancings Subject to New Conditions in Senate Banking Bill

Characterized as "protecting veterans from predatory lending," S.2155, the Economic Growth, Regulatory Relief and Consumer Protection Act, passed by the United States Senate on March 14, 2018 (the "Senate Bill"), imposes material conditions on the eligibility of non-cash-out refinancings for government guaranty under the Veterans Affairs ("VA") Loan Guaranty Program.

While the legislation has received significant attention for the loosening of rules under the 2010 Dodd-Frank Act applicable to banks, this particular provision should be of significant interest to government-insured or guaranteed residential mortgage loans. Specifically, the Senate Bill would add a new provision to federal statutes governing the VA's Loan Guaranty program to impose three requirements on all non-cash-out refinance loans before the loans could become eligible for VA guarantees.[1] These restrictions stem from the perceived negative effects of frequent refinancings of VA-guaranteed loans on veteran borrowers and Ginnie Mae securities holders.

Veteran borrowers have complained about aggressive advertising and sales practices by lenders specializing in the VA-guaranteed loan product. At the same time, Ginnie Mae has experienced higher-than-average loan prepayment speeds in its securities, which impacts the pricing of these securities and, in some circumstances, could result in higher borrowing costs for veteran borrowers. Ginnie Mae has focused its attention on streamline refinance transactions that require no borrower underwriting or appraisal (including the VA Interest Rate Reduction Refinance Loan ("IRRRL")) as a major contributor to the prepayment issues in its securities.

Because the statutes and regulations currently governing VA-guaranteed loan products do not set forth seasoning or net tangible benefit requirements for the refinancing of VA-guaranteed loans, Ginnie Mae chose to curb the rapid prepayment speeds it observed in its securities by establishing seasoning requirements for the pooling of government-insured or guaranteed refinance loans. Now the United States Congress has taken up the cause, except only for VA-guaranteed loans. In addition to the seasoning requirements soon to take effect for Ginnie Mae securities, the Senate Bill would impose a requirement on VA lenders to ensure a VA-guaranteed refinance loan is in the veteran's financial interest in three new ways in order for the loan to be eligible for a VA guaranty.

1. Recoupment of Fees and Costs

First, the Senate Bill would require that a veteran borrower recoup the fees and costs of a non-cash-out refinance loan within 36 months of loan issuance. That recoupment would have to be calculated through lower regular monthly payments (excluding taxes, escrowed amounts and VA funding fees) as a result of the refinanced loan. The originator of the refinance loan also would be required to provide a certification to the VA regarding the recoupment period for fees, closing costs and any expenses (other than taxes, escrowed amounts and the VA funding fee) that would be incurred by the veteran borrower in the refinancing of the loan.

VA loan guaranty regulations and guidelines already restrict the amount of the origination fee a lender can assess to a borrower, as well as the types of closing costs that a veteran can pay in a loan transaction. If the recoupment requirement were to become law, presumably refinance loans that meet the net tangible benefit test (discussed below) would permit a consumer to recoup fees and closing costs within the first three years of the loan. However, where that would not be the case, lenders could find themselves having to reduce their own fee or pay third-party costs on behalf of the borrower to ensure the loan would meet the recoupment standard.

With less money to be made on VA refinance loans under these circumstances, this may have the (intended or unintended) consequence of curbing lenders' interest in building an origination business focused on VA refinance transactions. Moreover, in an environment where the Department of Justice has used the False Claims Act to target originators of government loans and focused on lender and underwriter certifications of compliance as a basis for False Claims Act liability, the provision requiring a lender to certify to the recoupment period for a refinance loan is one that could carry risks for VA lenders if the certifications proved to be incorrect.

2. Net Tangible Benefit

Second, to be eligible for the VA guaranty, the Senate Bill would require a non-cash-out refinance loan to meet net tangible benefit standards according to four criteria:

- The refinancing lender provides the borrower with a net tangible benefit test;
- For fixed-rate to fixed-rate refinance loans, the interest rate is at least 50 basis points less than the previous loan;
- For fixed-rate to adjustable-rate refinance loans, the interest rate is at least 200 basis points less than the previous loan; and
- The lower interest rate is not produced solely from discount points, unless the points are paid at closing and the points are not added to the principal loan amount (with certain exceptions depending on the resulting loan-to-value ratio).

Current VA guidelines for the origination of IRRRLs generally require there to be a reduction in the borrower's interest rate, as well as a reduction in the borrower's principal and interest payment (with certain exceptions). Those guidelines do not establish specific parameters as to the amount of the reductions. Federal Housing Administration ("FHA") guidelines, however, require a "net tangible benefit" for its streamline refinance loans and impose the same thresholds for interest rate reductions that appear in the Senate Bill. One might think the legislation is based on those FHA standards, but the Senate Bill does not extend the refinance requirements to FHA loans. The Senate Bill would establish minimum thresholds by which interest rates must decrease and apply those standards only to non-cash-out VA refinance loans (not just the IRRRLs). Similar to guidelines applicable to IRRRLs, the Senate Bill is silent and, accordingly, appears to exempt loans that would refinance an adjustable-rate mortgage into a fixed-rate transaction from the interest rate reduction requirements.

We believe this to be the first time that Congress has taken steps to adopt an objective net tangible benefit test applicable to residential consumer mortgage loans. As noted, the VA imposes guidelines to require the borrower to realize a benefit on interest rate and mortgage payment for IRRRL loans, and the FHA similarly imposes a net tangible benefit requirement on its streamline refinance loans. The agencies, however, developed these requirements, which apply only to those loans where underwriting of the borrower's credit and income is not required to qualify the borrower for the streamline refinance product.[2] The Senate Bill does not merely task the VA with developing regulatory standards to measure the benefit of a refinance loan to a veteran or incorporate existing consumer protections from other federal laws; instead, the Senate Bill would seek to apply objective minimum standards to all non-cash-out refinance VA loans.[3]

3. Loan Seasoning

Third, the Senate Bill would not permit a non-cash-out refinance loan to be guaranteed by the VA until the later of (i) 210 days after the date on which the first monthly payment is made on the initial loan *and* (ii) the date on which the sixth monthly payment is made on the initial loan.

This standard is identical to the pooling restrictions established by Ginnie Mae in December 2017 through All Participants Memorandum ("APM") 17-06 for streamline refinance loans (including IRRRLs) and cash-out refinance loans.[4] The pooling restrictions established by Ginnie Mae are not specific to VA-guaranteed loans but apply to all streamline and cash-out refinances pooled into Ginnie Mae securities. Specifically, for pool issuances on or after April 1, 2018, streamline and cash-out refinances loans will be eligible for pooling into Ginnie Mae I single issuer pools and Ginnie Mae II multiple issuer pools[5] only if: (1) the borrower made at least six consecutive monthly payments, beginning with the payment made on the first payment due date; and (2) the first payment due date of the refinance loan occurs no earlier than 210 days after the first payment due date of the initial loan.[6]

Although the Ginnie Mae pooling restrictions are identical to the loan seasoning provisions in the Senate Bill regarding VA-guaranteed loans, it is important to note that Ginnie Mae's primary motivation in establishing the pooling restrictions was to slow prepayment speeds of Ginnie Mae securities to stabilize the pricing and market for these securities. The stated purpose of the Senate Bill is to protect VA borrowers from "predatory lending" in connection with refinance transactions. Applying a secondary market seasoning requirement to a lender's determination of borrower eligibility for a VA-guaranteed loan at the time of loan origination will present new challenges for VA lenders that are not necessarily present when a Ginnie Mae securities issuer is determining whether a loan can be included into a particular Ginnie Mae pool.

Rather than establish a minimum seasoning period measured from the closing date of the prior loan to the application date or closing date of the refinance loan, which would apply uniformly in all applicable VA refinance loans, the Senate Bill's standard would require the lender to have knowledge of the borrower's payment history on the prior loan in order to determine whether the lender can originate an eligible VA refinance loan. VA lenders that do not service the mortgage loan to be refinanced do not typically have access to the borrower's payment history on the loan to determine whether the borrower could be eligible for a VA refinance under the Senate Bill's seasoning standard. Thus, at a minimum, the proposed seasoning requirement would require lenders to modify the kinds of documentation required from the servicer and/or the borrower as part of the origination of the loan and ensure that the lender's processes for obtaining that documentation do not violate other federal laws and regulations governing the mortgage loan application process.

We note that the Senate Bill also includes a provision that would amend the provision of the National Housing Act governing Ginnie Mae's issuance of securities to prevent Ginnie Mae from guaranteeing a security that is backed by a VA-guaranteed mortgage that did not adhere to the seasoning requirements set forth above. While the loan seasoning timing requirements are consistent with both the Senate Bill's amendments to the VA statutory provision and the recent pooling restrictions announced by Ginnie Mae, we question whether this additional provision is necessary. As a threshold matter, Ginnie Mae is only authorized to include loans in its pools that are eligible for insurance or guaranty by the VA and certain other enumerated federal agencies. If the Senate Bill language becomes law, non-cash-out refinance loans will not be eligible for VA guaranty and, therefore, will not be eligible for pooling into Ginnie Mae securities. Thus, at least as it relates to non-cash-out VA refinance loans, this additional provision would be a "belt and suspenders" protection against early refinancing of such loans.

Conclusion

As noted above, the Senate Bill is an important step, but it is the first step in codifying its provisions into federal law. The Senate Bill is now in the House of Representatives, and it has already become the subject of some debate as to whether members of the House will attempt to amend or add to the Senate Bill before voting on whether to pass the legislation. The Senate Bill's language regarding VA-guaranteed refinances could change as a result of the remaining legislative process or could fail to pass if Congress ultimately does not vote to pass the legislation, which includes many provisions unrelated to VA loans. In any event, it will be important for participants in the VA loan program to watch closely the progress of S.2155 as it moves through the legislative process, as any amendments to the VA refinance provisions could have lasting impacts on the VA loan program.

If you have any questions about S.2155 or VA lending requirements, please contact either of the following lawyers.

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Endnotes

1 While the Senate Bill's provisions do not apply to cash-out refinance loans guaranteed by the VA, the Senate Bill obligates the VA to promulgate regulations no later than 180 days after enactment of the Senate Bill to ensure VA cash-out refinance loans are in the "financial interest" of the borrowers, including regulations related to recoupment of fees and costs, seasoning and net tangible benefits.

2 We note, for example, that the Commonwealth of Massachusetts has imposed a restriction on the refinancing of home loans within 60 months of a prior closing unless the loans are determined to be in the borrower's interest. The mere fact that a loan is guaranteed by the VA is one way to meet the borrower's interest standard in Massachusetts. Or, if the refinance loan is a qualified mortgage as defined under federal law, the refinance may close within the 60-month period. Neither of those standards, if used to satisfy Massachusetts law, requires any reduction in interest rate for the borrower.

3 The VA may still have latitude under the provisions of the Senate Bill to develop regulatory standards to further develop the requirement that "the refinancing lender provides the borrower with a net tangible benefit test." If that happens, the objective criteria for interest rate reductions may be but one component of an overall net tangible benefit requirement to qualify the borrower for a VA refinance loan.

4 The December 2017 APM was an extension of pooling restrictions Ginnie Mae announced in late 2016 in an effort to curb rapid refinancing that caused prepayment speeds to accelerate in its securities. Specifically, in October 2016, Ginnie Mae issued APM 16-05, which required that, for pool issuances on or after February 1, 2017, for a streamline refinance loan to be eligible for inclusion into Ginnie Mae I single Issuer pools or Ginnie Mae II multiple issuer pools, at

least six consecutive monthly payments must have been made on the existing loan. Notably, streamline refinanced loans with fewer than six consecutive monthly payments made on the existing loan could only be delivered into Ginnie Mae II custom pools. This APM applied to *all* streamline refinanced loans, including those loans insured or guaranteed by the FHA, the VA, the US Department of Agriculture's ("USDA") Rural Development ("RD"), and the Office of Public and Indian Housing ("PIH"), delivered into Ginnie Mae pools, not just refinanced VA-guaranteed loans. Ginnie Mae announced at the time that it would continue to monitor the issue of rapid prepayment speeds and consider other measures to address the issue if necessary.

5 Similar to APM 16-05, APM 17-06 stated that streamline and cash-out refinances that do not meet these requirements are eligible to be pooled into Ginnie Mae II custom pools if the loans otherwise comply with Ginnie Mae II custom pooling parameters.

6 APM 17-06 expressly stated that fully underwritten rate/term refinances of VA-guaranteed loans were free from these pooling restrictions so long as the corresponding housing agency (FHA, VA, RD or PIH) has implemented a fully underwritten rate/term refinance loan program specifying any attendant seasoning, loan performance, maximum loan-to-value, full documentation and appraisal requirements, and the refinance loan in question meets all such agency requirements.