



COMMENTS
to the
Veterans Affairs Department

regarding

38 C.F.R. § 36.4306
RIN 2900-AQ42, Doc. No. 2018-27263

83 Fed. Reg. 64,470 (Dec. 17, 2018)

**Revisions to VA-Guaranteed or Insured Cash-Out Home
Refinance Loans**

by the
National Consumer Law Center
on behalf of its low income clients
&
National Fair Housing Alliance

Feb. 15, 2019

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Summary: The VA’s rule change will provide needed protections for veterans but the rule needs refinement to prevent the abuse of loopholes.

1. Introduction

1.1 Overview

The National Consumer Law Center (NCLC)¹ submits the following comments, on behalf of its low-income clients, along with the National Fair Housing Alliance.²

These comments address the interim final rule announced on December 17, 2018, and effective on February 15, 2019.³ The rule amends 38 C.F.R § 36.4306 and makes changes to the VA loan guarantee program for mortgage refinances.

We thank the Veterans Affairs Department (the VA) for the opportunity to comment on the interim final rule. While we

¹ Since 1969, the nonprofit **National Consumer Law Center® (NCLC®)** has used its expertise in consumer law and energy policy to work for consumer justice and economic security for low-income and other disadvantaged people, including older adults, in the United States. NCLC’s expertise includes policy analysis and advocacy; consumer law and energy publications; litigation; expert witness services, and training and advice for advocates. NCLC works with nonprofit and legal services organizations, private attorneys, policymakers, and federal and state government and courts across the nation to stop exploitive practices, help financially stressed families build and retain wealth, and advance economic fairness. These comments were written by Andrew Pizor.

² The **National Fair Housing Alliance (NFHA)**, founded in 1988, is a consortium of more than 220 private, non-profit fair housing organizations, state and local civil rights groups, and individuals from 37 states and the District of Columbia. Headquartered in Washington, D.C., NFHA, through comprehensive education, advocacy and enforcement programs, provides equal access to housing for millions of people.

³ 83 Fed. Reg. 64,459 (Dec. 17, 2018).

generally agree with the new rule, refinements are needed to achieve the goal of protecting veterans and to prevent evasion of the rules' requirements. We urge the VA to amend the rule further to implement the recommendations we make in these comments.

1.2 Background

The interim rule limits when the VA may guarantee or insure loans that are used to refinance existing loans. Congress mandated these changes to protect veterans and the liquidity of the guarantee program from the consequences of loan churning.⁴ Loan churning is the repeated or serial refinancing of a borrower's mortgage for the benefit of the loan originator (such as a broker or lender) rather than for the borrower's benefit.

Churning hurts borrowers because each time the borrower refinances, the borrower incurs new closing costs. Whether they are paid in cash or financed, those costs will be an unnecessary expense unless there is a clear benefit to the borrower from the transaction. Such a transaction transfers the borrower's wealth—be it cash or equity—to the loan originator and others involved in the transaction and leaves the borrower poorer.

Churning also hurts those who invest in mortgage securities backed by VA loans. VA loans are typically bundled and securitized by Ginnie Mae. Those securities are then sold on the secondary market. This process frees up lender cash to make new VA loans. Each time an existing VA loan is paid off, the income generated by that loan stops flowing to the pool of securitized loans that the loan was part of. Paying off a loan before its scheduled maturity is called "prepayment." Most mortgage loans in the United States are prepaid, so securities investors take the prepayment rate into account when they decide what to pay for VA-backed mortgage securities. Churning causes the prepayment rate to go up, which then drives down the value of the securities. As a result, lenders must charge higher interest rates on VA loans to entice securities investors to fund

⁴ *Id.* at 64,465.

new loans (i.e., by purchasing more mortgage-backed securities). The result is that churning leads to higher interest rates on VA loans, thereby hurting veterans who take out mortgages.⁵

Efforts to reduce churning began with a November 2016 report from the Consumer Financial Protection Bureau that cited numerous complaints from veterans regarding aggressive and sometimes misleading attempts to convince them to refinance their VA mortgages.⁶ Around the same time, Ginnie Mae began to investigate unusually fast prepayments in its securities and created a joint “Lender Abuse Task Force” with the VA to address the churning problem.⁷ These efforts and their findings culminated in 2018 with the passage of section 309 (“Protecting Veterans from Predatory Lending”) of the Economic Growth, Regulatory Relief, and Consumer Protection Act.⁸

⁵ See Karen Jowers, *Army Times*, Experts: VA loan ‘churning’ can hurt vets ... and the mortgage market (Jan. 10, 2018), available at <https://www.armytimes.com/pay-benefits/2018/01/10/experts-va-loan-churning-can-hurt-vets-and-the-mortgage-market/>.

⁶ Consumer Financial Protection Bureau, A snapshot of servicemember complaints: A review of issues related to VA mortgage refinancing (Nov. 2016), available at https://files.consumerfinance.gov/f/documents/112016_cfpb_OSA_VA_refinance_snapshot.pdf. See also Letter from Sen. Elizabeth Warren to Michael Bright (Acting Pres. and Chief Operating Officer of Ginnie Mae) (Sept. 6, 2017) (inquiring about churning and citing CFPB report).

⁷ See Letter from Michael Bright to Sen. Elizabeth Warren (Sept. 14, 2017) (responding to Sen. Warren's inquiry about CFPB report and complaints), available at https://www.warren.senate.gov/files/documents/2017_09_14_Ginnie_Mae_Response.pdf.

⁸ Pub.L. 115-174 (May 24, 2018).

2. The Interim Rule provides important protections but needs improvement to be effective.

2.1 Summary of the statute and interim rule

Section 309 of the Act, codified as 38 U.S.C. § 3709, relates to the VA mortgage guarantee program. The VA implemented section 3709 by amending 38 C.F.R. § 36.4306. The amended regulation applies to the refinance of existing mortgage loans or other liens secured by the veteran's dwelling. Transactions that do not meet the requirements specified in the regulation may not be guaranteed by the VA. The inability to obtain a VA-guarantee is intended to discourage the practices and loan terms targeted by the statute.

The plain language of the regulation uses two key factors to categorize loans: (1) whether the old loan to be refinanced is VA guaranteed or not, and (2) whether the new loan amount is larger than the payoff on the old loan. Based on these factors, the refinance transaction covered by the interim rule fall into one of three categories:

1. transactions refinancing an old VA loan with a new VA loan where the amount of the new loan is less than or equal to the payoff on the old loan.
2. transactions refinancing an old VA loan with a new VA loan where the amount of the new loan is *greater than* the payoff on the old loan.
3. transactions refinancing an old *non-VA loan* with a VA loan—regardless of the amount of the new loan.

As implemented by the VA and when viewed in the context of other VA requirements, all of the loans subject to the interim rule must meet a number of requirements. All of them must be fully underwritten and pass the VA's ability to repay standards.⁹ In

⁹ 83 Fed. Reg. at 64,463. *But see* § 2.3.3 (discussing the question of whether the amended rule applies to the VA's streamlined refinancing program—interest rate reduction refinancing loans (IRRRLs)).

addition, loans in these three categories may not have an LTV in excess of 100%, including any part of the VA funding fee that is financed.¹⁰ The lenders in all of these transactions must also provide disclosures comparing the old and new loans. The disclosure must be provided at the time of application and again at settlement.¹¹

In addition, depending on which category a transaction fits into, some loans must meet one or more of the following new requirements:

- some loan originators must certify that the borrower will recoup the costs of the transaction through lower regular monthly payments;
- some transactions must provide the borrower with a net tangible benefit;
- certain loans must also meet restrictions on interest rate changes and discount points; and
- in some transactions, the old loan being refinanced must be adequately “seasoned”—meaning it must meet certain age criteria.

The strictest standards apply to loans that refinance existing VA loans where the old loan has a fixed interest rate and a payoff amount that is equal to or exceeds the amount of the new loan. Weaker standards apply to transactions refinancing non-VA loans, but the lender must still demonstrate that the transaction provides at least one of eight listed benefits to the borrower or the new loan may not be guaranteed.

The appendix to these comments explains the new requirements applicable to each of the three categories of loans.

¹⁰ 38 C.F.R. § 36.4306(a)(1)-(2) (as amended).

¹¹ 38 C.F.R. § 36.4306(a)(3)(ii), (iv) (as amended).

2.2 Recommendations for improving the new anti-churning provisions.

2.2.1 Add the VA funding fee to the recoupment requirement, and apply the requirement to all refinancing transactions.

Under section 3709 a new loan that refinances an existing loan may not be guaranteed unless three recoupment-related requirements are met: (1) the lender certifies “the recoupment period for fees, closing costs, and any expenses (other than taxes, amounts held in escrow, and [the VA funding fee]) that would be incurred by the borrower in the refinancing of the loan;” (2) these fees “are scheduled to be recouped” within 36 months after origination; and (3) “the recoupment is calculated through lower regular monthly payments (other than taxes, amounts held in escrow, and [the VA funding fee]) as a result of the refinanced loan.”

The interim rule incorporates the statute’s recoupment language almost verbatim.¹² Unfortunately neither the statute nor the regulation define “recoup” or “recoupment”. Black’s Law Dictionary defines recoupment as “[t]he getting back or regaining of something, esp. expenses.”¹³ We believe Congress intended to use this definition and that the statute requires loan terms that will allow the borrower to get back or recover the cost of closing the new loan.

While we agree with Congress and the VA that this will help reduce churning, the requirement is currently ill-defined and too narrow. The language of the rule should be clarified to ensure that it is implemented properly. We also recommend expanding the rule to include the VA funding fee and all refinancing transactions.

¹² 38 C.F.R. § 36.4306(b)(1) (as amended).

¹³ RECOUPMENT, Black's Law Dictionary (10th ed. 2014).

Funding fee: We urge the VA to include the VA funding fee among the fees, closing costs, and expenses that must be recouped.¹⁴ The funding fee pays for the VA guarantee and is required of most veterans. It ranges from .5% to 3.3% of the amount borrowed.¹⁵ As a result, it will cost most veterans thousands of dollars and will be one of the most expensive closing costs in a refinancing transaction. Even though the statute does not include the funding fee in the recoupment mandate, the VA has the authority to do so. Given the high cost of the funding fee, we believe that amending the rule to make it a component of the recoupment mandate will discourage predatory lenders and protect veterans from being fleeced.

Transactions covered: The interim rule only applies the recoupment requirement to loans that refinance existing VA loans.¹⁶ That will leave a significant number of transactions beyond the scope of the requirement, and those borrowers will be unprotected. In contrast, section 3709 mandates applying the requirement to all refinance loans to be guaranteed by the VA.¹⁷

¹⁴ See 38 C.F.R. § 36.4306(b)(1)(i) (as amended) (“The lender of the refinanced loan must provide the Secretary with a certification of the recoupment period for fees, closing costs, and any expenses (other than taxes, amounts held in escrow, and fees paid under 38 U.S.C. chapter 37) that would be incurred by the borrower in the refinancing of the loan”).

¹⁵ VA, Funding Fee Tables (undated) (listing fee rates as of enactment of Public Law 112-56), available at

https://www.benefits.va.gov/homeloans/documents/docs/funding_fee_table.pdf.

¹⁶ 38 C.F.R. § 36.4306(b) (as amended) (prefacing recoupment requirement with “If the loan being refinanced is a VA-guaranteed or insured loan, and the new loan amount is equal to or less than the payoff amount of the loan being refinanced, the following requirements must also be met—”).

¹⁷ See 38 U.S.C. § 3709(a) (prefacing recoupment requirement with “Fee Recoupment.-Except as provided in subsection (d) [a loan refinancing in which the amount of the principal for the new loan to be guaranteed or insured under this chapter is larger than the payoff amount of the refinanced loan] and notwithstanding section 3703 of

There is no reason to exclude transactions that refinance non-VA loans from this requirement. We urge the VA to apply the recoupment requirement to all transactions that refinance an old loan with a new VA loan.

Clarification: The phrase “[t]he recoupment must be calculated through lower regular monthly payments”¹⁸ does not clearly require that the new loan have lower payments than the old loan. Instead, we believe the recoupment requirement will be more transparent and verifiable if the rule is modified to explicitly require (1) that the new loan have payments that are lower than the old loan; and (2) that the total amount to be recouped must be less than the difference between the payments on the old and new loan multiplied by 36 months.

2.2.2 Clarify the seasoning requirement by adopting Ginnie Mae’s version.

Section 3709 imposes what it calls a “seasoning” requirement on refinance transactions. According to the statute,

a loan to a veteran . . . that is refinanced may not be guaranteed or insured under this chapter until the date that is the later of-

- (1) the date that is 210 days after the date on which the first monthly payment is made on the loan; and
- (2) the date on which the sixth monthly payment is made on the loan.¹⁹

this title or any other provision of law, a loan to a veteran for a purpose specified in section 3710 of this title that is being refinanced may not be guaranteed or insured under this chapter unless-”).

¹⁸ This phrase is used in 38 C.F.R. § 36.4306(b)(1)(3) (as amended) (“The recoupment must be calculated through lower regular monthly payments (other than taxes, amounts held in escrow, and fees paid under 38 U.S.C. chapter 37) as a result of the refinanced loan.”).

¹⁹ 38 U.S.C. § 3709(c).

The VA's interim rule uses a slightly different formulation: "The new loan may not be guaranteed or insured until the date that is the later of 210 days from the date of the first monthly payment made by the borrower and the date on which the sixth monthly payment is made on the loan."²⁰

Both versions fail to make clear which loan the seasoning requirement refers to. They could be interpreted as applying the requirement to the new loan—meaning it could not be guaranteed or insured until the later of the two dates specified in the statute. But Congressional intent makes that interpretation unlikely. Congress intended to discourage lenders from refinancing existing VA loans too quickly, so the seasoning requirement must be intended to ensure that the old loan is of a certain age before it is replaced with a new loan.

Ginnie Mae has interpreted the seasoning requirement this way. Several days after section 3709 was signed into law, Ginnie Mae issued a bulletin stating—

Effective with mortgage-backed securities guaranteed on or after June 1, 2018, a refinance loan insured or guaranteed under the United States Department of Veteran Affairs benefit program . . . is eligible for Ginnie Mae securities only if it meets the following condition.

The note date of the refinance loan must be on or after the later of:

- a) the date that is 210 days after the date on which the first monthly payment was made *on the mortgage being refinanced*, and
- b) the date on which 6 full monthly payments have been made *on the mortgage being refinanced*.²¹

²⁰ 38 C.F.R. § 36.4306(b)(2) (as amended).

²¹ Ginnie Mae, APM 18-04: Eligibility of VA Refinance Loans under the Economic Growth, Regulatory Relief, and Consumer Protection Act,

Ginnie Mae's reference to "the mortgage being refinanced" clarifies that the seasoning requirement applies to the *old* loan that will be replaced by the new VA mortgage. To avoid ambiguity, we recommend that the VA modify the interim rule to use the same seasoning language as Ginnie Mae.

2.2.3 Net tangible benefit

2.2.3.1 Description

Section 3709 and the interim rule require refinancing transactions to provide veterans with a net tangible benefit. We strongly support this requirement as a powerful safeguard to prevent harmful refinancing transactions. The rule expands on the statute by mandating one of eight possible changes deemed to pass the test. They are—

- (A) The new loan eliminates monthly mortgage insurance, whether public or private, or monthly guaranty insurance;
- (B) The term of the new loan is shorter than the term of the loan being refinanced;
- (C) The interest rate on the new loan is lower than the interest rate on the loan being refinanced;
- (D) The payment on the new loan is lower than the payment on the loan being refinanced;
- (E) The new loan results in an increase in the borrower's monthly residual income . . . ;
- (F) The new loan refinances an interim loan to construct, alter, or repair the primary home;
- (G) The new loan amount is equal to or less than 90 percent of the reasonable value of the home; or

S.2155 (May 30, 2018) (emphasis added), available at https://www.ginniemae.gov/issuers/program_guidelines/Pages/mbsguideapmslibdisppage.aspx?ParamID=87.

(H) The new loan refinances an adjustable rate mortgage to a fixed rate loan.²²

The first of these options, subparagraph (A)(eliminating mortgage insurance) is insufficient by itself and should be modified. Subparagraph (G)(an LTV of 90 percent or less) confers no benefit standing alone, so the option should be deleted from the list. These two recommendations are discussed below.

2.2.3.2 Eliminating mortgage insurance should only qualify as a net tangible benefit if the interest rate on the new loan is the same or less than the rate on the old loan.

Under the interim rule, one of the ways a refinancing transaction may satisfy the net tangible benefit test is by eliminating a mortgage insurance or monthly guarantee insurance requirement.²³ But this will only benefit the borrower if it is actually a net improvement in light of other changes. For example, the cost of a higher interest rate on the new loan could moot any savings from eliminating the insurance requirement.

In addition, evaluating the impact of eliminating mortgage insurance could be complicated by other aspects of the transaction. For example, the new loan could have a higher interest rate and a higher loan balance.²⁴ In that situation, it would be difficult for the borrower to assess whether the higher rate consumed the savings created by eliminating the mortgage insurance.

To prevent this provision from being abused, we recommend amending the rule so that eliminating mortgage insurance only qualifies as a benefit if the interest rate on the new loan is the same as or less than the rate on the old loan.

²² 38 C.F.R. § 36.4306(a)(3)(i) (as amended).

²³ 38 C.F.R. § 36.4306(a)(3)(i)(A) (as amended).

²⁴ I.e. a cash-out refinance (using industry-standard terminology).

2.2.3.3 Refinancing into a loan with a 90 percent or lower LTV should not qualify as a benefit.

According to the interim rule, a refinancing transaction will satisfy the net tangible benefit test if the “new loan amount is equal to or less than 90 percent of the reasonable value of the home.”²⁵ According to the VA,

A new loan that is equal to or less than 90 percent of the home's reasonable value will also provide a financial interest to the borrower because at least 10 percent of home equity is maintained. Such equity can, for example, leave some room for a future loan modification if the borrower experiences a temporary reduction in income. Also, maintaining and building home equity is in any homeowner's interest as such equity represents an investment and reduces the likelihood that, when property values fall, a homeowner will be left with a mortgage that exceeds the value of the home (*i.e.*, an “underwater mortgage”).²⁶

While we agree with the benefits of having at least 10 percent equity in a home, we strongly disagree with the VA's assertion that merely having a 90 percent LTV makes refinancing beneficial. The VA should delete this provision to avoid creating a loophole in the new rule.

A loan-to-value ratio (LTV) does not, by itself, have any bearing on whether a transaction benefits the borrower. A borrower is not necessarily better off if he refinances a loan with an 80 or 85 percent LTV into a new loan with a 90 percent LTV. And—all other factors being equal—a borrower who originally had a loan with a 100 percent LTV will not automatically see a benefit from

²⁵ 38 C.F.R. § 36.4306(a)(3)(i)(G) (as amended).

²⁶ 83 Fed. Reg. at 64,463.

merely refinancing when his property value increases.²⁷ Such a borrower already had equity in his house, so there is no need to refinance to see the benefits described by the VA in the above quotation.

For these reasons, the VA should delete subparagraph (G) from the list of net tangible benefits.

2.2.4 Apply the discount point restrictions to all rate reductions covered by the statute.

Section 3709 mandates a minimum interest rate reduction for two types of refinancing transactions, and imposes safeguards on the use of discount points to achieve those reductions:

- Under § 3709(b)(2), when both the old and the new loan have a fixed interest rate, the rate on the new loan must be at least 50 basis points lower;
- Under § 3709(b)(3), if the old loan had a fixed rate and the new loan has an adjustable rate, the rate on the new loan must be at least 200 basis points lower.

According to section 3709(b)(4), if the rate reduction is achieved by using discount points, the points must meet certain requirements:

- they must be paid in cash at closing, or;
- if the borrower finances up to one discount point, the loan-to-value ratio of the new loan (including any fees and expenses) does not exceed 100%;
- if the borrower finances more than one discount point, the resulting LTV (including any fees and expenses) cannot exceed 90%.

²⁷ Assuming the borrower refinances at the same interest rate and does not eliminate a monthly mortgage insurance requirement.

The VA incorporated these provisions into the interim rule but with an important difference. The statute applies the discount-point requirement equally to both the 50 basis point requirement in paragraph (b)(2) and the 200 basis point requirements in paragraph (b)(3). The interim rule, however, applies it only to the 200 basis point requirement.²⁸

The VA states that it did so because the statute places the word “and” between paragraph (b)(3) and paragraph (b)(4), which the VA interpreted as linking paragraph (b)(4) exclusively to (b)(3).²⁹ As a result, the interim rule puts no limit on how discount points could be used to achieve the rate reduction in paragraph (b)(2). According to the Federal Register, “VA recognizes other conclusions might be possible. However, VA’s interpretation implements the text, on its face, as a coherent and consistent framework, without having to consider whether Congress made a structural error.”³⁰

We believe the VA is incorrect. As the VA tactfully implies, the statute is poorly drafted and permits multiple interpretations. Given the ambiguity of the statute, the VA should rely on the clear Congressional intent to protect veterans. The VA’s interpretation will allow lenders to evade the rule by using discount points to achieve the rate reduction specified in (b)(2). That problem can easily be avoided by applying the discount rate provision to both paragraphs (b)(2) and (b)(3).

The limitation on points is important because discount points are expensive and opaque. Some researchers believe that consumers rarely benefit from paying discount points.³¹ So there is no reason to limit the protections to this one category of

²⁸ 38 C.F.R. § 36.4306(b)(4) (as amended).

²⁹ 83 Fed. Reg. at 64,461.

³⁰ *Id.* at 64,461.

³¹ See National Consumer Law Center, Mortgage Lending § 8.7.1 n.264 (2d ed. 2014), *updated at* www.nclc.org/library.

transactions. The discount points restriction should apply to all interest rate reductions covered by the rule.

2.2.5 Add a rate cap to protect veterans who refinance adjustable rate mortgages into fixed rate mortgages.

The statute and interim rule require a rate reduction when a transaction refinances an old fixed rate loan with a new fixed rate loan, or an old fixed rate loan with a new adjustable rate loan (an "ARM"). But there is no limit on the interest rate when refinancing an adjustable rate loan with a fixed rate loan.

We agree that converting from an ARM to a fixed rate loan can benefit a borrower. A fixed interest rate can provide stability that helps with budgeting, and it can enable a borrower to lock in a low interest rate. But the absence of any safeguards would permit a predatory lender to refinance a borrower into a fixed rate loan that has a significantly higher interest rate.

To protect veterans from unreasonable rate increases, we recommend that the VA adopt a limit on how much the rate may increase when refinancing from an ARM to a fixed rate loan. Creating such a limit is justifiable based on the analogous threshold for rate reductions in (b)(2) and (b)(3).

We recommend amending the interim rule so that, when refinancing from an ARM to a fixed rate loan, the new loan may not be guaranteed if the new rate exceeds the old rate by more than 200 basis points at the time of the transaction.

2.3 Difficulties with interpretation and application.

Implementing section 3709 requires addressing several areas of confusion raised by the language of the statute and VA policy.

2.3.1 The VA has properly interpreted a critical but ambiguous phrase in the statute.

Section 3709(a), (b), and (c) each state that "a loan to a veteran . . . that is being refinanced may not be guaranteed or insured under this chapter unless" certain requirements are met. This

phrase establishes a critical mandate: a loan cannot become a VA guaranteed loan unless it meets the requirements of this statute.

Unfortunately, the phrase “a loan . . . that is being refinanced may not be guaranteed . . .” is confusing. The act of refinancing a loan refers to paying off an old loan with a new loan. In common parlance, “the loan that is refinanced” is the *old* loan that is being paid off. This usage is similar to referring to “the loan that was foreclosed.” So section 3709 seems to refer to the old, existing loan rather than the new loan. In that usage, it would prohibit the VA from guaranteeing the old loan if the new loan did not meet the specified requirements.

But that would be impossible because the old loan is being paid off in the transaction so it is no longer in need of a guarantee, nor would it even be possible to guarantee a loan that has already been paid. The background of section 3709 clearly indicates that Congress wanted to discourage churning by denying the VA guarantee to new loans that do not meet the specified criteria. So it appears obvious that the statutory reference to “the loan that is being refinanced” is intended to refer to the *new loan* for which the lender desires a VA guarantee.

The VA implements this language by amending the existing 38 C.F.R. 36.4306(a), which (as amended) applies to a “refinancing loan made pursuant to 38 U.S.C. 3710(a)(5)” Section 3710(a)(5) refers to loans intended to “refinance existing mortgage loans or other liens” By doing so, we believe the VA has correctly implemented section 3709 in accordance with the spirit of the law.

2.3.2 The VA should switch to using industry-standard terminology to avoid confusion.

The Federal Register notice announcing the interim rule at issue is entitled “Loan Guaranty: Revisions to VA-Guaranteed or Insured Cash-Out Home Refinance Loans.” But the way the VA uses the term “cash-out refinance” is confusing. According to the VA Lender’s Handbook, “[a] cash-out refinancing loan is a VA-guaranteed loan that refinances any type of lien or liens against

the secured property.”³² The VA uses the term to distinguish between fully-underwritten refinancing transactions and its streamlined refinancing product, called the “interest rate reduction refinance loan” (IRRRL) program.³³

In contrast, for the rest of the mortgage industry, a cash-out refinancing loan is a mortgage that extends enough credit to pay off the old mortgage *plus* provides additional credit that the borrower can use for other purposes. Under the industry-standard definition, the hallmark of a cash-out refinancing transaction is that the amount of the new loan is larger than the payoff on the old loan (including any financed closing costs).³⁴ The excess is the “cash” referred to in the term “cash-out.”

³² VA Pamphlet 26-7, Revised, Chapter 6 at page 6-17 (as of February 5, 2019).

³³ See 83 Fed. Reg. at 64,459 (“Refinancing loans guaranteed or insured by VA have historically fallen into two broad categories: (i) Cash-out refinance loans (cash-outs) offered under 38 U.S.C. 3710(a)(5) and (a)(9) and (ii) interest rate reduction refinancing loans (IRRRLs) authorized under 38 U.S.C. 3710(a)(8) and (a)(11).”).

³⁴ See, e.g., Freddie Mac Refinance Programs (Aug. 2018), available at <http://www.freddiemac.com/learn/pdfs/uw/refinance.pdf> (comparing “no cash-out” and “cash-out” refinance mortgages); LendingTree website, available at <https://www.lendingtree.com/glossary/cash-out-refinancing/> (defining “cash-out refinancing” as “a refinance in which the new loan amount exceeds the total needed to pay off the existing mortgage. The difference goes to the borrower and can be used for any purpose.”); Deborah Kearns, Cash-out refinance pros and cons (Feb. 9, 2016), available at <https://www.nerdwallet.com/blog/mortgages/refinance-cash-out/> (“A cash-out refinance replaces your existing mortgage with a new home loan for more than you owe on your house. The difference goes to you in cash and you can spend it on home improvements, debt consolidation or other financial needs. You must have equity built up in your house to use a cash-out refinance.”); James Chen, Cash-Out Refinancing (Jan. 11, 2018), available at https://www.investopedia.com/terms/c/cashout_refinance.asp (“A cash-out refinance is a mortgage refinancing option where the new

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The industry-standard definition is useful because it enables lenders and borrowers to easily distinguish between cash-out and other types of refinancing. For example, Freddie Mac and FHA describe their refinancing programs by referring to "cash-out" and "no cash out" loans.³⁵ Industry commentators have also referred to "cash-in" refinancing, which is putting cash into a transaction so the balance on the new loan is lower than the payoff amount of the old loan.³⁶

In the VA's Federal Register notice, the Department acknowledges the need to distinguish between different types of refinancing transactions based on the comparative size of the loans:

Based on the way Congress structured section 3709, VA-guaranteed or insured refinance loans are now effectively grouped into three categories: (i) IRRRLs,

mortgage is for a larger amount than the existing loan to convert home equity into cash."); Holden Lewis, Cash-out refinance: When is it a good option? (Mar. 19, 2018), available at <https://www.bankrate.com/finance/financial-literacy/when-is-cash-out-refinancing-a-good-option--1.aspx> ("A cash-out refinance is when you refinance your mortgage for more than you owe and take the difference in cash. It's called a "cash-out refi" for short.").

³⁵ Freddie Mac Refinance Programs (Aug. 2018), available at <http://www.freddiemac.com/learn/pdfs/uw/refinance.pdf> (comparing "no cash-out" and "cash-out" refinance mortgages); FHA Handbook 4000.1 ("FHA insures several different types of refinance transactions: 1. Cash-out refinances are designed to pull equity out of the Property [and] 2. No cash-out refinances") FHA Handbook 4000.1 § II.A.1 at page 131 (eff. Sept. 14, 2015, last rev. Dec. 30, 2016).

³⁶ See, e.g., Dina ElBoghdady, Wash. Post, Low rates drive 'cash-in' refinances, A.12 (Feb. 2, 2011); Jack Guttentag, The Mortgage Professor, Is Cash-in Refinancing For You? (Apr. 10, 2011) ("Cash-in refinancing means putting cash into a transaction by paying down the balance, as opposed to cash-out refinancing where you take cash out by increasing the balance"), available at https://www.mtgprofessor.com/A%20-%20Refinance/is_cashin_refinancing_for_you.html.

(ii) cash-outs in which the amount of the principal for the new loan is equal to or less than the payoff amount on the refinanced loan (Type I Cash-Outs), and (iii) cash-outs in which the amount of the principal for the new loan is larger than the payoff amount of the refinanced loan (Type II Cash-Outs). (For ease of reference, VA is referring in this preamble to the types of refinancing loans as IRRRLs, Type I Cash-Outs, and Type II Cash-Outs, respectively.³⁷)

But the distinctions and terminology chosen by the VA still do not match industry standards, and create the risk of confusion. We recommend that the VA adopt the widely accepted industry standard terminology as follows:

- No cash-out loans: the VA's IRRRL program is one type of no cash-out loan, but this category would also include fully underwritten Type I Cash-Outs if the principal amount of the new loan is equal to the payoff amount of the old loan.
- Cash-out loans: this category would consist of what the VA currently refers to as Type II Cash-Outs, i.e. cash-outs in which the amount of the principal for the new loan is larger than the payoff amount of the refinanced loan.
- Cash-in loans: this category would include Type I Cash-Outs where the principal amount of the new loan is *less than* the payoff amount of the old loan.

The mortgage industry's standard terminology is more descriptive and easier to understand. Adopting it would eliminate the risk of confusion and make it easier for veterans and lenders to discuss the difference between different loan products.

2.3.3 The VA should amend the interim rule to clarify that it does not apply to the IRRRL program.

The plain language of section 3709 and the interim rule can be interpreted as applying to loans made under the VA's IRRRL

³⁷ 83 Fed. Reg. at 64,459.

program. It is likely that Congress intended to apply the new statute to IRRRLs as part of its goal to reduce loan churning. And the VA agrees that paragraphs 3709(a)-(c) apply to IRRRLs.³⁸

But it is less clear whether the interim rule applies to IRRRLs. The first sentence of the rule says it applies to “refinancing loan[s] made pursuant to 38 U.S.C. 3710(a)(5)”³⁹ Paragraph 3710(a)(5) refers to loans to “refinance existing mortgage loans” on a veteran’s dwelling. That clearly includes IRRRLs. But paragraph 3710(a)(8) authorizes the IRRRL program; the interim rule does not mention paragraph 3710(a)(8); and the Code of Federal Regulations has a separate section dedicated to IRRRLs.⁴⁰

The VA states that it will address section 3709’s impact on IRRRLs in a separate rulemaking.⁴¹ That most likely means that the newly amended rule (38 C.F.R. § 36.4306) does not apply to IRRRLs. But, because the plain text of the rule can be read to include IRRRLs, the VA should amend it to clarify that it does not do so.

³⁸ *Id.* at 64,460 (“VA understands subsections (a) through (c) to apply to IRRRLs and Type I Cash-Outs”).

³⁹ 38 C.F.R. § 36.4306(a) (as amended).

⁴⁰ 38 C.F.R. § 36.4223 (as amended).

⁴¹ 83 Fed. Reg. at 64,460 (“VA is not addressing section 3709's impact on IRRRLs, but plans to do so in a separate rulemaking.”).

APPENDIX: The three categories of refinancing transactions and the requirements that apply to them

This appendix summarizes the three categories of refinancing transactions created by the newly amended 38 C.F.R. § 36.4306 and briefly lists the restrictions applied to them.

Refinancing an old VA loan with a new VA loan where the amount of the new loan is less than or equal to the payoff on the old loan.

This category includes new loans that meet the following two criteria:

- They refinance an old VA loan with a new VA loan, and
- The amount of the new loan is less than or equal to the payoff amount for the old loan.

Using the VA's terminology, these are Type I Cash-Outs. Using industry-standard terminology, this category consists of cash-in and no-cash-out loans.

Under the interim rule, these transactions must meet the following requirements or the new loan will not be guaranteed:

- The transaction must the recoupment test. Notably, the recoupment test also satisfies the net benefit test for this category of loans by reducing the borrower's monthly payment.
- The old loan must be sufficiently seasoned.
- If the old loan has a fixed interest rate, the new loan must sufficiently reduce the interest rate. According to the rule, if the new loan has an adjustable rate, any discount points must meet additional requirements. Notably, the discount point restrictions only apply when the old loan has a fixed rate and the new loan has an adjustable rate. Nor are

there any rate or discount point restrictions when the old loan has an adjustable rate. These are flaws that we discuss further in §§ 2.2.4 and 2.2.5.

Refinancing an old VA loan with a new VA loan and the amount of the new loan is greater than the payoff on the old loan.

This category covers new loans that meet the following two criteria:

- They refinance an old VA loan with a new VA loan, and
- The amount of the new loan is greater than the payoff on the old loan.

Using the VA's terminology, these are Type II Cash-Outs. Using industry-standard terminology, this category consists of cash-out refinance loans.

Under the interim rule, these transactions must meet the following transactions or the new loan will not be guaranteed:

- The same seasoning test applies.
- The same interest rate restrictions apply.
- Unlike the loans in the previous category, these loans must pass the net tangible benefit test.
- But loans in this category are not subject to the recoupment test.

Refinancing old Non-VA loans with new VA loans.

This final category is much broader, including all VA loans that refinance existing non-VA loans. For these transactions, it does not matter whether the new loan amount is more or less than the payoff on the old loan. The requirements are the same regardless of the loan amount. In the VA's terminology, these are Type I and Type II Cash-Outs. Using industry-standard terminology, this

category includes all types of refinancing transactions: no cash-out, cash-in, and cash-out refinance loans.

Under the interim rule, these transactions must only meet the net tangible benefit test. They are not subject to the recoupment test, any seasoning test, or any interest-rate restrictions.