Funding Fee Payment Analysis

The St. Paul Regional Loan Center has discovered that in the last 8 years, Veterans have been paying funding fee charges when they were exempt from the Funding Fee. This report details the circumstances surrounding what caused this to happen, suggests options to ensure this does not happen in the future. As this is going to be a large undertaking we have also provided several options to return the money to affected Veterans.

Background

The VA Home Loan program generated more than $1.3 billion USD in funding fee revenue during Fiscal Year (FY) 2014. Those funds come from the 65% of Veterans who have not been determined to be eligible for waiver of the funding fee. In order to be eligible for waiver of the fee, Veterans must be in receipt of VA compensation for a service connected disability. The determination regarding whether or not compensation is awarded is made by the Veteran's Service Center (VSC).

When a rating determination is made by VSC, Loan Guaranty computer system, WebLGY, is updated to advise anyone who subsequently procures a Certificate of Eligibility (COE) that the Veteran is eligible for waiver of the Funding Fee.

Lenders utilize COE's to determine a Veteran or Servicemember's eligibility for the program, and whether or not they are required to pay the fee. When lenders determine that a Veteran is required to pay the fee, the lender accesses a system called the Funding Fee Payment System (FFPS) and electronically pays the fee.

What We Discovered

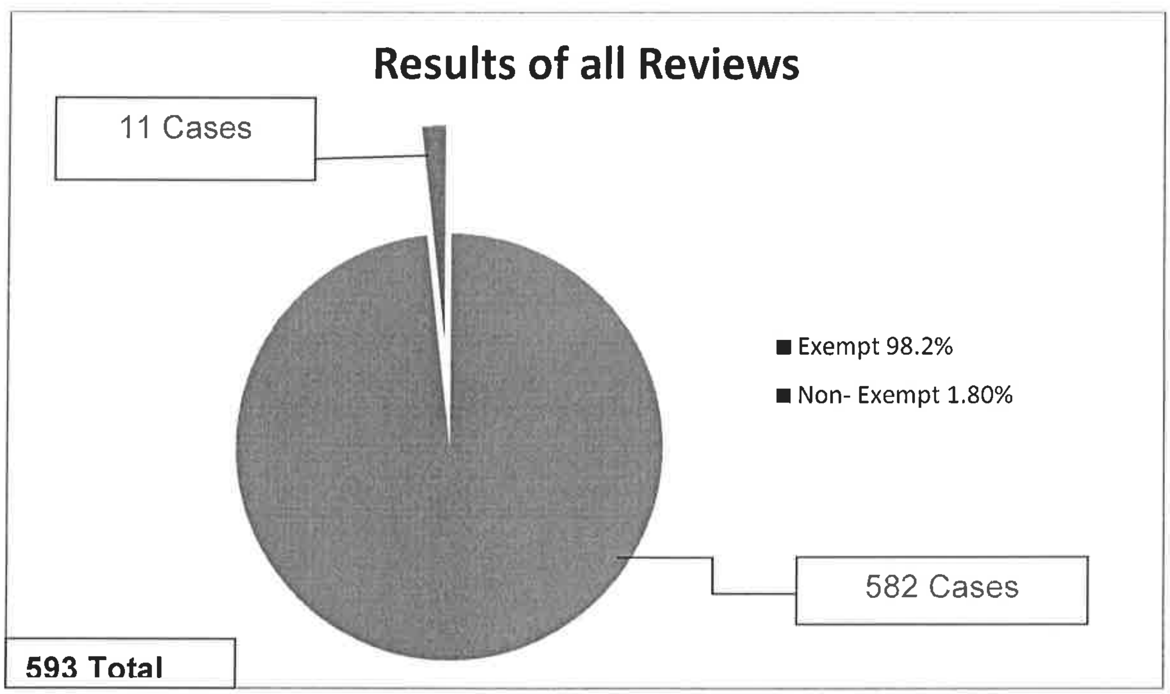
Due to a variety of factors, a certain number of Veterans end up paying a Funding Fee even though they shouldn't. The most common reasons this occurs are believed to be lender error, system limitations, and retroactive awards. We believed that these incidences were isolated and the process of returning Funding Fee overcharges to Veterans sufficient. During FY 2014, VA processed 4,265 Funding Fee refunds.

In an effort to determine the validity of that belief, the St. Paul Regional Loan Center procured a report from PA&I that listed approximately 52,000 loans where it was believed that funding fees were inappropriately paid between the dates of October 1, 2006, and May 31, 2014, and refunds were likely due. The total potential liability listed on the report exceeded $165 million USD. It was quickly pared down to 48,460 loans after Joint Loans and duplicates were removed. The next step in the process was to analyze a valid random sample to determine what portion of these loans would be due a refund.

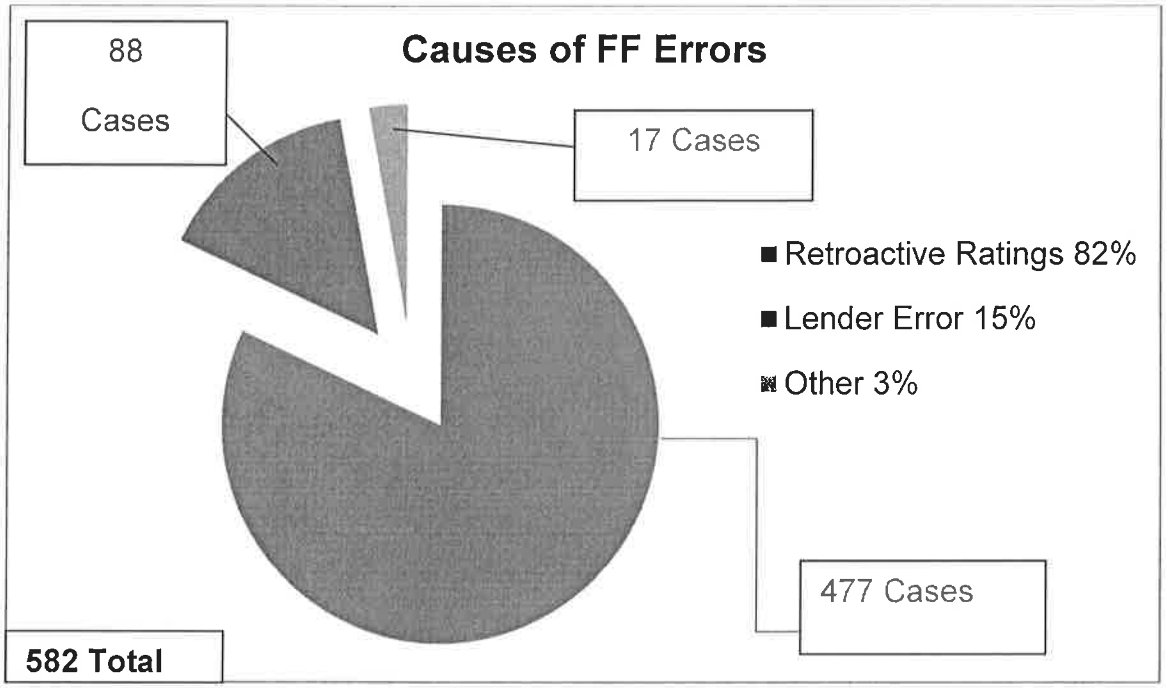
The Analysis

A total of 593 funding fees were randomly selected and analyzed for this report, providing a 95% statistical probability, with a deviation of 4.

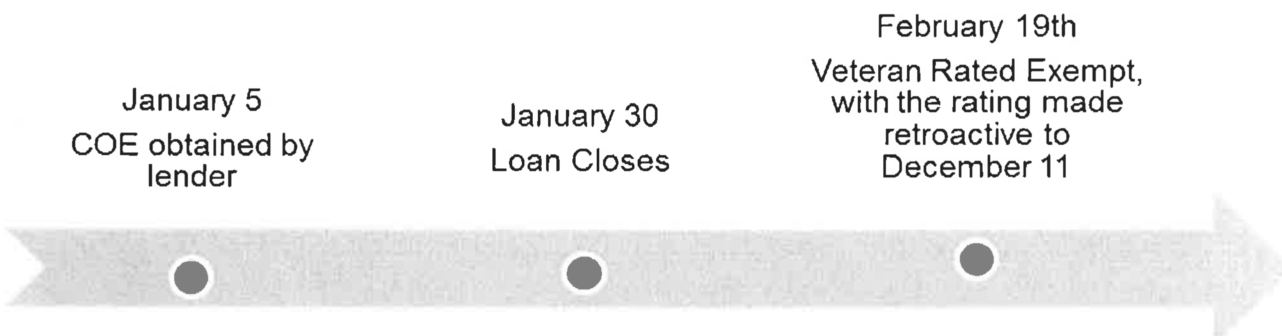
As you can see in the chart below, with the exception of a very small number of cases, (11), the vast majority of loans will require a refund. Extrapolating this figure over the entire report leads us to conclude that LGY will likely need to process 47,588 refunds.



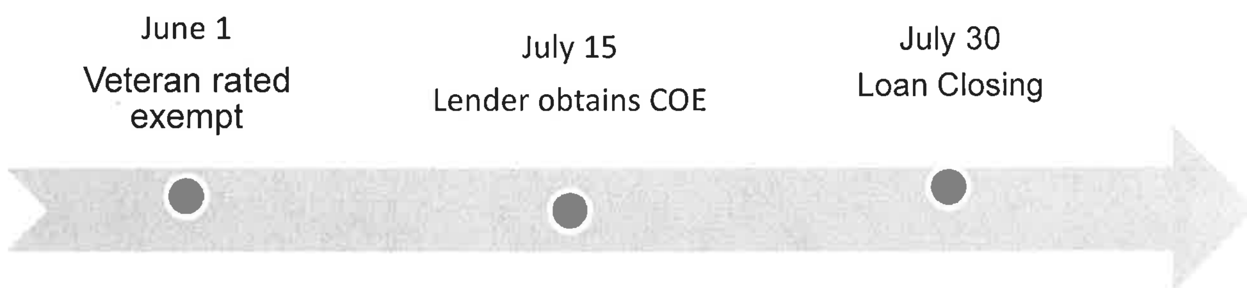
The second chart details the reasons Funding Fee errors occurred.



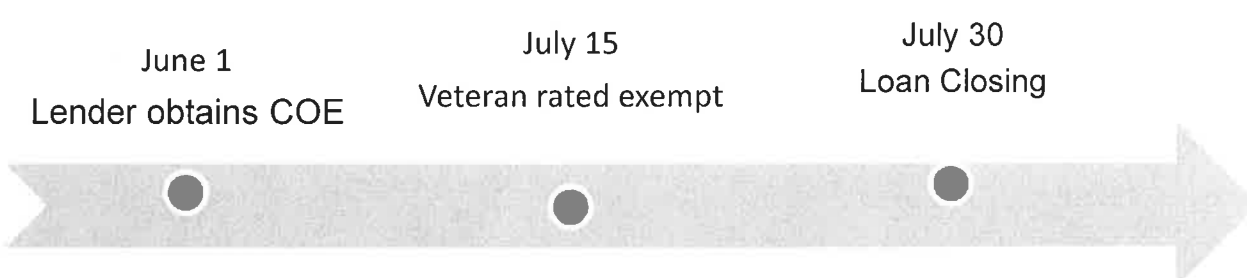
1. 82% <u>Retroactive Ratings</u>- The majority of errors identified during our research can be attributed to compensation claims being made retroactive to the date of loan closing. Although the actual timing of ratings made retroactively is often months or years apart from the closing date, the timeline below explains the general order of events.



2. 15% Lender errors- The second most prevalent type of errors were related to mistakes made by lenders. The majority of reviews showed that although lenders appeared to have a COE that indicated the Veteran was exempt from the Funding Fee, they still charged the fee. An example of that type of error is demonstrated below.



3. 3% Other- Although several items contributed to make up this category, the third most common factor, contributing to more than 1% of all errors was due to a circumstance in timing. In these cases, the lender happened to pull the COE just slightly before the rating determination was made. A sample timeline is provided below.



The remainder of the errors in the "other" category were:

- (6) A one-time event related to a system enhancement
- (3) Sensitive cases, where security level was an issue
- (1) Unknown

Action Plan

Fixing the Problems

When it comes to preventing the problems discussed in this report from reoccurring, we suggest the following 3 steps be taken.

1. 1% COE's should have a validity period of 90 days.
   If LGY were to enact a validity period of 90 days for all COE's, roughly 1% of the errors identified on the report could be prevented. Lenders know VA has a policy of accepting any COE presented and do not verify an old COE. Ideally, we should view the COE as a living document. One option could be to automatically generate a COE when an appraisal order or new loan number is generated. Of the sample reviewed for this report, 83% of the COE's were generated within 90 days of closing and 91% were issued within 120 days of closing.
2. 15% Automatic status check should be run while the lender guaranties the loan.
   Programming WebLGY to automatically check the Veteran's exemption status would resolve the cases of lender errors. We believe that when the lender clicks to submit their loan for guaranty, WebLGY should automatically run a check against SHARE to see if the Veteran has been rated and is receiving compensation. If they have, WebLGY should automatically select the loan for a COE only review. We considered recommending that WebLGY not allow lenders to guaranty a loan if the check revealed that a Funding Fee refund was due to the Veteran, but we decided that preventing lenders from guarantying loans would create confusion and cause some lenders to retain the funds instead of returning them to Veterans.
3. 84% Checking the report on a monthly basis.
   The report from PA&I should be generated once a month to ensure that all Veterans who receive a retroactive rating receive a refund. We recommend that the report be generated to show loans that have been guaranteed 90 days, in order to allow for our previous suggestions to implement.

Returning funds to Veterans

This report demonstrates that VA inappropriately collected approximately $150,901,534 on 47,588 loans since 2006. The question now becomes, how do we return it to them once we have determined that a refund is warranted?

Currently, when a funding fee refund is processed, lenders have to initiate the process by logging in to FFPS and entering a request. A VA technician then receives the request and researches the validity of the request, making a recommendation to their manager, who will either approve the request, ask for additional information, or denies it. On loans where the refund has been approved, lenders are instructed to return the funds in kind. This means that if the borrower paid the fee in cash, the lender needs to send them a check. More commonly, however, borrowers add the fee to their loan amount, and VA instructs the lender to reduce the principal balance of the loan.

A number of factors that are likely to make returning the funds more challenging than standard loans are listed below:

- Many of the loans will be paid off
- Loans that were refinanced into new loans
- Deceased borrowers
- Borrowers who have divorced, and may no longer hold any interest in the property
- Borrowers in default or foreclosure
- Veterans that simply can't be found
- Loans originated by companies that are out of business

For each of the scenarios above, a determination needs to be made regarding how the loan specialist should proceed when they encounter each situation.

Another critical issue that needs to be addressed is the requirement that funds be returned, in kind. Although returning the funds as they were received is the best option, it requires the loan specialist to review a HUD-1 and identify how the funds were paid. In many cases we will never see a HUD-1 and will need to rely on the information input into FFPS by the lender. Relaxing the "in kind" requirement, at least through the initial backlog, would definitely save time.

Resources

We estimate that Funding Fee refunds initiated by lenders currently take approximately 20 minutes to process. Extrapolating that number over the 47, 588 anticipated refunds gives us an estimated 951,160 minutes, or nearly 16,000 hours to complete. This would be approximately 8 full time employees (FTE) for 1 year. We believe that timeframe could be cut in half if a dedicated staff is utilized and they are allowed to apply all refunds to loans that are current.

One strategy that should be employed would be working directly with the lending institutions. Wells Fargo originated 13.87 % of the loans on the report, while Bank America is responsible for 4.86%, Mortgage Investors Corporation had 4.73% and Freedom Mortgage had 3.38% of the loans. We estimate that it will take 4 FTE approximately one year to refund all the money to Veterans. We also believe that a FTE allocation should be awarded to a station for processing all future refunds.

One final note-Although we believe that Veteran's did incur Funding Fees prior to 2006 that should be refunded, we were advised that this report includes the earliest date for which the data is available.