Growing Concerns Over VA Loan Churning

By: Jann Swanson | Thu, Jan 11 2018, 3:27 PM

A Ginnie Mae official told Congress this week that his agency has **growing concerns** over the incidence of "loan churning" in the VA mortgage program. Michel R. Bright, Ginnie Mae's Executive Vice President and COO was among four mortgage industry experts testifying about the issue to the House Committee on Veterans Affairs on Wednesday. Bright said since the loan churn problem became evident, Ginnie Mae has realized it could ultimately harm borrowers in the form of higher interest rates and has the potential to cause problems with investors that could spill over into FHA and USDA loan programs as well.

Starting in early 2016, the agency and its investors noted loan **prepayment rates were increasing** and serial refinancings were occurring with greater frequency in the VA mortgages Ginnie Mae guarantees and securitizes than in loans secured by other agencies. Some of the prepayments were at speeds that could not be justified by economic factors. Other alerts, especially a weakening of Ginnie MBS prices versus other MBS, pointed to the growth of anomalous refinancing behaviors.

Internal analysis, showed that some lenders had apparently found an opportunity for **quick profits** by aggressively pushing a series of loan refinances. There appear to be two underlying dynamics. There are an increasing number of veterans, and many of them are susceptible to advertising schemes that appear to come from reputable sources. Second, the Ginnie Mae security trades at a premium price, typically $1.05 to the dollar. This incentivizes lenders to pull loans from pools at "par," (or $1.00 to the dollar) and deliver them into a security at a premium, booking a 5 percent profit each time this occurs. Ginnie Mae believe it is the confluence of these factors that enable the loan churning.

It also appears that some lenders are employing two patterns; one is to originate a loan **substantially above** prevailing interest rates, i.e. a "premium loan." These loans may include debt consolidation, or are given to borrowers with very low credit scores, justifying in part the higher rates. But Ginnie's analysis found that premium VA loans are also a business model, using aggressive marketing tactics to push a higher rate than the borrower deserves; as proven by the rapid refinance that occurs almost immediately thereafter. Lenders immediately sell the loan into a Ginnie Mae MBS pool at a high price because of the high interest rate, not only profiting up front, but creating a loan ripe for another refinance into a lower rate.

Then that veteran begins almost immediately to receive a constant stream of solicitations to refinance from both the original lender and others, promising benefits like skipping a few payments, a cash out refi, or lowering the rate with an adjustable mortgage. Ginnie Mae sees borrowers who are convinced to refinance **multiple times in a year**. These refis are usually without tangible benefit to the borrower and often result in higher loan balances as refinancing fees are buried or hidden in the new loan.

The average cost of refinancing a VA fixed-rate refinance is **$6,000, with an average savings of $90 per month**. This means the veteran will need 5.5 years to recoup the loan costs.

The trend to higher interest rates is increasing the push to refinance fixed rate products into **adjustable** ones. The average fee for these refinances is $12,000, resulting in savings of $140, and requiring seen years to break even, assuming the rate doesn't adjust upward.

With rising home prices, some lenders now specialize in **cash-out** refinances. While there are benefits in some cases, Bright said, there are also some concerns. Ginnie Mae sees loans where borrower credit characteristics appear to change inexplicably from one month to another as well as the creation of a large group of veterans who no longer have equity. In a worst case, they might need to bring a check to the closing should they wish to sell.

Refinancing lenders are also offering to refund tax and insurance escrows or lure veterans with offers to skip a payment while the new loan is initiated get an escrow refund, and look at the monthly payment sans escrow charges. This tactic can lead to larger mortgages, more debt and the veteran paying a lot of money in fees for a riskier mortgage without sufficient escrows.

Much of the advertising directed at vets, Bright said, is inaccurate or misleading and some have the appearance of being checks or official correspondence from government agencies.

The churning also has **implications for the broader mortgage market**. The premium investors pay for Ginnie Mae bonds directly translates into lower rates for VA borrowers and those from other government loan programs. As loans are refinanced, they are removed from MBS pools, taking away the return investors expect as well as their incentive to price these bonds above par. This ultimately increases interest rates. Because VA loans are comingled in Ginnie Mae securities with other government programs, FHA, USDA and other borrowers are paying the increased costs as well.

These challenges are **not** theoretical Bright said. Ginnie Mae leadership recently spoke with several large foreign institutional investors about their ongoing Ginnie Mae MBS investments and **every conversation** related in part to concerns about the VA loan churn issue and its impact on investments. If investors flee the Ginnie Mae market, it could cause even higher borrowing cost for all veterans and others in the coming years.

Ginnie Mae has **already taken some steps** to eliminate churning. In 2016 it changed rules on how soon after a refinance a streamline transaction of that same loan can be pooled into an MBS. However, some lenders circumvented that rule by originating other types of refinances. Last month that rule was expanded to require a six-month seasoning before any type of refinancing.

Bright said there are three steps in a long-term solution. **First** Ginnie must tighten its requirements. This year it will develop a firm definition for premium loans and eliminate them from its securities. The VA must **also** establish a framework to protect veterans from predatory lending practices. The **third** step. is continuous surveillance of date collection and analysis to enforce adherence to the first two steps.

Also testifying before the committee were Jeffrey London, Director of the VA's Loan Guaranty Service; Dave Motley, Chairman of the Mortgage Bankers Association (MBA), and Brock Cooper, General Counsel for Veterans United Home Loans.

London explained that there are **two types** of VA refinances. The IRRRL, is a streamline loan generally used to obtain a lower interest rate than the existing mortgage, to reduce the loan term, switch from an adjustable to a fixed rate, or to make energy efficient improvements to the property. It cannot be used to cash out equity. The second type of refinance does allow for cash to be taken out.

Of the more than 1,500 lenders who originate loans, London said, fewer than 10 appear to be guilty of churning. These lenders have focused almost exclusively on IRRRLs, which, unlike VA originations and cash-out loans, do not require underwriting or valuation determinations. These lenders have targeted servicemembers and veterans who have VA-guaranteed loans precisely because IRRRLs are relatively inexpensive and can be completed quickly.

Cooper told committee members, "It does not matter how much a refinance purports to save a Veteran homeowner if it will take them a decade to recoup loan costs and fees that swell their loan balance. That does not put Veteran homeowners in a stronger financial position because they have less equity or may even be upside down on their home when they go to sell. The same could be said for convincing someone to refinance into an adjustable-rate mortgage without discussing the possibility for future rate increases or the potential for additional costs and decreased equity when later refinancing back into a fixed-rate mortgage."

MBA's Motley said, it is important to focus on options that target churning while **not impeding** the ability of servicemembers and veterans to obtain beneficial refinancing. The VA program is a unique entitlement, so while MBA supports quick action to limit abuses, it needs to be done thoughtfully to ensure that legitimate low-cost refinancing options for veterans are retained."

He suggested that instituting a maximum recoupment period for a borrower to break even could prevent lenders from charging substantial fees in exchange for minor reductions in mortgage interest rates. Ginnie Mae could also require a net tangible benefit test, such as required for FHA streamlined refinances, to ensure that the terms of the refinance produce **real benefits** for borrowers. Limits on the amounts that can be added to the principal balance would reduce equity stripping, and targeted consumer financial education about churning can better inform borrowers about the potential for abuse.

He concluded, "Many borrowers may not fully comprehend the net economic impact of their decision to refinance, leaving them vulnerable to situations in which they add substantial amounts to their overall loan balance while achieving only small reductions in their monthly payments. This is not what the program was intended to do, and these practices should be put to an end."

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