

liens released or paid on the obligations secured by such superior liens or rights by a holder or others without expense to or obligation on the debtor resulting from such payment, or release of lien or right; and all payments made on the loan shall be applied to the indebtedness as so reduced. Nothing in this paragraph affects any right or liability resulting from fraud or willful misrepresentation.

(Authority: 38 U.S.C. 3703(c)(1), 3710, 3712)

**§ 36.4840 Underwriting standards, processing procedures, lender responsibility, and lender certification.**

(a) *Use of standards.* The standards contained in paragraphs (c) through (j) of this section will be used to determine whether the veteran's present and anticipated income and expenses, and credit history are satisfactory. These standards do not apply to loans guaranteed pursuant to 38 U.S.C. 3710(a)(8) except for cases where the Secretary is required to approve the loan in advance under § 36.4807.

(Authority: 38 U.S.C. 3703, 3710)

(b) *Waiver of standards.* Use of the standards in paragraphs (c) through (j) of this section for underwriting home loans will be waived only in extraordinary circumstances when the Secretary determines, considering the totality of circumstances, that the veteran is a satisfactory credit risk.

(c) *Methods.* The two primary underwriting standards that will be used in determining the adequacy of the veteran's present and anticipated income are debt-to-income ratio and residual income analysis. They are described in paragraphs (d) through (f) of this section. Ordinarily, to qualify for a loan, the veteran must meet both standards. Failure to meet one standard, however, will not automatically disqualify a veteran. The following exceptions shall apply to cases where a veteran does not meet both standards:

(1) If the debt-to-income ratio is 41 percent or less, and the veteran does not meet the residual income standard, the loan may be approved with justification, by the underwriter's supervisor, as set out in paragraph (c)(4) of this section.

(2) If the debt-to-income ratio is greater than 41 percent (unless it is larger due solely to the existence of tax-free income which should be noted in the loan file), the loan may be approved with justification, by the underwriter's supervisor, as set out in paragraph (c)(4) of this section.

(3) If the ratio is greater than 41 percent and the residual income exceeds the guidelines by at least 20 percent, the second level review and statement of justification are not required.

(4) In any case described by paragraphs (c)(1) and (c)(2) of this section, the lender must fully justify the decision to approve the loan or submit the loan to the Secretary for prior approval in writing. The lender's statement must not be perfunctory, but should address the specific compensating factors, as set forth in paragraph (c)(5) of this section, justifying the approval of the loan. The statement must be signed by the underwriter's supervisor. It must be stressed that the statute requires not only consideration of a veteran's present and anticipated income and expenses, but also that the veteran be a satisfactory credit risk. Therefore, meeting both the debt-to-income ratio and residual income standards does not mean that the loan is automatically approved. It is the lender's responsibility to base the loan approval or disapproval on all the factors present for any individual veteran. The veteran's credit must be evaluated based on the criteria set forth in paragraph (g) of this section as well as a variety of compensating factors that should be evaluated.

(5) The following are examples of acceptable compensating factors to be considered in the course of underwriting a loan:

- (i) Excellent long-term credit;
- (ii) Conservative use of consumer credit;
- (iii) Minimal consumer debt;
- (iv) Long-term employment;
- (v) Significant liquid assets;
- (vi) Down payment or the existence of equity in refinancing loans;
- (vii) Little or no increase in shelter expense;
- (viii) Military benefits;
- (ix) Satisfactory homeownership experience;

- (x) High residual income;
- (xi) Low debt-to-income ratio;
- (xii) Tax credits of a continuing nature, such as tax credits for child care; and
- (xiii) Tax benefits of home ownership.

(6) The list in paragraph (c)(5) of this section is not exhaustive and the items are not in any priority order. Valid compensating factors should represent unusual strengths rather than mere satisfaction of basic program requirements. Compensating factors must be relevant to the marginality or weakness.

(d) *Debt-to-income ratio.* A debt-to-income ratio that compares the veteran's anticipated monthly housing expense and total monthly obligations to his or her stable monthly income will be computed to assist in the assessment of the potential risk of the loan. The ratio will be determined by taking the sum of the monthly Principal, Interest, Taxes and Insurance (PITI) of the loan being applied for, homeowners and other assessments such as special assessments, condominium fees, homeowners association fees, etc., and any long-term obligations divided by the total of gross salary or earnings and other compensation or income. The ratio should be rounded to the nearest two digits; e.g., 35.6 percent would be rounded to 36 percent. The standard is 41 percent or less. If the ratio is greater than 41 percent, the steps cited in paragraphs (c)(1) through (c)(6) of this section apply.

(e) *Residual income guidelines.* The guidelines provided in this paragraph for residual income will be used to determine whether the veteran's monthly residual income will be adequate to meet living expenses after estimated monthly shelter expenses have been paid and other monthly obligations have been met. All members of the household must be included in determining if the residual income is sufficient. They must be counted even if the veteran's spouse is not joining in title or on the note, or if there are any other individuals depending on the veteran for support, such as children from a spouse's prior marriage who are not the veteran's legal dependents. It is appropriate, however, to reduce the num-

ber of members of a household to be counted for residual income purposes if there is sufficient verified income not otherwise included in the loan analysis, such as child support being regularly received as discussed in paragraph (e)(4) of this section. In the case of a spouse not to be obligated on the note, verification that he/she has stable and reliable employment as discussed in paragraph (f)(3) of this section would allow not counting the spouse in determining the sufficiency of the residual income. The guidelines for residual income are based on data supplied in the Consumer Expenditure Survey (CES) published by the Department of Labor's Bureau of Labor Statistics. Regional minimum incomes have been developed for loan amounts up to \$79,999 and for loan amounts of \$80,000 and above. It is recognized that the purchase price of the property may affect family expenditure levels in individual cases. This factor may be given consideration in the final determination in individual loan analyses. For example, a family purchasing in a higher-priced neighborhood may feel a need to incur higher-than-average expenses to support a lifestyle comparable to that in their environment, whereas a substantially lower-priced home purchase may not compel such expenditures. It should also be clearly understood from this information that no single factor is a final determinant in any applicant's qualification for a VA-guaranteed loan. Once the residual income has been established, other important factors must be examined. One such consideration is the amount being paid currently for rental or housing expenses. If the proposed shelter expense is materially in excess of what is currently being paid, the case may require closer scrutiny. In such cases, consideration should be given to the ability of the borrower and spouse to accumulate liquid assets, such as cash and bonds, and to the amount of debts incurred while paying a lesser amount for shelter. For example, if an application indicates little or no capital reserves and excessive obligations, it may not be reasonable to conclude that a substantial increase in shelter expenses can be absorbed. Another factor of prime importance is the applicant's manner of

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meeting obligations. A poor credit history alone is a basis for disapproving a loan, as is an obviously inadequate income. When one or the other is marginal, however, the remaining aspect must be closely examined to assure that the loan applied for will not exceed the applicant's ability or capacity to repay. Therefore, it is important to

remember that the figures provided below for residual income are to be used as a guide and should be used in conjunction with the steps outlined in paragraphs (c) through (j) of this section. The residual income guidelines are as follows:

(1) *Table of residual incomes by region (for loan amounts of \$79,999 and below):*

**TABLE OF RESIDUAL INCOMES BY REGION**  
[For loan amounts of \$79,999 and below]

Family size <sup>1</sup>	Northeast	Midwest	South	West
1 .....	390	382	382	425
2 .....	654	641	641	713
3 .....	788	772	772	859
4 .....	888	868	868	967
5 .....	921	902	902	1,004

<sup>1</sup>For families with more than five members, add \$75 for each additional member up to a family of seven. "Family" includes all members of the household.

(2) *Table of residual incomes by region (for loan amounts of \$80,000 and above):*

**TABLE OF RESIDUAL INCOMES BY REGION**  
[For loan amounts of \$80,000 and above]

Family size <sup>1</sup>	Northeast	Midwest	South	West
1 .....	450	441	441	491
2 .....	755	738	738	823
3 .....	909	889	889	990
4 .....	1,025	1,003	1,003	1,117
5 .....	1,062	1,039	1,039	1,158

<sup>1</sup>For families with more than five members, add \$80 for each additional member up to a family of seven. "Family" includes all members of the household.

(3) *Geographic regions for residual income guidelines:* Northeast—Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Vermont; Midwest—Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin; South—Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, Puerto Rico, South Carolina, Tennessee, Texas, Virginia, West Virginia; West—Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, New Mexico, Oregon, Utah, Washington and Wyoming.

(4) *Military adjustments.* For loan applications involving an active-duty servicemember or military retiree, the residual income figures will be reduced by a minimum of 5 percent if there is a clear indication that the borrower or

spouse will continue to receive the benefits resulting from the use of facilities on a nearby military base. (This reduction applies to tables in paragraph (e) of this section.)

(f) *Stability and reliability of income.* Only stable and reliable income of the veteran and spouse can be considered in determining ability to meet mortgage payments. Income can be considered stable and reliable if it can be concluded that it will continue during the foreseeable future.

(1) *Verification.* Income of the borrower and spouse which is derived from employment and which is considered in determining the family's ability to meet the mortgage payments, payments on debts and other obligations, and other expenses must be verified. If the spouse is employed and will be contractually obligated on the loan, the combined income of both the veteran

and spouse is considered when the income of the veteran alone is not sufficient to qualify for the amount of the loan sought. In other than community property states, if the spouse will not be contractually obligated on the loan, Regulation B (12 CFR part 202), promulgated by the Federal Reserve Board pursuant to the Equal Credit Opportunity Act, prohibits any request for, or consideration of, information concerning the spouse (including income, employment, assets, or liabilities), except that if the applicant is relying on alimony, child support, or maintenance payments from a spouse or former spouse as a basis for repayment of the loan, information concerning such spouse or former spouse may be requested and considered (see paragraph (f)(4) of this section). In community property states, information concerning a spouse may be requested and considered in the same manner as that for the applicant. The standards applied to income of the veteran are also applicable to that of the spouse. There can be no discounting of income on account of sex, marital status, or any other basis prohibited by the Equal Credit Opportunity Act. Income claimed by an applicant that is not or cannot be verified cannot be considered when analyzing the loan. If the veteran or spouse has been employed by a present employer for less than 2 years, a 2-year history covering prior employment, schooling, or other training must be secured. Any periods of unemployment must be explained. Employment verifications and pay stubs must be no more than 120 days (180 days for new construction) old to be considered valid. For loans closed automatically, this requirement will be considered satisfied if the date of the employment verification is within 120 days (180 days for new construction) of the date the note is signed. For prior approval loans, this requirement will be considered satisfied if the verification of employment is dated within 120 days of the date the application is received by VA.

(2) *Active-duty, Reserve, or National Guard applicants.* (i) In the case of an active-duty applicant, a military Leave & Earnings Statement is required and will be used instead of an employment

verification. The statement must be no more than 120 days old (180 days for new construction) and must be the original or a lender-certified copy of the original. For loans closed automatically, this requirement is satisfied if the date of the Leave & Earnings Statement is within 120 days (180 days for new construction) of the date the note is signed. For prior approval loans, this requirement will be considered satisfied if the verification of employment is dated within 120 days of the date the application is received by VA.

(ii) For servicemembers within 12 months of release from active duty, or members of the Reserves or National Guard within 12 months of release, one of the following is also required:

(A) Documentation that the servicemember has in fact already reenlisted or extended his/her period of active duty or Reserve or National Guard service to a date beyond the 12-month period following the projected closing of the loan.

(B) Verification of a valid offer of local civilian employment following release from active duty. All data pertinent to sound underwriting procedures (date employment will begin, earnings, etc.) must be included.

(C) A statement from the servicemember that he/she intends to reenlist or extend his/her period of active duty or Reserve or National Guard service to a date beyond the 12 month period following the projected loan closing date, and a statement from the servicemember's commanding officer confirming that the servicemember is eligible to reenlist or extend his/her active duty or Reserve or National Guard service as indicated and that the commanding officer has no reason to believe that such reenlistment or extension will not be granted.

(D) Other unusually strong positive underwriting factors, such as a down payment of at least 10 percent, significant cash reserves, or clear evidence of strong ties to the community coupled with a nonmilitary spouse's income so high that only minimal income from the active duty servicemember or member of the Reserves or National Guard is needed to qualify.

(iii) Each active-duty member who applies for a loan must be counseled through the use of VA Form 26-0592, Counseling Checklist for Military Homebuyers. Lenders must submit a signed and dated VA Form 26-0592 with each prior approval loan application or automatic loan report involving a borrower on active duty.

(3) *Income reliability.* Income received by the borrower and spouse is to be used only if it can be concluded that the income will continue during the foreseeable future and, thus, should be properly considered in determining ability to meet the mortgage payments. If an employer puts N/A or otherwise declines to complete a verification of employment statement regarding the probability of continued employment, no further action is required of the lender. Reliability will be determined based on the duration of the borrower's current employment together with his or her overall documented employment history. There can be no discounting of income solely because it is derived from an annuity, pension or other retirement benefit, or from part-time employment. However, unless income from overtime work and part-time or second jobs can be accorded a reasonable likelihood that it is continuous and will continue in the foreseeable future, such income should not be used. Generally, the reliability of such income cannot be demonstrated unless the income has continued for 2 years. The hours of duty and other work conditions of the applicant's primary job, and the period of time in which the applicant was employed under such arrangement, must be such as to permit a clear conclusion as to a good probability that overtime or part-time or secondary employment can and will continue. Income from overtime work and part-time jobs not eligible for inclusion as primary income may, if properly verified for at least 12 months, be used to offset the payments due on debts and obligations of an intermediate term, *i.e.*, 6 to 24 months. Such income must be described in the loan file. The amount of any pension or compensation and other income, such as dividends from stocks, interest from bonds, savings accounts, or other deposits, rents, royalties, etc., will be

used as primary income if it is reasonable to conclude that such income will continue in the foreseeable future. Otherwise, it may be used only to offset intermediate-term debts, as described in this paragraph. Also, the likely duration of certain military allowances cannot be determined and, therefore, will be used only to offset intermediate-term debts, as described in this paragraph. Such allowances are: Pro-pay, flight or hazard pay, and overseas or combat pay, all of which are subject to periodic review and/or testing of the recipient to ascertain whether eligibility for such pay will continue. Only if it can be shown that such pay has continued for a prolonged period and can be expected to continue because of the nature of the recipient's assigned duties, will such income be considered as primary income. For instance, flight pay verified for a pilot can be regarded as probably continuous and, thus, should be added to the base pay. Income derived from service in the Reserves or National Guard may be used if the applicant has served in such capacity for a period of time sufficient to evidence good probability that such income will continue beyond 12 months. The total period of active and reserve service may be helpful in this regard. Otherwise, such income may be used to offset intermediate-term debts. There are a number of additional income sources whose contingent nature precludes their being considered as available for repayment of a long-term mortgage obligation. Temporary income items such as VA educational allowances and unemployment compensation do not represent stable and reliable income and will not be taken into consideration in determining the ability of the veteran to meet the income requirement of the governing law. As required by the Equal Opportunity Act Amendments of 1976, Public Law 94-239, income from public assistance programs is used to qualify for a loan if it can be determined that the income will probably continue for 3 years or more.

(4) *Tax-exempt income.* Special consideration can be given to verified nontaxable income once it has been established that such income is likely to continue (and remain untaxed) into the

foreseeable future. Such income includes certain military allowances, child support payments, workers' compensation benefits, disability retirement payments and certain types of public assistance payments. In such cases, current income tax tables may be used to determine an amount which can be prudently employed to adjust the borrower's actual income. This adjusted or "grossed up" income may be used to calculate the monthly debt-to-income ratio, provided the analysis is documented. Only the borrower's actual income may be used to calculate the residual income. Care should be exercised to ensure that the income is in fact tax-exempt.

(5) *Alimony, child support, maintenance, workers' compensation, foster care payments.* (i) If an applicant chooses to reveal income from alimony, child support or maintenance payments (after first having been informed that any such disclosure is voluntary pursuant to the Federal Reserve Board's Regulation B (12 CFR part 202)), such payments are considered as income to the extent that the payments are likely to be consistently made. Factors to be considered in determining the likelihood of consistent payments include, but are not limited to: Whether the payments are received pursuant to a written agreement or court decree; the length of time the payments have been received; the regularity of receipt; the availability of procedures to compel payment; and the creditworthiness of the payor, including the credit history of the payor when available under the Fair Credit Reporting Act or other applicable laws. However, the Fair Credit Reporting Act (15 U.S.C. 1681(b)) limits the permissible purposes for which credit reports may be ordered, in the absence of written instructions of the consumer to whom the report relates, to business transactions involving the subject of the credit report or extensions of credit to the subject of the credit report.

(ii) If the applicant chooses to reveal income related to workers' compensation, it will be considered as income to the extent it can be determined such income will continue.

(iii) Income received specifically for the care of any foster child(ren) may be

counted as income if documented. Generally, however, such foster care income is to be used only to balance the expenses of caring for the foster child(ren) against any increased residual income requirements.

(6) *Military quarters allowance.* With respect to off-base housing (quarters) allowances for service personnel on active duty, it is the policy of the Department of Defense to utilize available on-base housing when possible. In order for a quarters allowance to be considered as continuing income, it is necessary that the applicant furnish written authorization from his or her commanding officer for off-base housing. This authorization should verify that quarters will not be made available and that the individual should make permanent arrangements for nonmilitary housing. A Department of Defense form, DD Form 1747, Status of Housing Availability, is used by the Family Housing Office to advise personnel regarding family housing. The applicant's quarters allowance cannot be considered unless item b (Permanent) or d is completed on DD Form 1747, dated October 1990. Of course, if the applicant's income less quarters allowance is sufficient, there is no need for assurance that the applicant has permission to occupy nonmilitary housing provided that a determination can be made that the occupancy requirements of the law will be met. Also, authorization to obtain off-base housing will not be required when certain duty assignments would clearly qualify service personnel with families for quarters allowance. For instance, off-base housing authorizations need not be obtained for service personnel stationed overseas who are not accompanied by their families, recruiters on detached duty, or military personnel stationed in areas where no on-base housing exists. In any case in which no off-base housing authorization is obtained, an explanation of the circumstances justifying its omission must be included with the loan application except when it has been established by the VA facility of jurisdiction that the waiting lists for on-base housing are so long that it is improbable that individuals desiring to purchase off-base housing would be precluded

from doing so in the foreseeable future. If stations make such a determination, a release shall be issued to inform lenders.

(7) *Automobile (or similar) allowance.* Generally, automobile allowances are paid to cover specific expenses related to an applicant's employment, and it is appropriate to use such income to offset a corresponding car payment. However, in some instances, such an allowance may exceed the car payment. With proper documentation, income from a car allowance which exceeds the car payment can be counted as effective income. Likewise, any other similar type of allowance which exceeds the specific expense involved may be added to gross income to the extent it is documented to exceed the actual expense.

(8) *Commissions.* When all or a major portion of the veteran's income is derived from commissions, it will be necessary to establish the stability of such income if it is to be considered in the loan analysis for the repayment of the mortgage debt and/or short-term obligations. In order to assess the value of such income, lenders should obtain written verification of the actual amount of commissions paid to date, the basis for the payment of such commissions and when commissions are paid; *i.e.*, monthly, quarterly, semi-annually, or annually. Lenders should also obtain signed and dated individual income tax returns, plus applicable schedules, for the previous 2 years, or for whatever additional period is deemed necessary to properly demonstrate a satisfactory earnings record. The length of the veteran's employment in the type of occupation for which commissions are paid is also an important factor in the assessment of the stability of the income. If the veteran has been employed for a relatively short time, the income should not normally be considered stable unless the product or service was the same or closely related to the product or service sold in an immediate prior position. Generally, income from commissions is considered stable when the applicant has been receiving such income for at least 2 years. Less than 2 years of income from commissions cannot usually be considered stable. When an applicant has received income from commis-

sions for less than 1 year, it will rarely be possible to demonstrate that the income is stable for qualifying purposes; such cases would require in-depth development.

(9) *Self-employment.* Generally, income from self-employment is considered stable when the applicant has been in business for at least 2 years. Less than 2 years of income from self-employment cannot usually be considered stable unless the applicant has had previous related employment and/or extensive specialized training. When an applicant has been self-employed less than 1 year, it will rarely be possible to demonstrate that the income is stable for qualifying purposes; such cases would require in-depth development. The following documentation is required for all self-employed borrowers:

(i) A profit-and-loss statement for the prior fiscal year (12-month accounting cycle), plus the period year to date since the end of the last fiscal year (or for whatever shorter period records may be available), and balance sheet based on the financial records. The financial statement must be sufficient for a loan underwriter to determine the necessary information for loan approval and an independent audit (on the veteran and/or the business) by a Certified Public Accountant will be required if necessary for such determination; and

(ii) Copies of signed individual income tax returns, plus all applicable schedules for the previous 2 years, or for whatever additional period is deemed necessary to properly demonstrate a satisfactory earnings record, must be obtained. If the business is a corporation or partnership, copies of signed Federal business income tax returns for the previous two years plus all applicable schedules for the corporation or partnership must be obtained; and

(iii) If the business is a corporation or partnership, a list of all stockholders or partners showing the interest each holds in the business will be required. Some cases may justify a written credit report on the business as well as the applicant. When the business is of an unusual type and it is difficult to determine the probability of

its continued operation, explanation as to the function and purpose of the business may be needed from the applicant and/or any other qualified party with the acknowledged expertise to express a valid opinion.

(10) *Recently discharged veterans.* Loan applications received from recently discharged veterans who have little or no employment experience other than their military occupation and from veterans seeking VA-guaranteed loans who have retired after 20 years of active military duty require special attention. The retirement income of the latter veterans in many cases may not be sufficient to meet the statutory income requirements for the loan amount sought. Many have obtained full-time employment and have been employed in their new jobs for a very short time.

(i) It is essential in determining whether veterans in these categories qualify from the income standpoint for the amount of the loan sought, that the facts in respect to their present employment and retirement income be fully developed, and that each case be considered on its individual merits.

(ii) In most cases the veteran's current income or current income plus his or her retirement income is sufficient. The problem lies in determining whether it can be properly concluded that such income level will continue for the foreseeable future. If the veteran's employment status is that of a trainee or an apprentice, this will, of course, be a factor. In cases of the self-employed, the question to be resolved is whether there are reasonable prospects that the business enterprise will be successful and produce the required income. Unless a favorable conclusion can be made, the income from such source should not be considered in the loan analysis.

(iii) If a recently discharged veteran has no prior employment history and the veteran's verification of employment shows he or she has not been on the job a sufficient time in which to become established, consideration should be given to the duties the veteran performed in the military service. When it can be determined that the duties a veteran performed in the service are similar or are in direct relation to the

duties of the applicant's present position, such duties may be construed as adding weight to his or her present employment experience and the income from the veteran's present employment thus may be considered available for qualifying the loan, notwithstanding the fact that the applicant has been on the present job only a short time. This same principle may be applied to veterans recently retired from the service. In addition, when the veteran's income from retirement, in relation to the total of the estimated shelter expense, long-term debts and amount available for family support, is such that only minimal income from employment is necessary to qualify from the income standpoint, it would be proper to resolve the doubt in favor of the veteran. It would be erroneous, however, to give consideration to a veteran's income from employment for a short duration in a job requiring skills for which the applicant has had no training or experience.

(iv) To illustrate the provisions of paragraph (f)(10), it would be proper to use short-term employment income in qualifying a veteran who had experience as an airplane mechanic in the military service and the individual's employment after discharge or retirement from the service is in the same or allied fields; e.g., auto mechanic or machinist. This presumes, however, that the verification of employment included a statement that the veteran was performing the duties of the job satisfactorily, the possibility of continued employment was favorable and that the loan application is eligible in all other respects. An example of non-qualifying experience is that of a veteran who was an Air Force pilot and has been employed in insurance sales on commission for a short time. Most cases, of course, fall somewhere between those extremes. It is for this reason that the facts of each case must be fully developed prior to closing the loan automatically or submitting the case to VA for prior approval.

(11) *Employment of short duration.* The provisions of paragraph (f)(7) of this section are similarly applicable to applicants whose employment is of short duration. Such cases will entail careful

consideration of the employer's confirmation of employment, probability of permanency, past employment record, the applicant's qualifications for the position, and previous training, including that received in the military service. In the event that such considerations do not enable a determination that the income from the veteran's current position has a reasonable likelihood of continuance, such income should not be considered in the analysis. Applications received from persons employed in the building trades, or in other occupations affected by climatic conditions, should be supported by documentation evidencing the applicant's total earnings to date and covering a period of not less than 1 year as well as signed and dated copies of complete income tax returns, including all schedules for the past 2 years or for whatever additional period is deemed necessary to properly demonstrate a satisfactory earnings record. If the applicant works out of a union, evidence of the previous year's earnings should be obtained together with a verification of employment from the current employer.

(12) *Rental income*—(i) *Multi-unit subject property*. When the loan pertains to a structure with more than a one-family dwelling unit, the prospective rental income will not be considered unless the veteran can demonstrate a reasonable likelihood of success as a landlord, and sufficient cash reserves are verified to enable the veteran to carry the mortgage loan payments (principal, interest, taxes, and insurance) without assistance from the rental income for a period of at least 6 months. The determination of the veteran's likelihood of success as a landlord will be based on documentation of any prior experience in managing rental units or other collection activities. The amount of rental income to be used in the loan analysis will be based on 75 percent of the amount indicated on the lease or rental agreement, unless a greater percentage can be documented.

(ii) *Rental of existing home*. Proposed rental of a veteran's existing property may be used to offset the mortgage payment on that property, provided there is no indication that the property will be difficult to rent. If available, a

copy of the rental agreement should be obtained. It is the responsibility of the loan underwriter to be aware of the condition of the local rental market. For instance, in areas where the rental market is very strong the absence of a lease should not automatically prohibit the offset of the mortgage by the proposed rental income.

(iii) *Other rental property*. If income from rental property will be used to qualify for the new loan, the documentation required of a self-employed applicant should be obtained together with evidence of cash reserves equaling 3 months PITI on the rental property. As for any self-employed earnings (see paragraph (f)(7) of this section), depreciation claimed may be added back in as income. In the case of a veteran who has no experience as a landlord, it is unlikely that the income from a rental property may be used to qualify for the new loan.

(13) *Taxes and other deductions*. Deductions to be applied for Federal income taxes and Social Security may be obtained from the Employer's Tax Guide (Circular E) issued by the Internal Revenue Service (IRS). (For veterans receiving a mortgage credit certificate (MCC), see paragraph (f)(14) of this section.) Any State or local taxes should be estimated or obtained from charts similar to those provided by IRS which may be available in those states with withholding taxes. A determination of the amount paid or withheld for retirement purposes should be made and used when calculating deductions from gross income. In determining whether a veteran-applicant meets the income criteria for a loan, some consideration may be given to the potential tax benefits the veteran will realize if the loan is approved. This can be done by using the instructions and worksheet portion of IRS Form W-4, Employee's Withholding Allowance Certificate, to compute the total number of permissible withholding allowances. That number can then be used when referring to IRS Circular E and any appropriate similar State withholding charts to arrive at the amount of Federal and State income tax to be deducted from gross income.

(14) *Mortgage credit certificates*. (i) The Internal Revenue Code (26 U.S.C.) as

amended by the Tax Reform Act of 1984, allows states and other political subdivisions to trade in all or part of their authority to issue mortgage revenue bonds for authority to issue MCCs. Veterans who are recipients of MCCs may realize a significant reduction in their income tax liability by receiving a Federal tax credit for a percentage of their mortgage interest payment on debt incurred on or after January 1, 1985.

(ii) Lenders must provide a copy of the MCC to VA with the home loan application. The MCC will specify the rate of credit allowed and the amount of certified indebtedness; *i.e.*, the indebtedness incurred by the veteran to acquire a principal residence or as a qualified home improvement or rehabilitation loan.

(iii) For credit underwriting purposes, the amount of tax credit allowed to a veteran under an MCC will be treated as a reduction in the monthly Federal income tax. For example, a veteran having a \$600 monthly interest payment and an MCC providing a 30-percent tax credit would receive a \$180 (30 percent  $\times$  \$600) tax credit each month. However, because the annual tax credit, which amounts to \$2,160 (12  $\times$  \$180), exceeds \$2,000 and is based on a 30-percent credit rate, the maximum tax credit the veteran can receive is limited to \$2,000 per year (Pub. L. 98-369) or \$167 per month (\$2,000/12). As a consequence of the tax credit, the interest on which a deduction can be taken will be reduced by the amount of the tax credit to \$433 (\$600 - \$167). This reduction should also be reflected when calculating Federal income tax.

(iv) For underwriting purposes, the amount of the tax credit is limited to the amount of the veteran's maximum tax liability. If, in the example in paragraph (f)(14)(iii) of this section, the veteran's tax liability for the year were only \$1,500, the monthly tax credit would be limited to \$125 (\$1,500/12).

(g) *Credit*. The conclusion reached as to whether or not the veteran and spouse are satisfactory credit risks must also be based on a careful analysis of the available credit data. Regulation B (12 CFR part 202), promulgated by the Federal Reserve Board pursuant to the Equal Credit Opportunity Act,

requires that lenders, in evaluating creditworthiness, shall consider, on the applicant's request, the credit history, when available, of any account reported in the name of the applicant's spouse or former spouse which the applicant can demonstrate accurately reflects the applicant's creditworthiness. In other than community property states, if the spouse will not be contractually obligated on the loan, Regulation B prohibits any request for or consideration of information about the spouse concerning income, employment, assets or liabilities. In community property states, information concerning a spouse may be requested and considered in the same manner as that for the applicant.

(1) *Adverse data*. If the analysis develops any derogatory credit information and, despite such facts, it is determined that the veteran and spouse are satisfactory credit risks, the basis for the decision must be explained. If a veteran and spouse have debts outstanding which have not been paid timely, or which they have refused to pay, the fact that the outstanding debts are paid after the acceptability of the credit is questioned or in anticipation of applying for new credit does not, of course, alter the fact that the record for paying debts has been unsatisfactory. With respect to unpaid debts, lenders may take into consideration a veteran's claim of bona fide or legal defenses. Such defenses are not applicable when the debt has been reduced to judgment. Where a collection account has been established, if it is determined that the borrower is a satisfactory credit risk, it is not mandatory that such an account be paid off in order for a loan to be approved. Court-ordered judgments, however, must be paid off before a new loan is approved.

(2) *Bankruptcy*. When the credit information shows that the borrower or spouse has been discharged in bankruptcy under the "straight" liquidation and discharge provisions of the bankruptcy law, this would not in itself disqualify the loan. However, in such cases it is necessary to develop complete information as to the facts and circumstances concerning the bankruptcy. Generally speaking, when the borrower or spouse, as the case

may be, has been regularly employed (not self-employed) and has been discharged in bankruptcy within the last one to two years, it probably would not be possible to determine that the borrower or spouse is a satisfactory credit risk unless both of the following requirements are satisfied:

(i) The borrower or spouse has obtained credit subsequent to the bankruptcy and has met the credit payments in a satisfactory manner over a continued period; and

(ii) The bankruptcy was caused by circumstances beyond the control of the borrower or spouse, e.g., unemployment, prolonged strikes, medical bills not covered by insurance. Divorce is not generally viewed as beyond the control of the borrower and/or spouse. The circumstances alleged must be verified. If a borrower or spouse is self-employed, has been adjudicated bankrupt, and subsequently obtains a permanent position, a finding as to satisfactory credit risk may be made provided there is no derogatory credit information prior to self-employment, there is no derogatory credit information subsequent to the bankruptcy, and the failure of the business was not due to misconduct. If a borrower or spouse has been discharged in bankruptcy within the past 12 months, it will not generally be possible to determine that the borrower or spouse is a satisfactory credit risk.

(3) *Petition under Chapter 13 of Bankruptcy Code.* A petition under chapter 13 of the Bankruptcy Code (11 U.S.C.) filed by the borrower or spouse is indicative of an effort to pay their creditors. Some plans may provide for full payment of debts while others arrange for payment of scaled-down debts. Regular payments are made to a court-appointed trustee over a 2- to 3-year period (or up to 5 years in some cases). When the borrowers have made all payments in a satisfactory manner, they may be considered as having reestablished satisfactory credit. When they apply for a home loan before completion of the payout period, favorable consideration may nevertheless be given if at least 12 months' worth of payments have been made satisfactorily and the Trustee or Bankruptcy Judge approves of the new credit.

(4) *Foreclosures.* (i) When the credit information shows that the veteran or spouse has had a foreclosure on a prior mortgage; e.g., a VA-guaranteed or HUD-insured mortgage, this will not in itself disqualify the borrower from obtaining the loan. Lenders and field station personnel should refer to the preceding guidelines on bankruptcies for cases involving foreclosures. As with a borrower who has been adjudicated bankrupt, it is necessary to develop complete information as to the facts and circumstances of the foreclosure.

(ii) When VA pays a claim on a VA-guaranteed loan as a result of a foreclosure, the original veteran may be required to repay any loss to the Government. In some instances VA may waive the veteran's debt, in part or totally, based on the facts and circumstances of the case. However, guaranty entitlement cannot be restored unless the Government's loss has been repaid in full, regardless of whether or not the debt has been waived, compromised, or discharged in bankruptcy. Therefore, a veteran who is seeking a new VA loan after having experienced a foreclosure on a prior VA loan will in most cases have only remaining entitlement to apply to the new loan. The lender should assure that the veteran has sufficient entitlement for its secondary marketing purposes.

(5) *Federal debts.* An applicant for a Federally-assisted loan will not be considered a satisfactory credit risk for such loan if the applicant is presently delinquent or in default on any debt to the Federal Government, e.g., a Small Business Administration loan, a U.S. Guaranteed Student loan, a debt to the Public Health Service, or where there is a judgment lien against the applicant's property for a debt owed to the Government. The applicant may not be approved for the loan until the delinquent account has been brought current or satisfactory arrangements have been made between the borrower and the Federal agency owed, or the judgment is paid or otherwise satisfied. Of course, the applicant must also be able to otherwise qualify for the loan from an income and remaining credit standpoint. Refinancing under VA's interest rate reduction refinancing provisions,

however, is allowed even if the borrower is delinquent on the VA guaranteed mortgage being refinanced. Prior approval processing is required in such cases.

(6) *Absence of credit history.* The fact that recently discharged veterans may have had no opportunity to develop a credit history will not preclude a determination of satisfactory credit. Similarly, other loan applicants may not have established credit histories as a result of a preference for purchasing consumer items with cash rather than credit. There are also cases in which individuals may be genuinely wary of acquiring new obligations following bankruptcy, consumer credit counseling (debt proration), or other disruptive credit occurrence. The absence of the credit history in these cases will not generally be viewed as an adverse factor in credit underwriting. However, before a favorable decision is made for cases involving bankruptcies or other derogatory credit factors, efforts should be made to develop evidence of timely payment of non-installment debts such as rent and utilities. It is anticipated that this special consideration in the absence of a credit history following bankruptcy would be the rare case and generally confined to bankruptcies that occurred over 3 years ago.

(7) *Consumer credit counseling plan.* If a veteran, or veteran and spouse, have prior adverse credit and are participating in a Consumer Credit Counseling plan, they may be determined to be a satisfactory credit risk if they demonstrate 12 months' satisfactory payments and the counseling agency approves the new credit. If a veteran, or veteran and spouse, have good prior credit and are participating in a Consumer Credit Counseling plan, such participation is to be considered a neutral factor, or even a positive factor, in determining creditworthiness.

(8) *Re-establishment of satisfactory credit.* In circumstances not involving bankruptcy, satisfactory credit is generally considered to be reestablished after the veteran, or veteran and spouse, have made satisfactory payments for 12 months after the date of the last derogatory credit item.

(9) *Long-term v. short-term debts.* All known debts and obligations including

any alimony and/or child support payments of the borrower and spouse must be documented. Significant liabilities, to be deducted from the total income in determining ability to meet the mortgage payments are accounts that, generally, are of a relatively long term, *i.e.*, 10 months or over. Other accounts for terms of less than 10 months must, of course, be considered in determining ability to meet family expenses. Certainly, any severe impact on the family's resources for any period of time must be considered in the loan analysis. For example, monthly payments of \$300 on an auto loan with a remaining balance of \$1,500 would be included in those obligations to be deducted from the total income regardless of the fact that the account can be expected to pay out in 5 months. It is clear that the applicant will, in this case, continue to carry the burden of those \$300 payments for the first, most critical months of the home loan.

(10) *Requirements for verification.* If the credit investigation reveals debts or obligations of a material nature which were not divulged by the applicant, lenders must be certain to obtain clarification as to the status of such debts from the borrower. A proper analysis is obviously not possible unless there is total correlation between the obligations claimed by the borrower and those revealed by a credit report or deposit verification. Conversely, significant debts and obligations reported by the borrower must be dated. If the credit report fails to provide necessary information on such accounts, lenders will be expected to obtain their own verifications of those debts directly from the creditors. Credit reports and verifications must be no more than 120 days old (180 days for new construction) to be considered valid. For loans closed automatically, this requirement will be considered satisfied if the date of the credit report or verification is within 120 days (180 days for new construction) of the date the note is signed. For prior approval loans, this requirement will be considered satisfied if the date of the credit report or verification is within 120 days of the date the application is received by VA. Of major significance are the

applicant's rental history and outstanding or recently retired mortgages, if any, particularly prior VA loans. Lenders should be sure ratings on such accounts are obtained; a written explanation is required when ratings are not available. A determination is necessary as to whether alimony and/or child support payments are required. Verification of the amount of such obligations should be obtained, although documentation concerning an applicant's divorce should not be obtained automatically unless it is necessary to verify the amount of any alimony or child support liability indicated by the applicant. If in the routine course of processing the loan application, however, direct evidence is received (e.g., from the credit report) that an obligation to pay alimony or child support exists (as opposed to mere evidence that the veteran was previously divorced), the discrepancy between the loan application and credit report can and should be fully resolved in the same manner as any other such discrepancy would be handled. When a pay stub or leave-and-earnings statement indicates an allotment, the lender must investigate the nature of the allotment(s) to determine whether the allotment is related to a debt. Debts assigned to an ex-spouse by a divorce decree will not generally be charged against a veteran-borrower.

(11) *Job-related expenses.* Known job-related expenses should be documented. This will include costs for any dependent care, significant commuting costs, etc. When a family's circumstances are such that dependent care arrangements would probably be necessary, it is important to determine the cost of such services in order to arrive at an accurate total of deductions.

(12) *Credit reports.* Credit reports obtained by lenders on VA-guaranteed loan applications must be either a three-file Merged Credit Report (MCR) or a Residential Mortgage Credit Report (RMCR). If used, the RMCR must meet the standards formulated jointly by the Department of Veterans Affairs, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Federal Housing Administration, Farmers Home Administration, credit repositories, repository af-

filiated consumer reporting agencies and independent consumer reporting agencies. All credit reports obtained by the lender must be submitted to VA.

(h) *Borrower's personal and financial status.* The number and ages of dependents have an important bearing on whether income after deduction of fixed charges is sufficient to support the family. Type and duration of employment of both the borrower and spouse are important as an indication of stability of their employment. The amount of liquid assets owned by the borrower or spouse, or both, is an important factor in determining that they have sufficient funds to close the loan, as well as being significant in analyzing the overall qualifications for the loan. (It is imperative that adequate cash assets from the veteran's own resources are verified to allow the payment (see §36.4839(a)(3)) of any difference between the sales price of the property and the loan amount, in addition to that necessary to cover closing costs, if the sales price exceeds the reasonable value established by VA.) Verifications must be no more than 120 days old (180 days for new construction) to be considered valid. For loans closed on the automatic basis, this requirement will be considered satisfied if the date of the deposit verification is within 120 days (180 days for new construction) of the date of the veteran's application to the lender. For prior approval loans, this requirement will be considered satisfied if the verification of employment is dated within 120 days of the date the application is received by VA. Current monthly rental or other housing expense is an important consideration when compared to that to be undertaken in connection with the contemplated housing purchase.

(i) *Estimated monthly shelter expenses.* It is important that monthly expenses such as taxes, insurance, assessments and maintenance and utilities be estimated accurately based on property location and type of house; e.g., old or new, large or small, rather than using or applying a "rule of thumb" to all properties alike. Maintenance and utility amounts for various types of property should be realistically estimated. Local utility companies should be consulted for current rates. The age and

type of construction of a house may well affect these expenses. In the case of condominiums or houses in a planned unit development (PUD), the monthly amount of the maintenance assessment payable to a homeowners association should be added. If the amount currently assessed is less than the maximum provided in the covenants or master deed, and it appears likely that the amount will be insufficient for operation of the condominium or PUD, the amount used will be the maximum the veteran could be charged. If it is expected that real estate taxes will be raised, or if any special assessments are expected, the increased or additional amounts should be used. In special flood hazard areas, include the premium for any required flood insurance.

(j) *Lender responsibility.* (1) Lenders are fully responsible for developing all credit information; *i.e.*, for obtaining verifications of employment and deposit, credit reports, and for the accuracy of the information contained in the loan application.

(2) Verifications of employment and deposits, and requests for credit reports and/or credit information must be initiated and received by the lender.

(3) In cases where the real estate broker/agent or any other party requests any of this information, the report(s) must be returned directly to the lender. This fact must be disclosed by appropriately completing the required certification on the loan application or report and the parties must be identified as agents of the lender.

(4) Where the lender relies on other parties to secure any of the credit or employment information or otherwise accepts such information obtained by any other party, such parties shall be construed for purposes of the submission of the loan documents to VA to be authorized agents of the lender, regardless of the actual relationship between such parties and the lender, even if disclosure is not provided to VA under paragraph (j)(3) of this section. Any negligent or willful misrepresentation by such parties shall be imputed to the lender as if the lender had processed those documents and the lender shall remain responsible for the quality and

accuracy of the information provided to VA.

(5) All credit reports secured by the lender or other parties as identified in paragraphs (j)(3) and (4) of this section shall be provided to VA. If updated credit reports reflect materially different information than that in other reports, such discrepancies must be explained by the lender and the ultimate decision as to the effects of the discrepancy upon the loan application fully addressed by the underwriter.

(k) *Lender certification.* Lenders originating loans are responsible for determining and certifying to VA on the appropriate application or closing form that the loan meets all statutory and regulatory requirements. Lenders will affirmatively certify that loans were made in full compliance with the law and loan guaranty regulations as prescribed in this section.

(1) *Definitions.* The definitions contained in part 42 of this chapter and the following definitions are applicable in this section.

(i) *Another appropriate amount.* In determining the appropriate amount of a lender's civil penalty in cases where the Secretary has not sustained a loss or where two times the amount of the Secretary's loss on the loan involved does not exceed \$10,000, the Secretary shall consider:

(A) The materiality and importance of the false certification to the determination to issue the guaranty or to approve the assumption;

(B) The frequency and past pattern of such false certifications by the lender; and

(C) Any exculpatory or mitigating circumstances.

(ii) *Complaint.* Complaint includes the assessment of liability served pursuant to this section.

(iii) *Defendant.* Defendant means a lender named in the complaint.

(iv) *Lender.* Lender includes the holder approving loan assumptions pursuant to 38 U.S.C. 3714.

(2) *Procedures for certification.* (i) As a condition to VA issuance of a loan guaranty on all loans closed on or after October 27, 1994, and as a prerequisite to an effective loan assumption on all loans assumed pursuant to 38 U.S.C. 3714 on or after November 17, 1997, the

following certification shall accompany each loan closing or assumption package:

The undersigned lender certifies that the (loan) (assumption) application, all verifications of employment, deposit, and other income and credit verification documents have been processed in compliance with 38 CFR part 36; that all credit reports obtained or generated in connection with the processing of this borrower's (loan) (assumption) application have been provided to VA; that, to the best of the undersigned lender's knowledge and belief the (loan) (assumption) meets the underwriting standards recited in chapter 37 of title 38 United States Code and 38 CFR part 36; and that all information provided in support of this (loan) (assumption) is true, complete and accurate to the best of the undersigned lender's knowledge and belief.

(ii) The certification shall be executed by an officer of the lender authorized to execute documents and act on behalf of the lender.

(3) *Penalty.* Any lender who knowingly and willfully makes a false certification required pursuant to §36.4840(k)(2) shall be liable to the United States Government for a civil penalty equal to two times the amount of the Secretary's loss on the loan involved or to another appropriate amount, not to exceed \$10,000, whichever is greater.

(1) *Assessment of liability.* (1) Upon an assessment confirmed by the Under Secretary for Benefits, in consultation with the Investigating Official, that a certification, as required in this section, is false, a report of findings of the Under Secretary for Benefits shall be submitted to the Reviewing Official setting forth:

(i) The evidence that supports the allegations of a false certification and of liability;

(ii) A description of the claims or statements upon which the allegations of liability are based;

(iii) The amount of the VA demand to be made; and

(iv) Any exculpatory or mitigating circumstances that may relate to the certification.

(2) The Reviewing Official shall review all of the information provided and will either inform the Under Secretary for Benefits and the Investigating Official that there is not ade-

quate evidence, that the lender is liable, or serve a complaint on the lender stating:

(i) The allegations of a false certification and of liability;

(ii) The amount being assessed by the Secretary and the basis for the amount assessed;

(iii) Instructions on how to satisfy the assessment and how to file an answer to request a hearing, including a specific statement of the lender's right to request a hearing by filing an answer and to be represented by counsel; and

(iv) That failure to file an answer within 30 days of the complaint will result in the imposition of the assessment without right to appeal the assessment to the Secretary.

(m) *Hearing procedures.* A lender hearing on an assessment established pursuant to this section shall be governed by the procedures recited at 38 CFR 42.8 through 42.47.

(n) *Additional remedies.* Any assessment under this section may be in addition to other remedies available to VA, such as debarment and suspension pursuant to 38 U.S.C. 3704 and 2 CFR parts 180 and 801 or loss of automatic processing authority pursuant to 38 U.S.C. 3702, or other actions by the Government under any other law including but not limited to title 18 U.S.C. and 31 U.S.C. 3732.

(Authority 38 U.S.C. 3703(c)(1), 3710(g))

(The Office of Management and Budget has approved the information collection requirements of this section under control number 2900-0521.)

**§ 36.4841 Death or insolvency of holder.**

(a) Immediately upon the death of the holder and without the necessity of request or other action by the debtor or the Secretary, all sums then standing as a credit balance in a trust, or deposit, or other account to cover taxes, insurance accruals, or other items in connection with the loan secured by the encumbered property, whether stated to be such or otherwise designated, and which have not been credited on the note shall, nevertheless, be treated as a setoff and shall be deemed to have been credited thereon as of the date of the last debit to such account,