Chapter 7. Loans Requiring Special Underwriting, Guaranty and Other Considerations

Overview

Introduction

This chapter contains information about loans requiring special underwriting, guaranty, and other considerations.

In this Chapter

This chapter contains the following topics.

1. Joint Loans

Change Date

April 1, 2010, Change 12
- This section has been updated to correct hyperlinks and to make minor grammatical edits.

a. What is a VA Joint Loan?

"Joint loan" generally refers to a loan for which:

- a veteran and another person(s) are liable, and
- the veteran and the other obligor(s) own the security.

A joint loan is a loan made to:

- the veteran and one or more nonveterans (not spouse),
- the veteran and one or more veterans (not spouse) who will not be using their entitlement,
- the veteran and the veteran's spouse who is also a veteran, and both entitlements will be used, or
- the veteran and one or more other veterans (not spouse), all of who will use their entitlement.

A loan involving a veteran and his or her spouse will not be treated as a "joint loan" if the spouse:

- is not a veteran, or
- is a veteran who will not be using his or her entitlement on the loan.

A loan to a veteran and fiancé who intend to marry prior to loan closing and take title as veteran and spouse will be treated as a loan to a veteran and spouse (conditioned upon their marriage), and not a joint loan.

b. VA Regulations

The regulations in 38 CFR 36.4307 address joint loans.

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1. Joint Loans, Continued

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c. Terminology Used in this Section

To avoid confusion, the terms "veteran/nonveteran joint loan" and "two veteran joint loan" will be used throughout this section to include the various types of joint loans.

Veteran/nonveteran joint loan:
Common meaning: A loan involving one veteran and one nonveteran (not spouse).

For purposes of applying the principles explained in this section, this term will also be used to represent **any** other type of joint loan involving at least one veteran using his or her entitlement and at least one other person **not** using entitlement (can be a veteran or nonveteran, but not a spouse).

Examples:
- Three veterans using entitlement and one nonveteran.
- One veteran using entitlement and four nonveterans.
- Two veterans using entitlement and two veterans **not** using entitlement.

Two veteran joint loan:
Common meaning: A loan involving two veterans who are not married to each other, and both using their entitlement.

For purposes of applying the principles explained in this section, this term will also be used to represent **any** other type of joint loan involving only veterans, each of whom uses his or her entitlement.

It can include loans to:

- the veteran and the veteran's spouse who is also a veteran, if **both** entitlements will be used, or
- three, four, or more veterans, **all** of whom will use their entitlement.

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d. Occupancy

Any person who uses entitlement on a joint loan must certify intent to personally occupy the property as his or her home.

Any borrower on a joint loan who does not use entitlement for the loan (such as a nonveteran), does not have to intend to occupy the property.

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1. Joint Loans, Continued

e. How Many Units Can the Property Have?

If a property is to be owned by two or more eligible veterans, it may consist of four family units and one business unit, plus one additional unit for each veteran participating in the ownership.

Thus, two veterans may purchase or construct residential property consisting of up to six family units (the basic four units plus one unit for each of the two veterans), and one business unit.

If the property contains more than four family units plus one family unit for each veteran participating in the ownership and/or more than one business unit, the loan is **not** eligible for guaranty.

f. Which Joint Loans Require Prior Approval?

Any joint loan for which the veteran will hold title to the property and any person **other than** the veteran's spouse must be submitted for prior approval.

Any loan for which the veteran and the veteran's spouse will hold title to the property, whether or not the spouse also uses entitlement, may be closed automatically by a lender with automatic authority.

g. How to Underwrite a Joint Loan

The following underwriting considerations apply:

Part Type of Joint Loan	Underwriting Considerations Function
Two veteran joint loan	Consider the credit and combined income and assets of both parties. Strengths of one veteran related to income and/or assets may compensate for income/asset weaknesses of the other. However, satisfactory credit of one veteran cannot compensate for the other's poor credit.

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1. Joint Loans, Continued

g. How to Underwrite a Joint Loan (continued)

Part Type of Joint Loan	**Underwriting Considerations Function**
Veteran/nonveteran joint loan	Veteran's credit must be satisfactory and veteran's income must be sufficient to repay that portion of the loan allocable to the veteran's interest in the property. A different analysis applies to the portion of the loan allocable to the nonveteran. The credit of the nonveteran must be satisfactory. However, the combined income of both borrowers can be considered in evaluating repayment ability. In other words: • income strength of the veteran may compensate for income weakness of the nonveteran, but • income strength of the nonveteran cannot compensate for income weakness of the veteran in analyzing the veteran's ability to repay his or her allocable portion of the loan.

h. How to Calculate Guaranty and Entitlement Use on Veteran/ Nonveteran Joint Loans

Guaranty is limited to that portion of the loan allocable to the veteran's interest in the property.

The lender **must** satisfy itself that the requirements of its investor or the secondary market can be met with this limited guaranty.

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1. Joint Loans, Continued

i. Procedure

VA calculates the guaranty as described in the table below.

Step	Action
1	Divide the total loan amount by the number of borrowers.
2	Multiply the result by the number of veteran-borrowers who will be using entitlement on the loan. There is usually only one veteran borrower, in which case the result of this Step is the same as the result of Step 1.
3	Calculate the maximum potential guaranty on the portion of the loan arrived at in Step 2 (as if that portion was the total loan). Use the maximum guaranty table in section 4 of chapter 3 of this handbook.
4	VA will guarantee the lesser of: • the maximum potential guaranty amount arrived at in Step 3, or • the combined available entitlement of all veteran-borrowers.
5	VA makes a charge to the veteran-borrower's available entitlement in the amount of the guaranty. If more than one veteran is involved, VA divides the entitlement charge equally between them if possible. If only unequal entitlement is available, unequal charges may be made with the written agreement of the veterans.

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1. Joint Loans, Continued

j. Examples

Veteran/Nonveteran Loans

Borrowers and Available Entitlement	Total Loan Amount	Vet's Portion	Maximum Potential Guaranty on Vet's Portion	Entitlement Charge ------------ T=Total
Vet $36,000 Nonvet $0	$100,000	$ 50,000	$22,500	$22,500
Vet $36,000 Nonvet $0	$290,000	$145,000	$36,250	$36,250
Vet $27,500 Vet $36,000 Nonvet $0	$108,000	Total for both vets $72,000	Total for both vets $28,800	$14,400 $14,400 T=$28,800
Vet $25,000 Vet $11,000 Nonvet $0	$201,000	Total for both vets $134,000	$36,000	$25,000 $11,000 T=$36,000

Note: The last example would require a written agreement from the veterans to make unequal charges to their entitlement.

Quick Reference For Calculation Used	
Step	**Action**
1	Divide the total loan amount by the number of borrowers.
2	Multiply the result by the number of veterans using entitlement.
3	Calculate the maximum potential guaranty on the portion of the loan arrived at in Step 2, using the maximum guaranty table in chapter 3.
4	VA will make a charge to entitlement up to the amount arrived at in Step 3. • VA will divide the charge equally between multiple veterans if possible. • If Step 2 is greater than $144,000, additional entitlement may be added to each veteran's entitlement.

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1. Joint Loans, Continued

k. How to Calculate Guaranty and Entitlement Use on Two Veteran Joint Loans

As with a non-joint loan, the potential maximum guaranty on a joint loan is calculated based on the total loan amount.

l. Procedure

VA calculates the guaranty as described in the following table.

Step	Action
1	Calculate the maximum potential guaranty on the total loan amount. Use the maximum guaranty table in chapter 3.
2	VA will guarantee the lesser of: • the maximum potential guaranty amount arrived at in Step 1, or • the combined available entitlement of all veteran-borrowers. If the loan amount is greater than $144,000, additional entitlement may be added to each veteran's entitlement. If possible, VA will use this additional entitlement to arrive at equal entitlement charges for the veterans involved.
3	VA will make charges to the veterans' available entitlement which total the maximum guaranty arrived at in Step 1, or the total of their available entitlement if less than the maximum potential guaranty. VA will divide the entitlement charge equally between the veterans if possible, or, if only unequal entitlement is available, unequal charges may be made with the veterans' written agreement. ***Exception***: VA will make the entitlement charge for husband and wife veterans according to their preference.

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1. Joint Loans, Continued

m. Examples

Two Veteran Joint Loans

Veterans and Available Entitlement	Total Loan Amount	Maximum Potential Guaranty	Total Entitlement Charge Per Vet
Vet 1 $36,000 Vet 2 $36,000	$100,000	$36,000	$18,000 $18,000
Vet 1 $23,500 Vet 2 $ 8,500	$ 80,000	$32,000	$23,500 $ 8,500
Vet 1 $36,000 Vet 2 $36,000	$300,000	$75,000	$37,500 $37,500
Vet 1 $15,000 Vet 2 $20,000	$203,000	$50,750	$25,375 $25,375
Vet 1 $0 Vet 2 $0 Vet 3 $ 6,500	$300,000	$75,000	$25,000 $25,000 $25,000

Note: A written agreement from the veterans is required whenever there is unequal entitlement usage.

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1. Joint Loans, Continued

n. Certificate of Commitment

For joint loans involving one or more nonveterans:

- the loan amount shown on the commitment is limited to the veteran's portion of the loan, and
- the percent of guaranty is based on the ratio of the amount of entitlement the veteran has available to the veteran's portion of the loan.

VA will issue the Certificate of Commitment with a reminder that:

- no part of the guaranty applies to the portion of the loan allocated to the nonveteran, and
- in the event of foreclosure where a loss is sustained, the holder must absorb any loss attributable to the nonveteran's portion of the loan.

o. Loan Guaranty Certificate (LGC)

The "Amount of Loan" reflects **only** the veteran's portion of the loan.

If more than one veteran used entitlement on the loan, it will reflect the total of **all** portions allocable to those veterans.

For veteran/nonveteran joint loans, the LGC will contain the statement, "The amount of guaranty on this loan is limited to the veteran's portion of the loan."

The lender must satisfy itself that the requirements of its investor or the secondary market can be met with this limited guaranty.

Whereas the whole loan amount will appear on the mortgage security documents; that is, mortgage note or deed of trust, only the veteran's portion is shown on the Certificate of Commitment and the LGC.

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1. Joint Loans, Continued

p. Equal Credit Opportunity Act Considerations (ECOA)

The applicability of the guaranty to only a portion of the loan in the case of a veteran/nonveteran joint loan may cause a lender to refuse to accept an application for such loan.

This may appear to conflict with the ECOA prohibition against discrimination based on marital status, however, the lender may refuse the application under these circumstances without violating ECOA.

This is based on an exemption for VA being a special purpose credit program.

q. Calculation of the Funding Fee

Apply the appropriate funding fee percentage to any portion of the loan allocable to a veteran using his or her entitlement who is not exempt from the funding fee. Determine the appropriate percentage for the type of veteran involved from the funding fee tables in section 8 of chapter 8.

Example: On a no-downpayment loan to three veterans; one a first-time homebuyer, one a subsequent user, and one a first-time reservist; funding fee percentages of 2.15 percent, 3.3 percent, and 2.4 percent, respectively, would each be applied to one-third of the loan amount.

No funding fee will be assessed on any portion of a joint loan allocable to:

- a nonveteran,
- a veteran who did not use his or her entitlement, or
- a veteran who used his or her entitlement, but is exempt from the funding fee.

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1. Joint Loans, Continued

q. Calculation of the Funding Fee (continued)

Downpayment: The actual loan amount is allocated equally between the borrowers for purposes of calculating the funding fee, whether or not a downpayment is made, and regardless of where the funds for such a downpayment come from.

Example: On a veteran/nonveteran loan, the nonveteran makes a $5,000 (five percent) downpayment out of his cash resources, to purchase a $100,000 property, resulting in a $95,000 loan amount. The veteran is a first-time homebuyer. The veteran must pay a funding fee of $712.50, based on 1.5 percent of his/her $47,500 portion.

If situations arise which are not addressed here, contact VA for assistance.

2. Construction/Permanent Home Loans

Change Date

November 8, 2012, Change 21
- This section has been updated to make minor grammatical edits.

a. The Basics

VA will guarantee a "construction/permanent home loan," that is, a loan to finance the construction/purchase of a residence. The loan is closed prior to the start of construction with proceeds disbursed to cover the cost of, or balance owed on, the land, and the balance into escrow. The escrowed monies are paid out to the builder during construction.

The lender must obtain written approval from the borrower before each draw payment is provided to the builder.

This section does not address other construction loans guaranteed by VA; that is, those for the purchase of a residence newly constructed for the veteran by a builder who financed the construction from his or her own resources.

b. Amortization

The veteran begins making payments on a construction/permanent home loan **only** after construction is complete. Therefore, the initial payment on principal may be postponed up to 1 year if necessary. The loan must be amortized to achieve full repayment within its remaining term.

Example: If it takes 6 months to complete construction, the payment schedule for the veteran obtaining a 30-year mortgage must provide for full repayment of the loan in 29 years and 6 months.

Rather than requiring a balloon payment, it may be preferable to set up equal payments (beginning after construction is complete) which are large enough to repay the loan within the original maturity without a balloon payment.

The VA requirement that loans be amortized with approximately equal payments and the principal must be reduced at least once annually, also applies to construction loans. However, the final installment may be for an amount up to five percent of the original principal amount of the loan.

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2. Construction/Permanent Home Loans, Continued

c. What the Builder Must Pay

On a construction/permanent home loan, the builder is responsible for:

- interest payments during the construction period, and
- all fees normally paid by a builder who obtains an interim construction loan including, but **not** limited to:
  - inspection fees,
  - commitment fees,
  - title update fees, and
  - hazard insurance during construction.

d. Interest Rate

The permanent mortgage loan interest rate is established at closing.

Lender's may offer a "ceiling-floor" where the veteran "floats" the interest rate during construction. The agreement must provide that at lock-in, the permanent interest rate will not exceed a specific maximum interest rate yet also permit the borrower to lock-in at a lower rate based on market fluctuations.

Note: The borrower must qualify for the mortgage at the maximum rate.

e. What Fees the Veteran Can Pay

The veteran may **not** pay any fees that are the builder's responsibility. Fees the veteran can pay are described in chapter 8.

f. Funding Fee and Loan Reporting

The funding fee is due and payable to VA within 15 days of loan closing; that is, it is **not** tied to the commencement or completion of construction. The loan must be reported to VA within 60 days of receipt of a clear final compliance inspection report.

g. LGC

Although the loan will normally be considered guaranteed upon closing, the LGC on a construction/permanent home loan will not be issued until a clear final compliance inspection report has been received by VA.

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2. Construction/Permanent Home Loans, Continued

h. If Loan Proceeds Are Not Fully Disbursed

If construction is not fully completed and loan proceeds are not fully disbursed, guaranty will apply **only** to the proper pro rata part of the loan. To calculate the proper pro rata part of the loan:

- take loan proceeds disbursed for construction purposes,
- add any other payments made to the builder by or on behalf of the veteran,
- take the lesser of the above total or 80 percent of the value of that portion of the construction actually completed, and
- add any loan disbursements made for the purchase of the land on which the construction is situated.

3. Energy Efficient Mortgages (EEMs)

Change Date

November 8, 2012, Change 21
- This section has been updated to make minor grammatical edits.

a. What are EEMs?

EEMs are loans to cover the cost of making energy efficiency improvements to a dwelling. They can be made in conjunction with:

- a VA loan for the purchase of an existing dwelling, or
- a VA refinancing loan secured by the dwelling.

Acceptable energy efficiency improvements include, but are not limited to:

- solar heating systems, including solar systems for heating water for domestic use,
- solar heating and cooling systems,
- caulking and weather-stripping,
- furnace efficiency modifications limited to replacement burners, boilers, or furnaces designed to reduce the firing rate or to achieve a reduction in the amount of fuel consumed as a result of increased combustion efficiency, devices for modifying flue openings which will increase the efficiency of the heating system, and electrical or mechanical furnace ignition systems which replace standing gas pilot lights,
- clock thermostats,
- new or additional ceiling, attic, wall and floor insulation,
- water heater insulation,
- storm windows and/or doors, including thermal windows and/or doors,
- heat pumps, and
- vapor barriers.

b. Requirements

Funds for energy efficiency improvements are considered part of the total loan, which must be secured by a first lien.

If the labor is to be performed by the veteran, the loan increase will be limited to the amount necessary to pay for materials.

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3. Energy Efficient Mortgages (EEMs), Continued

b. Requirements (continued)

A loan for an existing property may be increased by up to $6,000 for energy efficiency improvements at the option of the lender and veteran at any time up to loan closing without VA's prior approval.

The lender must determine that the proposed weatherization and/or energy conservation improvements are reasonable for the particular property. The lender must evaluate the veteran's ability to pay the increased loan payments caused by the addition of energy efficiency improvements.

For energy efficiency improvements that will increase a loan amount by more than $6,000, the amount of the increase must be supported by an increased valuation in an equal amount.

c. Borrower Notice on the Notice of Value (NOV)

Information on EEMs is provided to a veteran who applies for a loan which requires an NOV (a loan for a home purchase or cash-out refinance). The NOV includes the following notice to the veteran:

"The buyer may wish to contact a qualified person/firm for a home energy audit to identify needed energy efficiency improvements to the property. In some localities, the utility company may perform this service. The mortgage amount may be increased as a result of making energy efficiency improvements such as: Solar or conventional heating/cooling systems, water heaters, insulation, weather-stripping/caulking, and storm windows/doors. Other energy related improvements may also be considered."

The mortgage may be increased by:

- up to $3,000 based solely on the documented costs,
- up to $6,000 provided the increase in monthly mortgage payment does not exceed the likely reduction in monthly utility costs, or
- more than $6,000 subject to a value determination by VA.

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3. Energy Efficient Mortgages (EEMs), Continued

d. Underwriting Considerations

Energy efficiency improvements up to $3,000*:*
The resulting increase in loan payments will normally be offset by a reduction in utility costs.

Energy efficiency improvements more than $3,000, up to $6,000*:*
The lender must make a determination that the increase in monthly mortgage payments does not exceed the likely reduction in monthly utility costs. Rely on locally available information provided by utility companies, municipalities, state agencies or other reliable sources, and document the determination.

Energy efficiency improvements over $6,000*:*
Lenders should exercise discretion and consider:

- whether the increase in monthly mortgage payments exceeds the likely reduction in monthly utility costs, and
- whether the veteran's income is sufficient to cover the higher loan payment.

A VA Certificate of Commitment issued before the decision to make energy efficiency improvements over $6,000 must be returned to VA for a determination that the applicant still qualifies.

Energy efficiency improvements in conjunction with an Interest Rate Reduction Refinancing Loan (IRRRL):
If the monthly payment (Principal, Interest, Taxes, and Insurance (PITI)) for the new loan exceeds the PITI of the loan being refinanced by 20 percent or more, the lender **must** certify to having determined that the veteran qualified for the higher payment.

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3. Energy Efficient Mortgages (EEMs), Continued

e. Documentation Required with Closed Loan Package

Energy efficiency improvements up to $3,000:
Evidence of the cost of improvements such as a copy of the bid(s) or contract itemizing the improvements and their cost.

Improvements more than $3,000, up to $6,000:
Evidence of the cost of improvements such as a copy of the bid(s) or contract itemizing the improvements and their cost, and the lender's determination that the increase in monthly mortgage payments does not exceed the likely reduction in monthly utility costs.

Improvements over $6,000:
Documentation of VA's valuation of the energy efficiency improvements, and for prior approval loans, the Certificate of Commitment must reflect the additional amount.

IRRRL with significant increase in payments:
If the cost of the improvements causes the new loan payment (PITI) to be 20 percent or more higher than the old payment (on the loan being refinanced), then include the lender's certification that it has determined that the veteran qualified for the higher payment.

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3. Energy Efficient Mortgages (EEMs), Continued

f. How to Calculate Guaranty and Entitlement Use

Guaranty is calculated on an energy efficient mortgage as described in the following table.

Step	Action
1	Calculate guaranty on the loan **without** the portion attributable to the energy efficiency improvements.
2	Calculate guaranty on the energy efficiency improvements portion by applying the same percentage used in Step 1.
3	Add the results of Steps 1 and 2 to arrive at guaranty on the entire loan.

However, the veteran's entitlement will **only** be charged the amount arrived at in Step 1; it is based upon the loan amount **before** adding the cost of the energy efficiency improvements.

***Example* 1**: If a veteran has full entitlement and applies for a loan of $80,000, plus $6,000 in energy efficiency improvements, VA will guarantee 40 percent of the full loan amount of $86,000. Thus, the dollar amount of the guaranty will be $34,400, even though the charge to the veteran's entitlement is only $32,000.

***Example* 2**: If a veteran with full entitlement applies for a $144,000 loan to purchase a home, and adds $6,000 in energy efficiency improvements, the 25 percent guaranty on the loan will only require the use of $36,000 entitlement, but the dollar amount of guaranty will be $37,500.

g. How to Calculate the Funding Fee

Calculate the funding fee based on the full loan amount including the cost of the energy efficiency improvements.

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3. Energy Efficient Mortgages (EEMs), Continued

h. Improvements Not Completed Before Closing

If the energy efficiency improvements are not completed before closing, the lender may establish an escrow or earmarked account and close the loan.

- A formal escrow is not required.
- Only the amount needed to complete the improvements must be withheld.
- Check the appropriate block in item 23, VA Form 26-1820, Report and Certification of Loan Disbursement.
- No additional documentation concerning the escrowed/earmarked funds must be submitted when reporting the closed loan.

Generally, the improvements should be completed within 6 months from the date of loan closing.

- Provide written notification to VA when improvements are completed and the escrow funds are disbursed, and
- assure the funds are properly applied to the costs of improvements.

If, after a reasonable time, the lender determines that the improvements will not be completed:

- apply the balance of the escrowed/earmarked funds to reduce the principal balance on the loan, and
- provide written notification to VA that this has been done.

i. Reimbursement to the Veteran out of IRRRL Proceeds

The veteran generally may not obtain cash proceeds from an IRRRL.

Note: There is **one** exception. Up to $6,000 of IRRRL loan proceeds may be used to reimburse the veteran for the cost of energy efficiency improvements completed within the 90 days immediately preceding the date of the loan.

4. Loans for Alteration and Repair

Change Date

April 1, 2010, Change 12

- This section has been updated to make minor grammatical edits.

a. Description

VA may guarantee a loan for alteration and repair:

- of a residence already owned by the veteran and occupied as a home, or
- made in conjunction with a purchase loan on the property.

The alterations and repairs must be those ordinarily found on similar property of comparable value in the community.

b. Value Considerations

The cost of alterations and repairs to structures may be included in a loan for the purchase of improved property to the extent that their value supports the loan amount.

5. Supplemental Loans

Change Date

November 8, 2012, Change 21
- This section has been updated to make minor grammatical edits.

a. What is a Supplemental Loan?

A supplemental loan is a loan for the alteration, improvement, or repair of a residential property. The residential property must:

- secure an **existing** VA-guaranteed loan, and
- be owned and occupied by the veteran, or the veteran will reoccupy upon completion of major alterations, repairs, or improvements.

The alterations, improvements, or repairs must:

- be for the purpose of substantially protecting or improving the basic livability or utility of the property, and
- be restricted primarily to the maintenance, replacement, improvement or acquisition of real property, including fixtures.

Installation of features such as barbecue pits, swimming pools, etc., does not meet this requirement.

No more than 30 percent of the loan proceeds may be used for the maintenance, replacement, improvement, repair, or acquisition of nonfixtures or quasi-fixtures such as refrigeration, cooking, washing, and heating equipment. The equipment must be related to or supplement the principal alteration for which the loan is proposed.

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5. Supplemental Loans, Continued

b. Required Lien and Maximum Loan Term

It is the lender's responsibility to obtain an effective lien of the required dignity.

Possible methods to secure a supplemental loan are:

- through an open end provision of the instrument securing the existing loan,
- through an amendment of the existing loan security instrument,
- by taking a new lien to cover both the existing and the supplemental loans, or
- by taking a separate lien immediately junior to the existing lien.

The maximum loan term is:

- 30 years if amortized, or
- 5 years if not amortized.

c. Other Requirements

The existing loan must be current with respect to taxes, insurance, and amortized payments, and must not otherwise be in default **unless** a primary purpose of the supplemental loan is to improve the ability of the borrower to maintain the loan obligation.

The making of a supplemental loan can never result in any increase in the rate of interest on the existing loan.

A supplemental loan to be written at a higher rate of interest than that payable on the existing loan must be evidenced by a separate note from the existing loan.

d. Prior Approval or Automatic Loan Closing

A supplemental loan will require the prior approval of VA if:

- the loan will be made by a lender who is not the holder of the currently guaranteed obligation,
- the loan is to be made by a lender that does not have authority to close loans on an automatic basis, or
- an obligor liable on the currently outstanding obligation will be released from personal liability by operation of law or otherwise.

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5. Supplemental Loans, Continued

e. Procedures

Submit a statement describing the alterations, improvements, or repairs made or to be made with the prior approval application (or loan closing package, if closed automatically). In addition, report the amount outstanding on the existing loan as of the date of closing of the supplemental loan in the loan closing package.

If the cost of the repairs, alterations, or improvements exceeds $3,500:
A NOV and compliance inspections are required.

If the cost of the repairs, alterations, or improvements does not exceed $3,500:
An NOV and compliance inspections are not required. Instead, a statement of reasonable value may be submitted. The statement must be completed and signed by a VA-designated appraiser. A VA-designated appraiser is an individual nominated by the lender (who may be an officer, trustee, or employee of the lender or its agent) who has been approved by the local VA office. The statement must specify:

- the work done or to be done,
- the purchase price or cost of the work and material, and
- that the purchase price or cost does not exceed the reasonable value.

In lieu of VA compliance inspections, the lender must submit a certification as follows:

"The undersigned lender certifies to the Department of Veterans Affairs that the property as repaired, altered, or improved has been inspected by a qualified individual designated by the undersigned, and based on the inspection report, the undersigned has determined that the repairs, alterations, or improvements financed with the proceeds of the loan described in the attached VA Form 26-1820, appear to have been completed in substantial conformance with related contracts."

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5. Supplemental Loans, Continued

f. Guaranty and Entitlement

If the supplemental loan will not be consolidated with a related outstanding guaranteed loan:

- the veteran must have sufficient entitlement for the new loan, and
- VA will issue a new LGC solely for supplemental loans.

If the supplemental loan will be consolidated with a related outstanding guaranteed loan, VA will issue a new modified guaranty certificate.

g. Procedure

If the veteran has no available entitlement, VA can still guarantee the supplemental loan provided the lender is the holder of the veteran's existing loan and the loans are to be consolidated.

The amount of the modified guaranty will be the maximum guaranty effective on the existing loan at the time the supplemental loan is closed.

To calculate the percentage of guaranty applicable to the combined indebtedness take the result of Step 1, and divide by the result of Step 3.

Follow the steps in the table below to calculate the percentage of guaranty applicable to the combined indebtedness.

Step	Action
1	Take the balance of the existing loan at the time of closing of the supplemental loan and multiply by the percentage of guaranty for the existing loan, as shown on the guaranty certificate.
2	Calculate the amount of guaranty that would be issued on the supplemental loan as an independent loan (do not exceed the amount of entitlement available to the veteran).
3	Take the balance of the existing loan and add the amount of the supplemental loan.
4	Take the result of Step 1 above and add the result of Step 2 above.
5	Divide by the result of Step 3 above.

6. Adjustable Rate Mortgages (ARMs)

Change Date

November 8, 2012, Change 21

- This section has been updated to note that VA's authority to guarantee ARMs and Hybrid ARMs is now permanent.

a. Definition of ARMs

The Honoring America's Veterans and Caring for Camp Lejeune Families Act of 2012 made permanent VA's authority to guarantee ARMs and Hybrid ARMs.

An ARM loan offers more flexible interest rates based on negotiated initial fixed interest rates coupled with periodic adjustments to the interest rate over time. Hybrid ARMs have longer initial fixed rates of 3, 5, 7, or 10 years, while a "traditional" ARM allows for an annual adjustment after 1 year.

b. Interest Rate Adjustments

Traditional ARMs:
Interest rate adjustments occur on an annual basis. The annual interest rate adjustments are limited to a maximum increase or decrease of one percentage point. Additionally, interest rate increases are limited to a maximum of five percentage points over the life of the loan.

Hybrid ARMs:
If the initial contract interest rate remains fixed for less than 5 years, the initial adjustment is limited to a maximum increase or decrease of one percentage point and the interest rate increase over the life of the loan is limited to five percentage points.

If the initial contract interest rate remains fixed for 5 years or more, the initial adjustment will be limited to a maximum increase or decrease of two percentage points and the interest rate increase over the life of the loan will be limited to six percentage points.

***Note*:** After the initial interest rate adjustment, annual adjustments may be up to two percentage points.

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6. Adjustable Rate Mortgages (ARMs), Continued

c. Underwriting an ARM

ARM loans that may adjust after 1 year **MUST** be underwritten at one percentage point above the initial rate.

Hybrid ARMs with a fixed period of 3 or more years may be underwritten at the initial interest rate.

7. Graduated Payment Mortgages (GPMs)

Change Date

November 8, 2012, Change 21
- This section has been updated to make minor grammatical edits.

a. Description

A GPM is a mortgage with the following amortization features:

- lower initial monthly payments than payments on a comparable mortgage under the standard amortization plan,
- periodic (normally annual) increases in the monthly payment by a fixed percentage for a stated "graduation period," and
- monthly payments that level off after the graduation period and remain the same for the duration of the loan.

Note: The payments after the leveling off period are higher than payments on a comparable mortgage under the standard amortization plan.

The method used to achieve this involves deferring a portion of the interest due on the loan each month during the graduation period and adding that interest to the principal balance. This **decreases** the monthly payments during the graduation period, and **increases** the outstanding principal balance during the graduation period, creating "negative amortization."

b. Acceptable Use of GPMs

GPMs should be used as an alternative for qualified veterans whose income:

- is expected to increase at a rate which can accommodate the increase in monthly payments, or
- is currently sufficient to accommodate the higher GPM payments after the leveling off period.

GPMs should **not** be used as a tool to qualify veterans who cannot qualify for loans under the standard amortization plan **unless** their income can reasonably be expected to increase at a rate which can accommodate the increase in monthly payments.

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7. Graduated Payment Mortgages (GPMs), Continued

b. Acceptable Use of GPMs (continued)

A GPM may be used **only** to acquire a single-family dwelling unit (but **not** a manufactured home) and can include funds for energy efficiency improvements.

A GPM may **not** be used for a refinancing loan, alteration, repair, or improvement only purposes, or to acquire a multiple unit dwelling.

c. Maximum Loan Amount and Downpayment Required

Existing properties:
The principal amount of the loan may **never** exceed the initial reasonable value of the property (the value indicated on the NOV used for loan closing).

- Since the principal balance increases during the initial years of the loan, a loan made for the full amount of reasonable value would violate this provision.
- Therefore, a downpayment is required to keep the principal balance from **ever** exceeding the initial reasonable value of the property.

To calculate the maximum initial loan amount and the required downpayment, use the Department of Housing and Urban Development's (HUD) tables for Plan III Section 245 GPMs showing outstanding principal balance factors and monthly installment amounts per $1,000 of original loan proceeds. The factors vary according to the interest rate on the loan.

Note: These tables are available on diskette through HUD offices.

Determine the maximum initial loan amount as follows:

Initial reasonable value of the property
÷
Highest outstanding principal balance factor per $1,000 of original loan proceeds for the particular interest rate (from the HUD tables)
x
1,000

The difference between this maximum initial loan amount and the initial reasonable value of the property is the amount of downpayment required.

Continued on next page

7. Graduated Payment Mortgages (GPMs), Continued

c. Maximum Loan Amount and Downpayment Required (continued)

New construction or existing homes not previously occupied:
The initial loan amount may not exceed the lesser of the purchase price or 97.50 percent of the initial reasonable value of the property. A downpayment will be required to cover the difference between the reasonable value and the initial loan amount.

The principal amount of the loan thereafter (including the amount of all interest deferred and added to principal, but not including any amount attributable to the funding fee or energy efficiency improvements) may not be scheduled to exceed the projected value of the property at any time.

Calculate the projected value of the property by increasing the reasonable value of the property from the time the loan is made at a rate not in excess of 2.5 percent per year, but never to exceed 115 percent of the initial reasonable value.

Downpayment:
- The amount required depends upon whether the dwelling is new or existing. (See above.)
- The veteran may choose to pay a higher downpayment to offset the negative amortization.
- The downpayment must be paid in cash from the veteran's own resources.

Impact of interest rate increase on loans in process:
Any increase in the interest rate requires recalculation of the maximum loan amount, downpayment, and payment schedule.

Funding fee and energy efficiency improvements:
The initial loan amount may be increased by the amount of the VA funding fee, if financed in the loan, and the cost of any energy efficiency improvements.

d. Amortization

Loan payments increase each year at a rate of 7.5 percent per year for the first 5 years. At the beginning of the sixth year, the payments become level for the remaining term. This amortization plan is similar (except for the "minimum cash investment" requirement) to HUD's GPM Plan III under Section 245 of the National Housing Act.

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7. Graduated Payment Mortgages (GPMs), Continued

e. How to Calculate Monthly Installments

Perform the necessary calculations using HUD tables for Plan III Section 245 GPMs showing outstanding principal balance factors and monthly installment amounts per $1,000 of original loan proceeds. The factors vary according to the interest rate on the loan.

Determine the monthly installment amounts as follows:

Number of thousands of dollars in the original loan amount (including the VA funding fee, if financed, and the cost of any energy efficiency improvements)
x
Monthly installment factor per $1,000 of original loan proceeds for the particular interest rate from the HUD tables (Different factors are provided for each of years 1 through 5, and year 6 and beyond.)

f. Annual Percentage Rate (APR) Calculation

HUD's GPM APR tables may **not** be used for VA purposes because they include an adjustment for the HUD mortgage insurance premium.

g. Underwriting Considerations

If there are strong indications that the applicant's income can reasonably be expected to keep pace with the increases in the monthly mortgage payment then:

- analyze the adequacy of the applicant's income, and
- complete VA Form 26-6393, Loan Analysis, using only the first year's mortgage payment in monthly shelter expenses.

However, if such strong indications are absent then:

- analyze the adequacy of the applicant's income, and
- complete VA Form 26-6393 using the payment which would apply if the loan was under the standard amortization plan.

The lower initial payments of the GPM can be considered a compensating factor, if appropriate.

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7. Graduated Payment Mortgages (GPMs), Continued

h. Veteran's Statement

The following statement must be signed by the veteran and submitted with each prior approval application or automatic loan report involving a VA GPM:

"I fully understand that because of the graduated-payment loan obligation I am undertaking, my mortgage payment excluding taxes and insurance will start at $________ and will increase by 7.5 percent each year for 5 years to a maximum payment of $_________ , and the mortgage balance will increase to no more than $_________ at the end of the _____ year. The maximum total amount by which the deferred interest will increase the principal is $________. Monthly installments will be due according to the following schedule:

- $__________ during the first year of the loan
- $__________ during the second year of the loan
- $__________ during the third year of the loan
- $__________ during the fourth year of the loan
- $__________ during the fifth year of the loan
- $__________ during the sixth year of the loan and every year thereafter."

If the interest rate increases after the veteran has signed the initial statement, an amended statement must be prepared and signed by the veteran before loan closing, and included with the loan closing package.

i. Other Requirements

The property securing the loan must have a remaining economic life of at least 30 years, as shown on the NOV.

While a GPM cannot be used to refinance another loan, a GPM can be refinanced by a fixed rate VA-guaranteed refinancing loan.

8. Growing Equity Mortgages (GEMs)

Change Date

April 1, 2010, Change 12

- This section has been updated to make minor grammatical edits.

a. Description

A GEM has gradually increasing monthly payments, with all of the increase applied to the principal balance. Compared to the standard amortization plan, GEMs have a faster accumulation of equity and earlier loan payoff.

GEM amortization plans are generally acceptable for VA loan purposes.

b. Amortization Examples

The initial payment on a GEM is typically based on what the payment would be for a 30-year mortgage under the standard amortization plan. Payment increases can be fixed or tied to an index.

***Example* 1**: Monthly payments are increased by three percent each year for the first 10 years. The payments level off in the eleventh year and remain constant through loan payoff. Loan payoff may occur within a few years of the leveling off of the payment, depending upon interest rate.

***Example* 2**: The increases in the monthly payments are based on a percentage of a Department of Commerce index that measures per capita, after-tax disposable personal income in the United States.

c. Underwriting

The lender must determine that the applicant's income can reasonably be expected to keep pace with the increases in the monthly mortgage payment.

9. Loans Involving Temporary Interest Rate Buydowns

Change Date

April 1, 2010, Change 12

- This section has been updated to correct hyperlinks and to make minor grammatical edits.

a. Description

As a marketing tool, builders, sellers, or lenders will sometimes establish and fund escrows to temporarily reduce a borrower's loan payments during the initial years of the mortgage. The borrower may also fund such an escrow for herself/himself as a financial management tool.

VA will guaranty loans involving temporary interest rate buydowns, if otherwise eligible.

A temporary interest rate buydown can be used in conjunction with **any** type of VA-guaranteed loan except a GPM.

b. Escrow Requirements

Funds must be safely escrowed with an independent third-party escrow agent beyond the reach of prospective creditors of the builder, seller, lender, and the borrower.

Exception: If the Federal National Mortgage Association is the holder, it may take custody of the funds.

The escrow agent must make payments directly to the lender or servicer. The funds may be used **only** for payments due on the note. The funds may **not** be used to pay past due monthly loan payments. If the loan is foreclosed or prepaid, the funds must be credited against the veteran's indebtedness.

Escrowed funds may **not** revert to the party that established the escrow. If the property is sold subject to, or on an assumption of the loan, the escrow must continue to pay out on behalf of the new owner.

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9. Loans Involving Temporary Interest Rate Buydowns,
Continued

c. If Borrower's Income is Expected to Keep Pace with Payment Increases

The loan application may be underwritten based on the first year's payment amount if there are strong indications that the income used to support the application will increase to cover the yearly increases in loan payments.

- Routine cost of living increases **cannot** be used for this purpose.
- Increases resulting from confirmed future promotions or wage percentage increases guaranteed by labor contracts (for example, teachers, auto workers) may be given favorable consideration.

The assistance payments must run for a minimum of 1 year. Scheduled reductions in the assistance payments must occur annually on the anniversary of the first mortgage payment.

The reduction in the assistance payments may be accomplished through annual payment increases in equal or approximately equal amounts, or equal annual increases in the interest rate.

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9. Loans Involving Temporary Interest Rate Buydowns, Continued

d. If it is Unclear Whether Borrower's Income Can Keep Pace with Increases

The loan application must be underwritten based on the **full** payment amount if there are no strong indications that the income used to support the application can reasonably be expected to keep pace with the increases in loan payments.

The buydown arrangement can be considered a compensating factor.
If the residual income and/or debt-to-income ratio is marginal, the buydown plan (used to offset a short-term debts), along with other compensating factors, may support approval of the loan. See "Compensating Factors" in section 10 of chapter 4.

Provide a statement signed by the underwriter giving reasons for approval.

The terms of the buydown arrangement are **not** limited to specific criteria such as a minimum or maximum number of years for application of the assistance payments.

It is the lender's responsibility to review and determine the acceptability of the buydown.

e. Other Requirements

Lenders must provide the veteran-borrower with a clear, written explanation of the buydown agreement.

A copy of the buydown and escrow agreements must accompany the loan submission.

10. Farm Residence Loans

Change Date

May 21, 2012, Change 20
- This section has been updated to make minor grammatical edits.

a. Eligibility

A loan for the purchase, construction, repair, alteration, or improvement of a farm residence which is occupied or will be occupied by the veteran as a home is eligible for guaranty.

The loan cannot cover:

- the nonresidential value of farm land in excess of the homesite,
- the barn, silo, or other outbuildings necessary to the operation of the farm, or
- farm equipment or livestock.

A portion of the proceeds of a loan to construct a farm residence on encumbered land owned by the veteran may be used to pay off the lien or liens on the land **only if** the reasonable value of the land is at least equal to the amount of the lien(s).

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10. Farm Residence Loans, Continued

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b. Underwriting

If some or all of the income necessary to support the loan payments comes from farming operations, the veteran's ability and experience as a farm operator must be established. The procedures and analysis provided under "Self-Employment Income" in section 2 of chapter 4 apply generally. In addition, apply the following:

New farmer or new farm operation:
Obtain the following:

- The veteran's proposed plan of operation of the farm, showing the number of acres for each crop, amount of livestock, etc., upon which an estimate of income and expenses may be made.
- The veteran's statement that he or she owns or proposes purchasing the farm equipment required to operate the farm. If additional indebtedness is to be incurred in the purchase of this equipment, the statement should contain full details as to repayment terms, etc.
- An estimate of farm income and expenses by a local farm appraiser designated by VA or another qualified person, or the estimate used by a lender that has agreed to carry an operating line of credit for the veteran. The estimate should be based on the veteran's proposed plan of operation, his or her ability and experience, and the nature and condition of the farm to be sold, including livestock and livestock products. The expense estimate must detail labor, seed, fertilizer, taxes and insurance, repairs, machinery, fuel, etc.
- A copy of a commitment from a lender for an operating line of credit or evidence of the resources to be used to cover operating expenses.

Experienced farmer continuing same farm operation:
If the veteran finances operations out of an operating line of credit, obtain records of advances from, payments to, and carryover balances on the operating line of credit for the last 3 years (or additional periods if needed to demonstrate stability of veteran's operation). Analyze the reasons for any build-up of operating debt.

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11. Loans for Manufactured Homes Classified as Real Estate

Change Date

May 21, 2012, Change 20
- This section has been updated to make minor grammatical edits.

a. How to Begin

This section only addresses manufactured homes which are, or will be, permanently affixed to a lot **and** considered real estate under state law.

Lenders considering making a loan involving a manufactured home that is **not** permanently affixed should contact the local VA office for processing instructions.

b. Allowable Loan Purposes and Calculation of Maximum Loan Amount

Permanently affixed manufactured home loans can be made for any of the allowable loan purposes listed in the table below. Loan specifications and treatment of these loans are virtually the same as for any other VA-guaranteed home loans from a loan processing standpoint, except for calculation of the maximum loan amount.

The following table provides the methods for calculating maximum loan amount.

Allowable Loan Purpose	Maximum Loan The loan amount is limited to:
To purchase a manufactured home to be affixed to a lot already owned by the veteran.	The lesser of: • the sum of the purchase price plus the cost of all other real property improvements, or • the total reasonable value of the unit, lot, and real property improvements, plus • the VA funding fee.

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11. Loans for Manufactured Homes Classified as Real Estate, Continued

b. Allowable Loan Purposes and Calculation of Maximum Loan Amount (continued)

Allowable Loan Purpose	**Maximum Loan** **The loan amount is limited to:**
To purchase a manufactured home and a lot to which it will be affixed.	The lesser of: • the total purchase price of the manufactured home unit and the lot plus the cost of all other real property improvements, or • the purchase price of the manufactured home unit plus the cost of all other real property improvements plus the balance owed by the veteran on a deferred purchase money mortgage or contract given for the purchase of the lot, or • the total reasonable value of the unit, lot, and property improvements, plus • the VA funding fee.
To refinance an existing loan on a manufactured home and purchase the lot to which the home will be affixed.	The lesser of: • the sum of the balance of the loan being refinanced plus the purchase price of the lot, not to exceed its reasonable value plus the costs of the necessary site preparation as determined by VA plus a reasonable discount on that portion of the loan used to refinance the existing loan on the manufactured home plus authorized closing costs, or • the total reasonable value of the unit, lot, and real property improvements, plus • the VA funding fee.

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11. Loans for Manufactured Homes Classified as Real Estate, Continued

b. Allowable Loan Purposes and Calculation of Maximum Loan Amount (continued)

Allowable Loan Purpose	**Maximum Loan** **The loan amount is limited to:**
An IRRRL to refinance an existing VA loan on a permanently affixed manufactured home and lot.	The sum of: • the balance of the VA loan being refinanced, plus • allowable closing costs, plus • up to two discount points, plus • the VA funding fee. ***Note***: This is the only type of permanently affixed manufactured home loan that does not require full underwriting and an appraisal. The provisions applicable to IRRRLs apply (See chapter 6) except the term of the loan may be as long as 30 years and 32 days.

12. Loans to Native American Veterans on Trust Lands

Change Date

April 1, 2010, Change 12

- This section has been changed to make minor grammatical edits.

a. General

VA can guarantee loans to Native American veterans on trust land. Lenders have shown little interest in making these loans because of difficulties obtaining titles to properties on trust land in the event of foreclosure.

VA does have a Native American Direct Loan Program. Lenders should advise interested Native American veterans to contact the nearest VA office for information.