USDA Should Modernize Mortgage Protections: Four Long-Overdue Policy Changes to Limit Rural Foreclosures

April 2019

The United States Department of Agriculture (USDA) operates two significant programs for financing the purchase or construction of single-family homes in rural areas in the United States through its Rural Development (RD) mission area. The agency serves as a lender under its Section 502 direct loan program and also acts as a guarantor of loans made by private lenders under its Section 502 guaranteed loan program. Almost one million households have USDA-guaranteed loans and over 200,000 households currently have direct loans.[1]

Both the direct loan program and the guaranteed loan program are designed to promote stable and sustainable homeownership in rural areas. However, a significant number of borrowers in both programs lose their homes every year due to hardships caused by circumstances beyond their control and by RD's failure to adequately address their needs. To promote sustainable homeownership and prevent unnecessary foreclosures and loss claims, the agency should adopt four critical servicing policies.

Almost one million households have USDA guaranteed loans, and over 200,000 households currently have direct loans.

Recommendations to Prevent Unnecessary Foreclosures and Loss Claims

1. USDA must make alternatives to foreclosure available for direct borrowers throughout the foreclosure process.

RD offers a number of foreclosure avoidance options, generally referred to as "loss mitigation options," for borrowers in both the direct and guaranteed loan programs who run into trouble making their mortgage payments. For borrowers in the guaranteed loan program, these options are available throughout the foreclosure process. However, RD takes the position that borrowers in the direct loan program cannot access foreclosure avoidance options, which the agency labels as "special servicing," once it accelerates a loan.[2] This policy shortens the time for resolving delinquencies and leads to unnecessary losses – to the agency, the homeowner, and the homeowner's community. [3]

Loan acceleration is an early step in a home foreclosure process that may take months or even years. After a loan is accelerated but before the foreclosure sale a borrower may experience a positive change in financial circumstances or qualify for a plan to bring the loan current. RD policy bars homeowners in the direct loan program from accessing these options even when significant time remains before a foreclosure judgment or sale.

RD's policy barring homeowners in foreclosure from accessing options to prevent foreclosure is fully out of step with the rest of the mortgage market. FHA-insured borrowers, for example, may access loss mitigation until shortly before a foreclosure sale. The same is true for borrowers whose loans are held by Fannie Mae and Freddie Mac. RD guaranteed loan borrowers also are allowed access to loss mitigation after acceleration.[4]

The USDA policy barring homeowners from options to prevent a foreclosure is fully out of step with the rest of the mortgage market.

The Real Estate Settlement Procedures Act (RESPA) regulations governing evaluation of loss mitigation require servicers to evaluate borrowers for all the loss mitigation options that a servicer can offer until a specified time prior to the foreclosure sale of the property.[5] RESPA rules recognize that defaulting homeowners frequently do not seek help from housing counselors and other experienced advocates until *after* they learn that foreclosure proceedings have begun with the acceleration of their home loan. These regulations apply to RD direct loans just as they do to all other "federally related mortgage loans."[6] RD's refusal to allow direct loan borrowers to access its major loss mitigation options after acceleration frustrates the goal of the RESPA rule. Meaningful loss mitigation options must remain available to homeowners throughout the foreclosure process.

RD's policy also clearly violates the statute that created moratorium relief for borrowers who have defaulted on their loans for reasons beyond their control. That statute applies "[d]uring any time such loan is outstanding. . . "and not only prior to acceleration." [7] In fact, in *United States v. Shields*,[8] a Vermont federal district court held that the agency's bar on post-acceleration moratorium relief violated the law because it is contrary to the moratorium statute. The agency nonetheless has continued a policy that is harmful to homeowners, costly to the government, contrary to the federal moratorium statute, and out of step with the rest of the mortgage market. This policy must be updated to make loss mitigation available to direct loan borrowers after acceleration.

2. Direct loan borrowers who complete a moratorium should automatically receive affordable loan modifications that address their post-moratorium income and financial situation.

RD is statutorily authorized to grant moratoriums of up to two years on mortgage payments to borrowers who suffer financial hardships for reasons outside of their control. By postponing the borrower's monthly mortgage payments, a moratorium provides significant relief to a borrower who is working through hardship. A moratorium does not, however, relieve a borrower of the obligation to repay the amounts that are deferred during the moratorium period.

Once a moratorium ends, it is almost always impossible for a borrower who is recovering from a financial hardship to pay all the deferred payments in a lump sum. This is particularly true for the low- and very low-income borrowers that the direct loan program serves. RD deals with this issue by offering only two options, both of which are inadequate. The first is forgiveness of the interest that has accrued during the moratorium, and the second is reamortization of the loan balance within the remaining term of the loan. The primary inadequacy of both of these options is that if either or even both are applied, the borrower's monthly post-moratorium mortgage payments will still always be greater than the pre-moratorium mortgage payments,[9] creating a payment shock that financially vulnerable borrowers coming off a hardship can ill afford.[10]

To prevent borrowers from failing after a moratorium, RD must stop refusing to allow loan term extensions after a moratorium.[11] Fannie Mae, Freddie Mac, FHA, and even the RD-guaranteed programs use loan term extensions as part of the loan modification process. As a result, the borrower's payment often decreases rather than increases. Because homeowners who have faced a hardship generally continue to experience pronounced decreases in income, extending the loan term so that the homeowner's monthly payment can be reduced after a moratorium improves loan performance and home retention.

RD must adopt a loan term extensions policy for direct loan borrowers. Such a change will help borrowers retain their homes and will improve the financial stability of the RD direct loan program.

3. For its guaranteed loans, RD must finalize the provisions of its August 23, 2018, proposed rule aimed at eliminating unnecessary barriers and improving loss mitigation options.

In August 2010, RD adopted a loan modification program based on the FHA Home Affordable Modification Program (HAMP) that focuses on creating an affordable payment plan for delinquent borrowers based on their income. As with FHA's HAMP program, the RD program allows loan servicers to combine a change in loan terms with a reduction of the amount due, which can include both the principal of the loan and past due charges. Unfortunately, in creating this program, the agency imposed unnecessary barriers to eligibility.

On August 23, 2018, RD proposed regulations that would eliminate some of these barriers. One proposed change would remove limits on Mortgage Recovery Advances, which allow lenders to receive advanced guarantee payments from RD in exchange for deferring past due amounts and, in certain circumstances, a portion of the loan principal in order to bring the loan current with an affordable payment. Borrowers still owe the amount of the advance, but the advanced amounts do not accrue interest and are generally due at the end of the loan or when the home is sold. RD currently limits the amount of a Mortgage Recovery Advance to 12 months of arrears. This rule unnecessarily prevents borrowers who struggle through an often-lengthy evaluation process from receiving Mortgage Recovery Advances. As RD noted in the discussion accompanying the proposed rules, HUD eliminated a similar rule from the FHA loss mitigation process in 2012.[12] RD needs to do the same, adopting its pending proposal.

RD should also implement Mortgage Recovery Advances for borrowers facing temporary hardships who do not need any other changes in their loan terms. With a stand-alone Mortgage Recovery Advance, borrowers would simply receive an advance to bring the loan current. Such advances work very well for homeowners who face only a temporary job loss or wage reduction. In those cases, borrowers simply need an advance to catch up on payments. The FHA loss mitigation process includes a variant of the stand-alone Mortgage Recovery Advance, and it has been successful for borrowers.[13] RD should follow the FHA's model and adopt its proposal for stand-alone Mortgage Recovery Advances.

4. USDA must eliminate other unnecessary barriers to affordable modifications for guaranteed loans and adopt additional beneficial concepts from FHA's waterfall.

RD should further update its guaranteed loan loss mitigation program by eliminating the requirement that the borrower's post-modification "debt to income ratio . . . must not exceed

55 percent."[14] When FHA eliminated the 12-month rule, it also eliminated its 55% back-end debt-to-income ratio (DTI) rule. This back-end rule was unnecessary because HUD, like RD, already applied an affordability analysis as part of the process of setting a target for the borrower's monthly payment. Unlike the target payment, the back-end ratio is challenging to apply with any certainty because expenses are hard to estimate and credit reports frequently include inaccurate or irrelevant information. RD should follow the FHA model and eliminate the 55% debt-to-income ratio requirement.

Lastly, RD should fully adopt the FHA-HAMP's system for determining a borrower's monthly payment, which is referred to as a "waterfall." This approach has proven to be an effective means of creating affordable, income-based loan modifications. The current form of FHA-HAMP[15] is particularly effective because it targets both borrower payment relief and affordability. Rather than simply pinning a modification to 31% of a borrower's income, the FHA-HAMP target payment system insures that payment relief is a factor in the waterfall. The mortgage industry has consistently noted the importance of payment relief in the success of loan modifications. RD should follow the FHA and adopt the waterfall system to help prevent unnecessary foreclosures.

Endnotes

[1] Corianne Payton Scally & David Lipsetz, *New Public Data Available on USDA Rural Housing Service's Single-Family and Multifamily Programs*, Cityscape: A Journal of Policy Development and Research, Vol. 19, No. 1 (2017) at 295, U.S. Department of Housing and Urban Development Office of Policy Development and Research, *available at* https://www.huduser.gov/portal/periodicals/cityscpe/vol19num1/ch17.pdf. Since 1949, when it was initiated, the RD direct loan program has financed over 1 million homes.

[2] 7 C.F.R. § 3550.211(h).

[3] Statement of Gideon Anders, National Housing Law Project, House Financial Services Committee, Subcommittee on Housing, Community Development, and Insurance at 13 (April 2, 2019) ("Anders Testimony"), available at https://financialservices.house.gov/uploadedfiles/hhrg-116-ba04-wstate-andersg-20190402.pdf.

[4] USDA, Loss Mitigation Guide: Single Family Housing Guaranteed Loan Program 4, 10 (July 2018), available at https://www.rd.usda.gov/files/3555-1chapter18.pdf.

[5] 12 C.F.R. § 1024.41.

[6] 12 U.S.C. § 2602(1)(B)(ii).

[7] 42 U.S.C. § 1475.

[8] 733 F. Supp. 776 (D. Vt. 1989).

[9] *See* United States v. Garner, 767 F.2d 104 (5th Cir. 1985).

[10] The forgiveness of interest accrued during a moratorium is also ineffective because borrowers are generally not informed of this option and RD has not made public any standards that it uses in determining eligibility for this forgiveness.

[11] 7 C.F.R. § 3550.208(b); Anders Testimony at 13-14.

[12] HUD, Mortgagee Letter 2012-22 (Nov. 16, 2012)

[13] HUD, Handbook 4000.1, FHA Single Family Housing Policy Handbook 609-611 (Mar. 27, 2019).

[14] 7 C.F.R. § 3555.304 (b)(1).

[15] HUD, Handbook 4000.1, FHA Single Family Housing Policy Handbook 611 (Mar. 27, 2019)..