Rural Lending Program Needs Urgent Reform to Protect Low-Income Homeowners:

USDA's Direct Loan Program must issue new hardship assistance rules and rescind policies that violate federal law

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For decades, the U.S. Department of Agriculture's (USDA) Direct Loan Program has expanded homeownership opportunities for low-income rural borrowers at limited cost to taxpayers. Unfortunately, the program faces significant challenges, leading to avoidable defaults and unnecessary foreclosures. The passage of the 21st Century Road to Housing Act (Road to Housing) offers a unique opportunity to put the Direct Loan program back on track to support housing stability for hundreds of thousands of rural families.

USDA needs to take several immediate steps:

- Update its options for helping borrowers recovering from financial hardship, including the implementation of the loan modification provisions of Road to Housing;
- Eliminate the ban on post-acceleration "special servicing," which violates the Administrative Procedure Act (APA) and hampers cost-saving measures;
- Evaluate the staffing and training of the agency's loan servicing department to ensure that borrowers are able to effectively access account information and address financial hardships.

I. The USDA Direct Loan Program helps low-income rural borrowers access homeownership.

The USDA Direct Loan program provides low-cost mortgages to low-income borrowers in rural areas. Unlike government-backed loan programs that rely on private lenders, such as the Federal Housing Administration (FHA) insured mortgage program and U.S. Department of Veterans Affairs (VA) guaranteed program, USDA makes Direct Loans itself and then services them. Since the Direct Loan program's creation in 1949, it has supported stable housing for millions of rural families.

The Direct Loan program does not compete with the private loan programs, but instead expands affordable housing for rural families. The program was "not intended to supplant or compete with private credit sources."[1] To be eligible for a Direct Loan, the applicant "must be unable to obtain credit from other sources on terms and conditions they can reasonably be expected to fulfill."[2] The USDA must also review existing borrowers on a regular basis to determine whether they can refinance to an affordable private credit alternative.[3]

Over its history, the Direct Loan program has proven to be one of the most cost-effective forms of housing support offered by the federal government. Between FY 2021-2025, for example, the all-in net cost to the government of extending a 33-year loan to a rural household averaged just under $12,600.[4]

II. Despite its important role in expanding affordable housing opportunities for rural families, the USDA Direct Loan mortgage program is facing major challenges.

Understaffing causing program breakdown. Advocates from across the country report barriers to communicating with USDA Direct Loan mortgage servicing representatives. They describe extremely long wait times on the phone, significant delays in the USDA processing requests, and a lack of access to basic information about their clients' accounts. Advocates have also reported that the agency's use of outside contractors significantly increases fees and costs to their clients. The National Consumer Law Center (NCLC) and the National Housing Law Project (NHLP) have heard these stories from advocates in California, Colorado, Illinois, Indiana, Kentucky, Maine, Michigan, Mississippi, New York, North Carolina, Ohio, Puerto Rico, Texas, Vermont, and West Virginia. When combined with the lack of options to resolve financial hardships, borrowers are often stuck with growing defaults and no way to resolve the problems. In Maine, the agency's failure to address a buildup of unresolved cases over years resulted in a deluge of USDA foreclosure cases.

High delinquency rates. Given these significant servicing issues, it is unsurprising that the number of borrowers experiencing payment challenges has been high. Office of Management and Budget (OMB) reports have stated and journalists have reported that the delinquency rate for USDA Direct loans is around 20%. This rate is significantly higher than delinquency rates on mortgages during the 2008 Financial Crisis and also double the rate that the U.S. Government Accountability Office (GAO) determined was acceptable for the program.

The USDA's high delinquency rates for the Direct Loan program are avoidable and unnecessary. With appropriate staffing and adoption of the flexible approaches to avoiding foreclosure (called "loss mitigation") implemented by the rest of the mortgage servicing industry, the USDA can reduce these rates substantially. The agency's failure to modernize its servicing approach led to needless delinquencies over the past decade.

Outdated foreclosure relief policies. The agency has not developed effective loss mitigation tools similar to those available to other homeowners with government-backed mortgages. The loss mitigation programs for other government-backed mortgages include a "loan modification" option that permanently adjusts the terms of the mortgage with the goal of lowering the monthly payment and an option that maintains the pre-hardship loan payment through the deferral of past due amounts until the end of the loan term ("deferrals" or "partial claims"). These options bring the loan current and allow the borrower to resume payments and avoid foreclosure, saving government-related programs from billions of dollars in losses. USDA has not adopted either of these loss mitigation strategies in the Direct Loan program.

The USDA's Direct Loan loss mitigation policies, which it calls "special servicing," do not utilize similar tools. The agency does allow for pauses on the borrower's payment obligation, called the "moratorium," but the moratorium option does not include a viable way to bring the loan current. Instead, at the end of the moratorium, USDA reamortizes the loan. Reamortization adds past-due amounts to the loan balance and then adjusts the monthly payment over the remaining term, which generally increases the borrower's payment.[5] Studies of loss mitigation programs show that loss mitigation options that increase payments fail at much higher rates than loss mitigation options that decrease payments, with the foreseeable result that they are ultimately more costly for both homeowners and, in this case, the U.S. government.[6]

Self-defeating and illegal cut-off of loss mitigation reviews. USDA cuts off its special servicing options once the agency accelerates a loan, which is one of the first steps in the foreclosure process, further hampering the effectiveness of its loss mitigation program.[7] This rule is contrary to the practice in the rest of the mortgage market. The other federal investors allow borrowers to access loss mitigation options well after acceleration. In fact, many borrowers only seek help once the loan is at this stage. This standard industry practice is reflected in the regulations under the Real Estate Settlement Procedures Act, Regulation X, the federal rules that govern the servicing of mortgage loans in default.[8] Regulation X protects borrower access to loss mitigation options up to 37 days before a scheduled foreclosure sale and does not prevent servicers from offering options even closer to the sale date.

USDA's policy of cutting off all special servicing options after acceleration is not only bad business, but it also violates federal law. The statute authorizing moratorium relief, 42 U.S.C. § 1475(a), specifically states that the option is available "during any time that any such loan is outstanding" and not just prior to acceleration. In *United States v. Shields*,[9] the U.S. District Court for the District of Vermont stated that "the regulation barring post-acceleration moratorium relief is invalid" under the Administrative Procedure Act. The U.S. District Court for the Southern District of West Virginia in *Wood v. USDA*[10] agreed that the rule "is plainly inconsistent" with the statute. Despite these decisions, the USDA has continued its costly practice of barring post-acceleration special servicing.

The combined effect of no loan modifications, severely limited servicing personnel, and a bar on post-acceleration special servicing has led to a tremendous backlog of delinquent borrowers. This increases costs to the agency and has left borrowers in limbo for years.

III. The Road to Housing legislation offers an important opportunity for the agency to address its servicing deficiencies.

The passage of the bipartisan 21st Century Road to Housing Act offers a unique opportunity to correct and update the agency's policies and practices and to put the Direct Loan program on track to support housing stability for hundreds of thousands of rural families. We urge USDA to take the following steps:

Make term extensions available. In Section 502 of Road to Housing, Congress provided the USDA with authority to modify the repayment term of its direct loans after they are made.[11]

Term extensions are the most common step that investors employ to adjust a borrower's monthly payment in connection with bringing the loan current, and the lack of a term extension hampers USDA's Direct Loan mortgage performance and default outcomes.

Given the significant number of delinquent loans, USDA should immediately implement the Road to Housing provision and develop a loan modification option to supplement its existing loss mitigation options. USDA has several models to consider when developing its program, including its own guaranteed-loan program, which includes loan modifications with term extensions as part of the menu of options to help borrowers avoid unnecessary foreclosures.

Remove the bar on post-acceleration loss mitigation. To maximize the effectiveness of the loan modification program and to comply with the APA, USDA should eliminate the bars on post-acceleration special servicing in 7 C.F.R. §§ 3550.207(a) & 211(h). Removing the bars would not require the agency to modify every delinquent loan, but it would lift an arbitrary barrier to cost-saving workouts that is inconsistent with the rest of the federally backed mortgage market.

Correct the harmful inadequacies in customer service and program implementation. The agency should also investigate and address the significant servicing problems that borrowers experience every day. Long wait times and delays harm borrowers and cost the USDA through increased, unaddressed defaults. The 20% figure for delinquent loans represents a significant risk to the agency, and the agency can and must take steps to reduce that rate.

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Endnotes

1. 7 C.F.R. § 3550.160(a).
2. Handbook HB-1-3550 § 4.10.
3. 7 C.F.R. § 3550.160(b).
4. The Sec. 502 subsidy appropriation total comes from the enacted FY 21-25 Agriculture Appropriations legislation. The 5-year loan total is found here.
5. It's worth noting that the agency does have the authority to waive interest in connection with a reamortization after moratorium, which would improve the payment. 7 C.F.R. § 3550.207(c). However, we have not heard reports of the agency frequently using interest forgiveness and the Handbook does not provide details about when to forgive interest other than restating the authority provided in the regulation. Handbook, HB-2-3550, at 5-15. In fact, advocates report that the agency frequently requests a significant downpayment in connection with a reamortization instead of reducing the amount owed.
6. In addition to the USDA direct loan program, the subject of this issue brief, USDA also administers a guaranteed loan program that operates in a similar manner to the FHA-insured

mortgage program. The USDA-guaranteed loan program includes a loan modification program to provide payment relief and a Mortgage Recovery Advance that allows borrowers to bring the loan current through a 0% loan from the agency.

7. Under 7 C.F.R. § 3550.211(h), “A borrower is not eligible for special servicing actions once the account has been accelerated.” And under 7 C.F.R. § 3550.207(a), a loan is not eligible for a moratorium if it is currently accelerated.
8. 12 C.F.R. § 1024.41.
9. 733 F.Supp. 776, 785 (D. Vt. 1989).
10. 2020 WL 1521801 at *7 (S.D. W.V. 2020).
11. The revised statute is found at 42 U.S.C. § 1472(a)(2).